compliance risk concepts

COMPLIANCE BULLETIN 03-14

turning risk into reward

A JW Michaels Company

> *Over the last couple of years, the Asset Management Unit has launched a series of innovative initiatives - often in partnership with OCIE - focusing on important regulations like the custody rule and on undisclosed principal transactions and conflicts of interest; identified funds with aberrational returns that engaged in misconduct and investment advisers with deficient compliance programs; and brought cases against boards that did not exercise their responsibilities to determine investment adviser fees or to value their funds' holdings properly.*

Excerpt from Keynote Address at Compliance Week 2014
Andrew Ceresney
Securities and Exchange Commission
Director of the Division of Enforcement
Washington D.C. • May20,2014

INVESTMENT ADVISER **BULLETIN**

RECENT SEC ENFORCEMENT ACTIONS PLACE GREATER EMPHASIS ON COMPLIANCE RULES

At CRC, we like to review the regulatory landscape to see how our clients' compliance programs fair against recent SEC enforcement actions. We've noticed a growing trend by the SEC to cite to the compliance rules (Rule 206(4)-7 under the Investment Advisers Act and Rule 38a-1 under the Investment Company Act), which require that advisers and boards of investment companies adopt policies and procedures that are reasonably designed to prevent, detect and correct violations of securities laws.

The SEC has recently brought enforcement action against advisers, investment companies and their boards for inadequate implementation and oversight of compliance policies and procedures. Below are four examples that touch on three important compliance mandates for advisers:

1) best execution practices and disclosures

2) valuation of securities, and

3) oversight of sub-advisers.

TALENT **SPOTLIGHT**

ABOUT THE AUTHOR: **VALERIE PIERRAT**

Valerie Pierrat is an accomplished compliance professional with over 15 years of experience in Financial Services combining compliance and operations knowledge with integrity to effectively balance needs of clients, independent board members and management. She has been repeatedly successful in meeting diverse challenges related to a changing regulatory environment, institutional client/board relations, and business implementation.

Valerie has managed a broad range of compliance matters related to registered investment vehicles, including– board consolidation and committee structure, oversight of third-party service providers, contract reviews, liability and D&O/E&O insurance requirements, proxy voting, and SEC exams. Having been previously employed by some of the nation's largest financial institutions, Valerie has managed compliance matters for top international asset managers, and most recently served as Chief Compliance Officer for the wealth management division of a large national bank, where she developed and implemented compliance programs for both the bank's registered investment adviser and its proprietary mutual fund.

Valerie graduated from Tuft's University with a Masters of Fine Arts and received her Executive Masters of Business Administration from Claremont Graduate University.

VALERIE PIERRAT

Senior Compliance Consultant- CRC

1

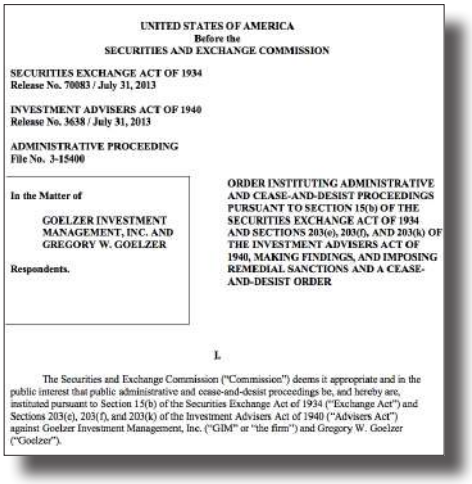
In the Matter of Goelzer Investment Management, Inc., *et al*,

Investment Advisers Act of 1940

Release No.3638 (July 31, 2013)[1]

Summary:

Compliance Failures Related to the Duty to Obtain Best Execution.



UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70083 / July 31, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3638 / July 31, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15400

In the Matter of

GOELZER INVESTMENT MANAGEMENT, INC. AND GREGORY W. GOELZER

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Goelzer Investment Management, Inc. ("GIM" or "the firm") and Gregory W. Goelzer ("Goelzer").

