

IAWEEK

A publication of **IAWatch**

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December 1, 2008

Convicted advisers face long prison terms; victims included actress' mom

A jury has convicted two investment advisers – 22 years after the government said the men embarked on their fraudulent path.

After a nine-week trial, jurors found **Alberto Vilar** and **Gary Tanaka** guilty of fraud. The pair had run the former registered advisory firm **Amerindo** ([IA Week](#), June 10, 2005). The government says the pair began their fraudulent scheme in 1986. The bursting of the Internet bubble in 2000 began to unravel their crimes.

The victims included long-time client **Lily Cates**, who has been identified as the mother of actress **Phoebe Cates**. Vilar and Tanaka made off with Lily Cates' \$5 million investment, the government says.

In 2003, Tanaka ordered an assistant to “cut-and-paste” Lily Cates' signature from one document to another to fake the approval of a transfer of \$250,000. Cates complained to the **SEC**. Later Vilar falsely claimed to the agency that Cates wasn't even a client.

A New York jury Nov. 19 found Vilar guilty of all 12 counts of fraud and Tanaka guilty of three of 12 charges. Both were convicted of securities fraud and investment adviser fraud and face up to 20 years in prison.

“We are very disappointed in the result,” said Tanaka's attorney **Glenn Colton** of **Wilson Sonsini Goodrich & Rosati** in New York. “Carefully document with your clients precisely the deal, terms and understanding,” he said of the lesson the case presents for other advisers. ■

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New six-step criteria offers flexibility in presenting past-specific recommendations

File a new no-action letter from the **SEC** in with the agency's critical guidance when it comes to how firms can reveal their past-specific recommendations. The [letter](#), in response to a request from [The TCW Group Inc.](#), which has a number of investment adviser subsidiaries, sanctions a methodology for objectively showcasing a list of positive and negative holdings.

It has always been a delicate dance between what the SEC permits and what firms seek to do in presenting past recommendations. The agency remains wary that such advertisements can be “inherently misleading” as firms are enticed to cherry pick winners and ignore losers. The industry long has argued investors are now shrewder and that the prohibitions in Advisers Act rule 206(4)-1 no longer make sense.

The new no-action letter rides that regulatory line, granting TCW more flexibility while comforting the

(Ad No-Action Letter, continued on page 2)

Options discussed for how hedge funds can handle redemptions

The current financial crisis dominated the **American Bar Association's** fall meeting on business law in Washington Nov. 21, including talk about how hedge funds are responding to requests for redemptions.

“I have been doing this a long time,” **Paul Roth**, partner at **Schulte Roth & Zabel** in New York, told the audience. “I've never seen markets like this before.”

The situation has created unique tensions for funds to balance their fiduciary responsibilities to continuing investors and redeeming those investors who want out.

Among the strategies hedge funds have deployed include suspending NAV as a means to halt redemptions, offering lower fees to lure institutional investors into a new class to keep them within a fund and dispensing distributions-in-kind. One speaker noted swaps and derivatives shouldn't be part of any distributions-in-kind.

Roth cautioned funds to closely examine their offering

(Causes & Cures, continued on page 2)

Ad No-Action Letter (Continued from page 1)

SEC that the six-step process employed by the firm would ensure the selection of objective recommendations.

TCW sought assurance the agency wouldn't recommend enforcement action if it used its methodology to create a chart of holdings to share with clients, prospective clients and others. The chart would feature no fewer than five positive and five negative holdings from a representative account. The SEC blessed the approach as long as it relies on these six steps:

1. The chart reflects the results of the calculation that consistently weights each holding in the account during the relevant period (e.g., monthly, quarterly).
2. The calculation used is consistent from one period to the next.
3. The chart displays no fewer than 10 holdings, divided equally among positive and negative ones.
4. The chart alerts readers how they can obtain the calculation's methodology and a list of each holding's "contribution to the overall account's performance" during the period.
5. The chart mustn't be misleading, e.g., it should give "equal prominence" to the winners and losers.
6. The adviser must share with those who ask "all supporting data necessary" that help to explain the criteria used.

"It is a very important, a very timely no-action letter," says **Amy Lynch**, president of **FrontLine Compliance** in Alexandria, Va. She praises its specific and detailed guidance. "Firms are definitely looking for new ways to market now in the down economy."

The latest no-action letter is the most substantial

one related to past-specific recommendations since the [IAA letter](#) of 2004. The TCW letter falls in line with the SEC's ongoing view that advertisements touting performance must be based on objective criteria.

