Speech

Doing the Right Thing: Compliance That Works for Investors

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Good morning. Thank you for that kind introduction. Before I begin, let me issue the standard disclaimer that the views I express today are my own, and do not necessarily reflect the views of the U.S. Securities and Exchange Commission ("SEC"), my fellow Commissioners, or members of the staff.

I am pleased to be here at the Regulatory Compliance Association's ("RCA") 2013 program on Regulation, Operations & Compliance. RCA's focus on compliance training and education for the investment industry, with particular emphasis on alternative asset management firms, is important for investor protection and I commend its efforts. With its 72,000 members, RCA efforts can have a powerful impact.

I am particularly delighted to be here because most of you here are involved with investment firms as either lawyers or compliance professionals, and I've spent a good portion of my career doing what many of you do. Before being appointed as a Commissioner at the SEC, I worked at various international law firms, where a portion of my practice involved representing investment advisers, investment companies, and private funds. In addition, I spent most of the 1990s as the general counsel and head of compliance for a global asset management firm. In more than 30 years as a practicing attorney in the securities industry, I've had the opportunity to interact with fund managers and investment advisers in the private sector and at the Commission. I fully appreciate the role that many of you play in the securities markets.

Recent data shows that the investment advisory industry has experienced rapid growth. Over the last ten years, the number of investment advisers has grown by about 50%.[1] The growth of the investment advisory industry is also highlighted by the increase in assets under management — from about $22 trillion in 2002, to almost $44 trillion in 2011.[2] In addition, the growth of the investment advisory industry is also reflected in the number of entities registered with the SEC and with state regulators. For example, in 2012, the SEC was responsible for overseeing more than 10,500 investment advisers,[3] as well as 9,700 mutual funds and exchange traded funds.[4] Of course, some small- to mid-sized advisers are registered with the states instead of the SEC and, as of January 1, 2013, there were approximately 17,200 investment advisers registered with the states.[5]

As to the number of entities registered with the SEC, the number was increased by the many private fund advisers — mainly advisers to hedge funds and private equity funds — that are now required to register with the SEC as result of the Dodd-Frank Act's[6] elimination of the private adviser exemption. This means that, in general, private fund advisers are now subject to regulatory oversight and other requirements, including SEC examinations. As of December 2012, there were over 4,000 private fund advisers registered with the SEC, and approximately 2,400 of those manage hedge funds. Of those 4,000 advisers, more than 1,500 have registered with the SEC since July 21, 2010, when the President signed the Dodd-Frank Act into law.[7]

Accompanying the growth in the number of registered entities, and the growth in assets under management, has been a proliferation in the types and complexities of investment strategies. Over the past few years, investment assets have been invested in more complex and sophisticated products — including derivatives, such as credit default swaps, collateralized mortgage obligations, collateralized debt obligations, and leverage and inverse exchange-traded funds. This complexity and growth, coupled with the lessons of the financial crisis, have highlighted the importance of investor protection.

Despite the increased complexity, or perhaps because of it, more and more Americans are entrusting their savings and retirement assets to the investment advisory industry. There's good news and bad news to this growth. The good news is that investors generally trust investment advisers. In fact, a 2012 survey found that investors trust their financial advisor more than their primary doctor or accountant.[8] The bad news is that the growth in size and complexity has resulted in more opportunities for mischief. The evidence of that bad news can be found in some grim statistics — for example, in fiscal year 2012, the SEC brought 147 investment adviser-related cases. This is roughly 20% of all enforcement cases, and accounted for the largest category of enforcement cases during that fiscal year.[9] In addition, the number of enforcement actions brought by state regulators involving investment adviser firms nearly doubled from the prior year — to 399 in 2011 — and accounted for 15% of all enforcement actions brought by state regulators.[10]

I am concerned about these statistics and their damaging effect. Investor trust and confidence in their financial advisers is based on the belief that investors will be treated honestly and fairly. Clearly, the statistics indicate that more work needs to be done to earn investor trust. To that end, I believe that a strong compliance program is the foundation on which investor trust is built and kept. In keeping with that belief, today I would like to highlight:

- The importance of building a culture of compliance that will result in a robust and effective compliance environment that works for investors; and

- The corrosive impact on investor trust that arises as a result of certain practices and conduct by investment advisers — particularly insider trading and problems in the area of valuation.

