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INSIDE...

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Recent cases display SEC emphasis on Form ADV disclosures

Jermaine Spence must have thought he was born to be an investment adviser. The website for his RIA, **FreedomTree Asset Management** in Atlanta, boosted of the firm's "27+ years of unparalleled leadership." That number just happened to match Spence's age when the CEO/CCO applied for **SEC** registration in 2008.

This month the agency filed civil charges against Spence and his firm for allegedly lying on the firm's Form ADV and its website. Another fib concerned the firm's AUM. Within weeks of registration, FreedomTree claimed $235 million in AUM.

A year later OCIE examiners came knocking and Spence didn't answer. The SEC claims he responded to the routine exam by failing to appear, produce documents, answer the exam deficiency letter and respond to an inquiry from the Enforcement Division. In a brief call with examiners, Spence allegedly admitted to having no clients or revenue. He didn't return **IA Watch**'s call.

A second recent enforcement case also touches on disclosure and Form ADV. This one spotlights **John Valentine**, president, and his firm, **Valentine Capital Asset Management** ($211M in AUM) in San Ramon, California. Valentine moved to settle Advisers Act violations for a "failure to fully and adequately disclose a material conflict of interest relating to the commissions received as a result of an investment recommendation."

Basically, the SEC said Valentine didn't tell clients that moving to a new investment would up his

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SEC provides guidance to help CCOs cope with valuation challenges

One of the more enduring challenges of the market crisis has been trying to determine the true value of certain securities. Last week the **SEC** held the first of what it promises will be many webinars directed at RIA CCOs. The topic of the inaugural event: Valuation.

"We understand the world has changed in the last few years," said **Matthew O'Toole**, assistant director within OCIE's San Francisco Regional Office, adding the agency expects that firms' valuation policies and procedures also would have changed.

While the Advisers Act doesn't mention valuation per se, its anti-fraud provisions infer investment advisers must ensure clients aren't taken, said **Doug Scheidt**, chief counsel in the SEC's Division of Investment Management (**IA Watch**, June 21, 2010). For example, most firms assess client fees based on asset values. A shady firm

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Best practices detailed for delivering Form ADV brochure to clients via e-mail

The lawyers may debate the fine-print of **SEC** regulations regarding the delivery of Form ADV, Part 2 but many firms already embrace the idea of sending the brochure to clients by e-mail.

The legal question centers on whether you must get the client's consent before sending the brochure by e-mail. Some believe so, pointing to this language from the new Form ADV rule (**IA Watch**, Oct. 4, 2010):

> *[A]dvisers may, with client consent, deliver their brochures and supplements, along with any updates, to clients electronically.*

But careful attention reveals this text links to a footnote taking the reader back to the SEC's 1996 interpretative guidance on use of electronic media by broker-dealers, transfer agents and investment advisers to deliver information to clients. This 14-year-old guidance didn't formally address delivery of Form ADV but rather broader "delivery obligations" under the Advisers Act and other securities laws. It clearly permits electronic delivery to clients.

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Valuation Guidance (Continued from page 1)

could pump up values to enhance its fees. Of course, the Investment Company Act specifically mandates valuation duties for mutual funds, he noted.

Dealing with Illiquid securities

The panelists recognized the challenges faced by the industry and that valuation is "not an exact science." They answered specific questions, including what to do for an illiquid security.

Use as many market inputs as you can, suggested **Rick Mayfield**, one of the new OCIE senior specialized examiners. His specialty: valuation. If there is no market for a security, this factor alone should reduce its value, he said.

Have a Plan B in case your firm's original procedure vanishes, recommended Scheidt. For example, you could develop a matrix that includes prices that similar assets are trading at to help arrive at a value.

They also shared actual exam experiences, exposing good and poor actions. **Good**: A firm that makes loans to utility companies considers additional factors in its valuations, such as kilowatt hours and the price of commodities if the plant runs on ethanol, corn or coal. **Poor**: A hedge fund that deals with loans for real estate but doesn't maintain policies and procedures for devaluing the properties in a struggling market or fails to adjust values based on hot and cold real estate markets.

A firm that doesn't like a falling price shouldn't label it as a fire sale without some evidence, such as knowing the investor had to get out of the security, added Scheidt.

Advice for CCOs

One mistake to avoid is having policies and procedures that differ from what your firm actually does. If staff aren't following your procedures, consider revising them or setting up training sessions to improve compliance. You also should have a procedure for handling breaches of your policy.

For fund of funds, firms should conduct due diligence on underlying managers if their offering documents pledge that they will (IA Watch, Aug. 16, 2010).

