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INSIDE...

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Pointers for filling out the most challenging parts of the supplements

If you've taken a crack at the new supplements, odds are difficulty arose when tackling outside business activity, additional compensation and supervision. The **SEC**'s recent FAQs provide help but go only so far (**IA Watch**, March 28, 2011).

Outside business activity

If the rep owns another business, it should be listed. **Stephen Galletto**, an associate with **Stark & Stark** in Lawrenceville, N.J., thinks of a client who runs an ice cream shop part of the year that brings in considerable income. He also recommends a rep disclose if he's a licensed insurance agent. Disclosure examples include:

> ***Nathan Sorum*** *is also licensed as an insurance agent and is in the business of selling life, health, long-term care, fixed annuity, and disability insurance products. Mr. Sorum may receive normal commissions through the sale of these insurance products which creates a similar potential conflict of interest as in the previous paragraph.*
>
> *Ms.* ***[Elizabeth] Anderson*** *teaches classes, typically for several days at a time several times per year, intended to prepare trust bankers to sit for the Certified Trust Financial Advisor exam, which is administered by the American Bankers Association.*

*This is not applicable to this supervised person [****Mark 1 Asset Management****].*

Additional compensation

(Part 2B Pointers, continued on page 3)

Brochure supplements vary as firms grapple with who to include in them

One brochure supplement appears as dry as the Mojave. Another springs to life like a TV commercial. A third highlights the **SEC**'s instructions in red and the firm's text in black. These examples demonstrate the various shades of brochure supplements emerging from the Commission's new rules.

"The only way you're going to get [clients] to crack this open is if it looks pretty," reasons CCO **Stephanie Brown** at **Merriman** in Seattle. "I really wanted this to fulfill its purpose" of being read and understood by clients, says Brown. Her firm's supplement crackles with energy and is rich in color and pictures of advisers. It offers multiple versions, a smaller PDF so as not to clog a recipient's e-mail box and a high-resolution one bound for a printer's press.

Pictures are sprinkled throughout the brochure of **Joseph Capital Management** in Hernando, Fla. "It needs to serve both functions" – regulatory compliance

(Brochure Supplements, continued on page 2)

Keep ERISA's rules in mind when giving gifts to potential plan clients

Say your firm meets with officials from an ERISA plan to discuss managing their assets and the morning evaporates. Can you offer to take your visitors to lunch?

In a word, yes – but keep ERISA's sometimes tricky rules in mind. Part of ERISA's rules dissuade auditors from quibbling over "insubstantial" items. The **Department of Labor**'s enforcement manual classifies these as amounting to less than $250 in "aggregate annual value," items such as "gifts, gratuities, meals, entertainment, or other consideration (other than cash or cash equivalents)." It would also permit reimbursement for certain educational expenses.

It's a best practice for ERISA plans to maintain gifts and entertainment policies, which could be stricter than this de minimus exception, so ask your plan officials about theirs.

Be aware of ERISA section 406(b). It prohibits

(ERISA Rules, continued on page 4)

Brochure Supplements (Continued from page 1)

and marketing – says CCO **Ron Rhoades**. He elected to squeeze the brochure and supplement containing all eight reps into one 81-page document. On the upside, "it simplifies your life" for delivery; on the downside, Rhoades anticipates it will mean more amending of the document throughout the year (but only uploading anew for material changes).

See the table on page 3 for deadlines for delivery of the brochure supplements. IAWatch.com also includes more than 15 examples of Form ADV, Part 2b brochure supplements. Find them all by clicking here, including another supplement that features pictures.

The supplement for **Mark I Asset Management** in Oklahoma City, Okla., stands out because president **Nicholas Harroz** purposely wrote under SEC instructions left in red. "I did that as more of a legal move," he says. If the document ever lands in court, he could point out what was verbatim taken from the government. Ironically, one client called to express confusion about a line of text and Harroz proudly pointed out those words originated at the SEC.

Who should be a subject of a supplement?