Lastly, I want to provide some information on the SEC's increased focus on the asset management industry. This increased focus may be an additional reason why your firms should want robust compliance functions.

A Culture of Compliance

President Theodore Roosevelt once said, "[i]n any moment of decision, the best thing you can do is the right thing."[11] In any discussion involving a compliance matter, all of us should ask whether we are doing the right thing — in particular, are we doing the right thing on behalf of investors? The concept of "doing the right thing" on behalf of investors should be the guiding principle of all compliance personnel, and should be at the heart and soul of any investment advisory firm.

One of the most important lessons I learned when I was a compliance officer is that an effective compliance program begins at the top. A firm's senior leadership must be visible and vocal advocates for a strong culture of compliance. It is critically important to foster an environment where everyone understands that the firm values honesty, integrity, and takes compliance issues seriously. And, to state the obvious, management must also provide the firm's employees with the necessary tools and resources to fulfill their compliance functions, such as hiring the right people, developing effective compliance controls, and designing appropriate policies and procedures that take into consideration the firm's fiduciary obligations to its clients.

The SEC has long focused on requiring a strong compliance culture at investment advisory firms. Going as far back as 1939 and culminating with the passage of the Investment Advisers Act of 1940 ("Advisers Act"), the Commission has always recognized the advisers' broad fiduciary duty to act in the best interest of their clients and the need to address all conflicts of interest between advisers and their clients.[12] As the Supreme Court stated in 1963, a fundamental purpose of the Advisers Act is "to achieve a high standard of business ethics in the securities industry."[13]

The importance of compliance functions is clearly reflected in various SEC rules. For example, both the Advisers Act and the Investment Company Act of 1940 ("Investment Company Act") require registered advisers "to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures."[14]

The importance of compliance programs is also underscored by the many Commission actions against investment advisers for failing to have adequate compliance procedures in place to prevent securities law violations.[15] In a 2011 case that was particularly egregious, the Commission brought an action against a firm that had no compliance program.[16] Moreover, the firm's chief compliance officer apparently lived overseas and had no compliance responsibilities.[17]

There are other troubling instances of firms ignoring their compliance responsibilities. Just last month, a Risk Alert issued by the SEC's Office of Compliance Inspections and Examinations ("OCIE") highlighted that the staff observed widespread and varied non-compliance with the SEC's custody rule.[18] The Risk Alert stated that approximately one-third (over 140) of recent examinations by the staff included custody related issues.[19] To be quite frank, this widespread failure is simply alarming. The Advisers Act custody rule is designed to protect and safeguard client assets, and the fact that one-third of entities reviewed by the staff had custody-related deficiencies is unacceptable.

Although I recognize that many investment advisers attempt to do a good job in fulfilling their statutory obligations, there are, unfortunately, still many instances where investment advisers fail to do the right thing. When that occurs, it may be necessary for the SEC to step in.

Insider Trading By Investment Advisers

One of the areas that has seen quite a bit of the SEC having to step in involves insider trading by investment advisers. As many of you know, the Advisers Act pays particular attention to insider trading. Section 204A requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent advisers or any of their associated persons from misusing inside information.[20] Part of this requirement is that investment advisers must adopt written code of ethics that sets forth a standard of business conduct for its employees that reflects the adviser's fiduciary obligations. The code of ethics must require, among other things, compliance with the federal securities laws by the advisers' employees, review of personal securities transactions, and reporting of violations to the chief compliance officer.[21]

