

■ Building Rules

The SEC is keeping busy writing regulations, and that means RIAs will be keeping busy trying to understand them.

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By Susan B. Weiner

Spring is here and with it, increased SEC regulation. All RIAs want to put their clients' interests first. If only compliance didn't cost advisors so much in time and money.

And if only the SEC's demands weren't evolving constantly. And if only RIAs didn't have to submit as—for the first time—inspectors from the SEC's Office of Compliance Inspection and Examination (OCIE) grill them about the annual internal compliance reviews which were to become effective last month.

There's no denying that compliance is becoming a bigger drag on RIAs' budgets and schedules. From 2004 to 2005, median compliance costs for RIAs of all sizes doubled from \$50,000 to \$100,000, according to a survey released last November by the Investment Adviser Association (IAA) and the CFA Institute. Expenses have risen because of the flurry of regulations between 2002 and 2005 mandating written policies and procedures, a code of ethics and the naming of a chief compliance officer among other new requirements.

Smaller RIAs specializing in high-net-worth clients might run up annual compliance expense of \$7,500 to \$15,000 for outside help, such as an attorney or compliance consultant, estimates Duane Thompson, managing director of the Financial Planning Association's Washington, D.C. office. "It's not pocket change, but it's a cost of doing business," he says.

In the post-Enron era, SEC compliance isn't a discretionary item any more, says Thompson. And the burden may feel especially heavy for RIAs who don't have a mature practice to absorb the costs, he adds.

Karen Barr, general counsel for the IAA, says, "Regulators don't differentiate in the least between small and large firms... We at the IAA hope the SEC steps back and looks at the cumulative impact on small advisors. We've been urging that for years." About 60 percent of the IAA's members hold less than \$1 billion in assets under management and employ 10 or fewer employees.

When inspectors spend three to five days on an audit, it's much harder on a small firm, where everyone "wears multiple hats" than on a large firm that has dedicated compliance staff. The compliance burden may take more time than money, says a Phoenix, Ariz.-based RIA who asked to remain anonymous. "But time *IS* money in this business," he adds.

(The CFA Institute has helpful charts at <http://cfainstitute.org/pressroom/pdf/CombinedCostsCompliance.pdf> .)

And the FPA's Thompson describes an SEC audit as "the converse of winning the lottery... Eventually you'll have a regulator come in your door and ruin your week"

One of the big unknowns is how SEC inspectors will handle the requirement, effective in April, for each firm to conduct an annual internal compliance review. Gene Gohlke,

associate director of the SEC's Office of Compliance Inspection and Examinations (OCIE) spoke with *Wealth Manager* about what he believes inspectors will be looking for. He sums up his recommendations with "a three-word mantra: preventing, finding and correcting" compliance issues.

Naturally, inspectors will want access to all documentation surrounding the review. That will help them get a good understanding of what was reviewed and who was involved. "I assume that the CCO has a role. It seems appropriate and prudent to have operating people involved in reviewing specific areas," says Gohlke. For example, it is helpful for the chief investment officer to review policies and procedures related to portfolio management. Moreover, "to be effective, there should be a good amount of input from senior management," he adds.

Some additional questions he would raise:

- What types of problems and exceptions occurred during the period reviewed?
- What was reviewed and how was the review conducted? For example, was the review based just on reading documents or were the staff members who performed the relevant functions interviewed about how well controls do or don't work?
- Was the work conducted mainly at one point or throughout the year, as dictated by changes in business practices or organization? Ongoing review is preferable because few investment firms are static.
- What weaknesses and strengths did the review find? What recommendations were made for follow-up and what is the status of their implementation?

Annual compliance reviews are not the SEC inspectors' only hot buttons. In Gohlke's eyes, the top three issues are best execution, soft dollars and directed brokerage. These are of particular concern because the cost of placing trades, spreads, market impact and opportunity costs are among the larger costs that advisory clients bear, explains Gohlke, who also advises that RIAs shouldn't blindly sign up with one firm to perform all trades. Attorney Richard Marshall of Kirkpatrick & Lockhart, Nicholson Graham in New York City says RIAs should be sure to document why their practices are in their clients' best interests.

Other issues that Gohlke highlights include: valuations, disclosures (especially in form ADV), performance advertising and business continuity— particularly in the post-Katrina environment.

Gohlke's comments are consistent with advice offered by compliance experts for avoiding trouble with the SEC. Take a three-point approach, says James Eccleston of Chicago law firm, Shaheen, Novoselsky, Staat, Filipowski & Eccleston. First, identify potential risks; second, develop procedures to address those risks; and finally, identify responsible individuals, including your chief compliance officer. Put another way, a good compliance approach is "aspirational, inspirational and perspirational," says Eccleston.

