Proxy Voting Disclosure. Separately, on a panel on SEC and NASD regulatory developments, Robert Plaze, associate director in the division, discussed the "thinking behind" the commission's proposals to require greater disclosures by investment companies and investment advisers in the proxy voting area (34 SRLR 1526, 9/23/02).

First, he said, "there have been serious incidences of conflicts that we are aware of." Plaze referred to potential conflicts on the part of funds and advisers in voting proxies on behalf of shareholders/clients in the best interests of those shareholders/clients. A conflict could arise, for example, when a mutual fund wishes to place a 401(k) program with a particular company that is in its portfolio.

In addition, according to Plaze, in the wake of Enron, Worldcom, and other corporate accounting and governance scandals, corporate governance matters have taken a front burner at the commission. The transparency that will result if the proxy voting disclosure proposals are adopted is "one piece of improving corporate governance in America," the SEC official remarked, "one piece of a larger mosaic."

Speaking on the same panel, Susan Nash, an associate director in the division, called attention to the "aggressiveness" of the commission in matters of disclosure. The proxy voting initiative is informed by the philosophy of an investor's "right-to-know," which has been a paramount concern for this commission, she recounted.

BY RACHEL MCTAGUE

Investment Advisers

OCIE Approach to Exams Changing For Investment Management Concerns

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations is modifying its approach to examinations of investment companies and investment advisers by focusing on firms' compliance systems, Gene Gohlke, associate director of the office, said Oct. 17.

The change shifts the staff's inspection, or exam, activities away from test checking, which has been used primarily until now, Gohlke said. It also entails more frequent inspections and the use of more SEC staff, which, Gohlke said, the agency will be able to afford with new monies authorized by the Sarbanes-Oxley Act.

Instead of a five-year exam cycle for advisers and funds, those firms will be inspected a minimum of every four years, but often as frequently as every two years, depending on how good their risk management and compliance systems are, Gohlke related.

Gohlke spoke on a panel on enforcement and compliance at an investment management regulation conference in Washington sponsored by the American Law Institute-American Bar Association.

Past Five Years. In the past five years, according to Gohlke, OCIE has conducted 6,915 exams of investment advisers and 1,323 exams of fund complexes. This means that every adviser and fund complex in existence since Oct. 1, 1997, was inspected within the five-year cycle ending Sept. 30.

In the universe of advisers, the SEC official noted, the top 100 firms in terms of assets under management manage more than 60 percent of assets under management of all advisers, including the smaller advisers regulated by the states. That total—of assets under management for all advisers—is currently $22 trillion, he said.

OCIE is changing how it selects firms for inspection and what is done during inspection.

Under the new regime for exams, Gohlke said, OCIE is changing how it selects firms for inspection and what is done during inspection. Firms will be inspected more or less frequently, Gohlke explained, depending on their assets under management, the complexity of their organizational structure, the presence of risk factors in their operations, and the quality of their internal controls and compliance processes.

OCIE has broken down investment management firms into three groups for purposes determining the frequency of inspections. In the first group are the 100 largest investment adviser firms. The top 20 will be examined every two years, while the remaining 80 firms will be on a cycle of between two and four years. Inspections will be given every two years to firms that have lower quality risk management and compliance systems, Gohlke emphasized.

Groups of Registrants. In the second group are the remaining 7,600 investment advisers. These firms will also be on a cycle of between two and four years, depending on control procedures, the extent to which they have custody of client assets, and whether there is side-by-side management of a private investment pool along with a registered fund, for example.

Finally, in the case of newly registered advisers and newly formed fund families, OCIE hopes to give an initial inspection within the first 12 months.

Under the new scheme of inspections, Gohlke said, no firm would remain without inspection for more than a four-year period, and "quite a few firms would be inspected every two to three years."

Fully implementing the new schedule for examinations "will take quite a few more people" than are currently on OCIE's inspections staff, Gohlke noted. The cost of the additional personnel is expected to be covered by appropriations authorized under Sarbanes-Oxley, which increased the SEC's authorization by hundreds of millions of dollars, to $776 million.

Substance of Exams. During inspections, Gohlke said, each firm will be given a "chance to make its case that its control systems are effective," that problems are found and corrected quickly. The inspections staff will want to see compliance manuals, but that will not suffice, he said. While the staff will not specify specific documents that it wishes to see, it is looking for documents that demonstrate the effectiveness of the compliance systems.

These documents would include exception reports, compliance work papers, compliance check lists, and reconciliation papers. What is desired by the staff is not

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"blank report formats," Gohlke explained, but the output of the compliance system.

He noted that such records are not required to be kept under the SEC's rules, but that if the firm does not keep them, it will be deemed "high risk" and will be subject to inspections every two years.