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Violation:

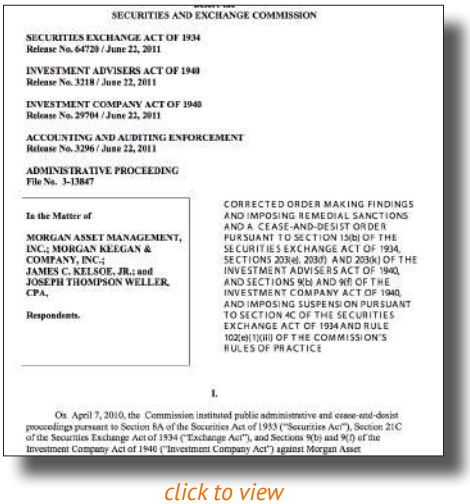
The SEC alleged GIM had "...inadequate compliance policies and procedures in effect to ensure that it sought best execution for its clients consistent with its statements in its Form ADV Part II and Part 2A.... GIM failed to adopt and implement compliance policies and procedures reasonably designed to prevent and detect misrepresentations by GIM such as the representations about the firm's broker selection policy described in GIM's Form ADV Part II and Part 2A." GIM settled these charges at a cost of nearly $500,000.

[1] *In a separate, but similar enforcement action, the SEC alleged that a dually registered broker-dealer and investment adviser had failed to conduct sufficient analysis in approving itself as executing broker for client trades. The SEC asserted that the firm also failed to implement its own best execution policies and procedures. In addition, the SEC alleged the adviser was in violation of the compliance rule under the Investment Company Act. The firm settled these charges at a cost of nearly $1 million. (See **A.R. Schmeidler & Co., Inc.**).*

2 In the Matter of Morgan Asset Management, Inc., *et al*, **Securities and Exchange Act of 1934** **Release No.69288** (June 22, 2011)

Summary:

Compliance Failures Related to the Valuation of Securities.



SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 64720 / June 22, 2011

INVESTMENT ADVISERS ACT OF 1940
Release No. 3218 / June 22, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29704 / June 22, 2011

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3296 / June 22, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-13847

In the Matter of

MORGAN ASSET MANAGEMENT, INC.; MORGAN KEEGAN & COMPANY, INC.; JAMES C. KELSOE, JR.; and JOSEPH THOMPSON WELLER, CPA,

Respondents.

CORRECTED ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, AND IMPOSING SUSPENSION PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e)(1)(iii) OF THE COMMISSION'S RULES OF PRACTICE

I.

On April 7, 2010, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Morgan Asset

click to view

Violation:

The SEC alleged the adviser had violated its fiduciary duty and committed fraud by:

1. misstating the value of the securities held in the funds that it managed;

2. omitting material information from the funds' board regarding the adviser's failure to adhere to the funds' stated valuation procedures; and

3. failing to fair value securities for which market quotations were not readily available.

In addition, the SEC alleged the adviser was in violation of the compliance rule under the Investment Company Act. The SEC stated that: "Morgan Keegan and Morgan Asset knowingly and substantially assisted the Funds' failure to implement fair valuation procedures, which resulted in prices that did not reflect current NAVs. Morgan Keegan, Morgan Asset, Kelsoe and Weller thereby willfully aided and abetted and caused the Funds' violations of Rule 38a-1." The fund's managers settled these charges at a cost of $200 million.

3 In the Matter of J. Kenneth Alderman, CPA, *et al*, **Investment Company Act of 1940** **Release No.30557** (June 13, 2013)

Summary:

Failure to Prevent Violations of Rule 38a-1 of the Investment Company Act.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. 30557 / June 13, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15127

In the Matter of

J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie W. Willis III,

Respondents.

Order Making Findings and Imposing a Cease and Desist Order Pursuant to Section 9(f) of the Investment Company Act of 1940

I.

On December 10, 2012, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against J. Kenneth Alderman, CPA ("Alderman"); Jack R. Blair ("Blair"); Albert C. Johnson, CPA ("Johnson"); James Stillman R. McFadden ("McFadden"); Allen B. Morgan Jr. ("Morgan"); W. Randall Pittman, CPA ("Pittman"); Mary S. Stone, CPA ("Stone"); and Archie W. Willis III ("Willis"), (collectively "Respondents" or "the Directors"). Respondents have submitted Offers of Settlement which the Commission has determined to accept.