When it comes to creating your policies and procedures, "the SEC has clearly said we're not looking for something that's off-the-shelf," says Eccleston. Policies and procedures should be customized for your client base and in terms of who's involved in the compliance process, he adds. Jeffrey Kelvin, president of Financial Planners Assistance says, "The hard part is the customization."

Attorney Marshall, a former SEC official, says it's important for RIAs to be proactive about compliance. The SEC expects you to take steps to prevent violations, he says. If violations occur, you should quickly detect them and take steps to prevent them from recurring. It's not like the old days, when RIAs could simply deal with issues as they arose, says Marshall.

David Spinar, senior vice president and chief compliance officer at Securities America, Inc. and Securities America Advisors, Inc., says the best way for RIAs to stay off the SEC's radar is to avoid client complaints. To do that, you should have frequent and meaningful contact with clients, promote a firm culture that always puts the client first, keep your required files current and well-organized, and provide an accurate ADV.

The IAA's Barr points out that "The SEC's view is that if it's not in writing, it didn't happen." While all compliance-related actions must be documented, some RIAs feel this is taken to an extreme. "You know how in real estate, it's location, location, location? A Boston RIA asks. "In this business, it is documentation, documentation, documentation. The paperwork part is out of control," he adds.

There's plenty that smaller RIA/wealth management firms complain about. "To the extent that smaller firms have less scale around which to spread the increased regulatory burden, I think it is fair to say that regulation has become more difficult for smaller advisors," says Spinar.

Compliance now takes up more senior management time. Firms used to be able to relegate compliance to a secretary or administrative assistant, says Nancy Lininger, a consultant and founder of The Consortium, a Camarillo, Calif. firm with expertise in RIA and broker/dealer compliance. Now, Lininger says, a more senior person has to get involved, even if the firm outsources some compliance duties.

A small firm's chief compliance officer (CCO) is placed in a tough position, according to Securities America's Spinar. That's because of "the expectation that the CCO be prepared to serve up to examiners the 'dirt' on his/her firm in the form of a certification of 'material regulatory breaches.'"

RIAs wish the SEC, especially its inspection staff, would better understand their business. "We're not a big broker/dealer," says Robert Tull, president of Tull Financial Group in Norfolk, Va. Accordingly, many issues on the inspectors' checklists weren't relevant to the inspection of his firm.

RIAs would also like to see more experienced inspection staff in their offices. "As soon as the examiners learn enough to be good at what they do, they go to work for the private sector for more money," says Frank Congemi, a RIA with offices in Queens, N.Y. and Deerfield Beach, Fla. Another RIA complained spending too much time educating an inspector who was accustomed to auditing mutual funds.

However, in Nancy Lininger's experience: "They do seem to understand the nuances." Gohlke points out that questions that may seem to reflect a lack of knowledge in fact represent inspectors probing for inconsistencies or other problems.

A Phoenix, Ariz.-based advisor says that inspectors once told him at 3 p.m. on Friday afternoon that he needed to produce a long list of documents by the following Monday. He would have preferred more notice, so he wouldn't have had to pay overtime for his staff to

comply. In that instance, says Gohlke, the advisor could request more time. However, he notes, by the terms of the books and records rule, advisors are required to produce them promptly, which has been defined as within 24 hours.

The fact that SEC regulations aren't defined in "black and white" has both pros and cons. On the one hand, some RIAs would like the SEC to issue "model practices," so they'd know exactly what they need to do to comply. On the other hand, the absence of such clarity gives flexibility to inspectors to make adjustments for smaller versus larger investment firms. According to the IAA's Barr, the Division of Investment Management intends to allow a great deal of flexibility, but people are worried about how the regulations are interpreted by the inspectors who fall under the OCIE. "Many of [the inspectors] are familiar with small advisor issues, but are reluctant to exhibit flexibility," Barr says.

Some observers believe the OCIE's interpretations aren't always consistent with the intentions of the Division of the Investment Management. "We defer to [the Division of Investment Management] because that's their job," says Gohlke. "If an advisor does feel that Investment Management is in one place and examination staff is someplace else, it's fair to call it to the examiners' attention," he adds.

SEC Commissioner Paul Atkins showed some awareness of criticism of the OCIE in a Feb. 28 speech to the IA Compliance Best Practices Summit. "The SEC should be assisting people like you in your efforts to comply with the rules. Well-intentioned individuals who are trying to comply with the rules on the books should be able to look to the SEC as a resource for facilitating their efforts, not as an ill-tempered policeman with a quota of tickets to hand out," Atkins said.

