

# IAWEEK

A publication of **IA**Watch

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July 6, 2009

## SEC charges CCO for ignoring ‘red flags of wrongdoing’

A free lunch can cost dearly. The SEC alleges several reps ripped off seniors invited to a free meal by pitching them unsuitable variable annuities. Also charged is the CCO of the firm and its affiliated RIA for failing to supervise the reps and ignoring signs of wrongdoing.

The case highlights one of the top risks for compliance officers: being hit with a charge of a failure to supervise. The SEC claims **Rose Rudden**, the CCO at RIA **Asset & Financial Planning** and broker-dealer **Prime Capital Services** of Poughkeepsie, N.Y., inadequately investigated complaints, took no remedial action against wrongdoers or waited too long to take action and “failed to respond reasonably to red flags of wrongdoing” in the sale of variable annuities. Rudden declined to comment to **IA Week**.

The [case](#), which includes claims of Adviser Act violations, among others, also charges the RIA’s owner, **Gilman Ciocia**, a tax prep firm, the B-D and several reps. The SEC seeks a halt to the behavior plus fines.

The SEC alleges Rudden’s failure to act permitted violations to continue. In one scenario outlined by the enforcement division, Rudden and the president of the firm confirmed through a handwriting expert that the supposed  
*(CCO Charged, continued on page 2)*

### July 13 issue of IA Week

Per our editorial schedule, there will be no July 13 issue of **IA Week**. Look for your next issue in your e-mail box and at [www.iawatch.com](http://www.iawatch.com) on Friday, July 17. ■

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## Expect examiners to request even more documents prior to a visit

You’ll be busier than ever responding to an announced SEC exam – one more outgrowth of the agency’s reaction to the scandals of the last year. And look for a future rule from the SEC designed to improve the agency’s surveillance of firms and revise its risk-based matrix that’s used to pinpoint which firms to examine.

The Office of Compliance Inspections and Examinations is working with **FINRA** and others to bolster the risk-based methodology, OCIE Director [Lori Richards](#) said recently. And the pre-exam work will include more research and due diligence of the firm and its affiliates and related persons.

“The objective is to obtain a better understanding of the firm’s business before examiners arrive, and to better utilize resources on-site. For firms, this will mean that examiners will request more information before the examination,” said Richards.

Examiners also are undergoing new training in areas such as options, derivatives, trading, anti-money

*(Exam Changes, continued on page 2)*

## Assuming discretion comes with proxy voting responsibilities

If your firm switches from not having to having discretion over client accounts then it also falls under the compliance obligations of the proxy rule.

Draw your attention to Advisers Act [rule 206\(4\)-6](#), known as the proxy voting rule. It requires that firms have written policies and procedures, that proxies are voted reasonably “in the best interest of clients,” address conflicts, give clients a way to find out how the firm voted, describe their policies and make them available should a client ask.

“It’s a very big deal,” says **Amy Lynch**, president of **Frontline Compliance** in Alexandria, Va., of the proxy voting responsibilities that come with discretion.

“If you have discretion,” adds **Elizabeth Knoblock**, a partner with **Mayer Brown** in Washington, “if you don’t [vote proxies or give clients the opportunity], you’ve basically breached a fiduciary obligation to your client.”

*(Proxy Voting Rules, continued on page 4)*

## Exam Changes (Continued from page 1)

laundering and distinct issues for dually registered firms. A new “fraud module” will list red as well as yellow flags that should summon examiner attention, e.g. “lack of separation of duties/dominant control person; self-custody or use of affiliates for custody/power of attorney over client accounts; aberrational performance claims; lack of independent audit, audit by obscure firm; dire financial condition of a firm or principals; aggressive self-promotions; poor controls over outside business activities; and unusual activity in error or inter-company accounts,” said Richards.

## Joint regulator training next month

Examiners from the SEC, FINRA and **NASAA** will convene in August to listen to case studies of various frauds and “a convicted fraudster — to hear about how he was able to perpetrate a fraud on shareholders and the techniques and deceptions he used to fool investors,” she said.

