

IAWEEK

A publication of **IA**Watch

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February 2, 2009

Advisory firm sued for ignoring DOL order to reinstate whistleblower

Daniel Fisher wants his old job back. Last month the financial consultant persuaded a **Labor Dept.** administrator that Fisher's employer, **Wells Fargo**, had retaliated against him for reporting that a top performer was violating the firm's code of ethics by gaming and selling away – two potential **SEC** violations.

Now Fisher's going to [court](#) to force Wells Fargo to implement the order by DOL's **Occupational Safety and Health Administration** that Fisher be given his old job back. One of the defendants is **Wells Fargo Investments**, an RIA.

Fisher is only the second whistleblower to go to court in an attempt to enforce a company to comply with a decision stemming from **Sarbanes-Oxley's** whistleblower protections, according to Fisher's attorney, **Jason Zuckerman** of **The Employment Law Group** in Washington.

"We do not agree with **OSHA's** findings and order," wrote Wells Fargo's VP of Public Relations **Kathleen Golden**. The company is appealing the order. "Wells Fargo insists on maintaining the highest ethical standards, and we'll continue to do so."

A hearing on the latest legal action is set for late February.

Three years ago, Fisher took his concerns to the firm's compliance manager, as firm policy dictates. Fisher related
(Whistleblower, continued on page 2)

Recent exam letters reveal regulators' spotlight post-Madoff

Two new exam letters obtained by **IA Week** highlight regulators' new interests: firms' relations with broker-dealers, adviser's dealings with **Bernie Madoff** and their pursuit of due diligence.

Last week we told you about a **FINRA** e-mail inquiring about broker-dealer business dealings with investment advisory firms ([IA Week](#), Jan. 26, 2009). Now we've received a copy of a [FINRA sweep exam letter](#) that went out last month with a response deadline of Feb. 6th. It drills even deeper into how broker-dealers work with advisory firms and specifically asks if the recipient referred "any customers to **Bernard L. Madoff Investment Securities**" or to Madoff directly.

IA Week has also obtained an **SEC** document request letter for an on-site exam that began last week. This letter, received by an RIA that operates as a fund of funds, doesn't mention Madoff by name but queries topics germane to
(Exam Letters, continued on page 2)

SEC officials frustrate senators' inquiry into how Madoff was missed

One senator characterized the "calamitous failure" to detect **Bernard Madoff's** alleged Ponzi scheme as the "darkest" chapter in the country's regulation of the financial services industry as [Linda Thomsen](#), director of the **SEC's** Division of Enforcement, and [Lori Richards](#), director of Office of Compliance Inspections and Examinations, listened at a Senate Banking Committee [hearing](#) Jan. 27.

The senators wanted to understand how the SEC missed Madoff's alleged fraud. They were frustrated, however, as Thomsen and Richards repeatedly deflected probing questions by saying the ongoing criminal investigation into the once-high-flying investment adviser from New York prevented them from discussing the specifics of the case ([IA Week](#), Dec. 12, 2008).

The hearing did expose some of the changes being contemplated inside the SEC in response to Madoff:

- **Re-think its risk-assessment analysis.** Much

(Madoff Hearing, continued on page 4)



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Exam Letters (Continued from page 1)

the lessons of the alleged multi-billion dollar scam. For instance the letter requests the “balance sheet and income statement” for the adviser’s most recent fiscal year and each hedge fund’s total assets (see box on this page).

Scandal’s full reach

Sources tells us the examiners indicated agency visits will be heavily shaped by the Madoff debacle. They also say the exams are part of the regulators’ attempt to assess the full reach of the scandal.

The issue of whether Madoff’s alleged Ponzi scheme was run out of his broker-dealer or advisory business “is one that I think is going to bedevil the Commission and FINRA for quite some time,” says **Larry Bergmann**, special counsel at **Willkie Farr & Gallagher** in Washington.

The five-page FINRA letter asks for a “written description of due diligence conducted on each” investment adviser, whether the firm referred any customers to IAs, their procedures governing such referrals and a schedule of all fees paid by IAs for those referrals. The letter also requests an “electronic list” of all registered persons at the firm who are affiliated with an IA. Similar questions are asked about referrals to Madoff.

Due-diligence focus

While the SEC letter doesn’t specifically mention due diligence, you can anticipate the agency will focus on this topic for IAs, too. “If you’re an investment adviser, you should expect to receive all sorts of due diligence questions that you have never received before,” says **Michael Koffler**, a partner with **Sutherland** in New York.

The SEC request letter does ask for fee calculations, a “list of illiquid securities,” valuation procedures, pricing

services used by the adviser, customer complaints and their resolution, written policies and procedures for the trading department and a list of “investor redemptions that have been halted, postponed, delayed or denied.”