Unfortunately, insider trading — particularly relating to hedge fund and hedge fund advisers — continues to be an area of active enforcement by the Commission.[22] In fiscal year 2012, approximately 16% of the insider trading cases brought by the Commission were against hedge funds and their advisers.[23] Just last month, the hedge fund advisory firm CR Intrinsic Investors agreed to pay more than $600 million to the Commission. CR Intrinsic was charged with participating in an insider trading scheme involving information about a clinical trial of a drug jointly developed by two pharmaceutical companies.[24] That same month, in a case involving expert networks, hedge fund advisory firm Sigma Capital Management agreed to pay nearly $14 million to settle insider trading charges involving one of its analysts, who obtained inside information about the quarterly earnings of two public companies.[25]

These recent cases highlight the continuing need for vigilance in this space. They make it clear that investment advisory firms should assess whether they have effective policies and procedures to identify and prevent the illegal use of inside information. They must provide training and guidance to ensure that, when employees come into possession of inside information, the firm has adequate and effective control processes in place to prevent illegal insider trading.[26] In addition, the firms ought to review their trades for unusual investment performance, for example, by comparing their performance to peer-groups and market performance in general, and determine whether trades were effectuated ahead of corporate announcements.

In addition, if an investment advisers' business involved interacting with expert networks, they must recognize that industry experts or consultants may have access to inside information that could be transmitted to the firm. As has been widely reported, the Commission has recently brought a number of cases involving these networks. Investment advisers must have policies and procedures to address this risk or face potential enforcement consequences.

Conflicts of Interest and Valuation

Another area that has seen recent SEC activity has involved the failure to price assets accurately. This is especially true in circumstances where market prices for investments are not readily available and "fair value" must be ascertained. We all know the importance of valuation and that there are inherent conflicts of interests that may arise in the valuation of investments; for example, investment advisers may have an incentive to provide higher prices for illiquid investments to show better performance, retain current investors, attract new investors, and, of course, charge more fees.

Not surprisingly, the valuation of portfolio securities is an area where the Commission continues to find misconduct.[27] For example, in 2011, the Commission charged a portfolio manager and others with inflating the fund's performance and net asset value by manipulating the valuation processes.[28] The portfolio manager and others worked together to provide fictional prices during the valuation processes and caused the fund to overvalue its holdings by as much as $163 million. In another case that has recently been in the news, the Commission brought a case against fund directors for delegating their responsibilities to determine "fair values" of portfolio securities to others, without providing any meaningful and substantive guidance.[29] This failure made it easier for the funds' portfolio manager to engage in misconduct by making numerous arbitrary and unsubstantiated adjustments to asset prices that did not reflect fair value.[30] As a result, a majority of the funds' fair valued securities — in most cases upwards of 60% — contained inaccurate and misleading net asset values.[31] To settle these charges, the investment advisers agreed to pay $200 million, and the portfolio manager agreed to pay $500,000 and was permanently barred from the securities industry.[32]

Valuation of assets is an area that the Commission will continue to look into; I encourage those of you with compliance responsibilities to pay close attention to your firm's valuation processes. An ounce of prevention will be worth a pound of cure.

The SEC's Focus on the Asset Management Industry

Before ending my remarks, I would like to take a moment to discuss the SEC's recent oversight efforts in the asset management industry. Given the compliance challenges facing investment advisers and the significant risks posed to investors when things go wrong, it is not surprising that the Commission and state securities administrators have a greater focus on the asset management industry.

The SEC efforts are on multiple fronts. One such effort has resulted in enhanced coordination between the various divisions and offices within the Commission. For example, the SEC's Division of Risk, Strategy, and Financial Innovation (or "Risk Fin") provides support on data analytics to various segments of the SEC, including enforcement and examinations.[33] In this regard, Risk Fin provides

support to Commission staff on issues dealing with the examination of investment advisers, investment companies, hedge funds, and other institutional investors.[34] Risk Fin's analysis of performance data has been used, among other things, to identify candidates for examination or investigation.

