

# Financial Services Alert

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## *In this issue:*

### *Developments of Note*

1. GAO Issues Report on Enhancements to SEC Examination Program
2. SEC Settles Administrative Proceedings with Pension Consultant and its Chief Compliance Officer over Code of Ethics and Compliance Program Shortcomings
3. SEC Permits Banks to Engage in Certain Reg S and Conduit Lending Transactions Without Being Deemed a “Dealer”
4. District Court Rejects Application of Preemption of State Mortgage Laws to Independent Agents of Federal Thrifts

### Other Item of Note

5. GAO Issues Report Addressing Limitations in SEC Enforcement Division’s Operations

## *Developments of Note*

### ➤ GAO Issues Report on Enhancements to SEC Examination Program

The General Accounting Office (“GAO”) issued a report that examines changes made by the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) to various aspects of its examination program for registered funds, advisers and broker-dealers in the period since the discovery of mutual fund trading abuses in late 2003. The report examines (a) OCIE’s risk-based approach to the examination of investment advisers and registered funds, (b) OCIE’s compliance with examination exit procedures and (c) reforms implemented since January 2006 designed to enhance other aspects of the examination process, such as improving communications with registrants. The report contains one formal recommendation, which is to relocate OCIE’s new examination hot line to an SEC division or office that is independent of OCIE, a recommendation that the SEC has indicated it intends to implement; the report also reiterates an earlier recommendation that the annual compliance reports prepared by the Chief Compliance Officers (“CCOs”) of registered advisers and funds be sent to the SEC for use in the risk analysis that determines OCIE’s examination priorities for these registrants.

*Risk-Based Examination Program for Advisers and Funds.* Following the mutual fund scandals, OCIE revised its examination approach from one where advisers and funds were examined routinely on an established schedule to a risk-based approach emphasizing the examination of higher risk investment advisers and funds. The report discusses various methodologies used by the SEC to identify risks and assign risk ratings to various registrants. The report notes that at the time OCIE implemented its new risk-based approach approximately 70% of registered investment advisers had not yet received a compliance risk rating through a routine examination and that OCIE had not examined most of the more than 4500 new investment advisers that had registered with the SEC since fiscal 2004. In order to assign a risk rating to an investment adviser that it has never examined, OCIE uses an algorithm that calculates a numeric score for the firm based on certain affiliations, business activities, compensation arrangements and other characteristics that OCIE has identified as posing conflicts of interest, *e.g.*, participation or interest in client transactions, managing portfolios for individuals and receiving performance fees. OCIE determines the risk profile for each registered adviser every year using the risk algorithm. Those that are designated as higher risk are added to the list of registrants scheduled for routine examination within the next three years. At the start of fiscal year 2006, OCIE officials indicated that they had identified about 10% of registered investment advisers as higher risk. Of the

higher risk firms, slightly more than half are firms that have been the subject of routine examinations within the last three years in which they were given a risk rating of “high,” and slightly less than half have been assigned their high risk rating by the risk algorithm. A small percentage of firms have been classified as higher risk because of their large size. OCIE automatically designates the top twenty investment advisers according to assets under management as higher risk. (The report also mentions, but does not evaluate, a voluntary pilot program begun in fiscal 2006 that uses dedicated teams of two to four examiners to provide more continuous and in-depth oversight of the largest and most complex groups of affiliated investment companies and investment advisers; this voluntary program is expected to have a limited number of additional participants by the end of 2007.)

