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■ INSIDE...

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Mystery last man to go in Credit Suisse case has compliance ties

No one's talking but a document filed last week by the **SEC** related to **Credit Suisse**'s settled $2.6 billion tax evasion fraud tantalizes by mentioning that 10 current employees of the Swiss giant will be fired over the debacle.

All will learn later this month that they must leave the firm by September – except for one person referred to only as the "December employee."

This unidentified "December employee" will be fired by the end of the year or a date when his "services are no longer needed by" **Credit Suisse Asset Management** ($41.9B in AUM) in New York.

Working in compliance

"The sole activity of the December Employee ... will be to perform compliance-related services in a specific area. The activity of the December Employee will be subject to direct supervision by senior legal personnel," reads the SEC's temporary order exempting the adviser from Investment Company Act section 9(c) sanctions that would normally attach to an entity that pleaded guilty to fraud.

The SEC had no comment and Credit Suisse didn't return an **IA Watch** inquiry.

Last week, the firm settled with the **Department of Justice,** which continues to pursue cases against individuals. The SEC and Credit Suisse settled a related action in February. ■

Hiring outside auditors could help solve lack of SEC IA exams, Gallagher says

Last week, **SEC** Commissioner **Daniel Gallagher** said he would recommend a rule that would allow for independent third-parties to examine advisory firms. Speaking at **FINRA**'s annual conference in Washington, D.C., Gallagher added that a solution to the regulatory disparity between broker-dealers and registered investment advisers needs to be found "before something blows up."

Gallagher did not explicitly say that RIAs should have to pay the costs of these exams, but he didn't reject the idea either. He said one possibility was to give big-four accounting firms, such as **KPMG**, the authority to examine advisers in the SEC's stead. Similar authority could be given to an SRO. If an accounting firm quoted too high a price, the RIA could select the SRO instead, said Gallagher.

A rule establishing examination authority for inde-

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OCIE's new trade blotter template likely to challenge advisers to comply

Perhaps you've mulled the best practice **Margaret Hornbeck** accomplished after we recently revealed OCIE's new 27-item trade blotter template (**IA Watch**, April 28, 2014). The CCO at **TrueNorth** ($406M in AUM) in Wichita, Kan., tested her firm's ability to produce a blotter to those specs.

"I think we can get the information. It takes some time to do it," says Hornbeck. She read OCIE's new template, selected a few accounts as a test and used *PortfolioCenter* to export data into a spreadsheet to mold a blotter meeting OCIE's preference. It won't be a press-a-button-and-make-it-happen solution, though, she adds.

Producing a blotter in line with OCIE's vision "would be a struggle for firms like us," says **Diane Chadwick** , director of strategic services at **Harvest Capital Management** ($423M in AUM) in Concord, N.H. She's "at the mercy of the software" the firm uses, **Advent**. For example, that system contains the date of a trade but not

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New Exam Idea (Continued from page 1)

pendent third parties "could include SROs, but not mandate them," he said. "That would drive pricing.. . . Whoever does it has to be overseen by the SEC."

FINRA Chairman **Rick Ketchum** later congratulated Gallagher for addressing "a huge disparity in oversight with regard to investment advisers." Ketchum didn't endorse the idea. He said FINRA would "look carefully at what comes out of this if the commission pursues it."

Many questions unanswered

David Tittsworth, president of the **Investment Adviser Association**, said Gallagher's idea was "worthy of consideration," but that a lot of questions need answering, such as who is qualified to conduct exams, what the standards would be, and how much it would cost. Tittsworth supports a user fees approach to pay for more IA exams as proposed in a bill by Rep. **Maxine Waters** (D-Calif.) (**IA Watch**, April 29, 2013).

Tittsworth said he would oppose any law or rule that gave FINRA any role in examining investment advisers because of what he calls FINRA's "poor track record at examining brokers."

Gallagher's suggestion for the use of outside auditors sounds reminiscent of an option under the SEC's revised custody rule (**IA Watch**, Nov. 15, 2011).

SEC Enforcement Director offers words of comfort to compliance officers

Just days after an **SEC** commissioner again sought to assuage industry compliance staff worries of being targeted by the agency, Enforcement Director **Andrew Ceresney** vowed last week only to go after unscrupulous CCOs.

Those "who perform their responsibilities diligently, in good faith, and in compliance with the law" needn't worry. However, his division "will continue to bring" actions against legal and compliance officers when they "have affirmatively participated in the misconduct, when they have helped mislead regulators, or when they have clear responsibility to implement compliance programs or policies and wholly failed to carry out that responsibility," said Ceresney at a conference.

As an example, he raised a case announced last week against a clearing firm's CCO who allegedly assisted the fraud. Ceresney's comments came days after Commissioner **Daniel Gallagher** again brought up supervisory worries by compliance staff (**IA Watch**, May 19, 2014).

