INVESTMENT ADVISER ASSOCIATION

April 1, 2009

Issue Number 196

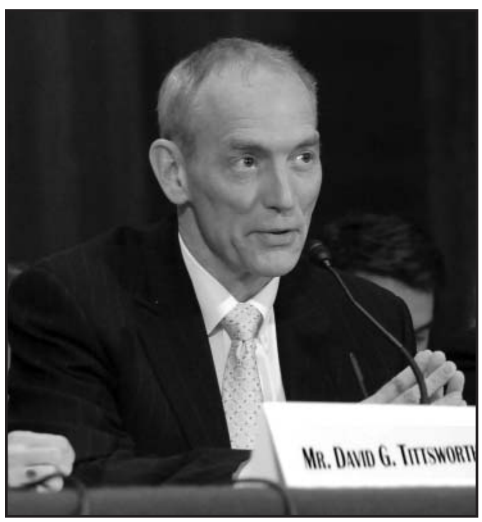
NEWSLETTER

IAA Testifies Before Senate Banking Committee

IAA Executive Director David Tittsworth testified before the Senate Banking Committee on March 26 at a hearing entitled "Enhancing Investor Protection and the Regulation of Securities Markets."

Other witnesses at the hearing included SEC Chairman Mary Schapiro, former SEC chairmen Arthur Levitt and Richard Breeden, former SEC commissioner Paul S. Atkins, FINRA CEO Richard Ketchum, Consumer Federation of America (CFA) Director of Investor Protection Barb Roper, and North American Securities Administrators Association (NASAA) President Fred Joseph.

Tittsworth presented IAA's views on regulatory reform and emphasized the need for Congress to focus on the root causes of the economic crisis: subprime mortgages, securitization of mortgage-related instruments, and the degree to which leverage contributed to the crisis. He testified that the IAA supports centralized registration and regulation of hedge fund managers by the SEC. "Investors and markets will



IAA Executive Director David Tittsworth testifying before the Senate Banking Committee

benefit from disclosure, compliance protocols, recordkeeping, exams, and other requirements that accompany SEC registration of hedge funds," Tittsworth stated. He also expressed IAA support for regulating of credit default swaps and other derivatives, asserting that "action must be taken to ensure that they can no longer exist outside of our regulatory system."

The IAA testimony discussed in greater detail Investment Advisers Act issues, including the idea of "harmonizing" broker and adviser regulation. Tittsworth noted in his opening statement that this idea "seems to be predicated on the notion that brokers and advisers do the same thing and that one set of laws and regulations should apply to both. We respectfully disagree."

"Fiduciary standards should apply to anyone who offers investment advice."

— IAA Executive Director David Tittsworth

He stressed that brokers typically execute securities transactions and

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ABOUT THE IAA

The Investment Adviser Association is a not-for-profit organization that exclusively represents the interests of SEC-registered investment adviser firms. The Association was founded in 1937 as the Investment Counsel Association of America. Its name was changed to the Investment Adviser Association in 2005.

The IAA played a major role in the enactment of the Investment Advisers Act of 1940, the federal law regulating the investment adviser industry. Today, the IAA consists investment adviser firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations.

SEC, FINRA, and State Regulators Testify Before Senate Banking Committee

On March 26, SEC Chairman Mary Shapiro testified on a panel at the Senate Banking Committee hearing entitled "Enhancing Investor Protection and the Regulation of Securities Markets." Of particular concern to investment advisers, she stated that the SEC is "studying whether to recommend legislation to break down the statutory barriers that require a different regulatory regime for investment advisers and broker-dealers, even thought the services they provide often are virtually identical from the investor's perspective."

The SEC Chairman's testimony also outlined other significant items relating to SEC-registered investment advisers including (1) possible annual third-party surprise audits for investment advisers that have custody of client assets, (2) third-party compliance reviews, and (3) attestation from senior officers of sufficient controls to protect client assets.

Shapiro said she has asked SEC staff to develop a series of reforms to better protect investors placing money with a broker-dealer or an investment adviser. Investment advisers with custody of client assets would need to undergo an annual third-party audit on an unannounced basis to confirm the safekeeping of those assets. Schapiro also indicated that she expects any proposed rule to also require "certain advisers" to have third-party compliance audits to review the firm's compliance requirements. She did not indicate what criteria would trigger that requirement and which advisers it would cover.

To help ensure that all broker-dealers and investment advisers with custody of investor funds carefully review controls for the safekeeping of those assets, she said she expects the Commission to consider a requirement that a senior officer from each such firm would be required to attest to the sufficiency of the firm's controls to protect client assets. The SEC would also expect to list publically those certifying firms on the SEC's web site thus permitting investors to check their own financial intermediary including the name of the audit firm and any individual firm auditor. Investors and regulators could then better evaluate the firm's auditors. The full test of Chairman Shapiro's testimony is available at http://www.sec.gov/news/testimony/2009/ts032609mls.htm.

> *"The SEC is 'studying whether to recommend legislation to break down the statutory barriers that require a different regulatory regime for investment advisers and broker-dealers"*
>
> *— SEC Chairman Shapiro.*

At the same hearing and on the same panel with IAA Executive Director David Tittsworth, Richard Ketchum, the new Chairman and CEO of the Financial Industry Regulatory Authority (FINRA) focused on the need to establish a self-regulatory organization (SRO) for SEC-registered investment advisers. His testimony echoes a speech he made earlier in the week (see "Inside the Beltway" column). Ketchum said FINRA is "uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently." The full test of Ketchum's statement is available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=854675e9-73fc-49499f69e7fb548d3373.

Fred Joseph, Colorado Securities Commissioner and President of the North American Securities Administrators Association (NASAA) proposed two items that would affect directly certain SEC-registered investment advisers. First, NASAA recommended that Congress increase the $25 million AUM test for SEC investment adviser registration – potentially to $100 million – thereby reducing the number of SEC-registered investment advisers the SEC would need to examine and permitting the SEC to focus its examination and enforcement resources on the largest advisers. Secondly, NASAA recommended that rather than permitting states to only take enforcement action against SEC-registered investment advisers if the state finds evidence of fraud, state securities administrators should have the authority to address any violation under state law, including, dishonest and unethical practices. The full text of Joseph's testimony is available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a312765f-986e-4a4b-ba19-02a0b45bcc40. ■

SEC Contacting Adviser Clients to Confirm Account Balances

On March 10, Gene Gohlke, Associate Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), sent a letter to the Investment Adviser Association to inform investment advisers of a new examination practice in which the SEC has been verifying the existence of client assets managed by the adviser it is examining. The SEC asked the IAA to inform its members of this examination practice.

OCIE's letter states that, "in order to perform a valid verification of assets, the staff must request independent confirmation of investor assets from various third-parties," including clients, derivative counterparties, hedge fund investors, custodians, DTCC, and auditors. In these requests, exam staff will seek confirmation of cash and securities held by a sample of advisory clients as of a specific date and confirmation of transactions in such accounts over a period of time. As part of its regular examination practice, the SEC's examination staff plans to begin asking a sample of advisory clients to confirm that their account balances as of a specific date were consistent with their own records and that the contributions and withdrawals from their account were authorized.