You have long been permitted to share *all* recommendations made over the last year or more, provided that list includes specifics (such as the name of the security, the recommendation, various market prices during that time and a caution that future profits aren't guaranteed). The SEC also recognizes you can share performance data readily with existing clients and those who solicit information from you. And most oral communications (excluding radio and TV) aren't considered advertisements.

The risks pop up when you share performance marketing in a solicited request designed to induce a client. That's where the objective criteria should be followed earnestly. Document your criteria, says Lynch.

Consider placing a link on your Web site that opens a PDF document detailing all of your recommendations for the past year, says **Daniel Bernstein**, director of Professional Services at **Market Counsel** in Englewood, N.J. This could satisfy your need to provide all past recommendations. The downside is your competitor could get a look at all of your past recommendations, too. An option would be to require the requester to share their identity before sending the document. ■

Causes & Cures (Continued from page 1)

memorandum before taking any action.

Causes and solutions

Others at the conference examined how we got here – and how we may recover. One cause was 20 years

(Causes & Cures, continued on page 3)

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CCO uses checklist approach to steer new employees down the compliance path

You probably already have a process for introducing new employees to your firm's compliance ways. But perhaps you can take some ideas from a checklist one of your peers shares with you.

Kevin Patton, CCO at **Renaissance Investment Management** (\$5.5 billion AUM) in Cincinnati uses a [New Associate Checklist](#) to help ensure he covers all the key items and that new employees understand their compliance responsibilities.

The SEC visited Patton's firm last spring, and while examiners didn't necessarily praise the checklist, it was among the documents they perused and found no problems with, he says.

The message sent is that compliance with the rules begins on day one, when Patton meets with the new employee and goes over the checklist. He covers the high points within the firm's 150 pages of compliance materials. He also inquires if the new employee moonlights elsewhere in the financial services industry – which would not be allowed. "We don't even want the appearance of a conflict of interest," he says.

That introductory compliance meeting occurs within a new employee's first week on the job at **GW & Wade** (\$2.7 billion AUM), Wellesley Hills, Mass. "We go over the code of ethics and our insider trading policy, and pretty much everything from soup to nuts from what we expect from them from a compliance perspective," says Compliance Officer **Robert Lavigne**. He emphasizes how compliance benefits the company's bottom line.

The new employee signs some of the attestations in that first meeting, but he also gets one week to review the firm's code of ethics and return a second signed attestation, says Lavigne. Then a second meeting is held to answer any questions the new employee may have. "I document everything on my end and put it in their file." ■

Causes & Cures (Continued from page 2)

of increasingly complicated arbitrage by markets that left regulators scratching their heads. "An expectation that the regulators would be able to stay ahead of this is unrealistic," said **John Hawke**, former Comptroller of the Currency and now a partner at **Arnold & Porter** in Washington. He also said the federal government's link to **Fannie Mae** and **Freddie Mac** should have been severed years ago.

Regulators can't win, said **Giovanni Prezioso**, partner

at **Cleary Gottlieb Steen** in Washington. "In times that are good, the pressures on regulators are all in a biased way towards easing capital standards, making lending easier ... responding to a business community," said Prezioso, former general counsel for the SEC. In bad times, the pressures fault regulators for not having done enough. Remember, he said, regulators operate within the political system.

"We have never been in this kind of position in our history," announced **Marc Lackritz**, former president/CEO of **SIFMA**. He blamed the Fed for clamping down on interest rates for too long, producing an oversupply of credit.

He predicted human nature guarantees that "we will go through these booms and busts forever."

This particular bust won't be reversed until housing prices hit a floor, he predicted. The system also needs more transparency and less leverage, he added.

Events have moved so quickly that **Treasury's** regulatory blueprint for change released last spring has already been overtaken by events, said **William Kroener** with **Sullivan & Cromwell** in Washington ([IA Week](#), June 16, 2008). "I think we're looking at a whole new playing field" going forward, he predicted.

Prezioso said even reading the tea leaves amongst all these changes creates risk. "I'm real skeptical of peoples' ability to predict the future," he said.

Short selling

The group also heard from **Erik Sirri**, the director of the SEC's Division of Trading and Markets. He told of the options the Commission has considered for dealing with short selling and acknowledged calls both in and out of the agency for a return of the uptick rule, which was repealed in 2007. "There's nothing imminent," he said.

One action the Commission is likely to take before the year ends is to create central counterparties to address credit default swaps, Sirri added. ■



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Former compliance officer barred for fraudulent invoice scheme

The SEC has stripped former Compliance Officer [Brendan Murray](#) of the right to associate with an investment adviser or company and ordered him to repay \$31,000 and pay a penalty of \$60,000 for a 7-year-old invoice scheme.

