U.S. Securities and Exchange Commission

Letter From the Office of Compliance Inspections and Examinations: To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections

May 1, 2000

Dear Registered Investment Adviser:

The inspection staff of the United States Securities and Exchange Commission (the "Commission") has prepared this letter to assist registered investment advisers in complying with the *Investment Advisers Act of 1940* ("Advisers Act") and the rules thereunder.[1] The Commission's examination staff conducts examinations of registered advisers to determine: 1) if advisers are conducting their activities in accordance with the law and disclosures made to clients; and 2) whether they have adequate systems and procedures in place to ensure that their operations are in compliance with the law.[2] This letter summarizes select areas reviewed and violations of the Advisers Act found during compliance examinations of investment advisers. Our intent is to educate investment advisers about such practices, and to encourage strong compliance and internal control procedures to ensure compliance with the Advisers Act.[3]

I. Duty To Disclose

Fundamental to the Advisers Act is an adviser's fiduciary obligation to act in the best interests of its clients and to place its clients' interests before its own. As part of its fiduciary duty to clients, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to clients.[4] Advisers are required to disclose any facts that might cause the adviser to render advice that is not disinterested. When an adviser fails to disclose information regarding potential conflicts of interest, clients are unable to make informed decisions about entering into or continuing the advisory relationship.

During inspections, the examination staff review an adviser's filings with the Commission[5] and other materials provided to clients to ensure that the adviser's disclosures are accurate, timely, and do not omit material information. Examples of failures to disclose material information to clients would include:

- An adviser fails to disclose all fees that a client would pay in connection with the advisory contract, including how fees are charged, and whether fees are negotiable;[6]

- An adviser fails to disclose its affiliation with a broker-dealer or other securities professionals or issuers; and[7]

- An adviser with discretionary assets under management fails to disclose that it is in a precarious financial condition that is likely to impair its ability to meet contractual commitments to clients.[8]

II. Trade Allocations

The staff generally scrutinizes trade allocation practices during examinations because there is a potential for clients to be harmed or defrauded if allocations are contrary to the clients' expectations. It is a good internal control practice for an adviser to adopt and implement strict trading policies and procedures. Described below are examples of how an adviser can defraud clients by allocating trades inequitably among clients:[9]

- An adviser may defraud its clients when it disproportionately allocates hot initial public offerings ("IPOs") to favored accounts, and does not adequately disclose this practice to all clients.[10] For example, allocations of IPOs may be inequitable when the following types of accounts are favored: proprietary accounts; accounts that pay performance-based fees; accounts that have relatively poor performance; and new investment companies (in order to boost performance to attract additional assets).

- An adviser may defraud its clients by waiting to decide how to allocate a trade among its clients' accounts based on subsequent market movements.[11] The concern is that the adviser could allocate the trade to favored clients if the price movement was favorable and allocate the trade to other accounts if the price movement was unfavorable. This practice is known as "cherry-picking," and violates the Advisers Act.

- An adviser may defraud its clients when it fails to use the average price paid when allocating securities to accounts participating in bunched trades and fails to adequately disclose its allocation policy. This practice violates the Advisers Act if securities that were purchased at the lowest price or sold at the highest price are allocated to favored clients without adequate disclosure.

III. Advertising Representations to Clients

The Advisers Act prohibits advisers from making misleading statements or omitting material facts in connection with conducting an investment advisory business.[12] The following are examples of false advertising or other misrepresentations to clients found during examinations:

- The use of testimonials, which include any statement of a client's experience with the adviser or a client's endorsement of the adviser. Testimonials are prohibited under the Advisers Act.[13]

- A representation or implication that the adviser has been sponsored, recommended or approved, or that its abilities or qualifications have

in any respect been passed upon by the Commission or any officer of the Commission. This is prohibited by the Advisers Act.[14] Also, the staff has taken the position that the use of the initials R.I.A. ("Registered Investment Adviser") following a name on printed materials would be misleading because, among other things, it suggests that the person to whom it refers has a level of professional competence, education, or other special training, when in fact there are no specific qualifications for becoming a registered investment adviser.[15]

- A reference to past, specific, profitable, recommendations made by the adviser, without the advertisement setting out a list of all recommendations made by the adviser within the preceding period of not less than one year, and compliance with other specific conditions.[16]

- A representation that any graph, chart, formula or other device can, in and of itself, be used to determine which securities to buy or sell, or when to buy or sell such securities, or can assist persons in making those decisions, without the advertisement prominently disclosing the limitations and the difficulties regarding its use.[17]

- A representation that a report, analysis or other service was provided without charge, when the report, analysis, or other service was provided with some obligation.[18]