> *"As part of its regular examination practice, the SEC's examination staff plans to begin asking a sample of advisory clients to confirm that their account balances as of a specific date were consistent with their own records and that the contributions and withdrawals from their account were authorized."*

Importantly, OCIE's letter to IAA states that these requests should not be considered as an indication by the SEC that any violations have occurred and should not reflect adversely on the adviser. Exam staff's letter to clients seeking account confirmation will also "make clear that the request should not be construed as a reflection on the adviser or that any violation of the law has occurred." OCIE also re-affirms that both its examinations and its communications with clients and other third parties during exams are non-public.

Although not mentioned in the letter, the new practice is clearly intended to address issues raised in connection with the Madoff fraud. In response to the SEC's announcement, some advisers are considering whether to take any preemptive action in notifying their clients that the SEC could make such requests, wait until presented with the issue when examined, or refer clients to any future announcements or statements the SEC might post on its website about these anticipated requests.

Please contact a member of the IAA legal staff at (202) 293-4222 if you have questions or need additional information regarding these issues.

IAA Submits Suggestions to SEC Addressing Self-Custody Issues

On March 6, the IAA submitted a letter to SEC Chairman Mary Schapiro discussing recommendations relating to self-custody of client assets in light of the Madoff fraud. The IAA letter responds to recent testimony by SEC staff indicating that the SEC intends to issue a rulemaking "to strengthen the custody and audit requirements for regulated firms."

The IAA letter focuses on dual registrants in self-custody situations – that is, where a firm in its role as investment adviser provides investment advice with respect to client assets and the same firm in its role as broker-dealer or bank actually holds the client assets. The letter discusses measures the SEC could consider to assist in preventing or detecting fraud in these situations. For example, the SEC could consider permitting self-custody only where firms segregate custodial duties from advisory functions and/or implement additional internal controls to protect clients. The SEC could also consider permitting self-custody only where there is some independent third-party involvement, such as a surprise audit, an internal/operational control audit, or a compliance control audit. The letter recommends flexibility in permitting advisers to select any one of these approaches so that the firm can leverage any existing reviews and tailor the approach to their business.

The IAA letter also recommends enhanced disclosure of self-custody situations in Form ADV. Currently, Form ADV is worded broadly to capture information about any firms deemed to have "custody," even though an independent custodian (bank or broker) actually holds the client assets. For example, Form ADV requires firms to state they have custody where an employee serves as a trustee to a client trust even though the assets are held at a bank. The IAA letter suggests that the SEC amend Form ADV to ask more specific questions designed to identify firms where an independent custodian does not hold client assets.

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IAA Submits Suggestions to SEC Addressing Self-Custody Issues — Continued from page 4

The IAA letter suggests that the SEC's inspection staff conduct combined examinations of dual registrants, employing both broker-dealer and investment adviser examination staff in a coordinated fashion. It also recommends that the SEC evaluate whether the changes to the broker-dealer custody rules could address the potential for fraud in self-custody situations. Finally, the letter reiterates the IAA's support for registration of hedge fund advisers, which would bring such advisers within the ambit of the custody rule.

Chairman Schapiro subsequently stated in congressional testimony that she has asked the staff to "prepare a proposal for Commission consideration that would require investment advisers with custody of client assets to undergo an annual third-party audit, on an unannounced basis, to confirm the safekeeping of those assets." She also anticipates that the staff will recommend requiring a senior officer from each firm to attest to the sufficiency of the controls they have in place to protect client assets. The IAA will keep members apprised of and submit comments on any such proposals.

The letter is available in the Comments and Statements section of the IAA web site. ■

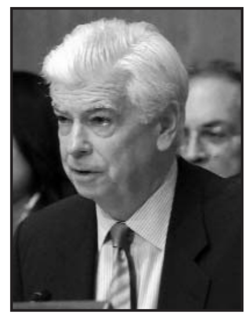
IAA Testifies Before Senate Banking Committee — Continued from front cover

sell financial products, whereas investment advisers provide advisory services, including managing client portfolios. Further, he pointed out that brokers often are compensated by commissions from selling products or executing trades and any related financial advice is non-discretionary and that, in contrast, advisers generally are compensated by fees and provide discretionary advice to clients. Finally, he made clear that brokers generally have custody of customer assets, whereas most investment advisers use the services of independent third-party custodians.

Senator Daniel Akaka (D-HI) greets IAA's David Tittsworth at Senate hearing

According to Tittsworth, "because of these and other differences, it doesn't make sense to impose rules on investment advisers that are tailored to product sales." Instead, he testified that "fiduciary standards should apply to anyone who offers investment advice," referring to a joint letter on this point that IAA, the North American Securities Administrators Association (the group representing state securities regulators) and the Consumer Federation of America (CFA) sent to the Banking Committee earlier in the week.

Tittsworth also testified regarding the possible creation – opposed by the IAA – of an SRO for investment advisers. He outlined the drawbacks to an SRO, including inherent conflicts of interest, questions about transparency, accountability, and oversight, and added costs and bureaucracy. Tittsworth stressed that the IAA particularly opposes the idea of FINRA as the SRO for investment advisers, given its governance structure, costs, track record, experience, and promotion of the broker-dealer regulatory model.



Senate Banking Committee Chairman Christopher Dodd (D-CT) questions witness

The IAA emphasized that the SEC has the expertise and experience to regulate the investment advisory profession. "Instead of creating an SRO for investment advisers, the following alternatives should be pursued: First, we support full funding for the SEC and believe Congress should examine alternatives to allow it to achieve long-term and more stable funding, including self-funding mechanisms. Second, as NASAA testified, the SEC should increase the $25 million threshold that separates SEC- and state-registered advisers. Third, the SEC should make improvements in its inspection program to better leverage and focus its resources."

IAA's written testimony is available in the Comments and Statements section of its web site: www.investmentadviser.org. ■

Compliance Summit Focuses on Best

This year's IA Compliance Best Practices Summit, cosponsored by the IAA and *IA Week*, featured SEC officials, members of the investment management industry, and lawyers in investment management providing their views of recent developments, a look at what's to come, and lessons from the past year. The two-day compliance conference met in Washington DC at the Omni Shoreham Hotel March 12 and 13, some highlights of which are outlined below.

Keynote Speakers

Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), set the stage at the start of the Summit discussing the "historic, but not insurmountable" challenges facing the global economy and our industry. She stated that the SEC expects firms to have fully operational compliance programs and that the recent market turmoil will not provide an adequate excuse for failing to do so. Richards also highlighted four compliance risks for advisory firms to address in the light of possible business changes: (1) scrupulous and meaningful disclosure – inadequate disclosure remains one of the most frequent examination deficiencies; (2) custody of client assets – including a letter from the SEC stating it would begin confirming client holdings directly with advisory clients; (3) performance claims – including inappropriately excluding or including material data; and (4) lack of sufficient resources supporting compliance programs. *See Compliance in Today's Environment: Step Up to the Challenge*, speech by Lori A. Richards (Mar. 12, 2008), available at http://www.sec.gov/news/speech/2009/spch031209lar.htm.

