ComplianceAlert

July 2008

Dear Chief Compliance Officer:

The SEC staff conducts compliance examinations of SEC-registered investment advisers, investment companies, broker-dealers, and transfer agents and other types of registered firms to determine whether these firms are in compliance with the federal securities laws and rules, and to identify deficiencies and weaknesses in compliance and supervisory controls. This "*ComplianceAlert*" letter summarizes select areas that SEC examiners have recently reviewed during examinations and describes the issues we found and some of the practices we observed. By periodically sharing this information with compliance personnel, our intent is to alert you to these issues, encourage you to review compliance in these areas at your firm, and encourage improvements in compliance and in compliance programs. Some of the practices we discuss are for informational purposes, are not legal requirements, and, depending on the characteristics of your firm, may not be practicable for your firm to implement given its business or operations. We note that this document was prepared by the SEC staff. /[1]

I. Investment Advisers/Mutual Funds

Personal Trading by Advisory Staff

Personal trading by access persons is an area of focus during many examinations of investment advisers. Specifically, examiners review an adviser's internal compliance controls surrounding its employees' trading and trading by the firm for its own proprietary accounts. Deficiencies frequently identified by examiners include:

- *Adviser's code of ethics was incomplete.* The adviser's code of ethics did not appear to address all regulatory requirements. For example, examiners have commented when firms' codes of ethics do not require access persons to obtain pre-approval before investing in certain limited investment opportunities (*e.g.*, private placements, hedge funds, or initial public offerings).

- *Adviser's code of ethics was not followed.* The adviser and/or its employees engaged in practices that deviated from the adviser's written code of ethics (*e.g.,* trades were not pre-cleared, pre-clearance forms did not contain information required to be provided by the employees, the adviser did not receive duplicate confirmations, and trades were placed in securities that are on the adviser's "do not trade" list). Examiners also commented when they believe an adviser had weak control procedures regarding oversight of supervised investment personnel (*i.e.*, portfolio managers, traders, and analysts), such as when these personnel disclosed sensitive portfolio and trading information to advisory personnel at other advisory firms, which were managing the supervised personnel's money in hedge funds or separate accounts.

- *Reporting requirements were not followed and/or monitoring was not performed.* Access persons did not submit, or did not submit in a timely manner, reports of their personal securities transactions or holdings consistent with applicable regulations or the adviser's policies and procedures. Also, some advisers did not review reports of access persons' personal trading for indications that trades were inconsistent with applicable regulations or the adviser's policies and procedures.

- *Disclosure was inaccurate.* The adviser's brochure appeared to contain inaccuracies with respect to its controls over personal trading.

Examiners recently conducted a risk-targeted examination review that focused on advisers' compliance practices and internal controls with respect to access persons' personal trading and trading in proprietary accounts. In addition to firms establishing procedures to ensure compliance with specific regulatory mandates, examiners observed that the following practices appeared to be effective in assisting in preventing violations of the Advisers Act:

Internal Compliance Controls

- Written policies and procedures were designed to address conflicts of interest with respect to trading in personal and proprietary accounts.
- Restricted lists and watch lists were accurate and maintained on a current basis.
- Time-stamped order tickets were utilized.
- To enable centralized monitoring of all trading, all personal securities transactions were effected through the adviser's trading desk.
- Trades in client accounts were consistently bundled with, or executed prior to, trades in personal or proprietary accounts.
- "Black-out" periods, during which access persons are not permitted to execute personal securities transactions, were strictly enforced.
- Access persons were prohibited from engaging in short-term trading (*i.e.*, the purchase and sale of a security within 60 days).
- Any exceptions from the policies stated in the adviser's code of ethics that were granted to supervised persons were reasonable and documented.
- Access persons were required to direct their broker-dealers to provide duplicate trade confirmations and copies of monthly brokerage statements to the adviser.

Compliance Review and Reporting

- Trade allocations were determined prior to or soon after the trade was executed. Any post-execution changes to trade allocation were documented and reviewed by an appropriate individual to ensure that the allocation was consistent with the adviser's policies and procedures.
- Documentation of pre-approval of personal securities transactions was created at the time of the approval and was maintained. In addition, pre-clearance forms prepared by access persons were subsequently compared to the actual trading in those persons' accounts.
- Procedures were in place to ensure that trading does not occur in client accounts, employee personal accounts, or the adviser's proprietary accounts while the adviser or its employees are in possession of material, non-public information pertaining to that security. Information barriers are in place to prohibit the flow of such information. These conflicts of interest were addressed in the adviser's written policies and procedures. Examiners especially focus on these procedures when a related person of the adviser also serves on the board of directors for an issuer and, therefore, may have access to non-public information.
- Performance of client accounts was compared to the performance of personal and firm proprietary accounts employing similar investment strategies for any indications of preferential treatment.