The collaboration between Risk Fin and the SEC's Division of Enforcement can be seen in the Commission's actions in combating investment adviser fraud. For example, in fiscal year 2012, the SEC filed several enforcement actions against advisory firms and their employees as part of an initiative called the "Aberrational Performance Inquiry," which identifies abnormal investment performance.[35] As part of this initiative, the Division of Enforcement and Risk Fin used risk analytics to evaluate hedge fund returns and identify fund performance that was inconsistent with the fund's investment strategy or other benchmarks.[36] In addition, as more data is obtained through Form PF, Risk Fin is expected to improve its risk analytics to better support the Division of Enforcement and OCIE.

The SEC's focus on the asset management industry can also be seen in the staff's efforts to more quickly examine newly-registered entities whose activities may pose greater risks. For example, as some of you may know, the SEC announced in October 2012 that it is conducting risk-based examinations of private fund advisers that have recently registered with the Commission.[37] Moreover, as you may have seen in the news, the SEC's proposed budget includes the hiring of as many as 250 additional examiners.[38]

However, it's not all about the Commission's efforts in enforcement and examinations. The SEC is also making an effort to publicize best practices and to offer staff guidance in a number of areas. In the last two years, OCIE has published seven Risk Alerts on a variety of subject areas, such as best practices for preventing and detecting unauthorized trading, and investment advisers' use of social media.[39] The Office of Investor Education and Advocacy also published a large number of investor alerts and bulletins covering topics such as custody of investment assets, hedge funds, selecting a financial professional, and transitioning of mid-sized investment advisers from federal to state registration.[40]

In 2011, OCIE also redesigned its compliance outreach program for investment advisers and investment companies to expand the program's intended audience from chief compliance officers to "all senior officers"; this recognizes the importance of compliance throughout an entity's business operations.[41] Moreover, the primary purpose of this program is to encourage discussions about compliance issues between Commission staff and chief compliance officers and senior officers of registered investment advisers and investment companies. This program can be beneficial to both the staff and the industry, and I encourage investment advisers to be proactive and to utilize this program.

Conclusion

Let me conclude by saying that the most important thing to remember about being an investment adviser is that you are ultimate fiduciaries to your clients. And one of the cornerstones of such a responsibility is an effective and robust compliance program that is embedded into an entity's investment culture from top to bottom.

Building a strong culture of compliance is important, especially when the success of your business depends largely on investor trust and confidence. A compliance program that focuses on investor protection also protects your business. This is true because the potential costs of serious compliance failures and violations of the federal securities laws can be much higher than any sanctions imposed by regulators. In the end, the reputational harm to your business may be more severe.

At a time when the SEC and the state securities administrators are looking more closely at the advisory industry, it only makes sense for the industry to support the compliance functions that can separate the resilient survivors from those who will be subject to tomorrow's enforcement actions.

In the end, it's important to do what's right according to the letter of the law, but it's better to think in terms of doing what's right because it is in the best interest of the client — and that is the real foundation of a culture of compliance.

Thank you.

[1] U.S. Securities and Exchange Commission, *Report on the Implementation of SEC Organizational Reform Recommendations* (Mar. 30, 2012), *available at* http://www.sec.gov/news/studies/2012/secorgreformreport-2012-df967.pdf.

[2] Investment Adviser Association, *2012 Evolution Revolution: A Profile of the Investment Adviser Profession*, p. 6, *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA-NRS_Evolution_Revolution_Reports/evolution_revolution_2012.pdf; U.S. Securities and Exchange Commission, *Dodd-Frank Changes to Investment Adviser Registration Requirements*, p. 5, *available at* http://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf.

[3] As of April 1, 2013, there were 10,615 investment advisers registered with the SEC (based on data derived from reports filed with the Commission on Form ADV); *see* Investment Adviser Association, *2012 Evolution Revolution: A Profile of the Investment Adviser Profession*, p. 2, *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA-NRS_Evolution_Revolution_Reports/evolution_revolution_2012.pdf.