Meanwhile, there's a bill pending in Congress to merge the OCIE back into the Division of Investment Management. "The odds are the bill won't pass," says Barr. However, she reckons the bill could have a positive impact if it gets the two groups talking about the issues. Attorney Eccleston agrees that the bill is unlikely to pass. "This is a real anti-SEC bill," he adds. Gohlke declined to comment on the situation..

Marshall sees some advantages to having OCIE as a separate entity because it gives the inspection function "a seat at the table" and the ability to lobby for budget, staffing and so on. On the other hand, the New York attorney says, it's harder for the regulators to formulate sensible rules because they're somewhat detached from the day-to-day workings of the industry.

RIAs are also concerned about the soft dollar policy under SEC review. Any restrictions on soft dollars will disproportionately affect smaller RIAs because they obtain more third party services, especially research, with soft dollars, says the IAA's Barr. But consultant Lininger says that complying with soft dollar regulations is mostly a matter of proper disclosure on Form ADV.

Other issues, such as email retention, were hot when they first emerged, but Spinar of Securities America says by now, most firms should have the software and hardware to manage them.

Does it feel as if there are already too many SEC compliance issues to track? In fact, the SEC has been in a lull. Why? It may be due to lack of a permanent head for its Division of Investment Management since Paul Roye announced his resignation in February 2005. (Acting head Mike Eisenberg, appointed in April 2005, was succeeded by acting head Suzanne Wyderko in January.) Or it could be that the so-called Merrill Lynch rule has been absorbing too much of the division's energy, suggests the FPA's Thompson.

Once the SEC gets its act together, it has plenty of issues to tackle. A big one is turning Part II of the Form ADV into a narrative brochure that would be more easily understood by investors, says Linda Rittenhouse, senior policy analyst with the CFA Centre for Financial Market Integrity. That would also make it more time-consuming for RIAs to prepare because they won't be able to simply check off the boxes.

Marshall foresees an easing of the prohibition against RIAs using testimonials and examples of specific past recommendations in their marketing materials. He also predicts that managed accounts will attract more regulatory attention. "Just because something is popular, it'll get looked at," the former SEC official says.

Another possibility is that the SEC, having added hedge fund managers to its purview this year, may seek to reduce the number of advisors it regulates by raising the AUM requirement from \$25 million to \$100 million. This could throw more advisors under state regulation. "That could be a big hiccup in the regulatory environment," says the FPA's Thompson. And of course, individuals states sometimes have quirky requirements.

Only one thing is certain: more regulatory attention for RIAs is on its way.

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SIDEBAR: Gene Gohlke's Checklist for How to Prepare for an SEC Inspection

In the list below, Gene Gohlke gives his take on how RIAs should prepare year-round for an SEC inspection. The list is excerpted from his speech delivered to the Fund of Funds Forum on Nov.14, 2005.

- Senior management establishes and maintains an effective, compliance oriented, tone at the top, which is the basis for establishing a robust culture of compliance throughout the firm.
- The firm creates, implements and updates an effective compliance program that covers all aspects of its activities and addresses all conflicts of interest on a continuing basis.
- An essential aspect of the firm's compliance program is the application of forensic tests in critical areas that may harbor possible illegal acts, schemes and arrangements.
- The firm designates a CCO that is knowledgeable regarding the Advisers Act, competent regarding compliance programs and issues and is empowered to require compliance by all staff of the adviser.
- The firm's CCO is an effective advocate for and consultant on compliance matters through out the firm, has the full support of senior management and is the "go to" person for compliance

issues.

- Responsibility for implementing compliance policies and procedures is specifically identified with individual managers at all levels throughout the firm and these persons are held accountable for effectively supervising their staff in the implementation of compliance policies and procedures and for compliance failures in their areas of responsibility; firm's CCO ensures that firm's compliance policies and procedures, including those for detecting and correcting problems, are being effectively implemented by the firm's business people.
- Appropriate attention is given to ensuring that full and fair disclosures to clients/fund boards of all material conflicts of interest are made on an ongoing basis.
- Adviser acts promptly to remedy the inevitable compliance breaches that occur and uses such events to evaluate whether their occurrence indicates the existence of compliance weaknesses that need to be addressed.
- Firm is aware of the usual range of information staff requests during inspections and is prepared to respond promptly and fully to specific requests for documentary information including appropriate and timely handling of information that may be protected under the attorney-client privilege.
- Managers and other staff throughout the firm are ready and able to respond fully to staff questions raised during discussions; the relationship between examiners and staff of the firm is cordial and cooperative and not adversarial.