SEWARD & KISSEL LLP

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Memorandum to Our Investment Management Clients and Friends

SEC Holds CCO Outreach Seminar

The Securities and Exchange Commission (SEC) hosted a panel discussion in late 2005 addressing a number of issues and concerns facing Chief Compliance Officers (CCOs) of registered investment advisers. The seminar was divided into 4 segments: The Role of the Chief Compliance Officer; Exams and Inspections; Trading and Market Issues; and Other Regulatory Issues. Staff members of the SEC led a panel of experts in discussing each of the topics covered during the course of the seminar. The following is a summary of some of the key points addressed during the seminar:

1. The Role of the Chief Compliance Officer

Identification of the Chief Compliance Officer

- The panel indicated that the CCO can come from within the adviser (i.e., an employee of the adviser) or outside the adviser (i.e., an employee of a service provider).

- However, whether an insider or outsider, the panel stressed that the CCO must "be empowered to compel compliance" and influence the actions of the employees of the adviser.

- For those CCOs that are appointed from inside an adviser, the panel discussed the obvious conflicts that arise from the dual responsibilities of facilitating and generating business for the adviser and enforcing compliance procedures, which at times may hinder actions intended to further the success of the business.

Interactions of the Chief Compliance Officer within the Organization

- The panel noted that ongoing compliance is a task that must fall to each member of the adviser's organization and its outside service providers.

- Therefore, it should be the CCO's responsibility to manage compliance, while certain day-to-day compliance functions could be delegated to those employees running the operations of the adviser.

Expectations and Potential Liability of the Chief Compliance Officer

- The panel indicated that the CCO should help build a "culture of compliance".

- The CCO should be a respected, easily accessible, reliable individual.

- SEC staff members on the panel indicated that the SEC will generally not question the business judgment of the adviser in the selection of its CCO, but the staff may have a role in judging the CCO's qualifications for the job.

- The SEC staff members on the panel indicated that they did not intend to bring an enforcement action against a CCO individually, unless he or she:

    - facilitated a fraud,

    - participated in a fraud, or

    - covered up a fraud.

Annual Review

- The panel stated that the annual review should be:

    - a log of changes and evolutions that occurred throughout the year

    - an opportunity to focus on certain compliance issues that were not addressed during the course of the year.

2. Exams and Inspections

Approach to SEC Examinations

- The panel stressed that it is very important for the adviser to be accommodating and professional in order to lay the foundation for a trusting, ongoing relationship between itself and the SEC.

- The panel also stated that the SEC also strives to be as accommodating as possible during the examination process. For example, the staff members on the panel indicated that the SEC will invite feedback on the document request list sent to each adviser. If an examinee believes that a certain item on the list is unnecessary or too burdensome to provide, they should tell this to the SEC. The SEC cannot promise it will remove an offending item from the list, but it will try to work around the issue or request alternate documentation.

Examination Process

- During the course of an examination, the panel stated that the SEC views the CCO as a facilitator and "point person" for the examination process. The CCO is not expected to have an answer to every question it poses, but the CCO should know where to find the answers.

- During the exam, the SEC will conduct interviews with employees of the adviser besides the CCO.
    - These individuals should be forthcoming and truthful with the information they provide.
    - To help streamline the interview process, the panel suggests that the CCO be present in order to keep each interview on track, ensure that accurate information is being conveyed, clarify issues that may appear confusing or unexplained, and interpret the differences between language used by the SEC and language used by those employees not initially involved with compliance.
    - Prior to the interview, the CCO should detail to all employees of the adviser the importance of being honest and the ramifications of dishonest behavior.
    - The CCO should prepare the interviewee for the interview and remind them to remain professional and refrain from being antagonistic with the examiner.
- The CCO needs to convey to its organization that compliance is not just the CCO's job, but that of every person in the firm. Part of being compliant is maintaining a "culture of compliance" throughout the organization.
- Prior to the examination, the SEC will provide the adviser with a document request list for an examination. The CCO should maintain copies of this list each time the adviser is examined and cross-reference each list to ensure consistent responses.
- In preparing for SEC examinations, many CCOs do a trial run using previous document request lists. In utilizing this tactic, the adviser will be better prepared if and when the SEC gives short notice for an exam (the SEC will typically give one week notice when dealing with small to medium-sized firms).
- Once the SEC completes an exam, it will conduct an exit interview with the adviser. It is important that both parties communicate during this process to ensure they have a common understanding of the results of the examination.
- If the firm is deficient in any matter, a deficiency letter will be sent within 60 to 90 days of the fieldwork for the examination.
- In responding to deficiency letters, the panel noted that speed in response is not always the best course of action.