[4] U.S. Securities and Exchange Commission, *Third Report on the Implementation of SEC Organizational Reform Recommendations* (Oct. 17, 2012), *available at* http://www.sec.gov/news/studies/2012/sec-organizational-reform-recommendations-101712.pdf; *see also*, Investment Adviser Association, *2012 Activity Report*, p. 28, *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA_Activity_Reports/ActivityReport_2012.pdf.

[5] Based on data derived from reports filed with the Commission on Form ADV.

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub L. 111-203 (2010).

[7] Investment Adviser Association, *2012 Evolution Revolution: A Profile of the Investment Adviser Profession*, p. 2, *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/Reports_and_Brochures/IAA-NRS_Evolution_Revolution_Reports/evolution_revolution_2012.pdf; Press Release, *More Than 1,500 Private Fund Advisers Registered With the SEC Since Passage of the Financial Reform Law* (Oct. 19, 2012), *available at* http://www.sec.gov/news/press/2012/2012-214.htm.

[8] *See,* John Hancock Financial, *John Hancock Trust Survey™ Finds Investors Trust Their Financial Advisor More Than Their Primary Doctor or Accountant* (June 6, 2012), *available at* http://www.johnhancock.com/about/news_details.php?fn=june0612-text&yr=2012 (According to an online survey, "out of a list including financial advisor, primary doctor, accountant, contractor/handyman, boss, and real estate agent - investors said they 'trust strongly' their advisor (84 percent), followed by primary doctor (79 percent) and accountant (74 percent)."

[9] U.S. Securities and Exchange Commission, *Fiscal Year 2012 Agency Financial Report, Management's Discussion and Analysis*, p. 16 (FY 2012), *available at* http://www.sec.gov/about/secpar/secafr2012.pdf#2012review; U.S. Securities and Exchange Commission, *Select SEC and Market Data 2012*, p. 3 (Fiscal 2012), *available at* http://www.sec.gov/about/secstats2012.pdf.

[10] North American Securities Administrators Association, *NASAA Enforcement Report*, p. 3 (Oct. 2012), *available at* http://www.nasaa.org/wp-content/uploads/2012/10/2012-Enforcement-Report-on-2011-Data.pdf.

[11] *See, Congressional Serial Set*, p. 215, Congressional Printing Office (2003).

[12] *See,* U.S. Securities and Exchange Commission, *Regulation of Investment Advisers* (Mar. 2013), pp. 1, 22, *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf; *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services*, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

[13] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

[14] *See,* U.S. Securities and Exchange Commission, *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, Rel. Nos. IC-26299 and IA-2204 (Dec. 17, 2003), *available at* http://www.sec.gov/rules/final/ia-2204.htm. These rules were passed in the wake of the market timing and late trading cases, as well as other misconduct relating to mutual funds. *See, e.g., In re Putnam Investment Management*, Investment Advisers Act Release No. 2192 (Nov. 13, 2003) (self-dealing); *In re Connelly*, Securities Act Release No. 8304 (Oct. 16, 2003) (market timing); *In re Markovitz*, Securities Act Release No. 8298 (Oct. 2, 2003) (late trading). In these cases, managers and senior executives at fund advisers breached their fiduciary duties by placing their own interests ahead of the interests of the funds and fund shareholders. Their misconduct harmed the funds and shook investor confidence. As a result, the Commission adopted rules designed to improve compliance by fund managers and board members.