The agency says Murray embarked on the fraud when the CEO of the firm where he worked, **Cornerstone Equity Advisers**, suffered a stroke. Over four months ending in Feb. 2002, Murray sent 12 phony invoices from third-party vendors to the administrator of funds Cornerstone advised. The ruse blew up on Murray after he filed a Form ADV with the SEC in an attempt to register a bogus advisory firm as a means to submit a fake invoice for work performed for the new adviser.

Murray claimed he was merely acting as directed by Cornerstone's president. The SEC didn't buy it. "The defense that one was merely following orders is not available where the fraudulent nature of conduct is obvious," it wrote. ■

More rules-of-the-road to survive an SEC exam

You've probably heard you should usher SEC examiners into their own conference room where they can plow through your documents when conducting an onsite exam. Add to this that it's a good idea if the room happens to be at the end of a hallway, far from all the action in the firm.

Take this tip from **K&L Gates'** recent webinar on [How to Prepare for an SEC Exam](#). The secluded room makes it less likely that examiners will overhear staff. For the same reason, you don't want to let them into your lunch room at noon.

The speakers identified several exam trends, including more deficiency letters being produced and exams that are lasting longer and are more rigorous. "The staff has become a lot more persnickety and I think this is in response to ... the current environment," said [Cary Meer](#), a K&L partner in Washington. "It is probably only going to get worse [under a new administration], particularly as the market is suffering."

The webinar produced these tips:

- √ **Update your risk matrix annually.** It should guide your annual review and specify how you will mitigate and test for the risks.

- √ **Be ready for requests to see examples** of when reality didn't correspond with your compliance plan.

Document these instances and you'll have them ready when examiners ask.

- √ **Demonstrate tone-at-the-top** by having your firm's top officials greet examiners upon their arrival.

- √ **Answer examiner questions directly**, don't elaborate but be honest. If you don't know an answer, state that and promise to get back to the examiners.

- √ **Appoint persons to produce requested documents**, map out the responsibility and set a time to receive status reports on their progress. "The name of the game always is to get the SEC in and out of there as quickly as possible," said Meer. "The most important thing you could do is to have all the documents ready for their review when they come."

- √ **Be organized.** Don't be antagonistic with examiners. ■

You can outsource compliance duties but must name a chief compliance officer

Tight times cause companies to examine where they can save a buck. **James Warring**, president/CEO of **Eaglestone Wealth Advisers** in Rockville, Md., saw an opportunity to cut costs by hiring an outsource company to run his small firm's compliance program.

Eaglestone's Form ADV lists its CCO as **Outsource Compliance Resources** – a company, not an individual. The problem is SEC rules require firms to identify a person as its CCO, **Bob Plaze**, associate director of the SEC's Division of Investment Management, tells **IA Week**.

Warring says SEC examiners visited his firm last May, meeting daily with a person from the outsource firm and never registering any grievance about the Form ADV listing. Warring says the firm passed with "flying colors." It's unclear whether the examiners knew of the firm's Form ADV listing of Outsource Compliance Resources.

An **IA Week** investigation of Form ADV data also uncovered more than 40 firms that failed to identify a CCO, another violation of SEC rules.

The Advisers Act specifies that the CCO be "an individual" who is a supervised person. The compliance program rule defines a supervised person as "any partner, officer, director (or other person ... or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser)."

"I don't think we need someone in the office all the

(CCO Rules, continued on page 5)

CCO Rules (Continued from page 4)

time” to do compliance, Warring says, as long as a firm has systems in place to help ensure compliance. Outsourcing for the 10-person firm provided a “way to cut costs and fulfill the company’s need at the same time.”

Outsourcing the compliance role is acceptable to the SEC.

IA Week couldn’t find a company in the Washington area identified as Outsource Compliance Resources and Warring declined our request for information about the company. ■


Short selling and regulation are topics for international task force

In a nod to the global nature of finance these days and the need to quell unsteady markets, a group of international regulators – including the SEC – announced task forces last week to examine regulation addressing short selling and unregulated markets, products and financial entities.

The SEC announced the task forces – to be chaired by authorities in Hong Kong, France and England – will aim to present their reports by February. ■



Report card out on SEC’s 2008 enforcement cases

Complaints about short selling soared, criminal filings topped 100 and enforcement actions against investment advisers ranked 4th among total cases brought by the SEC, according to the agency’s final assessment on FY 2008.