- The SEC staff members on the panel indicated a preference for a detailed response specifying what actions have been taken since the examination and what actions the firm expects to take to rectify any deficiencies.

- The panel indicated that the SEC prefers this response to come from a senior officer of the firm and not from the firm's outside counsel.

- The deadline for a deficiency letter response is 30 days, but the SEC may accommodate a request for an extension. If the firm does not receive a response within 30 to 60 days of its response to the SEC, then it is likely that the SEC is satisfied. The adviser can also call the SEC directly to determine whether the SEC is satisfied with its response.

Examination Guidelines to Evaluating Adviser's Compliance

- The panel indicated that the SEC, in assessing the structure of a firm's compliance program, takes into account, among other factors, the size, type and nature of the firm, the CCO's role, to whom the CCO reports and the information flow from senior management.

- The panel indicated that the SEC will assess the knowledge and competence of the CCO, especially in the case of smaller firms.

- The panel indicated that the SEC will look for, among other things, the emphasis on ethical behavior, the regard for the federal securities laws, how open and forthcoming personnel of the adviser act with regulators, and if there are appropriate checks and balances in place to ensure compliance.

Rationale for Examination by the SEC

- Generally, in routine exams, the examiners look at the compliance program as a whole, and then focus on particular areas of concern. If the exam is routine, the examiners will look at the compliance program as a whole and then make decisions as to which areas of the adviser's compliance procedures they will focus.

- If the exam is targeted or for cause, the SEC will generally focus on one area from the outset of the examination.

- The examiners usually pay careful attention to certain core areas, including trading and execution, use of soft dollars, marketing practices, anti-money laundering policies, and business continuity and contingency policies.

- Additionally, the SEC will look for compliance policies and procedures that are specifically tailored to the adviser's business, and not simply generic procedures. Furthermore, it will look to confirm whether each employee with investment advisory responsibilities has seen, understood and acted in accordance with the

compliance procedures. The SEC will also look to confirm whether the adviser has revised its procedures in response to deficiences cited in previous examinations.

Relevant Risk Factors in Establishing Firm's Examination

- A risk-based approach will be applied in determining which advisers to examine based on many factors including:
    - a firm's responses on Form ADV,
    - assets under management,
    - nature of the business,
    - custody arrangements, and
    - disciplinary or regulatory history of personnel.
- If the examiners determine that effective compliance controls are in place throughout the organization, then the "risk rating" of that adviser may go down.

Factors in Determining Whether to Refer an Exam to Enforcement

- The panel explained that there is no bright line test for enforcement.
- The panel indicated most enforcement actions involve harm to investors or a degree of apathy towards compliance on the part of the adviser.
- The panel indicated that the SEC generally suggests enforcement only for those matters that require enforcement proceedings in order to be corrected.
- The panel indicated that the SEC generally will not recommend enforcement for mere technical violations.

3. **Trading and Market Issues**

"Best Execution"

- The panel stated that one of an adviser's most important duties is to ensure that all of its trades are done on a "best execution" basis.
- The panel stressed that there is no bright line test in determining best execution without a thorough evaluation.
- The SEC also clarified that the requirement to seek "best execution" also applies to trading in fixed income securities.

- During an examination, the SEC will look to see if:
    - there are controls in place to monitor execution
    - there was any client directed brokerage
    - there was any purchase of non-research services
    - the allocation was accurate, documented and disclosed
    - there were any conflicts of interest.
- The panel also stated that the SEC will pay careful attention to (i) the use of affiliated brokers, (ii) advisers who receive direct payments from brokers proportionate to their trading volume with such brokers, and (iii) disclosure of soft dollar arrangements.

Trading Errors

- The panel acknowledged that trading errors will occur from time to time.
- Upon discovery of a trading error, advisers were encouraged to take measures to rectify the error to the detriment of the adviser, not the client.

4. **Other Regulatory Issues**

During the final segment of the seminar, the panel addressed various topics that have been raised by a number of advisers.