- Personal and proprietary securities transaction records were maintained electronically so that analyses could be more efficiently performed and outlier issues researched. Examples of analyses included, identifying when a high percentage of personal trades for an access person were profitable (in absolute terms and in relation to clients) or identifying when a personal trade resulted in exceptional returns.

- Prices were adjusted if, on the same day, trades in related accounts were executed at a better price than client accounts.

- The reviewer of personal securities transactions had his or her own personal securities transactions reviewed by another officer or control person of the adviser.

- Supervised persons who violated or continued to violate the adviser's policies and procedures with respect to trading in personal or proprietary accounts were reprimanded.

- The adviser periodically reported code of ethics violations to funds' boards of directors and provided prompt notice of any serious violations.

Examiners noted that, at many of the advisory firms that appeared to have effective compliance programs in this area, compliance personnel were actively involved in implementing those programs. For example, the compliance department implemented policies and procedures for personal securities transactions and trading in proprietary accounts and ensured that all employees were aware of the advisers' policies and procedures. Further, compliance personnel not only provided employees with the firm's code of ethics as mandated by the regulations, but expanded on the regulatory requirements by ensuring that firm employees received training in the adviser's policies and procedures and requiring firm employees to acknowledge each year, in writing, that they had *read* the adviser's code of ethics.

Proxy Voting and Funds' Use of Proxy Voting Services

Examiners recently reviewed practices with respect to the use of third-party proxy voting services, including the oversight and operational aspects of mutual funds' proxy voting, and how advisers managed conflicts of interest in proxy voting. The services performed by the third-party proxy services included the following: processing proxies for fund clients; managing and tracking proxy voting on securities held in client accounts; filing Form N-PX; report generation for reconciliation purposes; vote recommendations; research; and casting actual votes using the firms' or the service providers' guidelines. The most frequent service provided by a proxy voting service was the management of the administrative aspects of proxy voting. Some services were highly specialized. For example, a proxy service may be engaged solely to vote when the adviser has a material conflict of interest.

Proxy Voting Oversight and Operations

The funds examined typically had an oversight process, which included board participation, to monitor the funds' proxy voting. Among other things, examiners confirmed that fund boards reviewed and ratified the funds' proxy voting policies annually and analyzed significant changes. Typically, the boards received a copy of the funds' voting record on Form N-PX. Several advisers elected to establish a proxy voting oversight committee to monitor the proxy voting process and to ensure their proxy voting procedures were followed.

Most advisory firms had adopted policies and procedures with respect to proxy voting as required under the proxy voting rule. However, in some instances, examiners discovered that the proxy voting policies and procedures seemed to contain inaccurate information or were not followed. In other instances, the firm could not say whether it voted on several matters or whether an accurate record of those votes was recorded on Form N-PX. Some deficient practices highlighted by examiners included:

> *Board oversight of use of proxy service providers appeared to be weak.* In some instances, the funds had neither established controls to confirm that the proxy service providers' recommendations were consistent with funds' policies and procedures nor requested information regarding conflicts of interest at the proxy service providers.
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> *Advisers did not document their assessment of proxy service providers.* Some firms had not documented their review of the proxy service providers used; therefore, examiners could not assess whether the adviser had established and implemented measures reasonably designed to identify and address proxy voting firms' conflicts of interest. Examiners also could not confirm claims of proxy service provider independence.
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> *Funds voted inconsistently with their proxy voting policies.* Funds attributed these mistakes to clerical errors or misapplication of fund voting guidelines to specific votes.
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> *Funds did not file Form N-PX containing the funds' proxy voting record as required.* In several instances, firms did not include a record of all votes cast on Form N-PX. In other instances, proxies were not included on Form N-PX because they were never voted or funds did not meet the specific requirements of Form N-PX. For example, the form requires funds to briefly identify the matter voted on. Firms sometimes used vague descriptions of votes that did not succinctly describe the proxy matter or the fund's vote on the matter.
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> *Fund disclosures appeared deficient.* Several fund groups did not include the necessary disclosures in their Statements of Additional Information regarding the availability of the proxy voting policies and procedures, as required by Form N-1A.
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> *Improper fees were charged.* An adviser allocated proxy service fees to funds, purportedly for services rendered, which did not hold voting securities that would require such services. Another adviser used soft dollars to pay for proxy voting services unrelated to issuer research without adequately disclosing this practice.