Advisers are required to maintain written compliance policies and procedures in certain areas. *See, e.g.*, Investment Company Act Rule 17j-1(c)(1) (requiring each investment adviser and principal underwriter of a fund to "adopt a written code of ethics containing provisions reasonably necessary to prevent" fraud); Advisers Act Rule 206(4)-6 (requiring investment advisers to adopt and implement written policies and procedures to ensure voting in the best interest of the client); Section 204A of the Advisers Act (requiring each adviser to have written policies and procedures to prevent insider trading); Regulation S-P (Privacy of Consumer Financial Information), 17 CFR Part 248.30 (requiring investment advisers to adopt policies and procedures to protect customer records and information).

Advisers Act Rule 206(4)-7 (Compliance Procedures and Practices) states: "If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3), it shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) for you to provide investment advice to clients unless you: (a) *Policies and procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act; (b) *Annual review.* Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and (c) *Chief compliance officer.* Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this rule.

Investment Company Act Rule 38a-1 (Compliance Procedures and Practices of Certain Investment Companies) states, in relevant part: (a) Each registered investment company and business development company ("fund") must:

> (1) *Policies and procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal

underwriter, administrator, and transfer agent of the fund;

(2) *Board approval*. Obtain the approval of the fund's board of directors, including a majority of directors who are not interested persons of the fund, of the fund's policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund, which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund;

(3) *Annual review*. Review, no less frequently than annually, the adequacy of the policies and procedures of the fund and of each investment adviser, principal underwriter, administrator, and transfer agent and the effectiveness of their implementation;

(4) *Chief compliance officer*. Designate one individual responsible for administering the fund's policies and procedures adopted under paragraph (a)(1): (i) Whose designation and compensation must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund; (ii) Who may be removed from his or her responsibilities by action of (and only with the approval of) the fund's board of directors, including a majority of the directors who are not interested persons of the fund; (iii) Who must, no less frequently than annually, provide a written report to the board that, at a minimum, addresses: (A) The operation of the policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent of the fund, any material changes made to those policies and procedures since the date of the last report, and any material changes to the policies and procedures recommended as a result of the annual review conducted pursuant to paragraph (a)(3) of this section; and (B) Each Material Compliance Matter that occurred since the date of the last report; and (iv) Who must, no less frequently than annually, meet separately with the fund's independent directors.

[15] *See, e.g.*, U.S. Securities and Exchange Commission, *In the Matter of Oppenheimer Asset Management Inc., et al.*, Advisers Act Rels. No. 3566 (Mar. 11, 2013), *available at* http://www.sec.gov/litigation/admin/2013/33-9390.pdf; *In the Matter of Asset Advisors, LLC,* Advisers Act Rel. No. 3324 (Nov. 28, 2011), *available at* http://www.sec.gov/litigation/admin/2011/ia-3324.pdf*; In the Matter of Feltl & Company, Inc.,* Exchange Act Rel. No. 65838 (Nov. 28, 2011), *available at* http://www.sec.gov/litigation/admin/2011/34-65838.pdf*; In the Matter of OMNI Investment Advisors Inc., et al.,* Exchange Act Rel. No. 65837 (Nov. 28, 2011), *available at* http://www.sec.gov/litigation/admin/2011/34-65837.pdf; *In the Matter of JSK Associates, Inc. et al.*, Advisers Act Rels. No. 3175 (Mar. 14, 2011), *available at* http://www.sec.gov/litigation/admin/2011/ia-3175.pdf; and *In the Matter of Consulting Services Group, LLC et al.*, Advisers Act Rel. No. 2669 (Oct. 4, 2007), *available at* http://www.sec.gov/litigation/admin/2007/34-56612.pdf.

[16] U.S. Securities and Exchange Commission, *In the Matter of OMNI Investment Advisors Inc., et al.,* Exchange Act Rel. No. 65837 (Nov. 28, 2011), *available at* http://www.sec.gov/litigation/admin/2011/34-65837.pdf.

[17] *Id.*

[18] *See*, SEC's Office of Compliance Inspections and Examinations, *National Examination Risk Alert: Significant Deficiencies Involving Adviser Custody and Safety of Client Assets*, Vol. III, Issue 1 (Mar. 4, 2013), *available at* http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

[19] Rule 206(4)-2 under the Advisers Act, provides that an investment adviser has custody of client assets if it or its related persons holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.