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Violation:

The SEC brought enforcement action against all eight directors of the five registered investment companies advised by Morgan Asset Management. The SEC alleged the board had not fulfilled its obligation under the compliance rule to provide oversight of the adviser's policies and procedures, stating that: "It is a responsibility of a fund's board to ensure that the fund fulfills [its obligation to prevent violations of securities laws], particularly with respect to policies and procedures concerning the determination of fair value." No fines were imposed, but a "cease and desist" order signals the SEC's expectation of greater compliance oversight by fund boards.

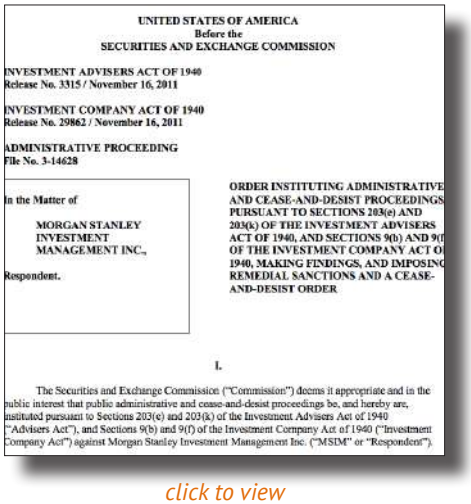
4 In the Matter of Morgan Stanley Investment Management, Inc.

Investment Advisers Act of 1940

Release No.3315 (November 16, 2011)

Summary:

Compliance Failures Related to Oversight of Sub-Advisory Services.



UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3315 / November 16, 2011

INVESTMENT COMPANY ACT OF 1940
Release No. 29862 / November 16, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14628

In the Matter of

MORGAN STANLEY INVESTMENT MANAGEMENT INC.,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Morgan Stanley Investment Management Inc. ("MSIM" or "Respondent").

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Violation:

The SEC alleged that Morgan Stanley had misrepresented to the fund's board the sub-advisory services being provided to the fund resulting in advisory fees being improperly charged to fund investors. The SEC further alleged that: "MSIM willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 by failing to adopt and implement written policies and procedures tailored to the firm's advisory business that were reasonably designed to detect and prevent Advisers Act violations. MSIM failed to adopt and implement procedures governing its oversight of AMMB's services and its representations and provision of information to the Board regarding those services in connection with the investment advisory contract renewal process." Morgan Stanley settled these charges at a cost of $3.3 million.

CONCLUSION

Recent SEC enforcement actions suggest its proactive review of compliance procedural matters may result in an increase in enforcement actions brought for lesser violations.

In light of the SEC's increased focus on how well advisers and boards of registered and unregistered investment companies provide compliance oversight, we urge our clients to take the following actions:

1. **REVIEW YOUR RISK ASSESSMENT –**
   While changes in your business may not warrant a full-blown risk assessment every year, your business practices may have evolved such that a focused review may be warranted. For example, if you are dually registered and have begun recommending your affiliated broker to execute client trades, you should review your best execution policies and procedures to ensure that:
   1) conflicts of interest are identified and controls implemented;
   2) your practices are consistent with your written procedures; and
   3) your disclosures to clients are consistent with your stated practices.

   Remember that the "duty of care" extends beyond lowest commission to include the broker's execution quality, financial solvency, responsiveness, and value of any research. Be sure that the analyses are conducted consistent with your procedures.

2. **TARGETED "GAP ANALYSES" -**
   Adopt a risk-based approach to align compliance practices with written policies and procedures. For example, your valuation procedures may need to go beyond the Accounting Standards Codification Topic 820 to include procedures for specific asset classes that you invest in. If you invest in fixed income or non-traded securities, your valuation procedures may benefit from a dedicated, specialized group that meets frequently and on an ad-hoc basis. Make sure you can explain how valuations are treated in different asset classes and how your procedures are being implemented.

3. **PRODUCE THE NECESSARY "COMPLIANCE ARTIFACTS" –**
   The SEC's focus on procedural matters will necessitate that advisers produce compliance artifacts that demonstrate:
   1) functionality;
   2) an auditable process; and
   3) consistency.

