

IAWEEK

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January 17, 2011

Compliance lessons abound in Schwab settlement in bond fund case

Last week's \$119 million settlement between the SEC and **Charles Schwab Investment Management** (\$204B in AUM) in San Francisco supplies a virtual scorecard for needed compliance policies and procedures.

It also provides another example of the SEC settling with a firm while keeping alive its case against employees ([IA Watch](#) , April 16, 2010). One of those employees is the former president/CEO of the RIA **Randy Merk**, who remains with Schwab. The other is former employee **Kimon Daifotis**, who couldn't be reached.

In December, Schwab issued a little noticed news release that named a new head of the RIA and stated Merk "takes on a Special Project role for the firm." A spokesman for Merk said he "will fight the SEC's civil lawsuit. The SEC's claims are infected by hindsight bias and are not supported by the actual evidence."

The SEC claims the men misled investors and investment advisers when running the YieldPlus ultra short bond fund. The fund peaked at \$13.5 billion and boasted a 5-star rating from **Morningstar** before plummeting to \$1.8 billion in the financial crisis. It had the misfortune of being stocked with mortgage-backed and asset-backed securities.

One incident the SEC recounts in its [complaint](#)  stems from a 2007 conference call with eight RIAs. One of the advisers asks about redemptions and the Schwab portfolio manager answers they've had "very slight negative flows" when in reality \$2 billion had been pulled by
(Schwab, continued on page 4)

How's that Form ADV, Part 2 coming? Find help with this guidance

If you're like most advisers, you're nowhere near finishing your plain-English Form ADV, Part 2 brochure. Book extra time, turn to colleagues, use a template and edit the work, suggest peers.

Before **Kerrie Young**, CCO at **Ferguson Wellman Capital Management** (\$2.4B in AUM) in Portland, Ore., sat down to the task she envisioned simply cutting and pasting from her firm's existing Form ADV. "It's really not that simple," she cautions.

Translating legalese to plain-English proved a challenge for **Stephanie Brown**, CCO at **Merriman** (\$1.3B in AUM) in Seattle, too. Merriman decided "we would end up with a better product if we started with a fresh slate," says Brown. Both firms employed templates [[IA Watch](#)  features templates and tools for Form ADV, Part 2. Find them by clicking [here](#)  ([IA Watch](#) , Oct. 18, 2010)]. *(Form ADV 2, continued on page 2)*

On eve of SRO-for-RIA study, lobbyists push their competing views

This is the week the SEC is to deliver to Congress its so-called section 914 study ([IA Watch](#) , Dec. 13, 2010). Many believe the Dodd-Frank study will tip the Commission's hand on the issue of an SRO for advisers.

Last week, **SIFMA wrote**  the SEC urging it to create an SRO for RIAs that provide advice to retail customers. It tied the issue to another study that should be out soon on fiduciary duty and harmonization of investment adviser and broker-dealer rules. "RIAs should be subject to comparable examination and enforcement [as brokers], which appears to be practically and readily achievable through use of an SRO," wrote **Ira Hammerman**, SIFMA's senior managing director/general counsel.

Institutional advisers could stay with the SEC, it reads. The letter argues an SRO is appropriate for retail advisers because they're smaller and "do not have substantial legal and compliance departments."

The letter acknowledges limited government resources and the SEC's inability to examine smaller advisers. It
(SRO To & Fro, continued on page 3)



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Form ADV 2 (Continued from page 1)

In Young's case, the brochure's "coming together pretty well." The toughest part was Item 12: Brokerage Practices. She decided to hand off that section to her trading department for it to take the first shot.

Best practices for completing the brochure

Brown expects her brochure to be completed by the end of this month, along with the firm's 15 supplements. She began in December by assembling a 10-person project team loaded with business staff. They considered outsourcing to a law firm but felt the price quotes (\$5,000-\$7,000) were too high. The RIA negotiated a flat fee (\$4,250) for a law firm to review the first and final drafts.

Fortunately, Brown found a gifted writer among her staff. She put together a bulleted list of the questions that must be addressed in each section of the brochure and went over the list with him. He produced a draft, which Brown and another colleague edited. They brought in a copywriter who checked grammar and further cleaned things up.

The revised draft then went to the project team. It included the heads of research, finance, the client service team and trading. Each got a week to read the entire brochure and suggest revisions.

Then the document went to the lawyers. The law firm discovered a few risks Merriman had missed. The attorneys sent back comments, including language drafted for the overlooked risks. Throughout the brochure, the lawyers urged the RIA to use less of "we" and more of the firm's name but Brown prefers the plain-English flow of the pronoun.

"It's been a lot of work," concedes Brown. "In the end, it's really going to come out to be a great product."

She estimates it's taken 50 hours thus far.

An added dividend is the effort has sparked the firm to find new ways to fine-tune its code of ethics.

Brochure supplements

Brown simplified her work by e-mailing reps with a list of questions (e.g., their education and employment history and disclosure requests). She gave them a few days to respond. She pasted their answers into individual supplements. The firm is adding color and pictures to sweeten the look.