*Risk-Based Examination Program Initiatives.* The report notes that OCIE has recognized that the use of compliance risk ratings is potentially limited because it does not measure the effectiveness of an adviser’s compliance controls that are designed to mitigate conflicts of interest or other risks that could harm investors. To improve the accuracy of the risk algorithm, OCIE initiated a sweep examination during 2007 of a sample of recently registered investment advisers that were identified as lower risk and that had not yet been subject to a routine examination by OCIE. These reviews have typically been targeted one day reviews that allow examiners to make an initial assessment of a newly registered investment adviser. Of the over 225 reviews completed by the time of the report, 85% resulted in a firm’s remaining classified as lower risk and 15% being reclassified as higher risk and placed on a three year examination cycle. OCIE indicated to the GAO that it plans to make these sweep examinations a regular component of its examination program. OCIE officials also indicated that they were exploring ways to obtain and use additional sources of information to allow them to further identify higher risk firms. OCIE has purchased access to commercial databases with information, such as investment adviser performance statistics, that OCIE does not otherwise have. OCIE is currently assessing these databases for surveillance purposes, primarily as a means to identify higher risk firms, for example, OCIE officials indicated that review of performance data may enable OCIE to identify a firm whose performance is significantly higher or lower than its peers, which suggests that the firm’s business practices deviate from the norm and require further follow-up. In addition, OCIE and the SEC’s Office of Information Technology are working on a project to identify other possible information sources that could help OCIE better monitor investment companies and investment advisers, and are formalizing this effort by creating a Branch of Surveillance and Reporting that will have staff permanently dedicated to reviewing and analyzing internal and external data sources to identify compliance risks at registered companies and investment advisers. The report notes that the annual compliance reports required to be prepared by fund and adviser CCOs are a potential source of information that might allow OCIE to better assess the effectiveness of registrants’ internal controls, but that OCIE staff currently review these compliance reports only as part of the examination planning process; there is no requirement that these reports be filed with the SEC. The GAO had previously recommended that the SEC obtain and review these reports, or the material weaknesses identified in them, periodically rather than solely in connection with planned examinations. OCIE officials noted that obtaining these reports on a regular basis would require rulemaking by the SEC.

*Examination Exit Procedures.* Based on a review of investment company, investment adviser and broker-dealer examinations, the report found that OCIE examiners generally applied OCIE’s exit procedures. These procedures, which provide examiners with flexibility to communicate deficiencies and examination outcomes to registrants, include an exit interview, in which examiners inform a registrant of deficiencies before closing an examination, and a closure notification letter, which communicates the outcome of the examination. These procedures may not apply under certain circumstances, such as when examiners refer their findings to the SEC’s Division of Enforcement and are asked to forgo some or all of the usual exit procedures in order to preserve the integrity of the ongoing examination. OCIE management also directed examiners to deviate from exit procedures under exigent circumstances, most recently for certain sweep examinations conducted during fiscal years 2003 through 2004 that addressed market timing and other newly emergent compliance issues. However, in the wake of the market-timing and other related sweep examinations, OCIE issued formal guidelines for initiating, conducting and concluding sweep examinations. These guidelines indicate

that sweep examinations should follow the same procedures as other types of examinations, including with respect to exit procedures.

*Initiatives to Improve Coordination and Communication.* The remainder of the report discusses a range of initiatives implemented since January 2006 in an effort to improve internal and interagency coordination and communication with registrants (largely in response to industry complaints and Congressional pressure).

- A formal review and approval process for sweep examinations – Under the guidelines applicable to sweep examinations, OCIE field examiners and OCIE staff must submit a list of firms proposed to be included in a sweep examination to OCIE management, which compares the list of proposed firms against a master list of firms subject to ongoing or recently completed sweep examinations to ensure that the firms are not bearing an undue share of examination focus, given the nature of their business and OCIE's risk assessment. Once finalized by OCIE, the sweep examination proposal and list of firms included in the sweep is provided to the SEC's Divisions of Market Regulation, Investment Management, or Enforcement for review. Finally, OCIE provides the SEC Commissioners an information memorandum summarizing the proposed sweep examination and its objectives with sufficient time for review prior to the sweep examination's commencement.
- Broker-dealer examination coordination – The various regulators conducting broker-dealer examinations have developed a database for the various examinations they conduct. OCIE examiners consult this database when planning examinations to avoid dual examinations of the same broker-dealer branch office (except where a broker-dealer has been selected for review as part of SEC's oversight program of self regulatory organizations). The pilot program for assigning permanent monitoring teams to the largest investment company and investment adviser complexes (discussed above) has each firm's OCIE monitoring team conduct all examinations related to the firm, including examinations at broker-dealer branch offices in different areas of the country which formerly would have been conducted by OCIE examiners from the applicable regional offices.
- Increased coordination with other SEC divisions - To improve coordination with other key SEC divisions, OCIE introduced a new training program for fiscal year 2007 taught by staff from the Divisions of Investment Management and Market Regulation that focuses on new SEC rules or on rules about which OCIE staff frequently have questions during the examination process. In addition, OCIE and the Division of Enforcement established interdivisional committees at SEC headquarters and in the regional SEC offices in late 2006 and 2007 to bring more transparency and consistency to the decisions made to pursue OCIE referrals concerning investment companies, investment advisers and broker-dealers to the Division of Enforcement. The interdivisional committees at SEC headquarters also include staff from the Divisions of Investment Regulation and Market Regulation.
- Examination hotline - In January 2006, OCIE established an examination hotline that registrants can call or e-mail anonymously to ask questions about their specific examinations or other issues, lodge complaints, or make comments. The report noted registrant concerns about the independence of a hotline in the Division about which complaints were being lodged. The report's one formal recommendation is that the hotline be relocated to an SEC division or office that is independent of OCIE, a recommendation that the SEC has indicated it intends to implement.
- Communication regarding examinations lasting more than 120 days - In July 2006, OCIE began requiring examiners to contact registrants when examinations extend beyond 120 days to discuss the status of the examination, the likely schedule for completion and the date of the final exit interview, subject to certain exceptions such as a referral to the Division of Enforcement. The report found that examiners had generally followed these notification procedures.
- Availability of information about OCIE's examination program and current compliance issues – The report discusses the following efforts to make more information about OCIE's examination program and current compliance issues available: (a) OCIE's issuance of a revised examination brochure with more detailed information to registrants about the examination process, including the