The joint regulatory training occurs every year in August, says **Patricia Struck**, administrator of the **Wisconsin Department of Financial Institutions’ Securities Division** in Madison. Regulators talk about hot topics, and share practices and techniques, e.g., how to tell when someone you’re interviewing is lying, she adds. ■

## CCO Charged (Continued from page 1)

signature of a 68-year-old widow who had been persuaded to use a maturing certificate of deposit to buy a variable annuity was a forgery.

Even after the rep involved in that case had his license pulled by Florida authorities, Rudden did not curtail his selling for more than one year, at which time the firm placed him under “heightened supervision.” The rep eventually left the firm. Later **FINRA** barred the rep from the industry, according to the SEC. ■

## Group forms to persuade Congress to mandate ‘authentic’ fiduciary standard

A group of RIAs has banded together to lobby Congress toward a tougher fiduciary standard for all advisers and broker-dealers who provide investment advice. Consider this another voice in a growing chorus trying to steer Congress as it moves toward regulatory reforms (**IA Week** [■](#), March 30, 2009).

The **Committee for the Fiduciary Standard** consists of 11 people who either work at RIAs or closely with advisory firms. Last week members announced their plans to lobby Congress. This week they expect to put up an online petition and to encourage advisers and their allies to sign it – with hopes of demonstrating to lawmakers widespread support for their proposal.

If Congress acts, the group wants lawmakers to mandate the 5-principle fiduciary standard that currently applies to advisers of ERISA plans:

1. Put the client’s best interest first.
2. Act with prudence; that is, with the skill, care, diligence and good judgment of a professional.
3. Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts.
4. Avoid conflicts of interest.
5. Fully disclose and fairly manage, in the client’s favor, unavoidable conflicts.

“This is what the profession absolutely needs,” says **Knut Rostad**, deputy CCO at **Rembert Pendleton Jackson** in Falls Church, Va., who formed the group. “Restoring investor trust is essential and the authentic fiduciary standard is required for that.” He compares the 5-principle standard to the Hippocratic oath for doctors.

*(Fiduciary Friends, continued on page 3)*

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## Fiduciary Friends (Continued from page 2)

President **Obama** has called for a fiduciary standard for professionals who give investment advice ([IA Week](#) , June 22, 2009) but his plan wasn't specific enough, says Rostad.

The group will work to counter "opposition in some quarters" who would prefer to maintain the suitability standard for broker-dealers or "water down" the fiduciary standard, the Committee states.

Advisers who wish to join the effort should contact [Rostad](#) . ■

## Electronic systems don't mean dispensing with the fundamentals of reconciliation

Should you reconcile to the penny? It does appear to be a best practice but having a de minimus exception is common, especially among accounts of institutional investors, sources tell us.

Most firms use software to help save time and avoid errors when it comes to reconciliation, notes **Amy Lynch**, president of **Frontline Compliance** in Alexandria, Va. However, some types of securities – private capital firms with physical certifications or private securities – continue to require manual reconciliation, adds **Carmine Angone**, senior compliance consultant at **Bekker Compliance Consulting Partners** in Hazlet, N.J.

Your internal records should mirror the custodian's, says Lynch. "Except for rounding errors, they should match," she continues.

Angone has witnessed de minimus exceptions of a few pennies for smaller advisers to as high as \$995 for larger institutional investors.

He recommends firms periodically review reconciliations for accuracy – something the **SEC** also has suggested.


Other best practices include keeping a log that tracks reconciliations, suggests **Karen Huey** of **Professional Compliance Assistance** in Canton, Ga. The log could be as simple as a printout from your reconciliation software's daily results. Or you could pair this printout with the daily exceptions report, which would show how you've fixed prior-day exceptions. You could scan these printouts or maintain a manual log, such as a Word table or an Excel spreadsheet, she adds.