Process for Identifying Potential Conflicts of Interest

An adviser might have a conflict of interest between its business interest and the interests of its clients and shareholders. The firms examined generally had a process to identify conflicts of interest with respect to proxy voting. Often firms relied on the fund's chief compliance officer, the adviser's proxy coordinator, or other advisory employees to identify such conflicts. The proxy coordinator was often a senior employee knowledgeable about potential conflicts of interest that may exist between the adviser and its clients. These processes generally appeared to be effective.

Valuation and Liquidity Issues in High Yield Municipal Bond Funds

Many high yield municipal bond funds invest in securities that trade in the secondary market on an infrequent basis or never trade in the secondary market. Market quotations for such securities are often not considered to be readily available. Such limited market activity usually results in the funds' boards determining the fair value of these instruments for net asset value purposes, often considering pricing services' evaluated prices. Further, liquidity determinations for a high yield municipal bond fund are critical to ensure that the fund is able to redeem fund shares within seven days, as required under the Investment Company Act.

During these examinations of high yield municipal bond funds, examiners generally focused on portfolio composition, valuation, and transaction activity. Specifically, examiners: analyzed the credit quality of portfolio holdings; reviewed illiquidity levels as determined by fund management;

compared sales prices to prior day valuations; compared bond valuations provided by pricing services to market transaction data; reviewed fund policies and procedures relevant to security valuation and determinations of liquidity including, where applicable, board oversight of those policies and procedures; reviewed portfolio credit and research files; and interviewed compliance and advisory personnel regarding policies and procedures and internal controls relevant to valuation and liquidity determinations.

During a series of targeted examinations focusing on high yield fund valuation, examiners noted the following:

> *Portfolio composition.* High yield funds with higher average credit qualities, fewer unrated securities, and fewer distressed and defaulted securities were generally less likely to have issues regarding valuation and liquidity raised by examiners. The percentage of illiquid securities held among the funds examined ranged from less than 1% to 70% of the fund's portfolio holdings. Examiners particularly focused on whether funds may have been overvaluing securities classified as illiquid.
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> *Disclosure.* High yield funds often did not disclose the increased risk with respect to liquidity and valuation, as required. For example, examiners commented in situations where the percentage of illiquid securities held by a fund dramatically increased and the fund did not disclose: that a dramatic increase in the percentage of the fund invested in illiquid securities occurred and the risks associated with such an increase; what effect, if any, the increase may have on the fund's ability to redeem investor shares in a timely manner consistent with the federal securities laws; and what steps, if any, the fund may take to dispose of some of the illiquid securities to bring the percentage within a range appropriate to the circumstances.
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> *Third-party pricing services.* Pricing services often relied on fund management to provide information needed to value securities held by high-yield funds. Examiners commented that the fund's disclosure may be misleading if, in such instances, the fund represented that its pricing source provided "independent" values. Examinations revealed that pricing services relied on fund management to provide information at times, which may have resulted in stale review periods and stale valuations for a number of Rule 15c2-12 exempt securities. In addition, some funds were unable to sell securities at approximately the evaluated prices provided by a pricing service. Examiners may comment if the fund's board does not consider this information when subsequently evaluating the accuracy of the evaluated prices provided by the pricing service.
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> *Cross trades.* An adviser's trading of securities among client accounts can create risks that securities will be "dumped" from one client account to another, that the securities may be mispriced because they are not traded in the open market, or that one client may otherwise be disadvantaged. The few funds examined that entered into cross trades of securities for which there was no secondary market information were unable to provide examiners with documentation supporting their determination that the evaluated prices provided by the pricing services and used to cross the trades sufficiently represented market values (*i.e.*, trade execution data, the latest bid and ask quotes, and information about offerings of similar securities).
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> *Board oversight.* It appeared that some funds did not adequately assess the accuracy of prices provided by pricing services. Examiners noted that some high yield funds' with effective valuation procedures required documentation and review of communications between portfolio management personnel and pricing services. The review of such communications can serve to detect and prevent inappropriate influence by portfolio management personnel over the valuation process and would substantiate the independence of a third-party pricing service.