Buddy Donohue, Director of the SEC's Division of Investment Management, and **Erik Sirri**, Director of the SEC's Division of Trading and Markets fielded questions from IAA Executive Director **David Tittsworth** during a luncheon address. Both directors responded to the prospect of a self-regulatory organization for investment advisers by declaring that nothing has been decided yet and stressing the fact that the new Chairman, Mary Schapiro, has only been at the helm of the SEC for six weeks. On the topics of registration of advisers to hedge funds and the potential merger of the SEC and the Commodity Futures Trading Commission, Sirri said that Congress will ultimately decide each issue. Donohue said two of his top priorities were Form ADV Part 2 and revisions to adviser books and records requirements. Finally, Sirri said that his division will look closely at Congressman Barney Frank's urging to reinstate the SEC's so-called uptick rule as well as potential alternatives. A Senate bill introduced March 16 would require the SEC to reinstate the uptick rule.

John Bogle, founder and retired CEO of The Vanguard Group, gave a luncheon address entitled "*Building a Fiduciary Society*." Mr. Bogle discussed applying the fiduciary duty to anyone giving financial advice, not watering down the standard in the name of harmonization: "But the fiduciary industry standard must be extended to other financial advisors, *including* broker-dealers who elect to act as advisors." Further, Mr. Bogle "totally support[ed]" extending the standards of fiduciary duty that now apply to investment advisers to all financial advisers, a "standard now advocated by … the Investment Adviser Association." *See Building a Fiduciary Society,* speech by John C. Bogle (Mar. 13, 2008), available at http://johncbogle.com/wordpress/wp-content/uploads/2009/03/iacompliance1.pdf.

> ***"This year's IA Compliance Best Practices Summit, featured SEC officials, members of the investment management industry, and lawyers in investment management providing their views of recent developments, a look at what's to come, and lessons from the past year."***

Hot Topics. **Tittsworth, Neil Simon**, IAA Vice President for Government Relations, and **Stephanie Monaco**, a partner with Mayer Brown, provided the Summit with details about possible legislative developments in Congress to "harmonize" the regulation of investment advisers and broker-dealers. Tittsworth issued a "Call to Arms" encouraging all investment advisers to join the cause and make their voices heard to advance the interests of investment advisers and persuade Congress to maintain appropriate regulations.

Custody. One of the hottest topics raised at the Summit was custody. **John Walsh**, OCIE Chief Counsel, said that OCIE is "very focused on custody and confirming assets." **Dan Kahl**, a Branch Chief in the Division of Investment Management, listed the custody rule first amongst the agency's top examination priorities. Of particular interest was the SEC's recent announcement that OCIE examiners will be contacting clients of adviser firms being examined "in order to perform a valid verification of assets." A direct response to issues raised by the Bernard Madoff fraud, the measure prompted a strong reaction from the panelists and audience alike. **Monaco** said she was shocked that the SEC will call clients and expect them not to worry. A copy of an SEC letter sent to the IAA about the process is available on the IAA web site.

Practices and the Fiduciary Standard

Best Execution. **Richard Marshall**, a partner with Ropes & Gray, noted that best execution implicated two duties: care and loyalty. The duty of care consists of three components: (1) best price; (2) fair commissions; and (3) good service. Marshall stressed that ensuring good service includes looking at your broker's solvency. The most obvious issue regarding the duty of loyalty is conflicts of interest, most commonly affiliated broker-dealers. Marshall said the best way to ensure compliance was to identify the conflicts, mitigate them to the extent possible, and disclose them to clients. **Christopher Jackson**, Director and Head of U.S. Retail Legal at Deutsche Asset Management, recommended having best execution committees reviewing these important areas: (1) broker selection, especially venue; (2) commissions; (3) trade analytic systems; (4) disclosure; (5) conflicts of interest; and (6) wrap fee arrangements. **Patrick Joyce**, Special Counsel in the SEC's Division of Trading and Markets, stated that the SEC looks carefully at average commission charges compared to commissions the adviser pays, any outlier commissions, and any concentration of commissions.

Form ADV Part 2. **Kahl** said that the SEC is "actively working on" amendments to Form ADV Part 2, and this project is a "priority within the Division [of Investment Management]." Further, the rule change is a matter of "when adopted, not if" it is to be amended. Kahl previewed the new format by saying it would evolve from the current check-the-box format to a narrative format. Advisers would be required to file ADV Part 2 electronically. Kahl noted that the most frequent comments received by the SEC involved the proposed annual delivery requirement. **Mari-Anne Pisarri**, a partner at Pickard & Djinis, reminded the audience that the latest SEC guidance on electronic delivery was in 2000. A significant problem would be in meeting the requirement to have evidence of delivery or obtaining each client's informed consent. To alleviate this issue, Pisarri suggested adding a provision to all advisory contracts consenting to electronic delivery, as well as including a legend on all documents that alerts readers to find the advisers Form ADV on the firm's website. Finally, **Christine Carsman**, Senior Vice-President and Chief Regulatory Counsel of Affiliated Managers Group, recommended involving business people in the disclosure review process to make sure functional areas are acting consistently with disclosure in Form ADV.

Business Continuity. **Mavis Kelly**, Assistant Director of OCIE, offered some information about inadequate policies and procedures for dealing with business disruptions. Historically, around 8% of advisers have inadequate plans. Common deficiencies include: plans missing critical elements, employees uncertain about actions to take in certain situations, untested plans, or even no plan at all. **Terrance O'Malley**, a partner at Fried Frank, noted that advisers are not legally required to have a business continuity plan, although he strongly recommended having one. **Jan Apthorp**, from Lee Financial Corporation, suggested asking yourself the following questions: Do your employees know what to do if you're gone? Do you have an alternative location? Can you restore and rely on backup data in 24-48 hours? She also suggested practice "drills" to further embed the plan.

Regulation S-P. The panel discussed the SEC's proposed revisions to Regulation S-P. **David Medine**, a partner at WilmerHale, stressed safeguarding customer information includes storage *and* disposal and that data security is an ongoing process which must evolve to meet changing environments. **Kris Easter**, Branch Chief, Office of Chief Counsel of OCIE, said she does not know when the Commission will work on the Reg S-P proposals but added that "OCIE is as anxious as you are" to see the Commission resolve these uncertainties in Regulation S-P. Easter discussed three recent cases of serious Reg S-P misconduct, including the sale of records and having databases susceptible to hacking and other breaches. She suggested the following compliance lessons: have a robust set of written policies and procedures reasonably designed to protect customer information; test your system to become aware of any vulnerabilities, and take action on those soft spots; and give your employees adequate training.