IV. Performance Claims

The staff carefully scrutinizes an adviser's performance claims, calculations, and supporting documents because clients and potential clients may consider the adviser's performance an important factor in selecting an adviser. Advisers frequently represent that their performance results are presented in compliance with the Performance Presentation Standards of the Association of Investment Management and Research ("AIMR Standards"). While the Commission does not endorse or enforce AIMR Standards, an adviser's inaccurate claim of AIMR compliance may constitute a false and misleading statement, which may violate the Advisers Act.[19]

In addition, other examples of performance claims that may be fraudulent include:

- Creating distorted performance results by constructing composites that include only selected profitable accounts, or are for selected profitable periods;[20]

- Comparing the adviser's performance to inappropriate indices (*e.g.*, stating or implying that a dissimilar index is comparable to the adviser's investment strategies);[21]

- Representing or implying that model or backtested performance is actual performance;[22]

- Failing to deduct the adviser's fees from performance calculations, without disclosure;[23]

- Representing falsely the adviser's total assets under management, credentials, or length of time in business; and

- Incorporating a predecessor adviser's performance into the adviser's advertised performance returns in a misleading manner, or when it is otherwise inappropriate.[24]

Advisers must also maintain records that substantiate their performance claims.[25] The staff has found that the most reliable substantiating records are third-party records, such as brokerage or custodian statements.

V. Personal Trading

The staff reviews personal trading practices of investment advisers closely during compliance examinations because of the potential for abuse. Examples of advisers' abusive personal trading activities prohibited by the Advisers Act[26] include:

- Trading in securities for personal accounts, or for accounts of family members or affiliates, shortly before trading the same securities for clients (*i.e.*, front-running), and thereby receiving better prices; and

- Directing clients to trade in securities in which the adviser has an undisclosed interest, causing the value of those securities to increase to the adviser's benefit.[27]

An investment adviser and its advisory representatives must maintain adequate records of personal securities transactions. These records must include: a description and amount of the security transaction; the date and nature of the transaction; the price at which it was effected; and the name of the broker, dealer, or bank that effected the transaction. Personal securities transactions must be reported to the advisory firm not more than 10 days after the end of the calendar quarter in which the transaction was effected.[28]

VI. Advisory Agreements

A review of investment advisory agreements is a standard component of compliance examinations because these agreements play an important role in defining the adviser's relationships with clients. It is critical that advisers operate in conformity with representations made in investment advisory contracts. Examples of when an adviser would be cited for failure to fulfill a contractual obligation include:

- Calculating advisory fees differently than the methodology agreed to in the contracts;

- Failing to comply with clients' wishes concerning directed brokerage arrangements; and

- Causing clients to invest in securities that are inconsistent with the level of risk that clients have agreed to assume.

An adviser's failure to fulfill a contractual obligation may constitute a material misrepresentation in violation of the Advisers Act.[29]

VII. Books and Records

The Advisers Act requires advisers to make and keep true, accurate, and current certain books and records relating to their investment advisory business.[30] During an examination, the examination staff will request copies of, or access to, the required books and records. Among other things, the books and records are reviewed and reconciled to confirm their accuracy, detect any omissions, and identify possible conflicts of interests and internal control weaknesses. An adviser's books and records may be found deficient for the following reasons:

- The books and records are incomplete, inaccurate, or otherwise inadequate;
- The adviser does not make or receive the required books and records; or
- The books and records are not maintained or preserved as required.[31]

VIII. Referral Arrangements

The Advisers Act establishes requirements that must be met if an investment adviser pays a cash fee for client referrals or solicitations. An adviser who pays cash solicitation fees must disclose its referral arrangements. The adviser also must maintain certain related records. The examination staff will confirm that the adviser maintains these records, including copies of: the written agreements between the adviser and the referring party; the referring party's written disclosure documents; and all clients' acknowledgments of receipt of written disclosure documents from the adviser and the referring party (which must be signed and dated). Also, the examination staff will confirm how the adviser ascertained whether the referring parties have complied with their contractual obligations.[32]

IX. Use of Brokerage

Investment advisers must use client assets for the benefit of clients, and must disclose certain information about their brokerage practices.[33] Advisers also have a duty, in executing client securities transactions, to seek to obtain the best net price reasonably available under the circumstances. If advisers use client brokerage to obtain research or other products and services, they must fully and accurately disclose this practice to clients. Some examples of violative activity the examination staff have found in this area include:

- An adviser allocates client brokerage to a broker in exchange for client referrals without full disclosure of the practice, or the fact that clients pay higher brokerage commissions and do not obtain the best

price and execution.[34]

- An adviser allocates client brokerage to a broker in exchange for research or other products without disclosure.[35]

X. Custody or Possession of Client Assets

Investment advisers with custody or possession of advisory client funds or securities must comply with the custody rule of the Advisers Act.[36] An adviser is deemed to have custody if it directly or indirectly holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. Actual possession of client funds or securities is not necessary to subject an adviser to the custody rule -- access and control is sufficient.[37] The custody rule is designed to protect clients by requiring advisers to institute certain safeguards, including making additional disclosures and maintaining additional records.

