

Investment Management E-news

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SEC Announces Common Deficiencies Found in Compliance Reviews

The staff ("Staff") of the Office of Compliance, Inspection and Examinations of the Securities and Exchange Commission ("SEC") on July 22, 2008 released a *ComplianceAlert* letter identifying common deficiencies it found in compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers, transfer agents and other types of registered firms. The letter is available at <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.

Personal Trading

The following deficiencies were frequently identified in the review of personal trading by access persons:

- Adviser's code of ethics was incomplete.
- Adviser's code of ethics was not followed.
- Reporting requirements were not followed and/or monitoring was not performed.
- Disclosure was inaccurate. The adviser's brochure appeared to contain inaccuracies with respect to its controls over personal trading.

By contrast, the Staff noted a number of specific internal compliance controls and compliance review and reporting practices that are effective means of preventing violations of the Investment Advisers Act of 1940, as amended. Many of the advisory firms that appeared to have effective compliance programs in this area have compliance personnel who are actively involved in executing those programs, such as implementing policies and procedures for personal securities transactions and trading in proprietary accounts and ensuring that all employees are aware of the adviser's policies and procedures.

Proxy Voting Oversight and Operations

Although most advisory firms examined were found to have adopted policies and procedures with respect to proxy voting as required under the proxy voting rule, examiners discovered in some instances that the proxy voting policies and procedures seemed to contain inaccurate information or were not followed. Deficiencies noted were:

- Board oversight of use of proxy service provider was weak.
- Assessment of proxy service providers was not documented.

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- Funds voted inconsistently with their proxy voting policies.
- Funds did not file Form N-PX containing the funds' proxy voting record as required.
- Fund disclosures regarding the availability of the proxy voting services and procedures in the Statements of Additional Information appeared deficient.
- Improper fees were charged; e.g., proxy service fees were allocated to funds, purportedly for services rendered, when the funds did not hold voting securities that would require such services and soft dollars were used to pay for proxy voting services unrelated to issuer research without adequately disclosing this practice.

Valuation and Liquidity Issues in High Yield Municipal Bond Funds

The Staff reviewed high yield municipal bond funds' practices for determining the fair value of their portfolio securities for net asset value purposes. Observed problems included the following:

- High yield funds often did not disclose their increased liquidity and valuation risks, as required.
- Pricing services relied on fund management to provide information at times, which may have resulted in stale review periods and valuations.
- There was no documentation supporting the determination that prices provided by pricing services and used in client trades sufficiently represented market values.
- Board oversight in assessing the accuracy of prices provided by pricing services was ineffective.
- Record retention for pricing histories of portfolio securities was inadequate.

Soft Dollar Practices

The Staff examined advisers' soft-dollar policies to better understand the extent to which advisers to institutional clients, including hedge funds, use soft dollar arrangements to obtain third-party and/or proprietary services or products; the disclosures advisers provide to their clients regarding soft dollar practices; and the policies and procedures that advisers who receive soft dollar benefits use to meet their fiduciary duty to seek best execution. The Staff found that most advisers disclosed the types of products, research and services received in exchange for soft dollars, as required. Advisers also generally complied with regulatory guidance regarding required soft-dollar disclosures. However, the Staff noted that several advisers failed to disclose the receipt of products and services outside the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, as amended, such as internet domain fees, wireless services for a Blackberry, and telecommunications and computer equipment.

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Use of Solicitors

Many broker-dealer firms designate their registered representatives as “solicitors” for an investment adviser. Examinations revealed that some solicitors/registered representatives were providing investment advice to customers by guiding the client’s selection of an investment program and the underlying products in the program. Other deficiencies noted were:

- Lack of supervisory controls where neither the broker-dealer nor the investment adviser had assumed responsibility for monitoring the suitability of the advisory services and the suitability of recommendations of the underlying investments;
- Inadequate written procedures to supervise solicitor activity by registered representatives; and
- Use of apparently false and/or misleading advertising and sales literature, failure to file sales material with the NASD (now FINRA), and/or failure to have a principal of the firm indicate evidence of review and approval of materials.

For more information about the *ComplianceAlert*, please feel free to contact your Butzel attorney, the authors listed below or other attorneys of the Investment Management Practice Group.

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