SEC Examinations. **Walsh** updated the Summit on the SEC's examination statistics relating to investment advisers for the past year. Over 1500 investment advisers were examined and, among these, 68% received a deficiency letter, 4% were referred for enforcement, and 31% saw no further action. Walsh noted that more than 90% of all examinations led to some corrective action. The top deficiencies were in the following areas: (1) information disclosure in Form ADV or brochures; (2) compliance rule; (3) personal trading and other codes of ethics violations; (4) performance advertising and marketing; and (5) portfolio management.

Portfolio Management. Several panelists suggested a return to the basics – clear, meaningful, written disclosure as well as policies and procedures, plus employee training – as the most beneficial actions an adviser could take at this time with respect to portfolio management. **Kelly** disclosed the most common deficiencies: not following client objectives; the client is in an inappropriate investment; failing to disclose conflicts; and the adviser not voting proxies in the client's best interest. **Mark Perlow**, a partner at K&L Gates, concluded by offering additional areas advisers should be self-policing: (1) style change because the characteristics of the underlying securities now held (for example, a series of small cap stocks growing into large cap stocks); (2) excessive risk-taking to try to blunt losses; (3) avoiding investments in a way that is inconsistent with guidelines, the investment agreement, or Form ADV; and (4) window-dressing the portfolio at the end of each reporting period. ■

IAA 2009 Webinar Series. REGISTER NOW!

The IAA is pleased to announce several webinars tailored to address important legal, regulatory, compliance, and other topics of interest for investment advisers in this current market environment. The webinars are scheduled as follows.

Compliance Programs for Smaller Advisers: Best Practices for CCOs

April 21, 1:00 – 2:15 pm Eastern

Presenter: Sara Emley, Partner, Buckley Kolar LLP and Michelle Kennedy, President, Compass Compliance Services LLC

Moderator: Monique Botkin, Senior Counsel, IAA

Smaller advisory firms with less than $1 billion in AUM or fewer than 10 employees may have fewer resources than larger firms. But small firms are subject to the same rules as large firms to implement policies and procedures that are reasonably designed to prevent violations of the Advisers Act and review those policies and procedures annually to determine whether they are adequate and implemented effectively. This webinar will focus on how small firm CCOs, who may wear many hats, may be able to best leverage their limited resources in this economic climate. Learn also how CCOs can become aware of potential "red flags" in their businesses and follow-up on any warning signs as part of their monitoring and testing program and annual review process. We will discuss common pitfalls, as well as best practices, for small firms with regard to the annual review, monitoring and testing your compliance program, and how to tailor your program to address the risks your firm may face.

Sara E. Emley is a Partner at Buckley Kolar LLP in Washington, D.C. Ms. Emley advises financial services firms, including investment advisers and broker-dealers, on investment adviser, investment company, and broker-dealer regulatory issues and assists them in structuring and developing products and services. She also advises financial services firms with respect to compliance with ERISA and other laws and regulations applicable to retirement accounts.

Michelle Kennedy is President with Compass Compliance Services LLC. Formerly Ms. Kennedy served as Vice President and Director of Compliance Platform Services for WealthTrust LLC, an investment holding company with ten affiliated investment advisory firms. She worked with WealthTrust for 3 years conducting the annual reviews for all affiliates, providing compliance support, advising on performance composite maintenance, including adherence to GIPS standards and supporting firms' onsite during SEC exams. Prior to joining WealthTrust, she was vice president of Greenwood Capital Associates, a registered investment advisor. During her fifteen years with the firm, she was responsible for compliance, operations and performance composite maintenance and served as the firm's CCO for the last four years of her tenure. Ms. Kennedy is past president and founding member of the Advent User Group.

Re-assessing Risk and the Annual Review in Current Market Conditions

May 20, 1:00 – 2:15 pm Eastern

Presenter: Monica L. Parry, Of Counsel, Morgan, Lewis & Bockius LLP

Moderator: Karen Barr, General Counsel, IAA

This has been no ordinary year. Recent market events are causing firms to review their risk assessment process and analysis as part of their compliance programs and annual review. Advisers are also focusing more intensely on the role of compliance in overall risk management, including operational and investment risk. This webinar will address how firms should be modifying their risk assessment and annual review processes in light of recent events. Learn about particular risks posed by the market crisis. The session will also cover the interplay between compliance and risk management.

Monica L. Parry is of counsel in the Investment Management Practice at Morgan Lewis in Washington, D.C. Ms. Parry's practice focuses on investment companies and investment advisers. Ms. Parry's background includes the simplification of prospectuses for a major mutual fund family, structuring and drafting contracts and disclosure documents for wrap fee programs, drafting service agreements and registration statements, and dealing with a variety of compliance issues involving both registered and unregistered advisers and funds. She has also been involved in numerous Investment Advisers Act matters and filings.

International Issues for Investment Advisers

June 4, 2009, 12:00 – 1:30 pm Eastern

Moderator: Jennifer S. Choi, Assistant General Counsel, IAA

<u>Panel 1 -- Providing Investment Advisory Services Outside the US: Key Issues to Consider and Case Study of the Middle East (45 minutes)</u>

Presenters: Charlotte Stalin (London), Andrew Wingfield (Doha), and Muneer Khan (Dubai), Partners, Simmons & Simmons

Advisory firms that are considering offering investment advisory services outside the United States have to navigate varied and unfamiliar regulatory schemes. This panel will focus on some key issues that investment advisers should consider in entering a new market and will provide as an example the challenges that investment advisers face in entering a geographic area like the Middle East.

Charlotte Stalin specializes in regulatory matters for financial institutions, including investment advisers. Ms. Stalin's work involves advising on numerous regulatory issues - ranging from licensing, marketing and selling restrictions in respect of a wide range of products and client types. *Andrew Wingfield* has advised on a wide range of regulatory and transactional matters in the financial services sector during his career

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at Simmons & Simmons in London, Hong Kong, New York and Doha. *Muneer Khan* has extensive experience advising on Islamic financing structures, with a particular focus on Shariah compliant investment funds.

Panel 2 -- Implications of the Foreign Corrupt Practices Act for Investment Advisers (45 minutes)
Presenter: Adam Hoffinger, Partner, Morrison and Foerster

Enforcement of the Foreign Corrupt Practices Act (FCPA) has become a significant priority for federal regulators. With governments around the world nationalizing or quasi-nationalizing private institutions, compliance with the FCPA has become even more complex. This panel will focus on the coverage of the FCPA, including third parties with whom advisers may establish business relationships to assist them in entering a new market. Also, learn about due diligence, training, and other procedures you should establish to protect your advisory firm and employees.

Adam Hoffinger is Partner at Morrison and Foerster in Washington, D.C. He represents clients on complex civil and white collar criminal matters, including securities, health care, money laundering, *qui tam*, Foreign Corrupt Practices Act, antitrust, environmental, and RICO. He also counsels corporations and individuals in compliance matters, internal investigations, and Congressional and regulatory matters. From 1985 to 1990, Mr. Hoffinger served as an Assistant United States Attorney for the Southern District of New York.