Ceresney also promised more cases like **Carl Johns'**, who got booted from the industry for lying to his firm's CCO (**IA Watch**, Sept. 2, 2013).

Signs of respect

Evidence that shows a firm respects the compliance role include when officers sit in on "critical meetings," their views are "sought and followed," they report to the CEO or board and are considered "important" business partners, he continued.

Ceresney also said his division's new Broker-Dealer Task Force will be concentrating initially on "anti-money laundering regulations and recidivist brokerage firms that shelter rogue brokers and engage in abusive activities." Its JOBS Act Task Force will look for instances where firms are employing "inadequate efforts to verify accreditation" of investors, among other topics.

Counting clients for Form ADV purposes isn't as easy as 1, 2, 3

Three questions under Item 5 of Form ADV, Part 1

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Counting Clients (Continued from page 2)

can cause you pause. Item 5.C. and Item 5.D. ask about your clients (numbers and percentages by type of client) and Item 5.F. seeks the number of accounts you serve. It can seem confounding to add it all up.

One rule to follow, though, is to stick with one method. For instance, firms can be challenged when it comes to trusts and family accounts. Find an answer in this SEC FAQ:

> *When answering Item 5.C, count clients the way you normally count them for your firm. Some advisers, for example, treat multiple members of the same family (and a family trust) as a single client, and other advisers treat multiple members of the same family (and a family trust) as separate clients. Similarly, an adviser could reasonably treat an individual and the individual's IRA account as one – or two – clients, depending on the circumstances.*

Whatever method you select, "it just needs to be consistent," says **Colleen Montemarano**, a consultant with **NorthPoint Compliance** in Point Pleasant Beach, N.J.

Form ADV, Part 1 instructs, under Item 5.D. that "the category 'individuals' includes trusts, estates, and 401(k) plans and IRAs of individuals and their family members, but does not include businesses organized as sole proprietorships." Private fund clients would be left out as well, unless you happen to also serve them as separately managed clients.

Remember that Item 5.D. also features a separate category for "high net worth individuals." These are qualified clients who are currently defined as having \$2 million in assets, excluding their residence. Qualified purchasers (a portfolio of at least \$5 million) also fit this category.

Trusts

The dividing line for a trust is \$1.5 million, says **Karen Huey** of **Professional Compliance Assistance** in Woodstock, Ga. If a trustee holds at least this amount, it should be counted within the percentage of high net worth individuals under Item 5.D., she says.

Let's illustrate all of this through a couple of examples:

√ You manage John Smith's IRA and also his wife Nancy's IRA within their joint account. "You can count that as one client" because it's under the same household, says Huey. Or you could count them as two clients for purposes of Item 5.D. but only one account under Item 5.F.

√ Now suppose Nancy is the trustee for an account her father left her. Her mother is the beneficiary and receives monthly income from the trust. After Nancy's mother dies, the trust passes to Nancy and her two siblings. It would make sense to count two clients in the Smith household – one for the IRAs and the second for the trust – "because the trust has different beneficiaries ... it has different goals and objectives," says Huey. This would also tick off two accounts for Item 5.F.

These scenarios demonstrate that the number of clients (Items 5.C. and 5.D.) and accounts (Item 5.F.) need not match.

Keep in mind that a trust with a living beneficiary can be replaced so you should have separate advisory agreements for the trust, counsels Huey. If a trust were set up to have, for example, three beneficiaries, each with a separate account but the same trustee, you should have three agreements and require that trustee to sign each one, she says. ■

Industry plows ahead one year after Blass speech, awaits pending SEC guidance

A year has passed since **SEC** official **David Blass** created a stir by reminding the industry that receiving transaction-based compensation may require a firm to register as a broker-dealer (**IA Watch**, April 15, 2013). The speech by the chief counsel in the Division of Trading and Markets especially caused private fund advisers to examine their practices. The agency continues to bring related enforcement cases. But too many consider the topic unresolved.

"The problem is the status quo is not very clear," says **Barbara Stettner**, a partner with **Allen & Overy** in Washington, D.C. The essence rests at that an adviser must qualify for an issuer exemption or avoid transaction-based compensation, she states.

"At this point, it's still a bit of wait and see," says **Stephen Wink**, a partner with **Latham & Watkins** in

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One Year Later (Continued from page 3)

New York. The Exchange Act rule at the heart of Blass's argument (Rule 15a-6) isn't new. It leaves an issuer to work through a broker-dealer or become one, he adds.

But many point out that the old rule doesn't fit the new world, especially the private equity space.