Do not regard the request letter as a new template being employed by the SEC, our source cautions, but you can see it as showcasing the “hot-button risk areas” that examiners are focusing on. ■

Examples of items found in recent SEC document request letter

The letter cited on page 1 includes requests for:

- All feeder or master funds used by the adviser.
- Total number of investors.
- Prime broker or custodians.
- A description of all side pockets.
- Communications to investors about changes in hedge fund strategies or investment terms.
- Minutes from investment committee meetings.
- Trade allocation policies and procedures.
- An explanation for each redemption.
- A list of all counterparties and credit risks created by these arrangements.
- Any third-party solicitation agreements. ■

Whistleblower (Continued from page 1)

that a licensed banker was violating SEC suitability rules by pushing clients to move their money into a Wells’ money market account. The banker earned more when the transactions occurred, but Fisher claimed she was really gaming (making inappropriate referrals to meet sales goals)

(Whistleblower, continued on page 3)

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Whistleblower (Continued from page 2)

and selling away (making recommendations away from the firm's partners where trades can't be reviewed).

The compliance manager promised Fisher "would not be chastised for bringing up his concerns," according to the [OSHA decision](#). After an investigation, the compliance manager confirmed Fisher's claims. The company later moved Fisher to a new location and cut his pay.

Fisher is no angel, according to the OSHA decision. It quotes a manager who felt Fisher's relationship with his old colleagues was "irretrievably broken" because of his history of "poor partnering, lack of professionalism, use of inappropriate language, bullying, and consumption of alcohol at business events."

There's no sign Wells Fargo ever ran into trouble with the SEC over the alleged suitability violations. ■

Ideas to ensure your shop's 'tone at the top' sings and doesn't stutter

If your firm awarded annual bonuses, in part, based upon an employee's adherence to its compliance rules, staff would take notice. The gesture would also demonstrate that your firm's top officials embrace the role of compliance and its importance to the organization.

The SEC has long encouraged a "tone at the top" that favors integrity, ethical behavior and transparency. Sometimes translating that vision into reality has proven difficult. Here are some suggestions for how leaders can clearly demonstrate to the troops that they support compliance:

√ **Create an introduction to each new policy that's a statement written and signed by your CEO/president**, suggests **Amy Lynch**, president of **FrontLine Compliance** in Alexandria, Va. The statement "says 'this is an important area for the firm,'" she adds.

√ **Have the CCO report to the firm's general counsel or CEO**, recommends **Peter Chepucavage**, general counsel at **Plexus Consulting** in Washington. Or make one of the firm's chief officers the CCO. This person could delegate the job's day-to-day responsibilities to a compliance officer, says **Daniel Bernstein**, director of Professional Services at **Market Counsel** in Englewood, N.J.

√ **Set up "escalation protocols,"** recommends **John McGovern**, a securities consultant in New York. These give the CCO the ability to show staff who aren't complying with the rules that the CCO is escalating the issue up the chain of command, e.g., by copying an employee's manager

or the CEO on an e-mail to an employee.

√ **Get direct access to the firm's CEO** (see the box on p. 5). This gets more challenging the larger your firm. Give your boss advanced notice that you wish the right to go directly to the CEO when a compliance issue demands it. Tell your boss your compliance responsibilities warrant this. Do this long before the need arises, suggests **Ann Oglanlian**, president of **ReGroup** in San Francisco; your boss would be less likely to quarrel with the request. For fund advisers, Chepucavage says the direct channel should extend to the firm's board.

Cultivating a culture of compliance requires a sustainable effort. A one-time push is not enough, former SEC Enforcement Director **Stephen Cutler**

√ **Give the CCO a managerial title**, e.g., managing director, senior VP or executive VP, says Chepucavage. The CCO also should sit on management and internal control committees, such as the credit, audit and risk teams.

√ **Provide the CCO with an employment contract.** Chepucavage says this would give the CCO additional confidence to do the job without worrying about losing it.

√ **Provide compliance with an adequate budget.** Bernstein recalls a question on past SEC document request letters that asked for the size of the compliance budget and for instances in which management denied a budget request by compliance. Budgets, by their nature, must be approved by senior management, so they signal the tone at the top, he says.

√ **Make adherence to compliance policies and procedures part of employee reviews and bonuses.** "This will indicate to each member of the firm that compliance counts and will be rewarded or punished," offers **Philip Posner**, senior compliance consultant and CFO at **Core Compliance & Legal Services** in San Diego.

√ **Encourage the CEO to walk the halls from time to time and talk with staff**, sending the message that "the compliance officer and the compliance department are an important part of the firm," says Lynch.

√ **Send out important compliance memos under the CEO's name**, not the CCO's.