Mergers and Acquisitions, Succession Planning, and Valuation Involving Investment Managers in the Current Market Environment

June 10, 1:00 -- 2:15 pm Eastern
Presenters:
Steven M. Levitt, Managing Director, Co-Founder, Park Sutton Advisors, LLC
Keith E. Mitchell, Principal and Founder, Mitchell Advisers, LLC

Despite challenging market conditions, the M&A market for investment and wealth management firms continues to be active. Well-capitalized financial institutions will be able to take advantage of unique opportunities during 2009/10. Independent firms – from positions of strength and weakness – will contemplate transactions for varied reasons. The size of the market plunge will make it difficult for some managers to right-size their businesses and restore profitability quickly enough. Similarly, succession planning is an important issue that most small and mid-sized investment and wealth management firms must address at some point in their lifecycle. Succession planning impacts the long-term viability of the business and is critical to clients, consultants, and employees.

> *"The IAA is pleased to announce several webinars tailored to address important legal, regulatory, compliance, and other topics of interest for investment advisers in this current market environment."*

Learn from decades of experience and real-world examples. This webinar will focus on the methodology for valuing firms, shed light on transactional activity in the investment and wealth management industry given current circumstances, as well as address the following subjects:

- Reasons for succession planning, including the generational issue
- Key challenges faced in implementing a succession plan
- Implications of corporate structure
- Valuation of equity
- Structures designed to incent employees
- Financing equity transition

Steven Levitt leads and co-founded Park Sutton Advisors, a joint venture company formed with established European financial group Meeschaert. He has focused on small- and middle-market M&A in the financial services sector for the past 12 years working with investment and wealth managers, broker-dealers, and fund administrators globally. Mr. Levitt's work has also included providing strategic and financial advice in connection with valuations, succession planning, and equity transition programs. Prior to Park Sutton Advisors, Mr. Levitt worked with Cambridge International Partners, MilleniumAssociates, and Putnam Lovell. He is based in New York.

Keith Mitchell is the principal of Mitchell Advisers, an independent strategic advisor to executives of asset management firms. His clients are typically navigating organizational growth, change, continuity planning, acquisitions or mergers. Mr. Mitchell's career within the asset management business spans over 20 years with extensive operational and strategic management experience, including start-up and turn-around situations for institutional and retail oriented firms in the US and abroad. Prior to Mitchell Advisors, Mr. Mitchell held executive positions at Putnam Lovell, AIB Asset Management Holdings, Delaware Management Holdings, Enterprise Capital Management, & Van Kampen. He is based in Atlanta.

Registration Information. The registration fee for each webinar is $125 for IAA members and $200 for non-members. Registration fees are charged per computer logon. Registration is a two-step process. Step 1 is to log on to http://iaa.webex.com and select the webinars you wish to attend. Step 2 is to complete a payment form located at:

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DID YOU KNOW?

Members Interested in Contacting Congress Can Reach Out to IAA for Assistance

In light of the ever-developing regulatory reform issues, poised to have a significant affect on the investment advisory profession, the IAA is encouraging its members to call upon Congress.

IAA VP for Government Relations Neil Simon is always available to assist members with talking points and answers to logistical questions before contacting Congress. The IAA feels it is critical that Congress understands why fiduciary responsibilities must be upheld – representatives and senators would benefit immensely if educated by their constituents inside the industry.

If you have questions regarding the IAA's position regarding regulatory reform, or would like to get more information before calling upon your members of Congress, please contact Neil Simon at (202) 293-4222 or neil.simon@investmentadviser.org. ■

SEC Warns About SEC Impersonators Claiming to Conduct Emergency Exams

In March, the Securities and Exchange Commission (SEC) issued a press release warning investors and financial services firms about con artists who may use the names of actual SEC employees to mislead potential victims. According to the SEC, in addition to tricking investors into revealing private information, individuals have attempted to impersonate SEC examiners in order to gather confidential information from broker-dealers and investment advisers. The con artists call firms, claim to be members of the SEC staff, demand immediate access to the firm's records, and sometimes claim to be conducting an "emergency" examination.

The SEC recommends that investors and firms always verify the identity of someone claiming to be from the SEC by asking for the caller's name, telephone number, and SEC office. Investors and firms should then call the SEC's personnel locator at (202) 551-6000 and ask to speak directly to that staff member. According to the SEC, "Most importantly, if the caller is suspicious and can't be verified, do not share any information. Similarly, if the caller resists providing proof of identity, or efforts to reach the caller through a published SEC telephone number are unsuccessful, do not give that caller any information."

Investors and firms that have been contacted by someone unfamiliar who is claiming to be an SEC employee should contact the SEC by calling 800-732-0330 or e-mailing help@sec.gov. If a caller claiming to be an SEC examiner does not appear to be a member of the SEC's staff, the incident should be reported to the SEC's Examination Hotline at (202) 551-EXAM. ■

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http://investmentadviser.org/eweb/docs/Public/2009_RegComp_Webinar_Payment-Form.pdf and fax the information to the IAA to (202) 293-4223 or mail to the IAA with a check.

For more information about the webinars, please contact Monique Botkin, IAA Senior Counsel, at (202) 293-4222 or monique.botkin@investmentadviser.org. For more information about registration, please contact Lisa Gillette, IAA Director of Meetings and Events, at (307) 733-3332 or lisa.gillette@investmentadviser.org.

2009 IAA Webinar Recordings available on the IAA web site:

Massachusetts Data Security Regulations
February 26, 2009
Presenters: Becky Burr, Christopher Harvey, and Lynn Charytan, Partners, WilmerHale LLP
Moderator: Paul Glenn, Counsel, IAA

SEC Exams: How Advisers Should Prepare for Exams After the Madoff Scandal
March 25, 2009
Presenter: Mari-Anne Pisarri, Partner, Pickard and Djinis LLP
Moderator: Valerie Baruch, Assistant General Counsel, IAA ■

Compliance Corner

— By Lorna A. Schnase*

Can an Adviser be Liable for the Wrongdoing of Another Adviser?

Heard in a congressional hearing probing the Madoff affair:

Rep. Jackie Speier (CA) [referring to the hedge fund managers that invested fund assets with Madoff]: Fairfield Greenwich and Tremont. Sophisticated investors, and yet they did not do their due diligence. Should we be going after them as well? Should someone be going after them, because they ripped off the American people?

Mr. Markopolos: I would say that they need to be looked into. If they didn't know, they were willfully blind and they got paid a lot of money for being willfully blind.

— Testimony of Harry Markopolos (the Madoff whistle-blower), in a hearing held February 4, 2009, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services.

In the industry, it is common for one adviser to help in the selection of another adviser to handle day-to-day management of a client account. This occurs, for example, in classic adviser/sub-adviser scenarios, wrap account and other SMA-type programs, manager-of-managers arrangements and other advisory relationships where the adviser's role includes helping the client to identify, hire, monitor and fire, when warranted, other advisers for the account.