"Reconcile to the penny at every opportunity," recommends Huey. So many things are tied to proper reconciliation, such as fees based on assets and performance data. "You should reconcile regularly because if that's

wrong your performance is wrong and your fee calculation is wrong," Huey says. ■


## Movement toward greater international cooperation among IA regulators

The growth of "global money managers" has increased cooperation internationally among regulators. The **SEC** has entered into agreements for greater supervision of investment advisers with regulators in England, Germany, Australia and Hong Kong.

"As the recent **Stanford** and **Madoff** Ponzi schemes have highlighted, international cooperation in combating fraud is more crucial than ever before," said SEC Commissioner [Luis Aguilar](#)  in addressing the **International Institute for the Regulation and Inspection of Investment Advisers** in Washington last month.

Beyond the international cooperation, he also said that broker-dealers who provide investment advice should be governed by the same "higher standards and fiduciary duties of advisers."

## Hedge fund regulation

In a separate speech before hedge fund managers in New York, [Aguilar](#)  said it appears inevitable that the industry will face regulation. "All over the world, legislators, regulators, investor groups, industry representatives and others are loudly calling for the industry to be regulated," he said.

The industry has grown into a powerhouse since the initial fund was established in 1949, he added. It poses risks today that can go largely unseen. "However, because for the most part hedge funds are not registered with the SEC, we are not able to adequately oversee how they are operating," Aguilar said.

He noted "hedge fund investors have been calling the Commission in unprecedented numbers," and the SEC has launched more investigations and enforcement cases. 2009 has already seen 25 cases compared with 19 in all of 2008. They involve insider trading, offering fraud, conflicts of interest, lying about performance and due diligence, and even theft.

It won't be easy for Congress to pass legislation that's both flexible and stringent, he acknowledged. Aguilar suggested "a tiered approach to registration," e.g., with smaller funds simply reporting their positions to the SEC and larger funds undergoing greater scrutiny.

But the "SEC has to be able to inspect all hedge fund advisers, and the funds that they manage, and otherwise

*(Global Regulators, continued on page 4)*

## Global Regulators (Continued from page 3)

engage in oversight through surveillance systems,” he continued.

Aguilar again called for Congress to give the SEC the power to be self-funded to pay for any new oversight duties. He pointed out in the Institute’s speech that the Office of Compliance Inspections and Examinations had 489 staff in 2003, and 425 today ([IA Week](#), May 18, 2009). “Clearly, not a good trend,” especially if Congress eyes more inspection duties for the agency. ■

## Proxy Voting Rules (Continued from page 1)

The written policies and procedures should be part of your compliance manual, says Lynch. These should take into account potential conflicts of interest.

You can elect not to vote the proxies – unless you advise an ERISA plan – but this should be disclosed and clients should put something in writing acknowledging this. For instance, your policy may state you won’t vote proxies for meaningless subjects that don’t affect clients, adds Lynch.

Firms typically disclose this information under Schedule F of Form ADV, Part II. The most common language states that the advisory firm will vote proxy unless the client reserves this duty to itself, says Knoblock. This is also where you can alert clients that they can request information on how your firm voted, too.

You also should put something in your client contract. Knoblock often sees a check-box format in contracts that forces the client to check either yes (I will vote) or no (let the firm vote) proxies.

**Michelle Jacko**, CEO of **Core Compliance & Legal Services** in San Diego, says smaller firms often don’t appreciate the hassles of proxy voting. “That’s a huge undertaking” in time and money, she says.

Firms that alert clients they don’t vote proxies must set up a system to notify issuers that proxies should be sent to

### Proposed changes to proxy voting rules approved by Commission

Expect a proposed SEC rule in the next few days, which you’ll be able to comment on, that seeks to bring more transparency to proxy voting. The Commission approved three changes last week that deal with executive compensation, governance disclosure and discretionary voting. The latter proposal may affect advisory firms that cast proxy ballots on behalf of clients although the details will have to await the Commission’s formal release of the rule. ■

the client. This option doesn’t apply to ERISA plans, Jacko adds. If an ERISA plan sponsor requests that your firm vote its proxies, then you must vote them, she says.