Ambiguity in SEC text leads firms to question who should merit a supplement (see story on page 1). The SEC's instructions clearly state a supplement is deemed for any staffer "who formulates investment advice for a client and has direct client contact" or "has discretionary authority over a client's assets," the latter even if the person lacks direct client contact.

Rhoades lumped all of the firm's advisers into one document. Brown stuffed 15 of the firm's 40 employees into hers. Both eschewed the Commission's relief allowing firms to highlight only the top team of five people "with the most significant responsibility for the day-to-day discretionary advice" for the client. Brown believes clients are "going to want to see who they're going to be working with," even if it were someone outside the top five.

There's general agreement that everyone on a firm's investment committee should be in a supplement, unless you go with the top five team approach. **Annie Lazarus**, CCO at **Landmark Partners** in Simsbury, Conn., had only to turn to her firm's PPM for a list of members of the investment committee when deciding who gets a supplement. Another easy route may be to cut and paste data from the old Schedule F, albeit following the new supplement outline.

But what about the CCO who may sit in on investment committee meetings? If the CCO focuses on compliance matters and doesn't contribute significantly to investment discussions, he can be left out, believes **Stephen Galletto**, an associate with **Stark & Stark** in Lawrenceville, N.J. If the CCO takes an active role in investment decisions or wears multiple hats, he should be in, he adds.

Rhoades opines that a CCO who sits on the investment committee should be in the supplement, even if he doesn't recommend strategies. Vetoing a decision on compliance grounds affects the outcome – demonstrating enough influence to justify inclusion in a supplement, he argues.

Some wonder about "relationship managers" who meet with clients but make no independent investment decisions, they simply mimic the stance emerging from the firm's investment committee. These people deserve to be in a supplement, says **Mark Tannenbaum**, a partner at **Ropes & Gray** in New York because "they are the face of the firm." Besides, adds Galletto, how can you be sure the

(Brochure Supplements, continued on page 3)

Brochure Supplements (Continued from page 2)

person won't go off script in one of those client meetings?

Delivery of supplements

Harroz at Mark I has e-mailed clients his supplement. He's also placed a copy on the firm's website and mailed it to those without e-mail addresses. He printed out a copy of the sent folder directory in his e-mail system to confirm delivery and also printed the send/receive folder.

Joseph Capital's supplement is bound for the firm's color printer, where it will be stapled and mailed to clients. Rhoades selected the U.S. Mail because he doesn't want to be hassled with confirming e-mail delivery.

He views the Form ADV as a "level three" disclosure, so recipients will first find when they open the envelope a colorful, four-page brochure describing the firm and a detailed FAQ brochure. This doesn't include an eight-page cover letter that contains reminders to check monthly account statements and quarterly reports and notes that it's possible someone from the SEC may call them (the letter also warns against fraudulent government agents and lists an SEC phone number to call to verify the agent's identity).

"I'll be surprised if 10% of our clients read any part" of the mailing, laments Rhoades. To augment the effort, the firm this quarter has set a goal of meeting with every client personally, via web video or over the phone to discuss the Form ADV and review any conflicts within the fee-only firm.

Rhoades' plan for updating the supplement gets tied to quarterly personal trading reporting. The eight reps will receive a copy of the supplement, instructions for updating it and directions for alerting him of changes. ■

Part 2B Pointers (Continued from page 1)

"Don't overdo it," counsels Galletto. "Disclose what you need to disclose." This could be bonuses or additional benefits received for making certain recommendations. He struggled somewhat before ultimately deciding that a client should disclose that he won an all-expenses paid trip for selling a certain amount of insurance.

> [Sorum's supplement] *Some training and educational conferences include the payment or reimbursement of travel, meals and lodging expenses for attendees. These extra benefits are not contingent upon sales targets or contests.*
>
> *Barry is the manager of Pavilion Woods Partners, LLC which owns the office building where* ***Barry M. Corkern & Co., Inc.*** *is located.*

Supervision

You must name a supervisor and a way to contact the person. The CCO makes much sense, says **Mark Tannenbaum**, a partner at **Ropes & Gray** in New York. "That's probably a good way to do it."