In these arrangements, can the adviser be held liable if a selected adviser commits wrongdoing, such as fraud? This question has shot to the surface again because of the Bernard Madoff affair, given that numerous hedge fund managers, banks and other advisers selected Madoff to manage their clients' assets, now lost in Madoff's massive Ponzi scheme. However, this article is not a post-mortem of the Madoff case. Rather, it addresses more broadly an adviser's potential liability for wrongdoing of another adviser in these types of arrangements, focusing in particular on an adviser's duty to supervise.

How Can an Adviser be Held Liable if Another Adviser Commits Wrongdoing?

One way is through a "failure to supervise" claim. An adviser's duty to supervise can be inferred from Section 203(e)(6) of the Investment Advisers Act of 1940 (Advisers Act), which in substance says an adviser can be liable when a person subject to the adviser's supervision commits a violation, if the adviser failed to reasonably supervise them with a view to preventing those violations.

Note that Section 203(e)(6) does not make an adviser directly responsible for the wrongdoing of others. Rather, it creates a separate claim against the adviser for its own failure, that is, for its own failure to supervise. Importantly, then, Section 203(e)(6) does not make the adviser a guarantor or insurer against wrongdoing by others, and the adviser is not automatically liable if something goes wrong. Rather, for the adviser to be liable under Section 203(e)(6), it must have failed in its own duty to supervise.

Does this Mean an Adviser Can be Liable for Failing to Supervise Someone Who is Not an Employee?

Yes. According to Section 203(e)(6), an adviser can be liable for failing to supervise anyone who is "subject to [the adviser's] supervision." Even if this phrase is read narrowly to mean only those who are "supervised persons" of the adviser, within the meaning of that statutorily defined term, the adviser would still be liable for failing to supervise not only employees, but also any other person who provides investment advice on the adviser's behalf and is subject to the adviser's supervision and control.

Notably, though, Section 203(e)(6) could be interpreted even more broadly than that, to cover not only not "supervised persons" within the defined term, but any other person who might be considered "subject to the adviser's supervision" as well. For example, an unaffiliated sub-adviser might be considered "subject to an adviser's supervision," as evidenced by factors such as a clause to that effect in the advisory agreement, even if it is not a "supervised person" within the defined term because it is not giving advice "on the adviser's behalf" or is not subject to the adviser's "control." ("Control" here means the power to exercise a controlling influence over the management or policies of a company.)

Either way, the SEC has taken the position that an adviser's duty to supervise does not end at organizational boundaries, so even a person who is not an employee and indeed is not an "affiliate" of the adviser could be considered subject to the adviser's supervision. This point has been driven home through enforcement actions, like Western Asset Management Co. and Legg Mason Fund Adviser, Inc., Advisers Act Rel. No. 1980 (September 28, 2001) (settled), where the SEC sanctioned an adviser for failing to supervise the employee of a sub-adviser who had committed securities law violations. It has also been driven home by public remarks of the SEC Staff, such as those of the Director of the Division of Enforcement at a December 2001 ICI Conference, who said an adviser/sub-adviser relationship between two unrelated enti-

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ties is equally likely to result in a supervisory relationship as one between related entities.

When is Another Adviser Considered Subject to an Adviser's Supervision?

This will depend on the facts and circumstances of each case. Relevant factors might include:

- Contract provisions. Is there a sub-advisory or other agreement between the advisers that expressly makes the other adviser subject to the adviser's supervision? Does the advisory agreement with the client specifically contemplate that the adviser will supervise, oversee or monitor other advisers selected to help manage the account?

- Relevant disclosures. What has the adviser disclosed in its Form ADV Part 2 or marketing materials about the relationship between the advisers, about the due diligence used to select other advisers, or about ongoing monitoring or oversight?

- Relationships among the individuals involved. Does the adviser have a broad, all-encompassing financial management relationship with the client or a narrow, single-focused engagement? Does the client have the internal resources or expertise necessary to monitor the other adviser itself? Are the advisers "affiliated" or are there other indicia of "control"? Is there an overlap in management or personnel between the advisers? Does the adviser have the ability or authority to affect the conduct of the other adviser?

- Course of dealing between the parties. What have been the parties' various roles to date? What would a client reasonably expect under the circumstances? What due diligence did the adviser do to select the other adviser initially? How else was the adviser involved in the selection of the other adviser or its personnel? Does the client look to the adviser for advice on whether to continue to retain the other adviser? Is the adviser the client's only point of contact on the account, or does the client communicate directly with the other adviser?

- The parties' expressed expectations or intentions. What have the parties said about these issues in oral communications or separate correspondence?

What Liability Might Result if an Adviser Fails to Supervise?

Section 203(e)(6) empowers the SEC to take administrative action against any adviser for violation of that section, which could result in a censure, limitation, suspension or deregistration. Monetary penalties may also be imposed and willful violations can lead to criminal fines and imprisonment.

Notably, Section 203(e)(6) does not expressly authorize private parties (such as clients and investors) to sue an adviser for failure to supervise. Indeed, the Advisers Act as a whole has been interpreted not to give any private party a right to sue for violations of the Act, except for a claim under Section 215 (the Validity of Contracts section) to rescind an advisory contract. See *Transamerica Mortgage Advisors, Inc. (Transamerica) v. Lewis*, 444 U.S. 11 at 24, 100 S.Ct. 242 (1979). This does not mean, however, that harmed clients, investors and other private parties are necessarily left without a remedy, as addressed in the next question.

How Else Might an Adviser be Liable in the Event of Wrongdoing by Another Adviser?

Aside from Section 203(e)(6), other claims may also exist, in many cases as an outgrowth of an adviser's basic failure to supervise. In some cases, the factors discussed above as relevant to Section 203(e)(6) will be relevant to those other claims as well. In addition, those other claims may be more fruitful for private plaintiffs to recover damages, to the extent not grounded in the Advisers Act where (as previously noted) private rights of action are limited:

- Fraud. Fraud claims may exist if an adviser's disclosure documents (such as its Form ADV Part 2), marketing materials or other communications materially misrepresent the scope or depth of the adviser's due diligence procedures when selecting, recommending or monitoring other advisers. The SEC may pursue fraud claims against an adviser under Section 206 of the Advisers Act. *See In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch)*, Advisers Act Rel. No. 2834 (January 30, 2009) (settled) (adviser found to have violated anti-fraud Section 206(2) by misrepresenting its process for selecting money managers). Clients pursuing fraud claims under the Advisers Act may be limited to a remedy of rescission under Section 215 as a result of the *Transamerica* case referenced above. However, state securities fraud claims may be available to clients (and state regulators) and clients may have common law fraud claims as well.

- Breach of contract. Advisory agreements that contain express or implied obligations for an adviser to supervise (or "oversee," "monitor" or "evaluate") another adviser may give rise to claims for breach of contract if the adviser is found to have failed in its supervisory responsibility.