[20] Section 204A of the Advisers Act.

[21] Advisers Act Rule 204A-1.

[22] U.S. Securities and Exchange Commission Press Release, *SEC Charges Sigma Capital Portfolio Manager with Insider Trading* (Mar. 29, 2013), *available at* http://www.sec.gov/news/press/2013/2013-49.htm. *See, SEC v. Whitman, et al.*, Lit. Rel. No. 22257 (Feb. 10, 2012) (the SEC charged a hedge fund manager and his firm for their involvement in the insider trading ring connected to Galleon), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22257.htm; *SEC v. Gupta, et al.*, Lit. Rel. No. 22140 (Oct. 26, 2011) (the SEC charged the former McKinsey & Co. global head with insider trading for illegally tipping Galleon's hedge fund manager while serving on the boards of Goldman Sachs and Procter & Gamble), *available at* http://www.sec.gov/litigation/litreleases/2011/lr22140.htm.

[23] U.S. Securities and Exchange Commission, *Select SEC and Market Data 2012*, p. 3 (Fiscal 2012), *available at* http://www.sec.gov/about/secstats2012.pdf. (In Fiscal Year 2012, the Commission brought a total of 58 insider trading actions, and nine of these actions involved hedge funds.)

[24] U.S. Securities and Exchange Commission, *In the Matter of CR Intrinsic Investors, LLC et al.*, Lit. Rels. No. 22647 (Mar. 18, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22647.htm.

[25] U.S. Securities and Exchange Commission Press Release, *SEC Charges Hedge Fund Firm Sigma Capital with Insider Trading* (Mar. 15, 2013), *available at* http://www.sec.gov/news/press/2013/2013-42.htm. On March 29, 2013, the Commission charged a portfolio manager at the hedge fund advisory firm Sigma Capital with insider trading ahead of the quarterly earnings announcements by Dell and Nvidia Corporation; Press Release, *SEC Charges Sigma Capital Portfolio Manager with Insider Trading* (Mar. 29, 2013), *available at* http://www.sec.gov/news/press/2013/2013-49.htm. The U.S. Attorney's Office for the Southern District of New York also announced criminal charges against the portfolio manager. *Id.*

[26] In addition, the firms ought to review their trades for unusual investment performance, for example, by comparing their performance to peer-groups and market performance in general, and determine whether trades were made ahead of corporate announcements.

[27] *See, e.g.,* U.S. Securities and Exchange Commission, *In re UBS Global Asset Management Inc.*, Advisers Act Release No. 3356 (Jan. 17, 2012), *available at* http://www.sec.gov/litigation/admin/2012/ia-3356.pdf. When market quotations are available, fund advisers generally use them to value securities. However, when market quotations are not available, the fund's board is responsible for determining the securities' "fair value" in good faith. Section 2(a)(41) of the Investment Company Act and rule 2a41—1 (17 CFR 270.2a41—1). From a regulatory perspective, documentation regarding performance calculations and investment decisions are important. One of the key aspects of a strong and effective compliance program is to ensure appropriate documentation by the valuation committee, investment committee, and other similar committees, especially to document decisions made, and actions taken, after committee meetings. *See,* Susan Mosher, *Private Equity Firms: Beyond SEC Registration As An Investment Adviser, How to Build and Administer an Effective Compliance Program*, Hedge Fund Compliance and Regulation 2013, Michigan Journal of Private Equity & Venture Capital Law (Vol. 1:177), p. 194.

[28] U.S. Securities and Exchange Commission, *SEC v. Michael R. Balboa, et al.*, Lit. Rel. No. 22176 (Dec. 2, 2011), *available at* http://www.sec.gov/litigation/litreleases/2011/lr22176.htm.

