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SEC OFFICIAL'S SPEECH REGARDING INVESTMENT ADVISER EXAMINATIONS

July 22, 1996 TO: COMPLIANCE COMMITTEE No. 19-96 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 23-96 INVESTMENT ADVISER MEMBERS No. 25-96 RE: SEC OFFICIAL’S SPEECH REGARDING INVESTMENT ADVISER EXAMINATIONS
____ Lori Richards, Director of the SECs Office of Compliance Inspections and Examinations (OCIE), recently delivered a speech regarding investment adviser examinations, focusing on the changes that have been made to OCIEs examination program over the past year. Significant aspects of her speech are summarized below and a copy is attached. Scope of Exams In an effort to maximize its resources, the OCIE has shifted away from conducting cyclical, comprehensive exams of every part of an advisers operations towards a more focused review of "critical" issues. What are deemed to be the critical issues will vary, depending on the type of adviser being examined. Richards stated that generally examiners will spend more time on the areas of the advisers operations where deficiencies or violations have been noted in the past, areas of importance to the adviser, areas where internal controls appear to be weak and areas where clients appear to be most exposed to potential conflicts of interest. Richards explained that the shift from a one-size-fits-all approach to a variable scope approach is part of the shift towards what she called "smart exams." These exams are intended to work as follows: once an adviser is selected for examination, the examiner will begin preparing for the exam by reviewing the advisers filings with the Commission, past inspection history, customer complaints received by the Commission and other relevant materials; the scope of the examination is then determined by two variables -- what the staff knows about an entity before they begin and what they learn while the exam is in progress -- and largely depends on the examiners professional judgment of an advisers own internal controls. The more confidence examiners have in an advisers own compliance and internal control systems, the more they will waive routine examination procedures. The customized or "smart exam" approach is intended to be fully implemented within the coming year. Selection of Advisers To Be Examined Richards reported that rather than continuing to use a purely cyclical approach, the OCIE has overlaid other considerations into its cycle to focus on those firms that present the most risk to investors. She stated that, "The single most important criteria in determining risk and therefore priority of examination for advisers is access to client money." In this regard, she stated that advisers with discretionary authority over investments, custody of assets or large amounts of money under management (e.g., non-discretionary management of $100 million or more), pose the greatest risk. To better ensure examination of these advisers, they are now the responsibility of the regional offices. Dividing the inspection program in this manner should reduce the inspection cycle for these advisers from twenty years to eight to ten years. She hopes to reduce the cycle even further to once every five years after the new staff that the

OCIE was recently allocated becomes available. Advisers not in the higher risk category are now being inspected in joint sweep examinations conducted with state securities regulators. Factors Triggering More Frequent Exams Richards stressed that the risk-based selection will not replace cyclical exams; rather, application of certain risk factors will assist examiners in determining whether an adviser should be examined more frequently than allowed by the cycle. These risk factors include: the size of the adviser; the number of clients; the advisers business; the length of time the adviser has been registered; the advisers prior exam history and results; its disciplinary history; its customer complaints; its affiliated persons; its advertising and performance claims; and information obtained from other regulators, including, among others, self-regulatory organizations and state securities regulators. With respect to advertising and performance claims, Richards stated that this summer the OCIE will be targeting for examination the "more successful money managers" and, as part of these exams, will pay particular attention to their performance claims. In this regard, it appears that the OCIE will focus on those advisers who "claim to have generated large short- term profits for clients that are substantially in excess of their peer group" and, consequently, "are the advisers that are winning frequently in selection contests, and are rapidly growing their money under management." Examination of "Trading Practices" Richards identified several items that fall under the broad topic "trading practices" that the staff is paying particular attention to this year. These practices include: allocation of trades, including allocation of bunched orders; the level of individualized treatment being provided to clients, to evaluate whether accounts are being managed like an investment company; soft- dollar arrangements; principal transactions, to ensure that the adviser is obtaining client consent before completing the transaction; and, personal trading conflicts. Amy B.R. Lancellotta Associate Counsel Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute’s Information Resource Center at (202)326-8304, and ask for this memo’s attachment number: 8078.