- Breach of fiduciary duty or negligence. If an adviser did not use reasonable diligence when selecting or overseeing another adviser, clients may have claims for breach of fiduciary duty of care or for negligence in the handling of their accounts. Similarly, if an adviser's family or other relationships with a selected adviser, or the adviser's own self-interest in fees, blinded the adviser to wrongdoing or led to lax vetting or oversight, clients may also have claims for breach of the duty of loyalty.

Advisers may have other regulatory exposures as well:

- Regulatory liability under Rule 206(4)-7. An adviser might also have violated Advisers Act Rule 206(4)-7 by failing to maintain a reasonably designed compliance program aimed at preventing the wrongdoing of sub-advisers or other advisers managing client accounts. Technically, Rule 206(4)-7 only requires an adviser's compliance program to cover its "supervised persons" within the meaning of the defined term (explained above in the second question). However, the SEC Staff has repeatedly said advisers should design their compliance programs taking into consideration all service providers who pose risk to the adviser's clients, whether or not they technically meet the "supervised person" definition.

- Regulatory liability under Rule 38a-1. Similar to Rule 206(4)-7, Rule 38a-1 under the Investment Company Act of 1940 requires registered investment companies to maintain compliance programs designed to prevent violations. However, in contrast to Rule 206(4)-7, Rule 38a-1 expressly requires a fund's compliance program to include oversight of the fund's key service providers, including advisers and sub-advisers. Accordingly, advisers managing funds could cause violations of Rule 38a 1 if they fail to supervise the fund's sub-advisers as expected.

- Exemptive orders. In some "manager of managers" arrangements with registered funds, SEC exemptive orders are obtained allowing the fund's adviser to replace the fund's sub-advisers without the otherwise required shareholder vote. As a condition to granting these orders, the SEC typically requires the fund's sub-advisers to be monitored under procedures reasonably designed to ensure their compliance. Thus, regulatory violations could result if steps are not taken to satisfy that monitoring condition.

- Aiding and abetting liability. Liability can also arise under the federal securities laws if an adviser willfully aids or abets a violation by any other person. Moreover, the SEC has contended that "willfully" simply means the person knew what he was doing and not necessarily that he knew what he was doing violated the law or would result in violations of the law. See the *Merrill Lynch* case cited above. Consequently, advisers could face claims that their inadequate supervision "aided" or "abetted" another adviser's wrongdoing by merely not catching it.

- Control person liability. Section 20(a) of the Securities Exchange Act of 1934 (Exchange Act) makes anyone who "controls" a wrongdoer liable for violations of that act, jointly and severally and to the same extent as the wrongdoer, subject to certain defenses. As a result, insider trading violations, securities fraud, reporting violations, and potentially other violations could be imputed to anyone who "controls" the wrongdoer. ("Control" in this case is left undefined, leaving courts the flexibility to determine the myriad ways that control could be exerted.) Thus, "control person" liability under Section 20(a) or under similar provisions in other laws is yet another avenue by which advisers might become liable for the wrongdoing of another adviser.

Depending on the facts, other claims may also exist. For instance, clients harmed as investors in pooled funds mishandled by an adviser (think of the "feeder funds" placed with Madoff, for example) may have claims against the advisers that got them into those funds. These may include classic 10b-5 and similar claims for fraud in the sale of securities, on the theory that fund investors were misled about the nature, scope or depth of the due diligence and oversight processes that would be undertaken by the fund manager. Some cases may also give rise to claims under the Racketeer Influenced and Corrupt Organizations Act (RICO), which allows recovery of treble damages and costs, including attorneys' fees.

Will a Successful Claim Against the Adviser Make a Harmed Client Whole?

Not necessarily. As discussed above, only in limited cases will the other adviser's wrongdoing be imputed directly to the adviser, making the adviser jointly liable to the same extent as the wrongdoer. In other cases, clients will have to pursue the adviser for its own failures under separate claims, such as breach of duty, breach of contract, fraud, or the like. Even then, issues such as causation and relative culpability may make damages awarded against the adviser fall short of the full losses sustained. In any case, a client's recovery of litigation costs and attorneys' fees is in doubt.

Given this, even clients with successful claims against their adviser may not be made whole, which can be particularly vexing for clients that cannot sue the wrongdoer directly or where the wrongdoer has already disappeared or become insolvent. This may prompt some clients, as in the Madoff case, to seek recovery from other parties. Targets may include custodians, auditors, administrators, lawyers or others.

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Legal & Regulatory update

SEC Announces Public Meeting to Consider Proposing Short Sale Price Test Rules

The SEC has announced that it will hold an open meeting on April 8 to consider whether to propose short sale price test rules. The SEC repealed the so-called uptick rule in July 2007 and will now consider its re-adoption or propose some comparable rule or other appropriate alternative. The former uptick rule was designed to permit short sellers only to sell securities "short" on an uptick or zero uptick (same price but the last time the price changed was upward). Some market participants have been requesting reinstatement of such a rule believing the absence of such a rule inappropriately facilitates excessive drops in downward markets. The meeting announcement is available on the SEC's web site at http://www.sec.gov/news/openmeetings/2009/ssamtg040809.htm.

Robert Khuzami Named SEC Director of Enforcement

On February 19, the SEC announced that former federal prosecutor Robert Khuzami has been named Director of the Division of Enforcement. Previously, Mr. Khuzami served as a federal prosecutor for 11 years with the United States Attorney's Office for the Southern District of New York. More recently, he has served as General Counsel for the Americas at Deutsche Bank AG. *See "Robert Khuzami Named SEC Director of Enforcement,"* available at http://www.sec.gov/news/press/2009/2009-31.htm.

SEC's Investment Management Division Provides No-Action Relief for "Liquidity Protected Preferred Shares" Purchasable by Money Market Funds

On March 12, the SEC's Division of Investment Management provided no-action relief addressing affiliate restrictions under the Investment Company Act regarding liquidity providers, their affiliated persons, or a registered closed–end investment company. Closed end funds are developing liquidity protected preferred shares (LPP) to replace existing auction rate preferred shares as a permissible investment for money market funds with the intention of increasing yields to investors. The no-action letter addresses whether the affiliated person restrictions are triggered by liquidity providers' acquiring all or a large portion of a fund's LLP or having the right to sell the LPP to the fund. Features of these arrangements potentially raising affiliate or control issues permit a liquidity provider (i) to elect up to two directors of the closed-end fund or (ii) exercise the ability to defeat unilaterally any proposal that would require the approval of a majority of a fund's outstanding preferred stock voting as a class. The staff granted no-action relief without necessarily agreeing with the applicant's analysis that the liquidity provider or its affiliates would not be deemed to control or otherwise be an affiliated person of the fund solely because of these features. *See SEC letter to ICI* (Mar. 12, 2009), available at http://www.sec.gov/divisions/investment/noaction/2009/ici031209.htm.

A complete copy of each month's Legal and Regulatory Update column is available on the Members Only section of the IAA web site. ■

REGISTER TODAY for the IAA 2009 Annual Conference!