Records retention. The manner in which some high-yield funds chose to maintain their pricing histories for portfolio securities created difficulties for the personnel responsible for the high-yield funds' pricing, and for boards of directors, to determine trends in price movements. Specifically, while not required, examiners have noted that funds' compliance reviews using electronic records allow for more efficient analysis and review of fund records for valuation anomalies and patterns requiring further research.

Soft Dollar Practices of Investment Advisers

Examiners recently reviewed the soft dollar arrangements maintained by a number of registered investment advisers. The focus of these examinations was to gain a better understanding of: the extent to which advisers to institutional clients, including hedge funds, use soft dollar arrangements to obtain third-party and/or proprietary services or products; the disclosures advisers provide to their clients regarding soft dollar practices; and the policies and procedures that advisers who receive soft dollar benefits use to meet their fiduciary duty to seek best execution.

In reviewing soft dollar transactions, examiners generally review arrangements that an adviser may have with both third-party and proprietary providers. Generally, examiners will review documents and information regarding the adviser's policies and procedures related to brokerage, trading, and soft dollar arrangements. In addition, examiners will consider the identity of broker-dealers and service providers used and the products and services received from them, as well as trade journals, commission runs, disclosure documents, investment advisory contracts, any written agreements relating to soft dollar arrangements (including commission sharing arrangements), and any documentation of the adviser's periodic evaluation of execution quality.

In our recent review, examiners observed the following:

Products and services. The advisers examined generally received both proprietary and third-party products and services through soft dollar arrangements with broker-dealers. Research and trade execution assistance products and services were the most common. Many advisers received "mixed-use" products or services and a few advisers received products and services outside those that are defined in the safe harbor under Section 28(e) of the Securities Exchange Act of 1934.

Total commissions directed. All of the advisers examined who had soft dollar arrangements told examiners that they had informal commission "targets" with the broker-dealers who provide them with third-party or proprietary research services. Advisers stated that these commission targets were intended as guides and did not obligate the advisers to firm commitments. On average, 20% of these advisers' total client commissions were directed to broker-dealers through which the advisers earned soft dollar credits, though the percentage among all of the advisers ranged from about 3% to 100%. Commissions on transactions that earned soft dollar credits ranged from $0.01 to $0.08 per share, with an unweighted average commission rate on soft dollar trades of $0.05 per share.
Best execution analyses. Most advisers documented their efforts to seek best execution, as required. Advisers typically conducted "periodic" execution quality reviews on an annual, semi-annual, or quarterly basis. To ensure consistency with regulations and internal compliance policies and procedures, many advisers chose to assign the responsibility for such reviews to brokerage or compliance committees. Examiners evaluated the quality of firms' best execution reviews, which varied – some were more detailed and comprehensive than others.

Most of the advisers examined who were relying on the Section 28(e) safe harbor made determinations that commissions were reasonable in light of the brokerage and research services received, as required. Some advisers, in making such determinations, elected to regularly compare the amount they might have been “paying up” against the actual value of the research. In situations where advisers have not evaluated the value of the research received through the use of soft dollar credits and the commissions are higher than examiners would expect for the instruments traded, examiners may question whether the advisers have overpaid for such research.

A few advisers accumulated large soft dollar credit balances at broker-dealers, up to millions of dollars in value. As a result, examiners analyzed further whether the commissions paid may not have been reasonable, especially when some advisers were paying higher commission rates and were not receiving products or research. For example, examiners evaluated whether an adviser had the opportunity to misappropriate client assets, such as if an adviser accepted cash rebates offered by broker-dealers for the outstanding soft dollar credit balances maintained with the broker-dealers.

Disclosures. Most of the advisers disclosed the types of products, research and services received in exchange for soft dollars, as required. Advisers also generally complied with regulatory guidance by disclosing: that clients may pay commissions higher than those obtainable from other broker-dealers in return for the research, products and services; that research is used to service all accounts and not just those accounts paying for it; and, the procedures they follow when they direct client transactions to particular broker-dealers in return for products, research and services received.

Most advisers complied with their obligation to disclose the existence of conflicts of interest from their receipt of research obtained with soft dollars, including the adviser’s incentive to use client brokerage commissions to purchase research that the adviser might otherwise have to purchase with its own money. They also, as required, disclosed that certain products and services may have a mixed-use and the extent of the allocation between hard and soft dollars. However, examiners commented when an adviser does not disclose conflicts of interest, such as when an adviser has acquired research with soft dollar payments from a research company in which affiliated persons have an ownership interest.

