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INSIDE...

September 2, 2013

In a first, portfolio manager tossed from the industry for misleading firm CCO

This is a story you may want to print and tape to your firm's refrigerator. The **SEC** has fined a former portfolio manager $350,000 and barred him from the industry for five years for repeatedly lying to the firm's CCO about personal trades and "willfully" violating rules requiring disclosure of such trades.

This marks the agency's first use of Investment Company Act rule 38a-1(c) to bring charges against someone for misleading a firm CCO.

"I expect this case would encourage would-be wrong-doers to think carefully before attempting to mislead their CCOs," says **Kevin Goodman**, associate regional director for exams in the SEC's Denver regional office. "I believe this case will be a tool that CCOs can use to illustrate that no one in the firm is above compliance."

In a settlement announced Aug. 27th, the SEC asserts that **Carl Johns** altered brokerage statements, trade confirmations and pre-clearance approvals over several years to hide more than 600 personal trades that should have been pre-approved by the CCO at **Boulder** (Colo.) **Investment Advisers** ($705M in AUM). Johns couldn't be reached for comment.

Johns violated Investment Company Act rule 17j-1(d), which requires quarterly reports of personal transactions and an annual listing of holdings. He also ignored the firm's code of ethics, which calls for all transactions to be "pre-cleared by" the CCO. Johns annually certified "that he received, read, and understood the Code of Ethics," according to the SEC's settlement.

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OCIE meeting: Examiners could return in short order if compliance seems lacking

Apparently it's called a "corrective action review" and OCIE's projecting that it will occur in 5% of IA/IC exams. If examiners find many deficiencies and determine that compliance lacks the resources to deal with them, it will dispatch examiners back to the registrant within six to 10 months after the conclusion of the exam to check on the firm's progress.

This was revealed Aug. 28th at OCIE's Compliance Outreach meeting in Chicago. **IA Watch** was denied access to the meeting but sources who were there have relayed what occurred. It's the first of four announced outreach meetings this year (New York Sept. 13; Atlanta Sept. 25 and San Francisco Nov. 6).

According to the agency, these meetings "provide an opportunity for the SEC staff to identify common issues found in related examinations or investigations and

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More best practices to improve your business continuity plan

Just days after the **SEC**, **CFTC** and **FINRA** issued joint best practices for firm business continuity plans (**IA Watch**, Aug. 26, 2013), OCIE followed suit. Last week it released a new risk alert documenting "notable practices" and "lessons learned" after Hurricane Sandy slammed the nation's financial hub last year.

Although there's some overlap of best practices between the two documents (use of remote sites, review your BCP), the format of OCIE's differs in that it presents best practices, mistakes and suggestions. **IA Watch** has learned that OCIE issued its release because it alone did the sweep exams of some 40 investment advisers following Sandy (**IA Watch**, Jan. 14, 2013). It coordinated with FINRA and CFTC for the post-storm exams of other registrants, such as broker-dealers and exchanges – which produced the joint release.

You could summarize OCIE's release as advocating that you think ahead. It notes that some advisers kept written BCPs while others developed them "just prior to the storm's arrival." Those hardest hit had no or

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discuss industry practices" with "all senior officers, not just CCOs."

Last week's meeting was kicked off by **Timothy Warren**, the acting regional director in Chicago, and **Louis Gracia**, the co-acting associate regional director of the exam program in the Windy City, according to an agenda obtained by **IA Watch**. Other sessions looked at REITs, investment companies, the activities of the Enforcement Division's Asset Management Unit and small advisers.

Some 250 attendees came to the free meeting. Some were turned away at the door for not pre-registering, even though there were some open seats, sources tell us.

Stats on exams

Deficiency letters go to about 85% of firms examined, according to statistics shared at the meeting. Four in 10 contain significant findings and 12% are referred to Enforcement.

During Q&A, speakers were asked about examiners targeting CCOs. The answer came back that if the CCO "is a clear outlier [and] isn't doing what he's supposed to be doing … then they may go after a CCO," says an attendee.

Topics included the recent **Goelzer** case (IA Watch, Aug. 5, 2013), in which a firm was ordered to hire a CCO after best execution problems and the **Carl Johns** case (see story on page 1), that booted a portfolio manager for lying to a CCO. "They're hoping to have some more of these [Johns] cases" to help CCOs, the attendee says.