(Part 2B Pointers, continued on page 4)

SEC Deadlines for Form ADV Brochures

Form ADV, Part 2a Plain-English Brochure

Fiscal Year End	File Brochure with IARD	Share Brochure with New/Prospective Clients	Share Brochure with Existing Clients
December 31	By March 31	Begin as of filing date	Within 60 days of filing date
March 31	June 30		
June 30	September 30		
September 30	December 31		
Newly Registered between Jan.-April 2011	At registration		

Form ADV, Part 2b Brochure Supplements

Fiscal Year End	Provide to New/Prospective Clients	Provide to Existing Clients
Newly Registered between Jan.-April 2011	May 1	July 1
Dec. 31-April 30	July 31	September 30
After May 1	After annual update/initial registration, at or before beginning to serve client	Within 60 days of annual update/initial registration

Source: **SEC** rules (**IA Watch**, Dec. 29, 2010). ■

Part 2B Pointers (Continued from page 3)

The two-person firm of **Mark I Asset Management** in Oklahoma City, Okla., lists both principals. This shows that one watches over the other and gives clients an alternative contact in case one is out, says president **Nicholas Harroz**.

> ***NorthPointe Capital*** **, *LLC*** *has adopted a formal compliance program designed to prevent, detect and correct any actual or potential violations by the adviser or its supervised persons of the Investment Advisers Act of 1940 ("Advisers Act"), and other federal securities laws and rules adopted under the Advisers Act. Our policies and procedures are designed to meet the requirements of the SEC's Investment Adviser Compliance Programs Rule and to assist the firm and our supervised persons in preventing, detecting, and correcting violations of law, rules and our policies.* ■

ERISA Rules (Continued from page 1)

certain transactions by plan fiduciaries, which could touch an investment adviser that manages ERISA funds. "It's kind of an anti-kickback rule," says **Mark Smith**, a partner at **Sutherland** in Washington.

"There's a bit of a grey area" with section 406(b), says **Jean Cogill**, a partner with **Bingham** in New York. While there's an absolute prohibition on these transactions and no official de minimus amount for them, there can be leeway (including various exceptions). For example, she cautions firms that act as ERISA fiduciaries from permitting a broker that seeks your ERISA business from treating a firm official to an expensive dinner. However, this is an ERISA-only restriction, so if the broker were after your non-ERISA business as well, then enjoy the meal.

"I think not accepting the gifts is the cleanest way," says **Edward Bintz**, a partner with **Arnold & Porter** in Washington. He serves as a fiduciary on his firm's pension committee. "I would never accept anything, even if it was de minimus, just because" of the image it could create.

Consider these best practices

The best practices in this area mirror those for non-ERISA business. For example, if your firm serves as an ERISA fiduciary, it should have an ERISA gifts and entertainment policy and track G&E via a log. Educate staff on your rules.

You should also be aware of Form 5500. It's the responsibility of the ERISA plan to file these annual documents with DOL, not service providers like investment advisers. But in some cases a hedge fund adviser could be seen as an ERISA plan itself as a "plan asset fund," notes Cogill, and then would have to file the form.

For the most part, investment advisers – as service providers to an ERISA plan – simply would be queried by the plan annually for information on their ERISA-related compensation, which could include gifts the RIA received. Last year inaugurated these additional so-called Schedule C service provider disclosures (**IA Watch**, Aug. 3, 2009).

Your firm no doubt received such a request in 2010 from the ERISA plan you serve if it received more than $5,000 in compensation from the plan. "Last year many plans asked for far more information from their service providers than they really needed," says Cogill. You may find these requests scaled back a bit this year.