On exams, "get someone who's a good communicator" from the valuation committee to talk with examiners about this complex topic, recommended **Thomas Verderber**, a staff accountant with the SEC's Regional Office in New York.

If a CCO can't demonstrate that she tests her firm's procedures around valuation "that's going to be a red flag … and make an examiner stay a little longer," warned Verderber. Expect examiners to sample the value of some securities – more assets, the larger the firm – and they'll want to see evidence you've conducted some forensic testing as well as "whether you are applying your methodology in a consistent manner," he continued.

CCOs need not be familiar with all assets but should be knowledgeable about those at level 2 and level 3, Verderber continued. And a CCO at a small firm should be taking the job seriously. "The examiner isn't going to look at that as an excuse [but] as a weakness," he said. The same with use of generic policies taken from off-the-shelf compliance manuals. ■

It's worth your time to sit in on interviews when SEC examiners arrive

A CCO could feel as if he's pulled in a thousand directions after **SEC** examiners take up position in the firm. Of course, you can't be in more than one place at once but you may want to take that spot alongside a firm

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executive getting quizzed by an examiner.

A California CCO regrets having missed such an interview during the firm's recent exam. The exchange provoked additional questions that might have been quelled then and there had the CCO been in the room.

Demonstrate organization

Other lessons emerging from the exam are to be able to demonstrate that you have an organized way to review compliance policies and procedures and to have some plan for staff training on your P&Ps.

An unexpected element of the exam swirled around the CEO's role as a general partner in a private placement. The firm didn't anticipate that examiners would dwell on the topic, requesting all relevant books and records around the transaction, including copies of all checks.

The firm received only a few days' notice before examiners trooped in, and set up camp for more than one week. In retrospect, the firm could have used more time to clean up account records. It was challenged to scrub the records so as to strip closed accounts. The CCO's advice: keep your accounts clean.

Once the document request letter arrived, the CCO set up a directory on the firm's computer system with folders matching the letter's request numbers. Staff were assigned to place in the folders the requested information. "I burned CDs for the examiners when they came in," says the CCO. "I kept one for myself so I knew I had what they had."

The CCO also prepared a PowerPoint presentation that described the firm, its principals and structure, printed it out and handed it to examiners shortly after they arrived. ■

Compliance pros suggest monitoring for employee use of social media

Even if your firm doesn't allow employees to engage in social media chats, you have an obligation to monitor compliance with that policy. One way to do this is by occasionally searching the Internet for your firm's name. Or you could purchase software that will do the searches for you.

These were among the best practices for use of social media revealed at **IA Watch**'s recent *IA Compliance Fall Conference 2010* in Philadelphia. Regulators are tracking the topic, noted **Mitch Gibbons**, a partner at **Mayer Brown** in Houston. She discussed a recent **FINRA** case and a second by the **SEC**. In one, the regulator inquired of the firm's policies on use of new media when it discovered a key person at the firm maintained a blog.

As for the rules, FINRA has issued its view 💻. The SEC continues to advise firms to follow its standard advertising and marketing guidelines, e.g., no testimonials, don't make recommendations and don't talk about products or your advice, said Gibbons.

The policy at RIA **Merriman** ($1.3B in AUM) in Seattle requires all employees with a social media account to have the firm's compliance department as a friend or a follower, said CCO **Stephanie Brown**. Her firm also restricts employees from providing recommendations for former colleagues on the sites.

If you have a policy, have consequences for violations, even if it's just a written warning, recommended **Janaya Moscony**, president of **SEC Compliance Consultants** in Philadelphia.

A company page

You could maintain a company social media page, stated Brown. One risk is that this could expose the identities of your clients because sites usually don't permit you to hide the identity of your "friends." So Merriman's policy on the site discloses that followers may include clients, that they weren't solicited to sign up as followers but signed up on their own accord, that they aren't compensated, their appearance isn't an endorsement of the firm and that it's not known if followers approve or disapprove of the firm's products and services.

Another risk with social media is the possibility that client communications can go out via the site's e-mail, bypassing your server and your archiving system, warned Brown.

Moscony talked of software by Socialware 💻 that monitors usage across various new media sites.

Editor's Note: If you missed their popular presentation in Philadelphia, sign up to tune into their Nov. 16, 2010 webinar, *Getting the Best of Social Media – and Not the Other Way Around* 💻, which will include examples of policies and firms' real-life use of social media. Register here 💻. ■

Special Delivery (Continued from page 1)

The interpretative guidance's only reference that an "investment adviser should obtain the intended recipient's informed consent" refers to "Personal Financial Information" sent electronically. The brochure wouldn't contain a client's personal information.