Firms “should have something prepared” to share with clients who request information on their proxy voting policies, recommends Lynch. This statement also should show how the firm voted for the prior year. ■

## Sample this proven due-diligence process for ideas for your firm

Checks and balances baked into your due diligence efforts can help eliminate the risks of missing something. If a potential business partner passes the first step used by **GAMS**, a \$15 billion New York-based fund of funds, it will run into a tougher, second step to climb.

Confidence in the process flowered even before GAMS employed it to uncover the risks with a potential fund run by a man named **Bernie Madoff**. The first leg in the process knocked Madoff out of contention. It’s built around the firm’s investment team visiting the potential partner to thoroughly understand its investment strategy.

“Let’s figure out how we could piece together the components of that ‘too-good-to-be-true’ story,” says **Joe Gieger**, GAMS’ managing director North America, in describing CIO **David Smith**’s 1998 visit to Madoff’s firm. “It was simply David trying to piece together how he arrived at the investment returns he was generating.”

The Madoff puzzle didn’t come together for Smith and GAMS decided not to take Madoff to Step 2: a probe by the firm’s operational team. “They do their own analysis,” says Gieger. This step includes examining the firm’s auditor, how the firm prices securities, vendor references and legal and back-office checks.

With valuation, the operations team will “analyze a trade to understand how that trade was priced” and whether it was priced properly.

It will also look at controls and procedures for the business, e.g., does the firm face risk because it’s too dependent upon one client, client type or one prime brokerage.

A firm that uses an affiliated broker-dealer always raises a red flag, he adds.

The operations due diligence team, which does have the power to overrule the investment team, plunges into data, scrutinizing how returns were generated. For example, if the partner states most of its returns originate internationally, the team would inquire of the components (trades in Europe, Russia, etc.).

*(Due Diligence Do’s, continued on page 5)*




## Due Diligence Do's (Continued from page 4)


GAMS approached Madoff again in 2002. “There were more red flags” this time, says Gieger. “It was rejected twice,” again without making it to Step 2.

He advises firms to continue to understand the key components of a partner’s business even after you decide to invest. ■


## Further evidence SEC actions have dented fails-to-deliver numbers


Total fails-to-deliver shares in the first quarter 2009 totaled 21.6 billion. While some may complain this is still too high, consider that the fails for last July alone exceeded 34 billion. First quarter fails in 2008 topped 63 billion.

All these digits add up to some level of success by the SEC in how it has responded to demands to address naked shorting ([IA Week](#) , June 8, 2009), according to an [IA Week](#) analysis of first quarter 2009 fails data from the agency. The drop-off continues a trend first seen after the SEC tightened shorting regulations ([IA Week](#) , March 16, 2009; [IA Week](#) , Oct. 27, 2008).

Despite this apparent success, a group of senators has [written](#)  SEC Chairman **Mary Schapiro** asking for more


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action. The lawmakers want the Commission to “consider the establishment of a pilot program to study whether a strict pre-borrow requirement would work effectively to end the problem of naked short selling,” in addition to a return of the uptick rule ([IA Week](#) , April 20, 2009).

The table below reveals the top securities with the most fails-to-deliver statistics during the quarter. The top one day victim was **DealerAdvance, Inc.**, which scored 800 million fails on one January day. **Ford** and **General Motors** appear on the list, timed to a period when concerns peaked about the financial health of the automakers. ■

## SEC releases money-market fund proposal


The proposed rule the SEC approved last month can now be found in black and white. The agency has released a 197-page [proposed](#)  rule that would revise Investment Company Act rule 2a-7 by setting limits on how many illiquid securities funds can maintain, permitting the