The **Feltl & Company** enforcement case (IA Watch, Jan. 9, 2012) also was raised to stress that "compliance cannot be on auto pilot," meaning compliance policies and procedures should be continuously reviewed.

An attendee found it odd that the SEC defined small advisers as those with fewer than 10 employees or managing less than $50 million in assets, "which wouldn't even be an SEC registrant."

IA Watch has received reports that consultants and even some firm generals counsel may have been purposely excluded from the Chicago meeting, too. SEC press staff didn't return an **IA Watch** inquiry into whether this was intended or OCIE's policy. ■

Oral arguments set for October in appeal of SEC v. SIPC case

The question of whether victims of the **Stanford** Ponzi scheme were customers who should have received some compensation from the **Securities Investor Protection Corp.** resurfaced recently when that Florida judge threw out a case against the **SEC** (IA Watch, Aug. 19, 2013).

You may recall the SEC sued SIPC over the Stanford case (IA Watch, Dec. 19, 2011). The SEC lost in federal court but appealed. The U.S. Appeals Court in Washington, D.C. has set Oct. 16th to hear oral arguments in the case. Attorneys for the two sides didn't return **IA Watch** inquiries.

The issue centers on whether certificates of deposit constitute securities. If they do, SIPC would have to compensate Stanford victims for some of their losses. SIPC refused to initiate a liquidation process in the Stanford case, attracting the SEC's ire. The SEC went to court to force SIPC's hand.

In court documents, the SEC admits the case won't answer the fundamental question "whether any of the Stanford victims qualify as 'customers' under SIPA." But it would demonstrate if the Commission can force SIPC to act. *(SEC v. SIPC, continued on page 3)*

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SIPC argues that Congress could never have intended to give the SEC that authority.

SIFMA, whose members fund SIPC, filed an amicus brief. It warns that SIPC's fund could "become exhausted" if the appellate judges are swayed to the SEC's view and that that would "increase the costs borne by investors" and SIFMA members. ■

Advisers to mutual funds and SMAs have a choice: one code or two

It's not uncommon for CCOs to oversee multiple entities these days, e.g., a mutual fund adviser and one that handles separately managed accounts. If you're in this situation, you can choose to go with one code of ethics across the structure or two.

Both Investment Company Act rule 17j-1 and Investment Adviser Act rule 204(a)-1 require a written code of ethics, but say nothing about whether they have to be separate. There are a few differences among the two that you may weigh as you decide.

Another factor to consider is that mutual funds must file their code of ethics along with their **SEC** registration statement, meaning that it can be seen publicly. Of course, many advisers post their code online anyway or openly invite the public to request a copy.

For years, **ProFunds Advisors** ($3.5B in AUM) in Bethesda, Md., kept separate codes but ultimately decided to combine them. "It's better to have one set of standards that you deliver to all employees with a consistent message," says **Victor Frye**, the RIA's counsel and CCO.

Separate codes also was the experience at past firms where **David Lui** worked. The CCO/risk officer at **Galliard Capital Management** ($85B in AUM) in Minneapolis, though, now believes "it's better to have one code." However, it may be easier for a compliance officer who's drafting the codes to keep them separate, he adds.

A CCO in a western state says it's easier to create one code and insert the names of both entities on the front cover and be done with it.

Reasons for separate codes

Todd Cipperman has witnessed firms using separate codes. The attorney at **Cipperman & Company** in Malvern, Pa., says there are advantages. "You may not want the board of the fund to get involved in issues that relate to the advisers," he says. For instance, regular reviews of personal trading by all access persons. Also, if you use a subadviser, that entity will have it have its own code anyway, he adds.

The two codes required by the Investment Company Act and the Advisers Act are basically the same, says **Judy Werner**, CCO with **Gardner Lewis** ($240M in AUM) in Chadds Ford, Pa. There are "some minor differences," e.g., the mutual fund may cover officers that don't apply to the advisory side of the business.

Sharing the code

Firms aren't shy about sharing their code of ethics. **Carnick & Company** ($250M in AUM) in Colorado Springs, Colo., maintains its code on its website. It reads, in part, that staff "will report all required personal securities transactions to" CCO **Craig Carnick**, except for automatic investment plans, treasuries and money market transactions.

Carnick tells **IA Watch** he hasn't tweaked his code of late but has stepped up the oversight of staff trading. He also pays for a mock audit annually. "I'd rather have the audit discover something than the SEC discover something," he says.