Survey shows progress on brochures

Last week the **National Society of Compliance Professionals** released a [survey](#) of 295 RIAs inquiring about their progress with their Form ADV, Part 2 brochures. About one in five answered they've already finished. Of these, 47% answered that the process consumed more than 10 hours. Given the way NSCP asked the question, the group believes that "it may be the case that considerable more time than ten hours was needed to complete the brochure." Stephanie Brown would agree.

NSCP concludes that respondents by and large don't regard the new brochure as "an onerous task." About the same percentage found the job easy (15%) as difficult (17%).

Most of the respondents (79%) drafted the brochure in-house, even if they ultimately had it reviewed by an attorney or a consultant. Taken as a whole – including those who haven't finished their brochures – about a third have used or plan to use a commercial template, nearly 40% will or have drafted it themselves and 15% will hire someone to draft it.

(Form ADV 2, continued on page 3)

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Form ADV 2 (Continued from page 2)

The most challenging aspects were the supplements and Item 8: Methods of Analysis, Investment Strategies and Risk of Loss [the firm must explain material risks attached to each “significant” investment strategy it uses]. The next toughest was Item 12: Brokerage Practices [must explain how the firm selects brokers and their compensation and address conflicts like soft dollars].

NSCP believes client base won't influence completion of the brochure. It also finds that nearly 30% of respondents plan to produce individual brochure supplements while about 16% anticipate group versions. Others are undecided or will do a mix.

Editor's Note: Find more guidance on completing the brochure and supplements at the [13th Annual IA Compliance Best Practices Summit](#) in Washington, D.C., March 21-22. Click <http://www.iawatch.com/2011summit/intro.html>.

SRO To & Fro (Continued from page 1)

also pushes for a “fresh start” in thinking about RIA exams and advocates that, if there is to be more than one SRO, the dually registered firms should choose their regulator.

Also last week, the **Financial Planning Coalition** ([IA Watch](#), Jan. 3, 2011) repeated its opposition to an SRO for advisers, which would need congressional approval. But if one comes to pass, **Dan Barry**, director of government relations at the **Financial Planning Association** in Washington, stated he hopes the SRO would function exclusively for advisers, consist of a board made up mostly of public citizens and maintain a process to hear from experts in the field.

IA Watch Exclusive

NYC announces pension placement agents must register as lobbyists

If your firm uses a placement agent to lobby for New York City pension business, the agent may well have to register as a lobbyist in the Big Apple. **IA Watch** has received a copy of a [letter](#) sent by the city to investment advisers alerting them to a new legal interpretation that regards agents, solicitors, finders and the like as lobbyists.

We just told you about a new California law that basically mirrors New York's ([IA Watch](#), Jan. 10, 2011). The New York letter, dated Dec. 29, 2010, states the new legal interpretation applies the city's lobbying law to “placement agents, other third parties retained by investment firms, and employees of investment firms” when they seek to influence investment decisions by the city's five pension boards.

A placement agent also would have to register a client, such as an RIA, if the firm would likely receive or expend \$2,000 a year on lobbying New York City officials.

“Beginning in January 2011, this office will be reviewing the activities of individuals, businesses, and organizations that, as of January 1, 2011, are attempting to influence investment decisions made by the pension funds and retirement systems of New York City,” writes **Patrick Synmoie**, counsel to the City Clerk. Synmoie tells **IA Watch** the letter will be sent to nearly 800 entities nationwide, including advisers, placement agents and marketers. He says the deadline to register has been extended to Feb. 15 to give affected entities additional time.

(Pension Lobbyists, continued on page 4)

Summary of Investment Adviser and Broker-Dealer SEC Enforcement Cases FY 2010 v. 2009

Total enforcement actions against investment advisers increased significantly in fiscal year 2010, according to [new data](#) released by the SEC. As this table demonstrates, administrative proceedings against advisers surged from Oct. 2009-September 2010, while actions against broker-dealers fell. The new report sustains the trend toward greater enforcement of insider trading cases, which rose to 53 in 2010 from 37 the prior year ([IA Watch](#), Dec. 14, 2009). The number of investor contacts (complaints and questions) to the SEC jumped 6% to 87,222 in FY 2010. These numbers have increased consecutively for the last seven years. The top complaint was advance fee fraud, with misrepresentations by investment advisers and others coming in at number six on the list of the top 10.

Regime	Civil Actions 2010	Civil Actions 2009	Adm. Proceedings 2010	Adm. Proceedings 2009	Total 2010	Total 2009	% of Total 2010	% of Total 2009
Investment Advisers	29 (115)	29 (171)	78 (106)	47 (56)	107 (221)	76 (227)	16%	11%
Broker-Dealers	6 (9)	26 (77)	64 (86)	83 (105)	70 (95)	109 (182)	10%	16%

Source: Comparison of SEC's FY 2010 and FY 2009 *Select SEC and Market Data* report. The first number captures total actions; parenthetical numbers refer to individuals involved.