*(Money Rules, continued on page 6)*


First quarter fails-to-deliver data			
Company	Total fails	Company	Total fails
Bebida Beverage Co.	1,683,628,780	Ariel Way, Inc	167,184,000
Mobilepro Corp-New	1,083,961,100	PharmaCom BioVet, Inc.	150,182,741
DealerAdvance, Inc.	800,666,667	Softnet Technology Corp.	145,115,352
American Security Resources Co	667,056,544	Crystal Intl Travel Group	142,316,483
World Hockey Association Corp.	612,749,733	General Motors Corp	139,811,018
Xinhua China Ltd	602,966,466	Remote Dynamics, Inc. New	138,229,925
Camelot Entertainment Group	592,829,171	Stem Cell Innovations, Inc.	113,256,640
Dura Automotive Systems Inc	529,120,668	Modern Technology Corp.	109,802,952
Ingen Technologies Inc New Com	503,492,281	Net. Bank Inc	98,653,989
Cross Atlantic Commodities Inc	465,391,874	Sunrise Consulting Group	95,000,000
Cord Blood America, Inc	403,831,083	Ford Motor Co (new)	93,135,677
Capco Energy Inc New	327,522,703	Citigroup	92,833,447
Titan Resources International	306,442,735	Good Life China Corp	92,369,050
Full Circle Image Inc	305,068,966	Universal Energy Corp. Ne	85,172,881
Neomedia Technologies Inc	303,427,079	Pilgrim Petroleum Corp	84,842,664
RCC Holdings Corp.	270,858,896	Thornburg Mtg Inc Com New	84,816,441
Eeoloclean Inds Inc	260,125,779	Image Worldwide Inc	80,325,780
Wellstar Intl Inc	255,520,350	Spdr Tr Unit Ser-1	79,698,287
Integrated Pharmaceuticals Inc	244,507,935	Health Sciences Group Inc	73,927,663
Doll Technology Group, Inc.	236,818,617	Guard Dog, Inc. Common	72,743,860
Medclean Technologies, Inc. Co	218,087,344	Airnet Communications	71,544,687
Interstate Bakeries Corp	209,056,882	Zvue Corporation Com	70,547,829
Sirva Inc	198,570,596	Aallied Security Innovatio	68,674,968
Mphase Technologies Inc	190,584,884	Red Reef Labs International	67,870,986
Flagship Global Health Inc Com	184,776,046	Gadzooks inc	66,772,241

Source: [IA Week](#) analysis of SEC data.

## Money Rules (Continued from page 5)



suspension of redemptions during risky periods, requiring investment advisers that manage fund portfolios to alert boards when credit ratings have fallen on certain securities and other changes ([IA Week](#) , June 29, 2009).

The proposal also would encourage fund directors to establish “guidelines for advisers to money market funds that address” the potential conflict of advisers increasing fund assets, and their advisory fees, by accepting riskier investors. “We are aware of more than one occasion in which a fund adviser ... has marketed the fund to ‘hot money’ in order to increase fund assets, which has exposed the fund to substantially higher risks,” the rules reads.

You have until September 8 to comment. Click [here](#)  to send the SEC your comment. ■

## Stanford denied bond, declared ‘a serious flight risk’

A federal judge in Houston last week sided with the government and declared accused Ponzi schemer **Robert Allen Stanford** a risk to flee to avoid a possible prison term of up to 375 years if convicted.

[The ruling](#) , unless reversed on appeal, likely means Stanford will remain in custody until his trial on fraud charges ([IA Week](#) , June 19, 2009).

Judge **David Hittner** cited several reasons for his ruling:

√ Stanford has traveled to more than 30 countries on five continents since 2005.

√ The accused failed to alert authorities that he possessed an Antiguan passport, and a second, supposedly expired Antiguan passport, hasn’t been found.

√ Stanford’s U.S. passport includes “multiple occasions” of exit stamps for Antigua but “no corresponding entry” stamps.

√ Stanford has access to money. Someone he hadn’t met until April put up \$36,000 for an apartment in Houston for Stanford to live in prior to the trial.

√ The knighted billionaire has no real ties to Houston. “Stanford’s longterm residence in Antigua and his frequent travels across the globe and to multiple foreign countries belie his contention that he has strong ties to Houston,” wrote Hittner.

## Madoff sentenced

A federal judge sentenced **Bernie Madoff** to 150 years in prison last year ([IA Week](#) , June 22, 2009). ■

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