[29] U.S. Securities and Exchange Commission, *In re J. Kenneth Alderman, Jack Blair, Albert Johnson, James McFadden, Allen Morgan Jr., W. Randall Pittman, Mary Stone and Archie Willis III*, Investment Company Act Release No. 30300 (Dec. 10, 2012), *available at* http://www.sec.gov/litigation/admin/2012/ic-30300.pdf; Press Release, *SEC Charges Eight Mutual Fund Directors for Failure to Properly Oversee Asset Valuation* (Dec. 10, 2012), *available at* http://www.sec.gov/news/press/2012/2012-259.htm.

[30] U.S. Securities and Exchange Commission Press Release, *SEC Charges Morgan Keegan and Two Employees With Fraud Related to Subprime Mortgages* (Apr. 7, 2010), *available at* http://www.sec.gov/news/press/2010/2010-53.htm.

[31] U.S. Securities and Exchange Commission Press Release, *SEC Charges Eight Mutual Fund Directors for Failure to Properly Oversee Asset Valuation* (Dec. 10, 2012), *available at* http://www.sec.gov/news/press/2012/2012-259.htm.

[32] U.S. Securities and Exchange Commission Press Release, *Morgan Keegan to Pay $200 Million to Settle Fraud Charges Related to Subprime Mortgage-Backed Securities* (June 22, 2011), *available at* http://www.sec.gov/news/press/2011/2011-132.htm.

[33] U.S. Securities and Exchange Commission, *Division of Risk, Strategy, and Financial Innovation: Overview*, *available at* http://www.sec.gov/divisions/riskfin.shtml.

[34] *Id.* (Risk Fin's Office of Investments and Intermediaries "[p]rovides economic and other interdisciplinary analysis in support of the Commission on issues related to the regulation and examination of investment advisers, investment companies, hedge funds and other institutional investors, broker-dealers, financial institutions, analysts affiliated with broker-dealers or financial institutions, Nationally Recognized Statistical Rating Organizations (NRSROs), and proposals for new financial products and services.")

[35] U.S. Securities and Exchange Commission, *Fiscal Year 2012 Agency Financial Report*, p. 131, *available at* http://www.sec.gov/about/secpar/secafr2012.pdf#2012review.

[36] *Id.*

[37] Letter from the SEC's Office of Compliance Inspections and Examinations to Senior Executive or Principal of a Newly Registered Investment Adviser dated Oct. 9, 2012, *available at* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

[38] *See*, U.S. Securities and Exchange Commission, *Agency and Mission Information*, p. 5 ("Therefore, under the FY 2014 request, one of the SEC's top priorities is to hire 250 additional examiners to increase the percentage of advisors examined each year, the rate of first-time examinations, and the examination coverage of investment advisors and newly registered private fund advisers."), *available at* http://www.sec.gov/about/reports/sec-fy2014-agency-mission-information.pdf.

[39] *See,* SEC's Office of Compliance Inspections and Examinations, *Public Alerts, Reports, and Letters*, *available at* http://www.sec.gov/about/offices/ocie/ocie_guidance.shtml; *see also*, SEC's Office of Compliance Inspections and Examinations, *National Examination Risk Alert: Strengthening Practices for Preventing and Detecting Unauthorized Trading and Similar Activities*, Vol. II, Issue 2 (Feb. 27, 2012), *available at* http://www.sec.gov/about/offices/ocie/riskalert-unauthorizedtrading.pdf. (This Risk Alert offers guidance on how firms can improve their review of controls designed to prevent unauthorized trading and other unauthorized activities.)

[40] *See,* SEC's Office of Investor Education and Advocacy, *Investor Alerts and Bulletins*, *available at* http://www.sec.gov/investor/alerts.shtml.

[41] U.S. Securities and Exchange Commission, *Compliance Outreach Program for Investment Advisers and Investment Companies*, *available at* http://www.sec.gov/info/complianceoutreach_ia-funds.htm.

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