Square peg, round hole

"The broker-dealer model is a square peg," says a CCO at a Connecticut private equity adviser. Forcing a PE firm to register as a broker-dealer would be like "jamming a round peg into that square hole .... The regulations shouldn't be intended to torment you into being part of a process that it was never built for," contends the CCO.

A prior hedge fund adviser that the CCO worked for registered as a broker-dealer because of its compensation structure. The requirements and process "were so silly and off-point to what we were doing" that they fit like an oversized coat, says the CCO.

What's in the works

It's well known that the SEC and a group of private practice attorneys are negotiating toward finding a solution that will satisfy both parties. Progress is being made, according to a participant involved in the process who spoke with **IA Watch**. "These things take time," says the participant. "It's moving."

The issues are varied and complicated, the person added. No timetable was given for when an agreement on the new guidance will be reached. David Blass didn't return an **IA Watch** phone call for comment.

In the meantime, "you do have to be careful because now you're on notice" after the Blass speech, says Wink. Before the speech, many private fund advisers could say they were in the dark on the issue. "Now the industry is fully aware of the risks," says Wink.

You should take two steps to help ensure compliance, recommends **Rich Goldman**, a partner with **Bingham** in Boston:

1. **Understand the compensation arrangements of your marketers**. Do they include transaction-based payments? Know how bonuses are determined.

2. **Inventory the responsibilities of staff who are engaged in marketing**. The more they perform non-marketing functions, such as investor relations, strategic development, report drafting, etc., the more "that may lean in the direction of them not having to register" as a rep of a broker-dealer, says Goldman.

Like many, Goldman eyes what may come out of the SEC-industry negotiations. He hopes it ends with "a solution that was more practical." For instance, perhaps broker-dealer registration would be unnecessary for advisers serving only accredited investors. Or for those that are already registered with the SEC as advisers. Do these firms really need another regulatory regime, questions Goldman.

There have been a couple of regulatory developments in the last year. In February, the SEC released a new no-action letter granting flexibility for transaction-based compensation in some M&A deals (**IA Watch**, March 24, 2014). However, "that relief probably doesn't work for most private funds," assesses Wink.

Last month, the comment period ended on **FINRA**'s Limited Corporate Financing Brokers proposal. If finalized, this proposal "would be something private funds could utilize" to market and compensate marketers, adds Wink.

The new guidance from the SEC is what most are waiting on. Meanwhile, the agency continues to bring enforcement actions (**IA Watch**, March 18, 2013 and **IA Watch**, May 20, 2013). Earlier this month, the SEC announced two enforcement cases involving entities acting as unregistered broker dealers. One case was against **Behrooz Sarafraz**. In a second, **Rafferty Capital Markets**, a registered broker-dealer settled a case over its assistance given to an unregistered broker-dealer. "You're always going to see these types of enforcement cases," predicts Stettner. ■

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the time, which is newly listed among the 27 items.

The time of a transaction would be available on trade tickets but then the firm would have to manually add the item to its blotter, a task that would prove too difficult. Add-on software from Advent that would report the time would be cost prohibited, Chadwick states.

It would take some time but **Schneider Capital Management Corp.** ($1.6B in AUM) in Wayne, Pa., should be able to cobble together most of the OCIE items. "Trade time would be impossible," says **Steven Fellin**, senior VP. Use of Advent's Report Writer Pro software would go far. "It would take some time" but Fellin's confident he could do it.

The big picture

Another sign that the new template fits with OCIE's big data initiative (**IA Watch**, March 3, 2014) echoes in the recent words of **SEC** Commissioner **Daniel**

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Trade Blotter (Continued from page 4)

Gallagher. "OCIE examiners can import a registrant's entire trade blotter for multiple years and immediately generate over 50 types of customized reports identifying potential red flags for account churning, excessive commissions, P&L irregularities, suspect asset allocation, front running, and even insider trading," he said.

"There is no requirement to produce the data in exactly the format that the SEC has requested," says **Krista Zipfel**, president of **Advisor Solutions Group** in Newport Beach, Calif. The Advisers Act doesn't even require that you maintain a trade blotter, notes **Ellen Bruno**, a consultant with **Compliance Advisor Professionals** in Berkley, Mass. Of course, you do have to keep records of trades (**IA Watch**, April 21, 2014). But the time of a trade isn't a requirement unless you're an adviser under the Investment Company Act, adds Zipfel.

A mistake advisers often make that draws deficiencies is they won't maintain trading records with the required items, says Zipfel. Instead, they assume their custodian will have the necessary elements but it doesn't.

"You want to please the regulators and accommodate them to make their lives easier," acknowledges **Seth Gelman**, CCO with **Brookfield Investment Management** ($19.8B in AUM) in New York, whose firm was examined last year. But you don't have to keep your records in exactly the format requested by OCIE as long as "you have [data] that's in compliance with the rules, then you're still satisfying your obligations."