During examinations, the staff has identified certain situations where an adviser may not realize that its practice constitutes custody under the Advisers Act even though it may not have physical possession of client assets. For example, an adviser has custody if it:

- Has a general power of attorney over a client's account;
- Has signatory power over a client's checking account;
- Maintains an omnibus-type account in its own name at a broker or bank in which client securities are maintained after trades settle;
- Obtains its advisory fees by directly billing client custodians without effective oversight by the client or an independent party;
- Serves as a trustee of client trusts; or
- Acts as the general partner of a limited partnership client.

The Commission's staff has issued several no-action letters in which it has identified certain situations in which the custody rule does not apply, or as to which it would not recommend enforcement action, provided that certain conditions are met.[38] If an adviser has custody over client funds or securities, the examination staff will confirm that the adviser either complies with the custody rule under the Advisers Act,[39] or follows the conditions set forth in an applicable no-action letter.

XI. Recidivism

The examination staff closely reviews the actions that advisers have taken to remedy the deficiencies cited during past examinations. Examiners have found instances where advisers have failed to correct violations cited during prior examinations, even after representing to the staff in writing that such violations would be corrected promptly. These violations may be subject to enforcement action, if appropriate.

XII. Inadequate Internal Control and Supervisory Procedures

A primary responsibility of an investment adviser is the supervision of its employees, to ensure that all of its activities comply with disclosures made to clients and with the provisions of applicable securities laws.[40] The most effective way to fulfill this responsibility is to construct and implement a comprehensive system of internal controls and supervisory procedures. Particular attention should be given to controls in those areas of an adviser's activities that pose the greatest potential for creating conflicts of interest or other results that can harm clients. During an inspection, examiners carefully evaluate advisers' internal controls and supervisory procedures. The following examples illustrate weaknesses in internal controls found during examinations:

- An investment adviser's operating procedures allow a portfolio manager to value the securities recommended, or override values provided by a custodian, for purposes of reporting to clients and calculating advisory fees without any independent review. A strong control environment would provide for a separation of duties and proper management oversight of pricing overrides.

- An investment adviser establishes comprehensive written control procedures, but does not properly monitor its business activities for compliance with these procedures. For example, an adviser's insider trading policy states that access persons may not trade shares issued by companies on a "restricted list," yet the adviser does not review personal securities transactions to ensure that inappropriate transactions did not take place.

- An investment adviser does not have an oversight process, other than that performed by the portfolio manager responsible for managing an account, to determine whether risks taken in managing client portfolios are consistent with each client's stated investment objectives and/or to measure and evaluate each client's risk tolerance.

* * * * *

We hope that this letter will assist investment advisory personnel in reviewing their firm's compliance, supervisory and internal control procedures, and foster compliance with the Advisers Act.

Sincerely,

Lori A. Richards
Director

Footnotes

1 The Commission's website contains a page (http://www.sec.gov/divisions/investment/iard/iastuff.shtml) with links to both the Advisers Act and the rules thereunder.

[**Webmaster's note:** footnote updated July 5, 2001.]

2 Section 204 of the Advisers Act requires investment advisers to produce the books and records required under the Advisers Act upon the request of the Commission's examination staff.

3 The comments outlined in this letter represent the views of the staff and are not necessarily those of the Commission. The information in this letter should not be used as a substitute for the Advisers Act and related rules, forms, instructions to the forms, no-action letters, interpretive letters, and releases, all of which are publicly available. Of course, this letter does not discuss all provisions of the Advisers Act and the rules thereunder with which advisers must comply. In addition, this letter is not intended to provide legal advice. You should direct all questions regarding specific aspects of your advisory business to legal counsel. [**Webmaster's note:** footnote updated November 28, 2001.]

4 *See S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

5 Among other required Commission filings, each Commission-registered investment adviser must indicate whether it remains eligible for Commission registration within 90 days of the end of its fiscal year by completing and filing Part 1A, Item 2 of Form ADV (Rule 204-1(a)(1) under the Advisers Act). [**Webmaster's note:** footnote updated July 10, 2001.]

6 Form ADV, Part II, Item D.

7 Form ADV, Part 1A, Schedules A and B, and Section 10 of Schedule D. Form ADV, Part II, Items 8 and 9. [**Webmasters' note:** footnote updated July 10, 2001.]