120-day notification and exit procedures, (b) a new guide prepared by OCIE to assist broker-dealers in complying with anti-money-laundering laws and rules and (c) OCIE's issuance of its first *ComplianceAlert* letter to CCOs summarizing select areas that OCIE examiners had recently reviewed during examinations and describing issues identified in those examinations.

### ➤ **SEC Settles Administrative Proceedings with Pension Consultant and its Chief Compliance Officer over Code of Ethics and Compliance Program Shortcomings**

The SEC settled enforcement proceedings against a pension consultant registered as an investment adviser under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and the pension consultant's former Chief Compliance Officer ("CCO") over (a) the pension consultant's failure to (i) adopt a code of ethics pursuant to Rule 204A-1 under the Advisers Act prior to the Rule's compliance date, (ii) maintain accurate written acknowledgements by its supervised persons of their receipt of that code once it was adopted and (iii) adopt and implement adequate written compliance policies and procedures as required by Rule 206(4)-7 under the Advisers Act, and (b) the CCO's aiding and abetting and causing of the foregoing violations. This article summarizes the SEC's findings in its order of settlement.

The pension consultant provides investment related consulting services primarily to public and private pension funds. It does not regularly provide discretionary money management services to its institutional clients, instead typically assisting them in discretionary money manager search and selection, asset allocation, performance measurement and review and investment policy review and design. The pension consultant has a wholly owned broker-dealer affiliate, which was created for the purpose of providing a commission recapture plan to clients. Under the commission recapture plan, clients have their trades executed through the broker-dealer affiliate, with a portion of the trading commissions generated by their investment activity used to offset the consulting fees charged by the pension consultant. The CCO, who was a founding partner and shareholder of the pension consultant, served as CCO of both the pension consultant and its broker-dealer affiliate.

#### **Code of Ethics Adoption and Recordkeeping Failures**

In July 2004, the SEC adopted Rule 204A-1 under the Advisers Act requiring all registered investment advisers to adopt a code of ethics. The compliance date for the Rule was February 1, 2005. One of the requirements for a code of ethics pursuant to Rule 204A-1 was that it mandate that all supervised persons execute a written acknowledgment of receipt of the firm's code of ethics. Amendments to the recordkeeping requirements of Rule 204-2 under the Advisers Act that accompanied the adoption of Rule 204A-1 required each adviser to maintain as records subject to inspection by the SEC all the written acknowledgments of receipt of the code of ethics executed by a firm's supervised persons. The pension consultant had maintained a code of ethics prior to the adoption of Rule 204A-1 that did not require supervised persons to execute a written acknowledgment of receipt of the code. The pension consultant did not amend its code to reflect this aspect of Rule 204A-1 prior to the Rule's February 1, 2005 compliance date. A March 11, 2005 deficiency letter to the CCO relating to an examination of the pension consultant completed during calendar year 2004, prior to the required compliance date of Rule 204A-1, included a reminder of Rule 204A-1's recent adoption and the February 1, 2005 compliance date.