You can always negotiate with examiners about one of their requests, reminds Bruno. She points out that a few of the items on OCIE's new list aren't even applicable to U.S. stocks, e.g., ISIN. A major custodian's system doesn't report the time of a trade. One client download the custodian's trade data and then tried to manually add some of OCIE's items. "It was a major pain for the client," she says.

IA Watch asked **Fidelity**, **Schwab** and **TD Ameritrade** if they plan to revise their trade data systems to match OCIE's new blotter. A spokesman for TD Ameritrade responded that advisers are letting them know regulators want more data. However, "examiners are 'testing' the advisor's ability to manage its own books and records." Fidelity and Schwab didn't respond.

Your custodian seems the logical place to start. Next stop should be your accounting system or data warehouse, recommends Gelman. Inquire about what types of trade blotters their systems are capable of constructing. Share OCIE's 27-item trade blotter template with them, adds Zipfel.

Matching big data with big data

Even before the news broke about OCIE's new blotter request, **Daruma Capital Management** ($2.5B in AUM) in New York began looking for a vendor to create a "data room," says CCO **Veronica Stork**. "It's basically a giant database of all of the data points you have," she adds. "It can pull all of the information together from different sources" and "opens up the ability to do centralized reporting with consistent data for different departments across the firm."

Still, with the system Daruma has in place today (Advent Axys) Stork thinks she could pull together at least the OCIE trade blotter items that would apply to her firm. "We'd have to do a custom report," she states. Venue would be difficult and some alternative tickers may be a challenge to get but, combined with its order management system, the firm can locate the data. The task is made easier because Daruma trades only equities and options listed on U.S. exchanges.

Regardless of your system's capabilities, test your trade blotter data for inaccuracies, Zipfel recommends. She often finds numerous errors when scrubbing a client's blotter. Common mistakes include reporting a transaction's costs (including commissions) rather than the price of the security, spreading commissions across multiple lots or lumping them into one transaction while a related trade incorrectly lists zero commissions, failing to adjust trades to U.S. currency, not having the ability to segregate trades by subadviser and not listing the broker.

"Data riddled with errors often results in" more intensive questioning from examiners and even deficiencies, Zipfel warns. "Organized and clean data go a long way to make a good first impression" with examiners and to send them on their way sooner, she says. ■

FSOC hears that asset managers don't pose systemic risk to the financial system

If the **Financial Stability Oversight Council** is intent on designating some investment advisers to be systemically important financial institutions (SIFIs) and bring them under FSOC's purview, that's not going to happen without a fight.

Opponents to the idea were heard at last week's FSOC meeting examining the asset management industry. They've voiced their views before (**IA Watch**, Nov. 11, 2013), but this time at the home of banking regulation, the **Treasury Department**.

"No money managers were bailed out" in the financial crisis, pointed out **Barbara Novick**, vice

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FSOC Meeting (Continued from page 5)

chairman at **BlackRock**, leaving unsaid that banks can't make this statement. "I don't see systemic risk lying with our asset managers," asserted **Citadel**'s CEO **Ken Griffin**, who held that the mega banks do pose the greatest risk to the system.

Dueling regulators

Tensions have increased between advisers' main regulator the **SEC** and the FSOC over concerns that the bank-dominated body seeks to muscle in on the SEC's regulatory turf (IA Watch, March 11, 2013). Last week, Treasury Under Secretary for Domestic Finance **Mary Miller** said a range of options may come out of the meeting from doing nothing to designating some advisers as SIFIs.

The gathering coincided with Rep. **Scott Garrett** (R-N.J.) introducing H.R. 4387 that would mandate greater transparency in FSOC's work. The congressman labeled FSOC as "one of the greatest threats to financial stability" and stressed it should refrain from selecting more SIFIs.

SIFMA released a statement again calling "unnecessary" the designation of asset managers as SIFIs. It urged FSOC to let the SEC complete its reforms before venturing into this territory.

Best practices

A firm wide risk committee consisting of partners and portfolio managers exists at **PIMCO** to review the structure of new products, the firm's Global Head of Portfolio Risk Management **William De Leon** told the Treasury meeting. "We ask a lot of tough questions," such as can the product meet clients' objectives, can the risks be managed and do clients understand the risks, he added.

Treasury already houses reams of industry data from Form PF, noted **Michael Mendelson**, portfolio manager of risk parity strategies at **AQR**. While some asset managers may indeed pose risks, "they just haven't been very big risks," he said.

"The past may not be a very good indicator of what we might see in the future," said **Sarah Breeden** of the Division of Financial Stability within the **Bank of England**. Several speakers mentioned concerns that with big banks and broker-dealers lending less, industry has turned to asset managers for liquidity. ■

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