The 2009 annual conference will be held at The Grand Del Mar in San Diego on May 6-8. Featured speakers include Horacio Valeiras, CIO of Nicholas-Applegate, Larry Speidell of Frontier Market Asset Management, Christopher Thornberg of Beacon Economics, J. Craig Venter of Synthetic Genomics on genetic code, the Honorable Luis Aguilar from the SEC, Bill Davidson from Qualcomm and Ivor Royston of Forward Ventures on biotechnology. Concurrent workshops on institutional and wealth management will be conducted by members of Casey Quirk and Schwab Institutional respectively on Wednesday, and the popular AUM-based breakout sessions with be held on Thursday afternoon. Social activities include a private dinner at the Museum of Contemporary Art, San Diego, and a dinner on Friday night.

Aside from an excellent line-up of industry experts, the annual conference serves as an important venue where we can meet and network with our peers. The conference brochure and registration forms are enclosed. If you have questions, please email Lisa Gillette at lisa.gillette@investmentadviser.org. We look forward to seeing you in San Diego! ■

INSIDE *the Beltway*

IAA, State Regulators, and Consumer Groups Refute Broker-Dealer Proposal for Universal "Fair Dealing" Standard

Testifying before the Senate Banking Committee at a March 10 hearing on "Investor Protection and the Regulation of Securities Markets," SIFMA (formerly SIA) – the trade association that represents broker-dealers – proposed the creation of a universal "fair dealing" standard of care for investment advisers and broker-dealers to replace the current fiduciary standard governing investment advisers.

SIFMA CEO Tim Ryan testified: "Rather than perpetuating an obsolete regime, SIFMA recommends the adoption of a 'universal standard of care' that avoids the use of labels [such as fiduciary] that tend to confuse the investing public, and express, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial service providers."

In a joint letter delivered on March 23 to the Senate Banking Committee, the Investment Adviser Association (IAA), the North American Securities Administrators Association (the organization representing state securities regulators), and the Consumer Federation of America refuted SIFMA's claims that this standard should be anything less than the highest standard of care recognized under the law – the fiduciary duty that investment advisers currently provide their clients.

"Despite our apparent agreement with SIFMA regarding the need for a functional regulatory approach and application of a consistent standard of care, we strongly disagree that the appropriate 'universal' standard of care should simply express principles of fair dealing. Instead, we submit that the fiduciary standard – which offers *the highest level of investor protection* – should apply," the letter stated.

To read the letter, go to "Comments and Statements" under the *Publications/News* section of the IAA web site at www.investmentadviser.org.

FINRA Says It's "Uniquely Positioned" to Build Oversight Program for Advisers

In his first speech as FINRA's Chairman and CEO, Richard Ketchum reiterated FINRA's previous suggestions that Congress consider granting it authority to extend its reach to the investment advisers. Speaking before a SIFMA compliance seminar on March 23, he asserted that "FINRA is uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently."

> *"What is needed is the development of a system that is tailored to fit the investment advisers, and not simply export in wholesale fashion our existing rulebook or governance structure."*
>
> *— FINRA's Chairman and CEO, Richard Ketchum*

"[T]he most glaring example of what needs to be fixed in the current system… [is] the disparity between oversight regimes for broker-dealers and investment advisers. The lack of a more meaningful examination program for investment advisers impacts the level of protection for every member of the public that entrusts funds to one of those advisors," Ketchum said. "[A]s we learned from Madoff, it does not make sense for two, separate, independent regulatory bodies to oversee investment advisers and broker-dealers, especially when these businesses may exist in the same legal entity."

Suggesting an apparent willingness to accommodate some investment adviser concerns in its campaign to extend its regulatory reach to advisory firms (as well as a difference with SIFMA's position as described above), Ketchum also said: "We recognize that although similar in many ways, there are some differences between investment advisers and broker-dealers. What is needed is the development of a system that is tailored to fit the investment advisers, and not simply export in wholesale fashion our existing rulebook or governance structure."

In this regard, he stated: "One of the primary issues raised about investor protection differences between the two channels is the difference between the fiduciary standard for investment advisers and the rule requirements, including suitability, for broker-dealers. This is the kind of issue that should be and will be on the table as we all look at how best to reform our regulatory system and strengthen investor protections… [L]et's explore seriously whether a properly designed fiduciary standard can effectively be applied to broker-dealer selling activities and, if there are problems raised, make a strong effort to resolve those problems. It is time we make an honest effort to break this logjam – two different standards is simply untenable in this world."

Ketchum reiterated these views in his March 26 testimony before the Senate Banking Committee, at which IAA also testified. The full test of Ketchum's written statement is available on the Senate Banking Committee web site: www.banking.senate.gov.

Contact Neil Simon, IAA Vice President for Government Relations, to share your views – or for more information – about these and other government relations matters. ■

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Compliance Corner — Continued from page 13

What Can an Adviser Do to Mitigate its Risk of Liability for Another Adviser's Wrongdoing?

The single most important thing an adviser can do is to maintain a robust compliance program that includes reasonable procedures for overseeing any advisers that they help to select. Procedures should be aimed at preventing, detecting and correcting violations, and should include the basic features of all well-designed procedures: • functional separation • "red flag" follow-up • clear assignment of responsibility • training, and • monitoring/testing. Initial and on-going due diligence in the selection of advisers should go beyond just looking at their track record and getting quarterly compliance certificates. In appropriate cases, site visits should be conducted and verifications obtained from independent third parties (auditors, custodians, background checks and the like). If we have learned anything from the Madoff scandal it is this: due diligence cannot be based on reputation alone and significant "red flags" cannot be ignored.

As a practical matter, robust oversight procedures increase the likelihood that wrongdoing will be prevented and that wrongdoing not prevented will be detected and corrected more quickly. As a legal matter, robust oversight procedures potentially offer these additional advantages:

- An express affirmative defense against a failure to supervise claim under Section 203(e)(6).

- An express defense under Section 21A(b)(1) of the Exchange Act to "control person" liability for insider trading committed by other advisers deemed to be under an adviser's "control."

- Mitigating potential regulatory liability for failure to maintain a reasonably designed compliance program under Rule 206(4)-7, Rule 38a-1 (for advisers managing funds) and/or any "manager-of-managers" SEC exemptive orders under which the adviser is operating.

- Mitigating the risk of other potential claims, such as breach of the duty of care, breach of loyalty, breach of contract or fraud.

* * *

Thus, there are many ways that an adviser might be held liable when an adviser they helped to select commits wrongdoing. However, adopting robust oversight procedures will reduce the risk that wrongdoing will go undetected and reduce the risk of legal liability in the event it does.

** Lorna Schnase (713-741-8821; www.40ActLawyer.com) has been practicing securities law for over 20 years. Her independent law practice emphasizes investment management matters, primarily for registered investment adviser and mutual fund clients. This information is provided strictly as a courtesy to readers for educational purposes. All facts and matters reflected in this article should be independently verified and should not be taken as a substitute for individualized legal advice. © 2009 Lorna A. Schnase* ■