Examiners also commented when advisers that acquired products and services outside the Section 28(e) safe harbor, such as internet domain fees, wireless services for a Blackberry, and telecommunications and computer equipment, did not disclose this practice to clients. Examiners also may comment if an adviser expressly represented to clients that it would only engage in soft dollar arrangements within the Section 28(e) safe harbor, but nonetheless earned soft dollar credits by trading in accounts for which the adviser does not have brokerage or investment discretion.

Compliance policies, procedures, and/or controls. Most advisers examined had policies and procedures related to soft dollar practices. While these policies and procedures varied per firm, examiners noted that effective practices required the adviser to maintain reports of soft dollar arrangements and transactions, reconcile commissions on a periodic basis, review mixed-use product allocation, and ensure that its chief compliance officer or a committee approve, in advance, specific products and services acquired with soft dollars.

II. Broker-Dealers

Examinations of Securities Firms Providing “Free Lunch” Sales Seminars

As part of a focused effort to protect senior investors, FINRA, NASAA and the SEC conducted a series of over 100 examinations of broker-dealers, investment advisers and other financial services firms that offer so-called “free lunch” sales seminars. In sum, examinations observed that:

Sponsors of "free lunch" sales seminars offer attractive inducements to attend. The seminars are commonly held at upscale hotels, restaurants, retirement communities and golf courses. In addition to providing a free meal, the firms and individuals that conduct these seminars often use other incentives (*e.g.*, door prizes, free books, and vacation deals) to encourage attendance.

Often, the target attendees are seniors. Many of the "free lunch" sales seminars are designed to solicit seniors. They are advertised with names like "*Seniors Financial Survival Seminar*" or "*Senior Financial Safety Workshop,*" and offer "free" advice by "experts" on how to attain a secure retirement, or offer financial planning or inheritance advice. The advertisements used to solicit attendees often imply that there is an urgency to attend. For example, invitations include phrases such as "limited seating available" or "call ***now*** to reserve a seat."

Seminars are designed to sell. Many sales seminars were advertised as "educational," "workshops," and "nothing will be sold at this workshop," and many advertisements did not mention any investment products. Nonetheless, the seminars apparently were intended to result in the attendees' opening new accounts with the sponsoring firm and, ultimately, in the sales of investment products, if not at the seminar itself, then in follow-up contacts with the attendees. Examiners noted that the most commonly discussed products at the sales seminars were variable annuities, real estate investment trusts, equity indexed annuities, mutual funds, private placements of speculative securities (such as oil and gas interests), and reverse mortgages.

Some firms had particular compliance and supervisory controls that appeared to be effective. Regulators identified specific compliance and supervisory practices that appeared to be effective in ensuring compliance with the securities laws and rules. For example, requiring its employees to forward all materials to its home office for a supervisory and compliance review prior to using the materials at sales seminars. Another effective procedure utilized checklists to aid supervisors with the approval process for seminars and seminar materials (more detailed examples of these practices are set forth in Appendix B to the public report referenced below).

Half of the examinations found that firms used advertising and sales materials that may have been misleading or exaggerated or included seemingly unwarranted claims. Many broker-dealer firms did not submit their sales material to NASD (now FINRA) for review, as required by NASD advertising rules. The most common types of apparently misleading statements appeared on mailers and advertisements for the sales seminars, and involved statements about the safety, liquidity or anticipated rates of return. Statements included, for example: "Immediately add $100,000 to your net worth," "How to receive a 13.3% return," and "How $100K can pay 1 Million Dollars to Your Heirs." Additionally, some sales materials made comparisons between dissimilar investments or services, included representations about the expertise or credentials of the registered representative that may have been misleading or confusing, or involved testimonials that may have been misleading.

Individuals attending the sales seminars may not understand that the seminar is sponsored by an undisclosed company with a financial interest in product sales. The mailers and advertisements for the sales seminars often focused on the individuals who would be conducting the seminar, and often included the name of the registered representative or investment adviser, a photograph and information about his/her background as an expert in providing investment advice, and his/her history in the local community. Attendees at the seminars are not always provided with the name of the firm sponsoring the seminar, and may not be aware that product sponsors (*e.g.*, mutual fund companies and insurance companies) may provide funding for the seminars with the expectation that investment professionals will sell their products. In these situations, seminar attendees may not have known that the financial adviser speaking at the seminar was not unbiased in making product recommendations.