Charles Schwab openly shares its code of ethics. It directs that staff must regularly report "current holdings" that include at least "the title and type of security, and as applicable the exchange ticker symbol or CUSIP number, number of shares, and principal amount of each mutual fund and ETF; the name of any firm in which any mutual funds or ETFs are held; and the date the Access Person submits the report."

The code of ethics at **Saturna Capital Corporation** ($3.9B in AUM) in Bellingham, Wash., prohibits any access person "whether directly or indirectly" from giving or receiving "a Gift in excess of $100 per year to or from any person associated in any capacity with another firm. All Gifts must be reported to the Chief Compliance Officer within 30 days of receipt."

Here's an example from the code of ethics of **Century Management** ($1.9B in AUM) in Austin, Texas:

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One Code or Two (Continued from page 3)

No Access Person shall enter an order for his or her own account for the purchase or sale of a Reportable Security on a day during which any Client Account has a pending buy or sell order in the same Reportable Security until after the Client's order is executed or withdrawn.

You may also grab some ideas for your code from the one at **Luther King Capital Management Corporation** ($13.9B in AUM) in Fort Worth, Texas. It reads in part that "Access Persons must promptly report any actual or suspected violations of this Code of Ethics to the Chief Compliance Officer." The CCO "will report, at least annually, to the Board of Trustees of the Funds … any material violations of this Code and any procedures or sanctions imposed in response thereto." ■

More BCP Advice (Continued from page 1)

inadequate plans that didn't anticipate the need for employees to work from home or remote locations. On the smart side, OCIE notes that one adviser booked a suite of hotels rooms before Sandy rolled in.

Mistakes to avoid

Here are some examples of mistakes uncovered by OCIE's sweep:

√ Maintaining offices that weren't "geographically diverse"

√ Failing to require third-party vendors to annually test their BCPs and report the results to the adviser

√ Not keeping an updated list of vendor contacts

√ Neglecting to test "all critical business operations and systems" during BCP testing and

√ Opting "not to test their cloud-based disaster recovery solution because of the extra charge for this service. Consequently, these advisers did not secure contracts to provide back-up generators and did not know that there was insufficient capacity to handle all of their customers," writes OCIE.

Best practices to mimic

Best practices found during the sweep include:

√ Deploying multiple back-up servers

√ Moving sensitive electronic equipment to higher floors

√ Using wireless cards or multiple providers to access the Internet

√ Testing the ability to connect with vendors

√ Adding generator capability to power an entire building's electricity and air conditioning, and regularly testing the generator, perhaps weekly

√ Requiring business units to identify contingency scenarios and forming BCP planning committees stocked with business staff and senior managers

√ Picking back-up sites that run on a separate power grid and

√ Hiring answering services to provide updates to clients.

The release also notes that many "advisers stated that they are now exploring the use of cloud computing." It goes on to suggest you also may wish to reach out to clients before a storm hits to ask if they have any pressing transactions to make in case service was disrupted.

Some have questioned whether the Advisers Act even mandates that a firm have a BCP. The release states that an adviser's fiduciary duty to clients includes "taking steps to protect the clients' interests from risks resulting from the adviser's inability to provide advisory services after, for example, a natural disaster." It also quotes the compliance rule, which pushed BCP policies and procedures, stating that an adviser has a duty to provide client services after "a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel." ■

List of Treasury forms means bigger advisers may have to file at least one

While Forms ADV and PF may be close to your heart, know that there is a slew of other federal regulatory forms that certain advisers may have to complete. We've told you about **Treasury**'s Form SLT (**IA Watch**, March 12, 2012), but there are many others. But first, the good news.

The **Bureau of Economic Analysis** has rescinded its plan to require a U.S. person that owns more than 10% of a non-U.S. entity to report that to the BEA, says **Jason**

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Brown, a partner with **Ropes & Gray** in Boston. You'd know if the BEA expects that report from you because it's now by invitation only, he adds.

The other list of forms, including so-called TIC B forms, may have to be completed by investment advisers. The government uses the data to track the flow of capital internationally, to form policy and for the U.S. balance of payments accounts.

Take that Form SLT. If you hold more than $1 billion in reportable securities on the last business day of the month, you must file this document by the 23rd day of the following month. It can be transmitted electronically to the Treasury.

That $1 billion threshold can be hit in several ways. For example, if you manage a hedge fund that holds $500 million in non-U.S investments, plus have $500 million in investments from non-U.S. investors, you've hit it, says Brown.