After receiving the deficiency letter in March 2005, the CCO revised the pension consultant's code of ethics in an effort to comply with Rule 204A-1 and prepared written acknowledgments of receipt of the code of ethics code for execution by the pension consultant's supervised persons. When the CCO provided the written acknowledgment forms to the pension consultant's supervised persons in March, April, May and June 2005, he instructed them to date the forms as of either January 19 or 20, 2005, so it would appear that the pension consultant had complied in a timely manner with Rule 204A-1, although none of the supervised persons had received the revised code of ethics until March 2005 at the earliest. On June 9, 2005, the SEC staff requested that the pension consultant provide it with all documents evidencing compliance with Rule 204A-1. The CCO provided the SEC staff with the written

acknowledgements he had collected. The SEC found that by virtue of the foregoing the pension consultant had violated Rule 204A-1 and Rule 204-2 and that the CCO had aided and abetted and caused those violations.

### **Compliance Program Deficiencies**

When the pension consultant was initially formed in 1990, the CCO purchased a pre-packaged written "Investment Adviser Policies and Procedures Manual" from a compliance outsourcing firm. This pre-packaged policies and procedures manual was later supplemented with a copy of the 1989 version of the Advisers Act, SEC Release No. IA-1092 from 1987 regarding the scope of the Advisers Act, and an e-mail retention policy prepared in 2000. In December 2003, the SEC adopted Rule 206(4)-7 under the Advisers Act, which requires each registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Rule 206(4)-7 had a compliance date of October 5, 2004. In adopting Rule 206(4)-7, the SEC noted that there was no "single set of universally applicable required elements" for an investment adviser's policies and procedures, and that "[e]ach adviser should adopt policies and procedures that take into consideration the nature of that firm's operations." In addition, in describing how advisers should go about designing their policies and procedures, the SEC suggested that firms "should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks."

In September 2003, several months after the SEC had issued a proposing release for Rule 206(4)-7, but prior to the rule's adoption, the CCO purchased an updated pre-packaged Investment Advisers Policies and Procedures Manual electronic template from a compliance outsourcing firm. The CCO printed a paper copy of this template, made certain handwritten annotations on it and then appended it to the pension consultant's existing 1990 pre-packaged policies and procedures and the other documents constituting the pension consultant's compliance policies and procedures up to that time - the 1989 version of the Advisers Act, SEC Release No. IA-1092 and the 2000 e-mail retention policy. As of October 5, 2004, the compliance date for Rule 206(4)-7, these documents constituted the pension consultant's written policies and procedures.

The SEC took issue with the pre-packaged policies and procedures manuals and templates purchased by the CCO in 1990 and 2003 on several grounds. First, they were designed for use by investment advisers offering discretionary money management services to clients and were not designed for use by institutional or pension consultants. In particular, the pre-packaged policies and procedures manual and template did not adequately address the conflicts of interest unique to the pension consultant's business. In addition, many sections of these generic forms were completely inapplicable to the pension consultant. The SEC found that in adopting the pre-packaged policies and procedures manual and template the pension consultant failed to undertake adequate efforts to identify the risk factors or specific conflicts that may have been applicable to its particular business. In particular, the SEC cited the pension consultant's failure to give specific consideration to any of the potential conflicts of interest existing in its relationship with the wholly-owned broker-dealer subsidiary through which it ran its commission recapture plan. Neither of the pre-packaged policies and procedures addressed the financial incentive for the pension consultant to refer clients to discretionary money managers that use the affiliated broker-dealer rather than other broker-dealers, or that have a history of generating more commissions than other managers. Because of the inadequacies of the pension consultant's compliance policies and procedures, the SEC found that the pension consultant had violated Rule 206(4)-7 and that the CCO had aided and abetted and caused those violations. (As in another recent enforcement proceeding involving a pension consultant's conflicts of interest (see the September 25, 2007 *Alert*), the SEC found no violations of the Advisers Act's anti-fraud provisions designed to protect advisory clients.)

## Remedial Efforts

During the SEC's investigation, the pension consultant voluntarily retained an independent compliance consultant to assist in bringing the pension consultant's written supervisory and compliance policies and procedures, and disclosure documents used with existing and potential clients, into compliance with applicable requirements under the Advisers Act. When the pension consultant became aware of the extent of the CCO's conduct as described above with respect to the pension consultant's code of ethics, the pension consultant placed him on administrative leave and removed him from all compliance and supervisory roles. Following an independent investigation into the CCO's conduct, the pension consultant allowed the CCO to return to the firm in the limited capacity of providing advisory services to his existing clients, while operating under heightened supervisory standards. The SEC took the pension consultant's prompt remedial efforts and cooperation with the SEC staff into consideration in reaching the settlement.