"Consent is not a requirement" for Form ADV

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Special Delivery (Continued from page 3)

electronic delivery, says **Michael Koffler**, a partner with **Sutherland** in New York. He quotes the 1996 guidance's three pillars: 1. **Notice** (a client needs to know to look for electronic delivery); 2. **Access** (the client must have the ability to receive an e-mail, for instance) and 3. **Evidence of delivery**.

One way to satisfy that last requirement is by "obtaining the intended recipient's informed consent to delivery through a specified electronic medium, and … obtaining evidence that the intended recipient actually received the information, such as by an electronic mail return-receipt or by confirmation that the information was accessed, downloaded, or printed," the SEC wrote in 1996.

Think twice about using return receipts

"I actually would advise against" using a return-receipt e-mail because "it creates a tremendous burden for your firm" in having to spend time sorting through the returned e-mails, says **Kyle Weeks**, owner of **Securities Compliance Management** in Cumming, Ga. He favors a negative consent approach: alerting the client the brochure will be sent by e-mail unless the client indicates otherwise.

This seems to fit with the SEC's 1996 guidance, which states if the client prefers traditional paper delivery, then the adviser should accommodate his wishes.

The most conservative approach would be to insert a section into your advisory contract that forces the client to check a box next to either yes or no for the question would the client accept firm correspondence via e-mail, says **Ephraim Lemberger**, counsel with **Bingham** in New York. "I think that's probably the cleanest thing you can do."

Other choices are to use a separate form that seeks the consent or accept a client's e-mail that he wishes to receive information electronically as consent.

Andrew Guzzetti, CCO with **DLG Wealth Management** ($39M in AUM) in Clifton Park, N.Y., isn't certain what approach his firm will take but it will start with a phone call. "A call is always the best thing in our business," he says. The firm would notify the client that delivery would come by e-mail and then send one with a consent letter attached asking the client to sign the form and return it.

A CCO at a dually-registered firm in Pittsburgh will continue to mail the brochure next March but will combine it with its annual privacy form mailing to save money. When reps first meet with clients they secure a consent form in writing, which the firm keeps on file. The CCO cautions dually-registered firms to clearly note in their system who is an advisory client versus a brokerage client.

Maintain the records

You should have some type of recordkeeping system, says Lemberger. For example, you could automatically route all copies of e-mails received about the brochure to a specific folder or database. Or perhaps maintain a file folder by client and copy all of the client's e-mails to the folder. Be sure to back up the folders, he counsels.

Koffler wishes the SEC would update its 1996 guidance. The Internet's "no longer a novel thing," he says. He thinks the Commission should accept as delivery notice that the brochure is on the firm's website.

This summer's Form ADV rule did mention that some in the industry would like to "send clients a notice providing a Web site link to where the brochure is posted on the Internet, rather than having to deliver the actual brochure to clients." However, the agency said it's "not making such changes at this time, but will continue to consider different approaches to delivering financial information to investors" in the future.

Editor's Note: Sign up for **IA Watch**'s next webinar, *Form ADV, Part 2: Solid Advice to Satisfy the New Plain-English Requirements and Meet Your Filing Deadline*. It will be held Tuesday, Oct. 19 from 2-3:30 p.m. ET. Register here. ■

Advisers are letting clients know they're prepared for an emergency

You may consider describing your firm's business continuity plan to clients and prospective clients via your website. Alabama gets hit from time to time by the whirl of a hurricane and its destructive aftermath, which could explain why **BHK Investment Advisors** ($730M in AUM) in Birmingham, Ala., describes its BCP on its site.

The description includes alternate phone numbers clients can use and indicates its full BCP addresses data backup, recovery, an alternate physical location for employees, its clearing firm and more.

Explore the website of **Mid-Atlantic Securities** ($30M in AUM) in Raleigh, N.C., and you'll find how it describes its BCP. The firm also features alternate phone numbers and offers readers the opportunity to request the full BCP, as BHK does, too. "We plan to

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Business Continuity (Continued from page 4)

continue regular business activities within a few hours of a disruption or as quickly as conditions allow," the site states.

There are differences in the descriptions. For example, BHK notes your "orders and requests for funds and securities could be delayed during" an emergency, and Mid-Atlantic pledges that "we will have access to contacts at our clearing firm in order to communicate with them any orders that our clients submit to us" and mentions the broker also has a continuity plan.

Test your BCP from time to time

The biggest mistake firms make with their BCPs is not testing them. "The SEC expects" plans to be tested, says **Victoria Hogan**, president of **NorthPoint Compliance** in Red Bank, N.J.

The most critical task in keeping a business running is backing up and restoring firm data, she says. One test you could do is to restore data tapes from an alternate location. Or switch your website to a different server.