There are exclusions for assets held by a qualified U.S. custodian or if your firm owns more than 10% of a company. However, once you have filed SLT, you must continue to submit it monthly through the end of the year, even if you drop below that $1 billion threshold, says Brown.

Here's a list of other forms you should be aware of:

- **Form S** tracks cross-border transactions of at least $50 million in any given month. A limited partner investment of that size in a Cayman Islands fund would prompt the filing responsibility. Other triggers could be buying a non-U.S. company, luring a non-U.S. investor into your fund or distributing the proceeds of a sale (excluding profits). Private equity fund managers would most likely be affected by this form, says Brown.
- **Form SHC** chronicles those holding at least $100 million in non-U.S. interest. This form doesn't have to be filed until 2017, so "you don't have to worry about that for awhile," says Brown.
- **Form SHC(A)** goes to the Fed but only if you've been asked to file it.
- **Form SHL** reports when non-U.S. investors enter a fund that tops $100 million. This report, which won't be due until August 2014, must be filed every five years.
- **Form SHL(A)** will be by invitation only; if you're not asked to submit it, you don't have to.

In addition, there are several so-called TIC B forms [Treasury International Capital Forms BC, BL–1, BL–2, BQ–1, BQ–2 and BQ–3]. These replace the old TIC C forms. You can find more information on these forms here.

Brown notes that Treasury dishes out penalties for ignoring these responsibilities, even as it recognizes there's widespread non-compliance. The government won't likely look back but may put more attention into catching current and future violators. Penalties range from fines up to $25,000 for each missed filing and even possible jail time for willful violators, says Brown. ■

Dual-Registrants

Firms criticize proposed expansion of insider trading monitoring

Groups representing the industry are calling for **FINRA** to ease provisions contained in its latest proposed supervision rule that would expand the categories of accounts that would need to be subject to procedures aimed at spotting insider trading. They say this proposed change would be impractical.

Industry groups criticized several portions of FINRA's proposed consolidation and update of the NASD and **NYSE** supervision rules, but among the proposed changes spurring the loudest outcry is one involving a requirement to supervise for insider trading the accounts at the firm held by certain family members of reps - even if these relatives are in-laws who have no financial ties to the rep or are grown children who have moved away and are financially independent.

This would replace a narrower requirement that focused on accounts of individuals in the rep's household or family where the rep has a financial interest or discretionary authority to make investment decisions or the person is financially dependent on the rep, **SIFMA** noted in it's comment letter.

Under the proposed new definition, a "covered account" would include "any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with the member where such account is introduced or carried by the member."

FINRA's rationale for the change is that insider trading typically involves relatives.

SIFMA said it's concerned that the proposal would omit the conditions that apply - for instance, that the rep has an interest in the account or the account holder depends on the rep financially.

Reps might not know that some of these relatives

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have accounts at the firm and it could be difficult for the reps to find that out, some commenters said.

There are "basic practical hurdles" to the proposed change, **Wells Fargo Advisors**' Director of Regulatory Policy **Robert McCarthy** wrote in a comment letter to the **SEC** regarding FINRA's proposal.

"Namely, a non-dependent relative may be uncomfortable disclosing private information such as personal financial status or social security numbers."

Read more from this story at www.iawatch.com.

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The CCO discovered "certain irregularities" and questioned Johns, who continued to mislead the officer. He allegedly swore that some accounts were closed when they weren't, the settlement reads.

A 'key employee' and a complete shock

Boulder Investment Advisers' current CCO **Stephen Miller** vividly recalls the case. Johns was a "key employee" and the discovery of his lies came "as a complete and utter surprise to everyone." Miller, who also is the firm's president, was CEO/general counsel at the time of the discovery.

Johns evaded detection for so long because he used fake documents. The CCO at the time, who **IA Watch** has decided not to identity, was "doing a very detailed job of looking at the pre-clearance records and holdings reports and found some inconsistencies and she just followed the trail," recounts Miller. The CCO has moved to another investment advisory firm and didn't return **IA Watch** calls and e-mails.

Boulder self-reported the case to the SEC "as soon as we had done our internal investigation," remembers Miller.

He hopes the case carries a message for the industry. The small firm, which serves four closed-end fund clients, runs a vigorous compliance program supported by owners who are very ethical "and they want to do the right thing," says Miller. The firm delegated "an abundance of authority" to the prior CCO and gave her "free rein to follow this from the beginning to the end," he continues. "She did a great job."

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