8 Rule 206(4)-4(a)(1) under the Advisers Act.

9 *See* Section 206 of the Advisers Act.

10 *See In re F. W. Thompson Company, Ltd.*, Advisers Act Release No. 1895 (Sept. 7, 2000). [**Webmaster's note:** footnote added November 28, 2001.]

11 *See In re James L. Foster, Laurie F. Foster, Steven M. Bolla, and William E. Busacker, Jr.*, Admin. Proc. File No. 3-10236 (June 20, 2000). [**Webmaster's note:** footnote added November 28, 2001.]

12 Section 206 of the Advisers Act and Rule 206(4)-1 thereunder.

13 Rule 206(4)-1(a)(1) under the Advisers Act.

14 Section 208(a) of the Advisers Act.

15 *See Mandell Financial Group,* SEC no-action letter (pub. avail. May 21, 1997).

16 Rule 206(4)-1(a)(2) under the Advisers Act.

17 Rule 206(4)-1(a)(3) under the Advisers Act.

18 Rule 206(4)-1(a)(4) under the Advisers Act.

19 Section 206 of the Advisers Act and Rule 206(4)-1(a)(5) thereunder.

20 *See Valicenti Advisory Services, Inc. v. SEC,* 198 F.3d 62 (2d Cir.1999).

21 *See Covator/Lipsitz, Inc.* (pub. avail. Oct. 23, 1981) and *Anametrics Investment Management* (pub. avail. May 5, 1977), SEC no-action letters.

22 *See, e.g., Clover Capital Management, Inc.*, SEC no-action letter (pub. avail. Oct. 28, 1986). *See also In the Matter of LBS Capital Management, Inc.*, Advisers Act Release No. 1644 (July 18, 1997).

23 *See Investment Company Institute*, SEC no-action letter (pub. avail. Aug. 24,

1987).

24 *See Great Lakes Advisors, Inc.*, SEC no-action letter (pub. avail. Apr. 3, 1992).

25 Rule 204-2(a)(16) under the Advisers Act requires advisers to maintain "all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return used in advertisements."

26 Section 206 of the Advisers Act.

27 *See In the Matter of Roger W. Honour*, Advisers Act Release No. 1527 (Sept. 29, 1995). *See also In the Matter of John J. Kaweske*, Advisers Act Release No. 1539 (Nov. 27, 1995).

28 Rule 204-2(a)(12) under the Advisers Act.

29 Section 206 of the Advisers Act.

30 Rule 204-2 under the Advisers Act identifies the books and records that are required to be made and kept. Paragraph (e) of this rule states that certain of these books and records must be "maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on records, the first two years in an appropriate office of the investment adviser."

31 Paragraphs (e) through (g) of Rule 204-2 under the Advisers Act clarify the manner, location, length of time, and medium by which books and records must be maintained and preserved.

32 Rules 204-2(a)(10) and (15) and 206(4)-3 under the Advisers Act.

33 Form ADV, Part II, Items 8 and 12.

34 Section 206 of the Advisers Act. *See also In re Mark Bailey*, Advisers Act Release No. 1105 (Feb. 24, 1988).

35 For an extensive discussion of soft dollar examination findings, *see* Office of Compliance Inspections and Examinations, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, (Sept. 22, 1998). This report is available on the Commission's website at http://www.sec.gov/news/studies/softdolr.htm.

36 Rule 206(4)-2 under the Advisers Act.

37 *See* Advisers Act Release No. 1000. *See also Melville G. MacKay,* SEC no-action letter, (pub. avail. May 27, 1977).

38 *See John B. Kennedy* (pub. avail. June 5, 1996); *Blum Shapiro Financial Services, Inc.* (pub. avail. April 16, 1993); *Seth C. Warner & Co.* (pub. avail. April 18, 1985); *Crocker Investment Mgmt. Corp.* (pub. avail. April 14, 1978); and *PIMS, Inc.* (pub. avail. Oct. 21, 1991), SEC no-action letters. Advisers that are also registered broker-dealers are exempted from the custody rule provided that the broker-dealer is complying with the net capital requirements under the Securities Exchange Act of 1934 (Rule 206(4)-2(b) under the Advisers Act).

39 Among other things, the staff will confirm that the accountants performing the annual funds and securities verification and filing Form ADV-E (Rule 206(4)-2 (a)(5) and Schedule G (Form ADV, Part II, Item 14) have followed all requirements adopted by the Independence Standards Board ("ISB") for Auditors.

40 Section 203(e)(6) of the Advisers Act.

http://www.sec.gov/divisions/ocie/advltr.htm

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