Many examinations discovered indications that firms had poorly supervised these sales seminars. Examiners noted indications of weak supervisory practices in 65 of the 110 examinations. For example, a common finding was that firms appeared to have inadequate supervisory procedures or had not implemented their procedures with respect to sales seminars held by their employees.

In some examinations registered representatives or investment advisers holding the sales seminars had recommended investments that did not appear to be suitable for the individual customers. In 25 of the 110 examinations (or 23% of examinations conducted), examiners found indications that unsuitable recommendations to purchase investments were made at the sales seminars, or following the seminar when an attendee opened an account. The investments appeared to be unsuitable in light of the customers' investment objectives or time horizon – *e.g.*, a risky investment was recommended to an investor with a "conservative" investment objective, or an illiquid investment was recommended to an investor with a short-term need for cash.

In some instances, the sales seminars may have involved fraud. Examiners found indications of possible fraudulent practices in 14 examinations (or 13% of the examinations conducted), that involved potentially serious misrepresentations of risk and return, liquidation of accounts without the customer's knowledge or consent, and sales of fictitious investments.

Financial services firms should take steps to supervise sales seminars more closely, and specifically take steps to review and approve all advertisements and sales materials for accuracy. In addition, the report concluded that firms should redouble efforts to ensure that the investment recommendations they make to seniors are suitable in light of the particular customer's investment objectives, and assure that supervisory procedures with respect to sales seminars are being implemented effectively. Regulators participating in these examinations will continue to focus examination, enforcement and regulatory efforts on the use of sales seminars targeted to seniors.

The results of the examinations are described in detail in a public report entitled, *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 10, 2007), at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf. The report includes a list of supervisory practices that were identified during examinations and that appeared to be effective (Appendix B of the report).

Valuation and Collateral Management Processes

Examiners recently completed examinations of certain large broker-dealer firms to assess their valuation and collateral management practices as they relate to subprime mortgage-related products, and coordinated these valuation examinations with FINRA. The examinations generally focused on the controls around the valuation process. An important control is the verification by independent personnel of the valuations assigned by trading personnel. This independent verification function is referred to as the "product control." During the late spring and summer of 2007, examiners observed, in general, that firms faced increasing difficulty in independently verifying their inventory valuations due to a lack of market liquidity. As a result, firms have become more reliant on modeled prices as opposed to independent third party pricing services and/or transactions. Several firms revised their valuation procedures to consider more broadly observable market information by looking to trades in the derivative markets, which include single name credit default swaps and subprime mortgage-related index trades in credit default swaps, to assist in the calibration of valuations. Examiners noted the following issues during the review:

Price verification deficiencies. At some firms, the product control groups employed certain processes that appeared to be of questionable merit or failed to be sufficiently vigorous in undertaking the price verification function. This included the use of outdated information in determining valuations, reliance on non-independent contributing sources for valuation determination, the failure to fully address variances, and the use of manual procedures (in contrast to the use of automated processes in the verification function, including the use of data feeds and modeling tools).

Insufficient staffing. In some examinations, the independent product control groups did not appear to be sufficiently staffed, and/or were staffed with individuals with limited experience in validating modeled prices, which left them highly reliant upon trading personnel for valuations.

Policies and Procedures. The policies and procedures for verifying inventory valuations were not documented; and/or, were not accurately and/or sufficiently detailed; and/or, the intended procedures as documented were not adhered to.

Documentation. In some examinations, the documentation standards and practices with respect to the retention of the price verification work performed by the product control groups were not established and/or memorialized. In addition, standards were inconsistent across firms in that, some retained a substantial amount of documentation, while others recreated the supporting analysis or were unable to provide support for their independent valuations.

Verification of Collateral Prices. In some examinations, the product control groups were not routinely engaged in assessing the valuation of collateral. At some firms, only the limited number of securities that were both held as collateral and held in inventory were subject to review by the product control group. At other firms, subprime securities held as collateral were solely by proprietary traders and/or outside pricing services, with no oversight by the product control group. In addition, one firm utilized prices received directly from an affiliate of two counterparties to value collateral that it was financing for those very same counterparties.

Inconsistent pricing. In some examinations, there were limited instances of inconsistent pricing between the same securities held in inventory and also held as collateral for financing transactions with counterparties. These discrepancies appeared to result from limitations in data management at these firms.

