

SECURITIES INDUSTRY
PRACTICE GROUP

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SEC FIELD EXAMINATION ALERT

In an effort to provide additional guidance on compliance issues identified in recent field examinations, the SEC's Office of Compliance Inspections and Examinations (OCIE) has issued a *Compliance Alert* directed at broker-dealers and investment advisers. You may view the *Alert* in its entirety at www.sec.gov/about/offices/ocie/complialert.htm. Below we highlight selected areas which may be of interest to you in preparing for future SEC and SRO reviews of operations and records.

Registered Investment Advisers (RIAs)

Personal Trading by RIA Staff. The OCIE found numerous instances of improper personal securities trading by, and inadequate supervision of, advisory staff personnel. In addition to noting insufficient safeguards incorporated in the written codes of ethics required for RIAs, the OCIE report identified frequent cases where personal trading records, such as duplicate confirmations, were not required and maintained for advisory personnel and/or were not reviewed by supervisors. The *Alert* includes a suggested list of practices for preventing violations of the Advisers Act such as conflict of interest procedures, restricted security and watch lists, strict enforcement of "black-out" periods, limitations on short-term trading, pre-approvals, and price-allocation requirements when advisory staff are trading in personal accounts at about the same time as customer transactions are occurring in similar securities. While these requirements have been standard for broker-dealers, the SEC appears to be concerned that many RIAs such as smaller asset management firms are not aware of or are ignoring them.

Valuation Issues. OCIE staff analyzed numerous deficiencies in the valuation practices of RIAs with respect to high yield municipal bond funds whose securities were included in money management portfolios. Among the questionable practices cited were inadequate disclosure of illiquid markets, use of poorly defined and unsupervised third-party pricing practices, use of customer cross-trades to establish pricing, and the absence of detailed internal procedures for establishing valuation.

Soft Dollar Practices. In reviewing the soft dollar arrangements used by a number of advisers to hedge funds and other institutional clients, the OCIE staff focused on the extent of such use, the adequacy of disclosure to advisory clients, the adequacy of written soft dollar procedures and their relationship to best execution practices. While the *Alert* suggests a degree of satisfaction with the soft dollar practices reviewed by OCIE, the staff commented on the need to disclose use of soft dollars to purchase products outside of the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, the purchase of "mixed use" products and services, and the need to continually update written procedures to ensure that soft dollar transactions are being appropriately managed, reviewed, and approved by responsible supervisors.¹

Broker-Dealers

Offices of Supervisory Jurisdiction (OSJs). Broker-Dealer OSJ structures used in lieu of traditional branch offices elicited some significant criticism by OCIE examiners. Among the major gaps noted were: (i) inadequate written supervisory procedures relating to review of customer accounts, handling and reporting of customer complaints, OSJ inspections and the documenting of supervisory responsibilities; and (ii) serious deficiencies in recordkeeping relating to trade blotters, employee outside accounts, new customer accounts and the like.

Hybrid Functions of Registered Representatives. In reviewing broker-dealer firms whose registered representatives were engaged as compensated “solicitors” for investment advisers, the OCIE observed a lack of controls for monitoring the suitability of the investment advisory services recommended to the broker-dealer customers, a gap in responsibility for client account supervision between the broker-dealer and the investment adviser, a need for more specific written supervisory procedures, and a lack of oversight in the distribution of misleading advisory service sales materials.

Insurance Company Broker-Dealers. In examining broker-dealer subsidiaries of insurance companies, the OCIE staff found numerous deficiencies in supervisory procedures, customer suitability and in net capital, noting that many managers of these firms had their primary experience in the insurance industry and lacked “comprehensive knowledge” of securities industry rules.

Subprime Valuation Issues. From its examination of a number of larger broker-dealers handling subprime mortgage-related products, the OCIE noted substantially increased difficulty on the part of such firms in independently verifying the valuation of subprime collateral (known as “product control”) because of the substantial decrease in market liquidity. Among criticisms voiced were questionable price verification practices, insufficient staffing for product control functions, inadequate documentation and retention of underlying justification for pricing, and inconsistency in pricing practices for the same or similar securities. The staff urged the use of “strong control practices” and listed six specific areas in which firms were expected to improve their product control group functions.²

Conclusion

Unlike the issuance of a release by the full Commission, the *Alert* does not impose specific requirements on securities industry firms, but is only suggestive of remedial measures which firms should consider. In our view, however, today’s regulatory “suggestion” can sometimes become the basis for tomorrow’s regulatory deficiency.

¹ We note that the OCIE survey comes less than 18 months after the effectiveness of the SEC’s revised guidelines for the use of the soft dollar safe harbor. We reviewed and explained these guidelines in our prior report to clients entitled “Soft Dollar Practices in 2007,” available at www.gsblaw.com/pdfs/GSB_Soft_Dollar.pdf, by email or by fax upon request.

² We recently conducted a symposium, in conjunction with the Association of Corporate Counsel, on preparing for potential litigation and regulatory inquiries resulting from the subprime credit crisis. A transcript of the symposium is available upon request.