Chepucavage says the tone at the top can be demonstrated by sending the CCO to national seminars. The heightened visibility of the position at these events quietly says something about the firm's view of compliance. ■

Got a story idea?

Contact Carl Ayers at 301-287-2435 or e-mail cayers@iaweek.com

Madoff Hearing (Continued from page 1)

of the SEC's analysis of a firm's risks currently originates with answers provided on Form ADV. Richards hopes to someday augment this with other data. Factors that can result in a firm receiving a higher risk rating – and a greater likelihood of an exam – include whether the adviser receives performance-based fees, sells more than investment advice, engages in principal or cross transactions, compensates others for referrals, maintains custody or has a past disciplinary action. She told senators the SEC conducts its risk analysis four times a year.

- **Possibly mandate that investment advisers must use an independent custodian.** Both Richards and Thomsen said they would favor this. They told senators about 1,000 investment advisers hold custody, as Madoff did.

- **Subject all RIAs to some minimum examination.** The SEC pair cited a lack of resources as a problem. Senators asked for a report on what's needed. Sen. **Charles Schumer** (D-N.Y.) said he's introduced a bill that would add 100 new SEC enforcement staff and hundreds of FBI agents to pursue financial fraud.

- **Strengthen audit and custody requirements.**
- **Focus exams on custody issues.** Richards revealed 1,521 investment adviser exams occurred in 2008, touching 14% of registered firms.

“We want action very quickly,” Sen. **Christopher Dodd** (D-Conn.) told the SEC officials. The two consented to his wish for them to update the committee every three months on how the SEC is changing its examination program.


Richards also testified that the SEC has already launched a pilot program that gives “monitoring teams” the responsibility to stay in regular contact with a number of larger advisory firms. The program mirrors a similar one the **Federal Reserve** uses to oversee larger banks.

Thousands of tips

The SEC literally receives hundreds of thousands of tips each year alleging possible fraudulent behavior, said Thomsen. Staffing resources prohibit the Commission from investigating every one, she added. Her group seeks to investigate the most credible ones. On any given day, it may receive hundreds of e-mails carrying tips.

One senator castigated her for not responding to the now well-known letter from **Harry Markopolos** – who warned the SEC at least twice that Madoff was operating a giant Ponzi scheme – that included 29 red-flags. Thomsen didn't know how many complaints feature so much detail

but promised to get back to the committee.

Senator **Robert Menendez** (D-N.J.) noted Madoff's firm was investigated eight times over 16 years by various regulators, and wondered how his fraud could have gone undetected. Richards noted OCIE had never examined Madoff's firm, **Bernard L. Madoff Investment Securities**, which registered in 2006. The New York regional office conducted at least two inquiries of Madoff's operations, though ([IA Week](#) , Jan. 12, 2009).

Ponzi schemes cost billions


In 2006 – long before Madoff – Americans suffered \$9.6 billion in Ponzi scheme losses, according to testimony from **John Coffee**, professor of Law at **Columbia University Law School** in New York. “Ponzi schemes are not rare. They are increasing,” he told the hearing, adding the Madoff scandal has cast a “chilling shadow” that won't be lifted “until we fix the system.”

Besides mandating advisers use independent custodians, he said Congress could consider expanding **FINRA's** mission to regulate RIAs or create a separate SRO to do the job.

Coffee also alerted senators to a hole in regulation that may let feeder funds that helped pump up Madoff's coffers escape responsibility. ■

Regulator's policies glimpsed in answers to congressional questions

New SEC Chairman **Mary Schapiro** favors the registration of hedge funds, wishes to bring CDOs and other such securities under the giant regulatory tent, supports repealing the law that prohibits the regulation of swaps and looks forward to working with Congress to ensure her agency is “funded at a level commensurate with its responsibilities.”

She recently outlined her views on top issues in a written [response](#)  to questions from Sen. **Carl Levin** (D-Mich.). “I believe additional oversight capability is essential and I look forward to working with Congress to ensure that the agency has the resources it needs,” wrote Schapiro, who was formally sworn in as the new chairman on Jan. 27.

In arguing for the closing of regulatory gaps, she wrote “The biggest lesson from these market collapses is that we cannot allow financially important products that have a massive impact on our markets and our economy to operate in our system without high standards of oversight, transparency, and accountability.”

In a separate [response](#)  to Levin's questions,

(Schapiro's Views, continued on page 5)


Schapiro's View (Continued from page 4)

new Treasury Secretary **Timothy Geithner** echoed Schapiro's support of hedge fund registration "because we need greater information and better disclosure in the marketplace."