Margin on collateral. In some examinations, the processes surrounding the issuance and resolution of margin calls were not established, adhered to, and/or adequately documented. In some examinations, the application of margin on collateral held for financing transactions was not adequately documented in the firm's procedures and/or was unsupervised, resulting, in some cases, in variances from the firms' established procedures.

In this area, the following would be examples of strong control practices:

The product control group at firms employ processes and procedures that are aligned with market conditions. Policies and procedures with respect to valuation contemplate the possibility of illiquid markets, and that illiquid market conditions will necessitate alternative pricing methodologies that may require the verification and assessment of modeled inputs and the calibration of valuations against trades or trade information inferred from activity in similar securities and or the derivative markets.

The product control group is adequately staffed and includes members that have the experience, knowledge and capability of assessing the valuation of the securities they are charged to review.

There are established standards and documentation is maintained to support the valuations appearing on their financial statements. Retention of records used in determining value helps provide the necessary audit trail and transparency that is essential to understanding the valuation of these securities. Such records include inputs to models, cash flow analyses, valuation matrix assignments, a description of third party valuation sources that were utilized, and any other relevant information.

Independent product control groups are involved in monitoring collateral valuations by, at a minimum, including difficult-to-value positions in periodic month-end reviews.

Firms maintain an internal data warehouse that serves as the internal repository for security position information, including periodic valuations, in order to ensure consistency amongst various inventory trading accounts and collateral valuations.

Firms ensure that price verification, collateral management, and margin call processes and procedures are adequately documented and contain enough specificity to ensure consistent application. Furthermore, firms ensure that changes to written procedures are timely incorporated and that procedures are implemented effectively.

Broker-Dealers Affiliated with Insurance Companies

Many insurance companies have broker-dealer subsidiaries that were initially created or purchased to facilitate the sales of insurance/securities products, such as variable annuities and variable life insurance. Many of these firms have transitioned over time to become full service broker-dealers.

Examiners conducted targeted reviews of a number of broker-dealer subsidiaries of insurance companies. Examinations observed:

Apparently unsuitable recommendations and apparently inadequate supervisory procedures. Some examinations identified apparently unsuitable mutual fund and/or variable annuity transactions. Examiners also discovered instances of apparent supervisory deficiencies that were primarily the result of inadequate written supervisory procedures maintained by the firms and instances of failure to implement written supervisory procedures.

Financial responsibility rule deficiencies. Examiners noted deficiencies in firms' compliance with the financial responsibility requirements for broker-dealers and identified the need for net capital adjustments.

Many of these apparent deficiencies were due to lack of compliance, operational and supervisory controls. In some cases, these firms were managed by individuals whose primary experience was in the insurance industry, and who did not appear to have a comprehensive knowledge of the rules and regulations of the securities industry.

Supervision of Solicitations of Advisory Services

Examiners conducted a series of targeted examinations of broker-dealer firms that had designated their registered representatives as "solicitors" for an investment adviser. The examinations reviewed, among other things, how supervision was implemented for these registered representatives' activities as solicitors. In general, a solicitor is the investment adviser's "salesman" to potential clients of the adviser; however, in these examinations, examiners noted that the solicitors/registered representatives were providing investment advice to customers – they were guiding the client's selection of an investment program and the underlying products in the program.

Lack of responsibility for suitability. In some cases, the examinations discovered an apparent lack of supervisory controls - that is, neither the broker-dealer nor the investment adviser had assumed responsibility for monitoring the suitability of the advisory services and the suitability of recommendations of the underlying investments for the customers of the broker-dealers, or the clients of the investment adviser. In particular, examiners noted that the investment adviser attempted to delegate responsibility for performing a suitability review to the broker-dealers by contract, which created an apparent gap in the supervision between the adviser and the broker-dealer.

Supervision for suitability. Several broker-dealers did not appear to fully comply with their supervisory obligations because they did not establish and/or enforce adequate written procedures to supervise solicitor activity by their registered representatives. In particular, it was often unclear whether transactions recommended to customers by registered representatives had been reviewed by a principal for suitability.

Sales material. Some of the broker-dealer firms used apparently false and/or misleading advertising and sales literature, and apparently did not file their sales material with the NASD, and/or they failed to have a principal of the firm indicate evidence of review and approval of materials.