DOL has provided FAQs around the Schedule C data requests. The FAQs also mention a de minimus exception for gifts and entertainment reporting, holding that "ordinary promotional gifts, such as a coffee mug, calendar, greeting cards, plaques, certificates, trophies and similar items of insubstantial value" with a value under $10 need not be reported on Schedule C. "On the other hand, this FAQ would not cover a gift that clearly has a value in excess of $10, such as a $400 golf club or an expensive luxury pen," DOL writes.

That same FAQ also takes up meals "of insubstantial value." It alerts ERISA plans they need not report such a gift or meal "which is tax deductible for federal income tax purposes by the person providing the gift or meal and would not be taxable income to the recipient. The gift or gratuity must be valued at less than $50, and the aggregate value of gifts from one source in a calendar year must be valued at less than $100. If the $100 aggregate value limit is exceeded, then the value of all the gifts will be reportable compensation." Gifts of less than $10 wouldn't count toward this $100 annual limit. Remember, this is for reporting purposes by the plan – not a prohibition against receiving such gifts.

Union plans face different disclosures

These brief details on ERISA disclosure should toss in Form LM-10. This falls to any service provider to a Taft-Hartley union plan. It would list anything of value given to a union official, e.g., by an investment adviser serving the plan. It also features a de minimus threshold of $250, says Cogill.

There's an outside chance that if DOL investigators have no problem with gift giving that a plan participant

(ERISA Rules, continued on page 5)

ERISA Rules (Continued from page 4)

could. Cogill says technically a plan member could sue over a violation but the risk is small and larger issues must be at stake to prompt a lawsuit.

Finally, all of this skirts minor, additional disclosure requirements scheduled to take effect next January through a new DOL rule (**IA Watch**, July 26, 2010). ■

Industry warns CFTC proposal would raise costs and add duplicative regulation

The comments are in to the **CFTC** about its new proposed rule to eliminate the so-called "4.5 and 4.13 exemptions" that could force many hedge funds that invest in commodities to register with the agency (**IA Watch**, Feb. 28, 2011). The consensus on the proposal: it's bad news.

The **Investment Adviser Association** asked the CFTC to rescind the proposal because it would force a "large number of investment advisers" to register with the Commission. "The new registration requirements would apply even if commodity interests are used only for hedging or risk management purposes," it wrote, adding the agency could find the information it seeks from the **SEC** via Form ADV disclosures and the proposed Form PF (**IA Watch**, Feb. 7, 2011).

The RIA **Vanguard** in Valley Forge, Pa., submitted that investment advisers to registered investment companies (RICs) already fall under the Advisers Act and the Investment Company Act. "The Acts also provide a mechanism for oversight of RICs and their investment advisers by the SEC through the inspection process," it added.

The **Investment Company Institute** also raised the cross regulation concern. The proposal would catch most investment companies, subjecting them "to both SEC and CFTC regulation, potentially resulting in duplicative regulation in many areas, as well as conflicting requirements in others." At a minimum, the regulatory conflicts should first be resolved, it continued.

The proposal "is silent regarding which entity – the fund, its investment adviser, or its directors – would be required to register as a CPO," noted the **Independent Directors Council**. It urged the Commission to indicate fund directors would not be the registering entity.

If finalized, the rule would "increase dramatically … the cost of responsibly operating an investment adviser in the United States; decrease the competitiveness of U.S.-based advisers" versus international competitors and impose "unnecessary costs" while bringing "negligible benefits to the marketplace," predicted the **Managed Funds Association**.

The RIA **Invesco Advisers** described the proposal's 5% threshold as outside industry practice. "The current margin levels required would likely subject a RIC to unwarranted limitations on its use of commodity futures, commodity option contracts and swaps," it wrote. ■

SEC loosens requirements for a fund to notify shareholders of a new subadviser

A recent **SEC** no-action letter grants flexibility to an investment adviser that oversees mutual fund portfolios when it comes to alerting shareholders of the hiring of a new subadviser. **Nationwide Fund Advisors** sought relief from a prior exemptive order that held the adviser to several options that would have notified clients up to 40 days before taking action. Nationwide felt these options presented challenges and asked to share the news of the hiring of a new subadviser after the appointment. The SEC said yes.