## Sanctions

Among other sanctions, the SEC assessed civil money penalties of \$20,000 and \$10,000 against the pension consultant and the CCO, respectively. In addition, the CCO was barred from association in a compliance capacity with any broker, dealer or investment adviser.

## ➤ SEC Permits Banks to Engage in Certain Reg S and Conduit Lending Transactions Without Being Deemed a "Dealer"

The SEC finalized exemptions under Section 3(a)(5) of the Securities Exchange Act of 1934 (the "Exchange Act") permitting banks to engage in certain riskless principal transactions under Regulation S and securities lending activities as principal (so-called "conduit lending") without being deemed a dealer under the Exchange Act. The amendments become effective November 2, 2007.

*Regulation S.* As to the Regulation S dealer exemption, the final rule exempts riskless principal transactions by a bank that (1) purchases an "eligible security" from a broker-dealer ("BD") or issuer and sells the security to a purchaser not in the US, provided the sale is in compliance with 17 CFR 230.903; (2) purchases an "eligible security" from a person who is not a US person (as defined in Reg S) after the initial sale with a reasonable belief that the security was initially sold outside the US in compliance with Reg S and resells the security to a purchaser who is not in the US or is a BD (with additional requirements if the resale is before the expiration of the distribution compliance period); or (3) purchases from a BD an "eligible security" after the initial sale in the reasonable belief that the security was initially sold outside the US in compliance with Reg S and resells the security to a purchaser who is not in the US (with the same additional requirements if the resale is before the distribution compliance period). Exemption (3) was made pursuant to commentator request based on the SEC's acknowledgement that the requirements for the bank to create a reasonable belief are substantially the same whether it purchases the security from a non US person or a BD. An "eligible security" for these purposes is a security not being sold from the inventory of a bank or an affiliate, and that is not being underwritten by the bank or an affiliate on a firm-commitment basis.

*Conduit Lending.* The final rule also adopts as proposed an amendment to the Exchange Act to permit banks, without having to register as a "dealer" to engage in "conduit lending" with either (A) qualified investors, or (b) employee benefit plans that own and invest, on a discretionary basis, not less than \$25 million. "Conduit lending" is a type of securities lending whereby a bank "borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same securities, as principal, for its own account." The exemption also permits banks to provide "securities lending services," which is defined to include selecting and negotiating with the borrower, receiving, delivering or directing the receipt of loaned securities, and receiving, delivering or directing the receipt of collateral.

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## ➤ **District Court Rejects Application of Preemption of State Mortgage Laws to Independent Agents of Federal Thrift**

The United States District Court for the Southern District of Ohio (the "District Court") declined to extend federal preemption of Ohio's state mortgage licensing laws to exclusive agents of State Farm Bank, F.S.B., a federal thrift. The District Court's decision conflicts with a 2006 decision in the United States District Court for the District of Connecticut ("District of Connecticut"). In 2004, the Chief Counsel of the OTS issued an interpretive letter to State Farm Bank concluding that local licensing laws were preempted as to exclusive agents of federal thrifts, to which interpretation the District of Connecticut gave controlling weight. However, in granting summary judgment in favor of the Ohio Division of Financial Institutions, the District Court held that the OTS failed to comply with the Administrative Procedures Act by issuing the interpretation because it did not promulgate new regulations subject to formal public notice and comment procedures. The District Court stated that, although the OTS might have the authority to promulgate regulations extending federal preemption to such agents, current OTS regulations do not provide for such preemption." *State Farm Bank F.S.B. v. Reardon*, No. C2-05-268 (S.D. Ohio).

## ***Other Item of Note***

### ➤ **GAO Issues Report Addressing Limitations in SEC Enforcement Division's Operations**

The General Accounting Office (the "GAO") issued a report that evaluates the SEC Division of Enforcement's investigation planning and information systems and its oversight of the Fair Fund program for distributing monies collected in securities law enforcement cases to affected investors. The report details measures taken to address limitations in the Division's processes and systems for planning, tracking and closing investigations and eliminate delays in the distribution of Fair Fund monies, noting that substantial problems remain. The report includes several recommendations, all of which the SEC has indicated it will implement.