At CRC, we are committed to helping our clients stay ahead of the curve with targeted compliance solutions that fit your risk profile.

Valerie Pierrat- *Senior Compliance Consultant*
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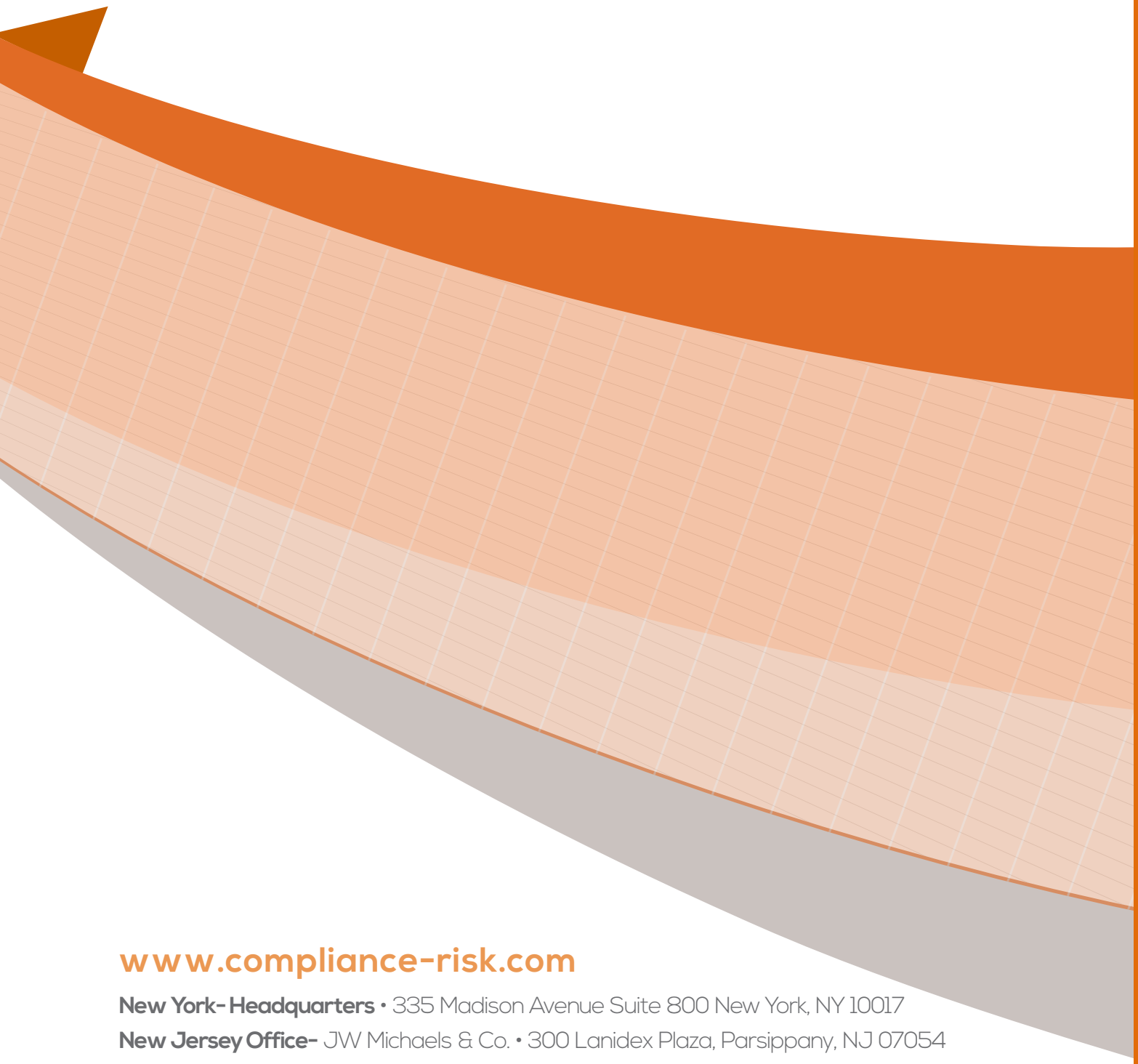

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