Mortgage Financing as Credit for the Purchase of Securities

In recent years, some broker-dealers have recommended that their customers purchase securities, and, to finance the purchase of securities, the broker-dealer has recommended that the customer obtain a second or reverse mortgage on their home through a bank affiliated with the broker-dealer. In these transactions, a risk exists that the customer may not generate sufficient returns in his/her securities account to fund the interest due on the mortgage, and that investors may risk the loss of their home.

Examiners conducted a risk-targeted examination of broker-dealer firms to evaluate this practice. Examinations noted that many of the firms had specifically prohibited their registered representatives from recommending that customers obtain loans (other than through margin accounts) to purchase securities. Examinations revealed, however, that some firms maintained incentive programs for registered representatives to refer customers to an affiliated bank for a mortgage.

Supervision and record-keeping. Examinations indicated that supervision and record-keeping relating to these activities appeared to be poor. For example, some firms did not provide adequate supervision over registered representatives to ensure that they complied with the firm's policy prohibiting a registered representative from recommending that customers obtain a home mortgage to purchase securities. Broker-dealers did not have records readily available that would indicate instances where customers had obtained a home mortgage from an affiliated bank and used the proceeds to purchase securities. Absent this information, broker-dealer firms did not appear able to assess compliance with the firms' internal policy prohibiting registered representatives from recommending that customers obtain a home mortgage to purchase securities.

Suitability. Examiners made comments with respect to the suitability of recommendations, as well as a possible misrepresentation about the "safety" of mortgaging a home to purchase securities by registered representatives at another firm.

Office of Supervisory Jurisdiction Supervisory Structure

Examiners conducted a targeted review of a sample of broker-dealer firms' supervisory and compliance controls under an Office of Supervisory Jurisdiction (OSJ) structure. In particular, examiners reviewed each firm's supervisory structure and practices, and its supervision of its branch offices, including the results of the firm's internal inspections.

While examinations revealed apparent deficiencies in a range of areas, the most notable pertained to:

> *Supervisory policies and procedures.* Many of the broker-dealers and OSJs examined apparently had not adopted, implemented, and/or consistently adhered to adequate written supervisory procedures. These deficiencies involved procedural and substantive inadequacies in the review of customer accounts, the handling and reporting of customer complaints, reviews of correspondence and employee accounts, annual branch inspections, and the execution of supervisory duties. These apparent supervisory and compliance deficiencies allowed indications of sales practice problems to go undetected and unreviewed by many of the firms examined. For example, examiners noted instances of Class B and Class C shares of mutual funds being recommended where it appeared that customers could have received breakpoint discounts for purchasing Class A shares, thereby raising suitability issues.
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> *Record-keeping.* Examiners also discovered apparent books and records deficiencies, including failures to: prepare adequate records documenting customer complaints; prepare and maintain checks received and variable annuity trade blotters; maintain employee outside account statements; maintain or approve customer new account forms; complete order tickets; and maintain customer advisory agreements.

III. Transfer Agents

Practices with Respect to "Lost Securityholders"

When the owner of a security is "lost," transfer agents are required to exercise reasonable care to ascertain the securityholder's correct address. Under the transfer agent rules, a recordkeeping transfer agent must conduct at least two searches for the securityholder at no charge to the securityholder using at least one information database service. Once these two searches are performed, any further searches can result in the securityholder being charged for the costs associated in locating him/her.

Examinations of transfer agents were conducted in order to understand current practices with respect to the search process performed for "lost" securityholders and the use of third-party "search firms" that search for lost securityholders. Examinations observed that:

> *Revenue-sharing.* Some transfer agents received a part of the fee that the search firms charged to securityholders when the securityholder was found on the third search. This fee-sharing could pose a conflict of interest, as it may conflict with the obligation of the transfer agent to use reasonable care to ascertain the securityholder's address during the first two required searches, as the transfer agent will stand to generate funds only if the securityholder is located during the third search. Some transfer agents received preferential pricing from the search firm for conducting the required two searches if they were also engaged to conduct the third search.
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> *Reasonable care.* It appeared that some transfer agents inappropriately refused to deal with securityholders who attempted to correct their addresses on the transfer agents' records.
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> *Charges to securityholder.* Search firms retained by a transfer agent charged securityholders fees during the "free search" phase.

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This "*ComplianceAlert*" letter summarizes select areas that SEC examiners have recently reviewed during examinations and describes the issues found. We encourage you to review compliance in these areas at your firm, address any compliance or supervisory weaknesses and implement improvements as appropriate to your firm's compliance and supervisory programs.

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