Document Request Lists. The way in which OCIE seeks documents, Gohlke said, is that it sends out document request lists to the firms seeking documents that show what compliance mechanisms are in place for best execution, allocation of initial public offerings, personal trading, and other areas. Gohlke added that OCIE's request informs firms that if their controls are "not good," then other documents will have to be provided to the staff, including quarterly reports, for example.

In other remarks, Gohlke said that OCIE will "probably" be at least part of the SEC staff that oversees the new Public Company Accounting Oversight Board. Sarbanes-Oxley provides that the SEC will have oversight responsibility for the new board, which must be named by Oct. 28. The staff in charge, Gohlke suggested, could be OCIE, or OCIE along with the Chief Accountant's staff, or some other arrangement.

Speaking on the same panel, Barbara C. Chretien-Dar, assistant director in the Office of Enforcement Liaison of the Division of Investment Management, stressed that portfolio managers who are making allocation decisions need an "independent outside person looking at their allocations" to spot troubling patterns or other problems.

"In the past year," she said, "there have been more cases in the fund area than previously that highlight compliance issues."

Codes of Ethics. Another area of concern to the staff relates to funds' codes of ethics. There have been cases in which there is an ethics code on paper, but it is not implemented, Chretien-Dar said. For instance, lack of implementation is seen where the firm does not educate personnel about the code.

Chretien-Dar also said that she would "not be surprised to see" more SEC cases in coming months against firms for failing to have adequate systems in place to prevent the misuse of material nonpublic information. These would be brought under Investment Advisers Act Section 204(a), she said. There does not necessarily have to be underlying trading going on that violates the statute. Rather, firms must update their system to reflect what the principals of the adviser are doing and to address the question of whether information can flow back to portfolio managers.

Appearing on the same panel, Richard Marshall, a member of Kirkpatrick & Lockhart, New York, enumerated factors that the Federal Sentencing Guidelines says should be considered by a court as evidence that a defendant firm has good compliance and should be given "a break." Those are "good people" who have been screened and trained; written procedures; clear lines of supervision; systems that have been tested to find and fix problems; and the ability to respond to red flags indicating problems.

Marshall said that he adds five more factors to the list: recordkeeping; compensation that gives incentives not to violate the law; watchdogs such as independent directors, an advisory board, and outside counsel; support from the top—i.e., management buying into the company; and an intelligent commitment of resources to risk assessment.

By Rachel McTague

Antifraud

News Wires Not Liable for Securities Fraud Over Phony Press Release, 2d Cir. Affirms

Emulex Corp. shareholders who sold at a loss after the distribution of a phony news release that the firm was under investigation failed to state a securities fraud claim against Internet Wire Inc. and Bloomberg L.P.—the wire services that unwittingly distributed the hoax—the U.S. Court of Appeals for the Second Circuit affirmed Oct. 10 in an unpublished order (*Hart v. Internet Wire Inc.*, 2d Cir., No. 01-9259, 10/10/02).

The plaintiffs claimed that the wire services were reckless and should have spotted red flags indicating that the release was phony. However, the per curiam opinion said, they failed to allege that the wire services intentionally distributed the false statements.

"At most," the court concluded, "plaintiffs have alleged errors and omissions—such as failure to detect or investigate typing errors, inconsistencies of naming, and other supposed signs of the Release's inauthenticity—that suggest carelessness or haste, not an 'egregious refusal to see the obvious, or to investigate the doubtful, which may in some cases give rise to an inference of recklessness.' "

Short Seller, Former Wire Employee Perpetrates Hoax. According to the district court's opinion, on Aug. 24, 2000, Mark Simeon Jakob of California, a former Internet Wire employee and Emulex short seller who was losing money on the firm's rising price, posed as a public relations executive and sent a phony Emulex press release to Internet Wire for distribution. The release was later picked up and distributed by Bloomberg.

Emulex, headquartered in Costa Mesa, Calif., is "a leading supplier and developer of storage networking host bus adapters based on both Fibre Channel and IP networking technologies," according to its Web site, was then traded on Nasdaq and is now traded on the New York Stock Exchange.

The phony release—which said that Emulex was under investigation by the Securities and Exchange Commission, that its earnings were being restated, and that its CEO had quit—caused the Nasdaq stock price to fall immediately.

Jakob was later charged civilly and criminally, and pleaded guilty to two counts of securities fraud and one count of wire fraud (32 SRLR 1230, 9/18/00; 32 SRLR 1385, 10/9/00; 33 SRLR 54, 1/15/01). He was sentenced to 44 months in prison in the criminal action (33 SRLR 1177, 8/13/01). Jakob also settled the SEC's civil antifraud charges (33 SRLR 1110, 7/30/01).

Emulex shareholders sued Internet Wire and Bloomberg for securities fraud under 1934 Securities Exchange Act § 10(b), but the district court dismissed the case with prejudice, ruling that the shareholders had failed to allege scienter (33 SRLR 1511, 10/22/01).