He also wrote that "Product innovation outstripped the capacity of initial risk management and regulatory oversight to keep up" and that he believes "that we must have a much stronger and comprehensive framework of safeguards in place to protect investors and consumers and to provide greater financial stability." ■

Reports on hedge fund industry offer roadmap for regulation and due diligence

If you needed one more sign that the government's likely to mandate registration of hedge funds, consider a new report from the **President's Working Group on Financial Markets**. The group last month released two new reports, and each can help firms with compliance and in conducting due diligence.

The first, [*Best Practices for the Hedge Fund Industry*](#) , lays out a framework for a compliance program that's similar to what RIAs must have in place. For example, it suggests funds establish a code of ethics, create a tailored compliance manual and designate someone to be an independent chief compliance officer.


The report's detail could be helpful to any RIA who struggles with how best to deploy their program. The 67-page document recommends how to address conflicts, training and even the compliance function.

"This will be a roadmap for" hedge funds, says [Judith Gross](#) , principal of [JG Advisory Services](#) , a hedge fund consultant in New York. She says the report hands

them a blueprint to prepare for coming regulations and helps lead them "to ask all the right questions" to shore up operations in these difficult days.

The reports also emphasize the need for funds to "institutionalize some checks and balances" and to separate functions, e.g., to preclude your portfolio manager from also being your risk officer or to form a valuation committee without your portfolio manager. These steps contradict the way 99% of hedge funds operate today, she adds.

Due diligence

Thanks to **Bernie Madoff**, this phrase glows red hot. The second report from the group, [*Principles and Best Practices for Hedge Fund Investors*](#) , may appear to be geared only for investors. But when hedge funds act as feeder funds, they become investors. This report includes a process for due-diligence – covering the examination of personnel to the investment model used. You may crave more details, but the process could give you some ideas you may have missed.

Here's one example on business management: "Investors should obtain information from hedge fund managers on their governance and compensation structures, nature and breadth of ownership of the manager, degree of client concentration, and stability of client base. Investors should assess the stability of the manager's overall business."

The reports may be seen as controversial in places. Gross says one recommendation when it comes to valuation is that funds disclose level three securities as tagged by FAS 157 rules. "That's where all of the problems are coming from," she notes, in that illiquid assets fall into level three. ■

What a CEO wants to see from the CCO

A CCO can improve his image in his CEO's eyes by understanding and appreciating the business side and taking the initiative to stay on top of new and emerging regulatory rules and how they would affect the firm's business, according to CEO **Paul Schaeffer** of **Reflow Management Company** in San Francisco.

He made his comments to **Ann Oglanlian**, president of **ReGroup** in San Francisco, in an interview for an article on how CEOs view the CCO role. Oglanlian believes CCOs would be well served by:

1. **Observing the rule of three.** In interactions with your CEO, limit your topics. "Synthesize the detail into three actionable items," she counsels. And give the CEO at least three solutions, "so he has options." Understand the pros and cons of each option and be ready to recommend and defend your choice.
2. **Reading what CEOs read**, such as the *Harvard Business Review* and other trade publications. Be curious. Learn the business. Ask questions of traders and other staff. You'll be seen as "becoming a competitive advantage to your firm ... not just overhead."
3. **Learning new skills**, such as how to negotiate with and manage people. ■


NASAA lays out how it would like Congress to revise financial services' regulation


Last week the **North American Securities Administrators Association** urged Congress to return to state regulators the ability to go after banks for security violations and to enforce Rule 506 under Regulation D.

These recommendations were contained in NASAA's "13-point pro-investor legislative agenda." It includes a call for more transparency of derivatives, regulation of hedge funds, extending the fiduciary standard to all investment advisers, stronger limits on short sales, new restrictions on credit rating agencies and knocking down legal hurdles that stymie citizens from seeking damages for securities fraud. ■

SEC offers answers to Securities Act and private transactions questions


You can find dozens of new compliance answers to nagging questions on two updated Web sites from the Commission.

[One Web site](#)  offers answers to questions about the Securities Act. For instance, would an "ERISA plan qualify as an accredited investor under Rule 501(a)(1) if it had less than \$5 million in assets but had an arrangement through its trustee with a registered investment adviser to receive investment advice, when the ultimate investment decision is made by the trustee?" The **SEC** answers no, unless the registered investment adviser were given full discretion under the plan.

A [second Web site](#)  displays 25 updated questions and interpretations related to private transactions. For example, the Commission notes that an issuer and an affiliate can make a joint filing of Schedule 13E-3 for a transaction that's going private.

You may want to bookmark these two sites should you ever have a Securities Act or 13E-3 question. ■

Register for Feb. 17 webinar

Testing is a primary component of any good compliance program. But sometimes finding ideas for tests can be a challenge. Consider it a challenge no more, when you sign up for our Feb. 17th webinar, [New Ideas to Jumpstart Your Program with Effective & Workable Forensic Testing](#) . ■


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