Nationwide will be allowed to alert shareholders within 90 days of the hiring, via written notice as well as a website announcement. The attorney who prompted the SEC's letter, **Lawrence Stadulis** of **Stradley Ronon** in Washington, said Nationwide wouldn't permit him to talk with **IA Watch**. ■

Federal judge dismisses Madoff investors' lawsuit against SEC

Last week U.S. District Court Judge **Laura Swain** in New York dismissed a lawsuit from two former investors harmed by **Bernie Madoff**'s Ponzi scheme against the **SEC** claiming gross negligence for not uncovering the fraud. The judge determined the plaintiffs hadn't overcome the high hurdle of the government's sovereign immunity from such lawsuits by failing to find "a duty imposed on the SEC to conduct its investigations in a particular way."

"That the conduct in question defied common sense and reeked of incompetency does not indicate that any formal, specific, mandatory policy was 'likely' violated," wrote Swain.

Plaintiff **Phyllis Molchatsky** and others brought the suit in 2009 (**IA Watch**, Jan. 4, 2010). Her attorney said he was disappointed, was considering next steps and continues to believe the Federal Torts Claim Act supports such lawsuits.

Last week's decision may not auger well for investors

(Dismissed, continued on page 6)

Dismissed (Continued from page 5)

of accused fraudster **Robert Allen Stanford**, who earlier this month filed a similar legal action against the SEC (**IA Watch**, April 4, 2011). ■

Madoff victims appeal decision to toss CCO case to bankruptcy court

A federal judge has dismissed a lawsuit against **Peter Madoff**, the former CCO at the now infamous firm overseen by his brother, essentially ruling the matter belongs in the bankruptcy proceedings in New York that are cleaning up the mess from the **Bernard L. Madoff Investment Securities** RIA.

The **Lautenberg Foundation** – which is related to the family of Sen. **Frank Lautenberg** (D-N.J.) – sued Peter Madoff for losses it suffered in the fraud (**IA Watch**, Oct. 12, 2009), claiming the CCO should have known what was going on. The foundation's attorney, **Michael Griffinger** of **Gibbons** in Newark, N.J., tells **IA Watch** his client is appealing the decision by U.S. Bankruptcy Court Judge **Burton Lifland** to fold the case into the bankruptcy proceedings.

Bernie Madoff repeated in a recent interview that his brother Peter had nothing to do with the fraud. Peter Madoff's attorneys chose not to comment. ■

SEC Chairman says she looks forward to implementing fiduciary duty standard

Recent comments from **SEC** Chairman **Mary Schapiro** indicate that she expects the Commission to move forward and implement a new, uniform fiduciary duty standard for investment advisers and broker-dealers. Such a suggested move was in a staff report on the matter.

Speaking April 8 before a Dallas gathering of the **Society of American Business Editors and Writers**, Schapiro said, "As I have long advocated, the report recommended the establishment of a uniform fiduciary standard of conduct for all financial professionals when they provide personalized investment advice about securities to retail investors. I believe that investment professionals' first duty must be to their clients, and I look forward to beginning work soon to codify the report's recommendations." SEC action on a new fiduciary duty standard could occur later this year, according to **Jennifer McHugh**, senior advisor to the Chairman.

The report, mandated by Section 913 of the Dodd-Frank Act, has come under fire from two of the five commissioners, **Troy Paredes** and **Kathleen Casey**, and by **Scott Garrett**, the new Republican chairman of the House Subcommittee on Capital Markets. ■

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Group Publisher: Hugh Kennedy
301-287-2213 | hkennedy@ucg.com

Publisher: Carl Ayers
301-287-2435 | cayers@iawatch.com

Associate Editor: Vincent Taylor

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Our Address: IA Watch
Two Washingtonian Center
9737 Washingtonian Blvd., Suite 100
Gaithersburg, MD 20878-7364

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