The report, [Select SEC and Market Data Fiscal Year 2008](#) , shows one of every six enforcement cases the agency brought was against investment advisers (see table below). In total, the agency recovered \$774 million in disgorgement and \$256 million in penalties in all enforcement cases brought between Oct. 2007-Sept. 2008. During that year, Commission staff filed 108 criminal actions (e.g., indictments).

A top 10 list of complaints received during the year by the SEC resides in the report, and it shows short selling complaints jumped to the top of the list, ballooning 187% to 1,735 in 2008. Complaints about inaccurate or incomplete disclosures and other misrepresentations leapt from 148 in FY 2007 to 1,130 in 2008, rising from #10 the year before to #3. Problems with redemptions, liquidation or closing went up 35% and complaints about SEC rulemaking went up 571% over 2007. ■

Dec. 5 deadline for those who wish to extend money market protections

Treasury  announced last week that it is extending its money market insurance program until the end of next April. The temporary program had been due to expire next month ([IA Week](#) , Oct. 6, 2008). If you advise a fund that took advantage of the insurance, you have until Dec. 5 to notify Treasury whether you wish to extend your coverage. It’s too late to apply for coverage if you don’t already have it. This item went out Nov. 25 as breaking news to subscribers. Be sure your e-mail address is attached to your account so you don’t miss urgent news. ■

Your clients’ ‘change personality’ could help assess their investment strategy

Forget the Rorschach test. Toss out the Myers Briggs Exam. If you want to understand your clients better to persuade them of the merits of your investment strategy, know their “change personality.”

That is the thinking behind a new study that places investors into four personality types: (1) venturer (2) adapter (3) pursuer and (4) anchored. If you know which category your client falls into, you can have a better chance of connecting with them, says **Will Prest**, senior retirement strategist for **Transamerica Retirement Management** in Minneapolis, which commissioned the study. It took a year and included data from 2,000 people over the age of 50.

(Client Personality, continued on page 6)

SEC FY 2008 Enforcement Summary

Category	Civil Actions	Administrative Proceedings	Total	Percentage of Total Actions
Investment Advisers	24 (67)	55 (94)	79 (161)	12%
Broker-Dealers	15 (39)	45 (50)	60 (89)	9%

Source: SEC report [Select SEC and Market Data Fiscal Year 2008](#) ; parentheses contain number of defendants and respondents. ■

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Client Personality (Continued from page 5)

Here's more on the four types:


1. Venturer: These people find change to be exciting. They're highly confident. A client who's a venturer wants an adviser who has expertise he doesn't have, says Prest. The adviser's challenge will be whether he can coach a venturer. The study found these are mostly males, their median annual household income is \$63,000 and their median household assets are \$242,000.

2. Adapter: These people can respond to change but they're not looking for it. They also possess a high-level of self confidence and believe they have things under control. "But if you treated them the same as a venturer, you'd make a big mistake because change is actually very stressful for them," says Prest. In an adviser, they want a trusted partner, he says. "They're probably your best clientele." They also make up about 1/3 of the population, are mostly female with annual median income of \$63,000 and household assets about \$233,000.



3. Pursuer: These investors tend to buy on the good news and sell on the bad. "They really need an adviser's help," says Prest. They need a tough coach. They're largely female, median income is \$49,000 and their median assets are \$132,000.

4. Anchored: The bumper sticker on the car of these investors reads "keep it the same," notes Prest. "They find change incredibly stressful." They're more pessimistic and probably have been driven dour by the current market. These investors need a teacher and someone they can trust. It's important to give an anchored investor the pros and cons of every investment scenario you discuss with them. And stay in touch regularly. "If you're absent, they will leave," he warns. These investors are largely female with a median annual income of \$52,000 and \$167,000 in median assets.

While the recent market may have all four personalities rethinking things, it wouldn't have changed their essential being, Prest contends. They're wired as they're wired, he says.

Want to find your – or your clients' – change personality? Prest invites you to take the 5-question online [test](#) .

Fixed-indexed annuities not part of securities proposal, Donohue says

The SEC's [proposal](#)  to categorize some equity-indexed annuities as securities doesn't include a plan to put fixed-indexed annuities into that group, the Director of the Division of Investment Management said in a recent [speech](#)  in Washington.

Some of the 4,000 comments the SEC received on the proposal were from people who thought the rule would cover fixed-indexed annuities.

"If the staff makes a final rule recommendation, we would expect to make clear that traditional fixed annuities are excluded," said IM Director Andrew Donohue, addressing the ABA Conference. ■

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