E-mail Retention and Monitoring[1]

- The panel stated that the SEC will have access to all business records, regardless of whether they are required to be kept pursuant to the Investment Advisers Act of 1940 (Advisers Act).
    - Electronic documents will not be treated any differently than paper documents.
    - To that end, certain e-mail communications may be requested based upon an initial review of the adviser's compliance policies and procedures.
        - If the SEC discovers that any compliance procedures are weak, then the SEC will follow with a request for e-mails focusing on those areas of concern.

[1] The SEC has recently indicated that it will soon be releasing formal guidelines concerning e-mail retention. Such guidelines may expand on or supersede what the panel indicated.

        - Requests may be specific to a person and/or focused on a particular activity depending on facts and circumstances.

    - In order to facilitate such request in the most efficient manner possible, the panel noted that the SEC suggests that managers maintain e-mail in a "searchable" database.

- The SEC does not necessarily require that all e-mails be maintained.

    - If the adviser adopts a policy that does not require it to maintain all e-mails, it must implement a policy that ensures that e-mails that are necessary to be retained (under the "required books and records" rule under the Advisers Act) are in fact not being deleted. The deletion policy should be a "well thought out policy" that appropriately handles different types of e-mails.

    - Any e-mail deletion policy should have some sampling process built in to ensure that required records are not being destroyed.

        - To that end, the panel stated that the SEC would find it reasonable to have a policy to destroy research analysts' e-mails after 60 days, if during that 60 period there is a sampling process done and the sample indicates that none of these e-mails are captured under record retention rules.

        - The panel also indicated that the adviser may have a block of e-mails deleted after the 60 days, even though there is a risk that one or two e-mails might be destroyed that would have been captured under the record retention rules (as long as the sampling process is sufficiently executed).

- The panel discussed the impact of the attorney-client privilege on e-mail retention. The panel acknowledged the necessity to maintain the attorney-client privilege and suggested that such e-mails should be segregated from the adviser's database by including a key word, such as "Privileged", and sent to outside counsel for their review.

- Any policy designed to delete all SPAM e-mails is generally OK as long as the SPAM filter is legitimate and is monitored in some way to make sure that the filter is not inadvertently capturing and rejecting e-mails that would be covered by record retention rules.

- If instant messaging is used, there should be a retention system in place to capture relevant messages.

- The CCO should monitor e-mails, even if they are being reviewed electronically for certain key words.

Administering the Code of Ethics

- Ensuring compliance with the adviser's code of ethics is one of the most important and challenging tasks of the CCO.

- The panel described a number of ways to enforce a successful code of ethics.

    - For example, the panel stated that it is desirable for the CCO to compare profitable trades in employee accounts to the performance of the adviser's client accounts. If there is a large discrepancy in favor of the employee's account, it may suggest to the CCO that the employee has found a way to manipulate the code of ethics to advance his/her interests ahead of the adviser's clients.

    - In addition to testing, the CCO should actively ensure that employees are being forthcoming in their disclosure of personal holdings by reconciling various reports delivered by employees as required by the adviser's code of ethics. The panel stated that while reconciling all positions is not necessary, spot checks should be conducted on a routine basis. The panel also discussed the potential abuse by those service providers who have access to an adviser's clients' portfolio information. The panel indicated that it may be prudent to require that service providers with such access sign and acknowledge the adviser's code of ethics.

- The panel also stated that it would be prudent for third parties who have access to the adviser's portfolio positions to sign and adhere to the adviser's code of ethics.

Form ADV and IARD

- The CCO must be clearly designated on the adviser's Form ADV.

- It is imperative that the CCO's contact information (including e-mail address) be correct, as that is how the SEC will communicate with the CCO regarding annual filings.

Anti-Money Laundering

- The panel stated that there are proposed Treasury Rules which call for an AML program that looks at transactions rather than a "know your client" approach.

- The panel indicated that it did not believe the AML Program will include a required customer identification program.

- The panel noted that the Investment Advisers Association has a good model for AML procedures for smaller investment advisers who do not manage mutual funds.

Valuation Issues

- The panel noted that the CCO should not be assuming executive/business responsibility (e.g., the CCO should not chair a pricing committee).

- The CCO can and should observe the valuation process to ensure that it is done properly.

- Upon examination, the SEC will determine if valuation is a high risk area for the firm (i.e., does the adviser hold securities that are difficult to value, are securities held at different prices for different clients). If so, the SEC will inquire as to the reasons behind such discrepancies.

If you have any questions regarding this summary, please contact an attorney in the Investment Management Group at (212) 574-1200.

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