"You don't necessarily have to [test] the entire plan," says Hogan. Test select elements, recognizing that they may depend upon additional parts of the plan also being activated. July and August are good times to conduct such tests, although it's more ideal to test an element each quarter. This way it won't take years to actually test your entire plan, she adds.

Hogan shares with you a template to aid in your disaster recovery plan. The template encourages firms to inventory and rank items based on their importance to the firm's continued business viability in an emergency. For instance, you'll probably regard software, servers, telephones and Internet access as critical. Alternatives could be use of home computers and cell phones with Internet access. ■

SEC doesn't get a great grade on protecting private information

You certainly know the risks firms can face for violating the privacy protections of Reg S-P (**IA Watch**, July 27, 2009), so it may surprise you to learn the **SEC** could improve its safeguards.

SEC Inspector General **David Kotz** this month released two reports examining the agency. One finds "high level vulnerabilities affecting SEC computer systems" making them "vulnerable to exploitation and infiltration."

We've previously documented how at least one state got sloppy with sensitive personal information (**IA Watch**, June 28, 2010). Kotz's report on the SEC includes pictures of unsecured filing cabinets, which theoretically could have contained data on RIAs.

Kotz also found personally identifiable information "casually left on work tables, fax machines, and desks"; that the agency has no completed policies and procedures for destroying portable media storage devices; and that agency laptops can be simultaneously connected to the SEC's network and an external wireless network, "exposing the SEC network to potential compromise by a malicious attacker." Staff in Los Angeles violated SEC rules by e-mailing personal information to their own e-mail addresses, Kotz revealed.

He made several recommendations for change, including that all wireless cards on SEC laptops be turned off when the computers are connected to the Commission's network.

13F filings

Kotz also examined how the agency handles 13F filings in a second report. He makes the stunning revelation that no one at the SEC actually "conducts any regular or systemic review of the data" submitted quarterly by institutional advisers with individual equity holdings above $100 million.

As a result, many of the filings contain errors or problems, Kotz found. For example, a graduate student discovered a bank was continuing to file by paper 13F forms 11 years after the creation of an electronic form.

Perhaps 4,000 advisers file 13Fs each quarter. Kotz did discover OCIE sometimes relies upon the data during RIA exams.

Kotz found the SEC hires a third-party to compile the official list of 13F securities, in an arrangement that technically may violate federal law. "The lack of a formal contract poses a risk to the SEC that the third party could stop preparing the list at any time," writes the IG.

He submitted 12 recommendations, including that Chairman **Mary Schapiro** should delegate the responsibility of reviewing the 13F filings to a division or office and that the 13F form should be updated to make "data easier to extract and analyze." ■

Accounting firm gets dinged over faulty surprise custody exams of RIA

As advisory firms with custody scramble to find accountants willing to begin a surprise exam by year's end, the **SEC** has slapped a CPA and his accounting firm

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with Advisers Act violations because they "negligently failed to conduct custody examinations" of an RIA.

The firm of **Altschuler Melvoin and Glasser** and CPA **G. Victor Johnson II** didn't admit or deny the SEC claims but will pay $24,000 for its actions in conducting exams of **Sentinel Management Group** ($1.5B in AUM) in Northbrook, Ill.

Altschuler erred by not following professional accounting standards and failing to recognize that Sentinel's holding of certain securities violated the custody rule, according to the SEC. On some occasions, it's surprise exams weren't even surprises – as the firm alerted the RIA when it was coming or let the adviser select the date of the exam.

The accounting firm has been sold. Its new owner had no comment and Johnson couldn't be located.

The SEC has provided guidance to accountants on how to conduct the surprise custody exams, and pointed out sample audit reports (**IA Watch**, Sept. 10, 2010). And **IA Watch** has shared guidance on how RIAs can approach the exams (**IA Watch**, May 17, 2010).

An SEC official tells **IA Watch** there's no message to the industry in the timing of the case; it's simply a coincidence. The agency began investigating the accounting firm after Sentinel failed. The RIA faces its own enforcement action and its demise remains a subject for a bankruptcy court, says the official.

This isn't the first time the agency has targeted an accounting firm for poor performance. But the SEC official says RIAs and the industry have "this case now to look to" for "rules of the road" in hopes of avoiding similar failures. ■

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commissions. The $400,000 in extra commissions will disappear, as the Commission seeks about $500,000 in fines from Valentine.

These and other cases show the "SEC is focusing on Form ADV disclosure," says **Susan Grafton** of **Gibson Dunn & Crutcher** in Washington. The cases serve as "at least a reminder, if not a message" from the SEC to advisers to be thorough with Form ADV disclosures. "The Commission is going to look closely at the statements made by advisers as well as omissions," states **Rick Firestone**. ■

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