ACA COMPLIANCE GROUP

INVESTMENT ADVISER ASSOCIATION

IM Insight

OLD MUTUAL

2007 Investment Management Compliance Testing Survey

Summary Report
September 4, 2007

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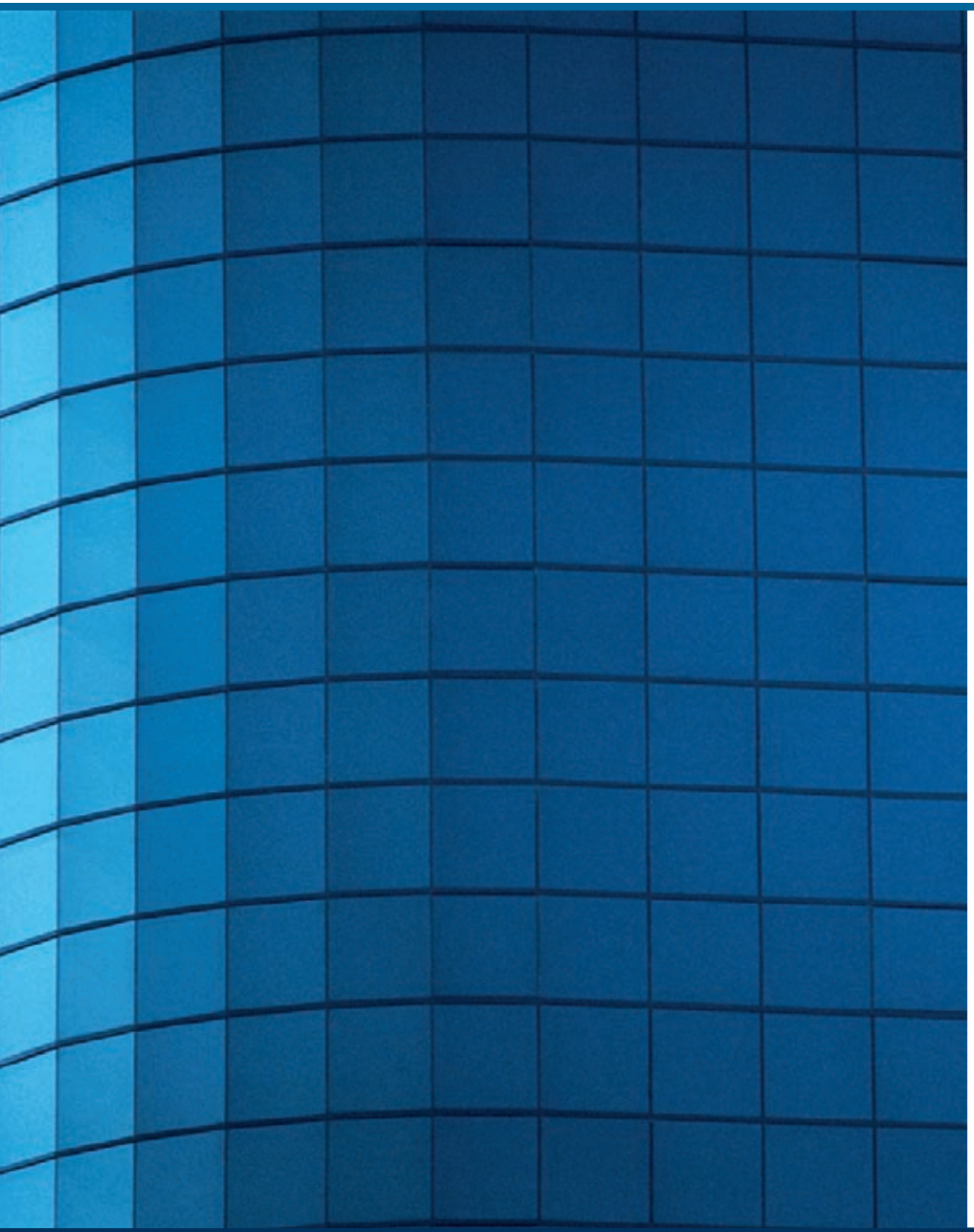

Introduction

Nearly four years have passed since the U.S. Securities and Exchange Commission adopted Rule 206(4)-7 under the Investment Advisers Act of 1940. The "compliance program rule," as it has come to be called, requires SEC-registered investment advisers to adopt and implement compliance policies and procedures, appoint a chief compliance officer (CCO), and conduct annual compliance reviews.

While the industry has adapted well to the first two requirements, the third — the annual review — continues to present challenges for many advisory firms. Last summer, an informal SEC staff study found that over 40 percent of advisers examined during a four-month period received a deficiency letter comment on their annual review process. Speaking at the SEC's 2006 CCOutreach National Seminar, Gene Gohlke, an associate director in the SEC's Office of Compliance Inspections and Examinations, reported that examiners in those inspections concluded "that the firm maybe didn't get it" or "didn't do enough to actually take a critical look at its compliance program."

But how does a compliance professional know whether or not his or her firm has "gotten it" or has "done enough" testing during the annual review process? In a footnote in its December 2003 compliance program adopting release, the SEC stated:

> *Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the adviser's fulfillment of its duty of best execution), or an analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities).*

Beyond that statement, the SEC has provided little formal guidance on how advisers should test their compliance programs. The absence of guidance, in some respects, is deliberate: Because the SEC wanted to provide firms with maximum flexibility to tailor their compliance program to their particular business, it did not set out specific elements that an adviser must include in its policies and procedures, nor did it mandate specific ways to test those policies and procedures.

As evident during the past few years, the flexibility to tailor compliance programs has presented a challenge for advisers as they grapple with various testing-related questions: Should we be doing more rigorous testing? Are we performing the right kinds of tests? Should we prepare a written report summarizing the results of the annual review?

This survey was intended to address these questions by providing the investment management industry with new and practical compliance testing ideas and specific benchmarks that can be used to assess the adequacy of future periodic and annual review efforts. Many of these testing ideas were drawn from suggestions made by the staff of the SEC's Office of Compliance Inspections and Examinations during their CCOutreach seminars, as well as from industry participants. The survey revealed that advisers have responded to OCIE's outreach and other testing ideas with enhanced compliance testing and assessment protocols. Moreover, although not specifically required by the compliance program rule, virtually all advisers documented their annual review and apprised senior management of the results.

The survey organizers would like to thank the more than 450 survey respondents for their time, effort, and shared interest in our survey. Participants' responses were thoughtful, insightful, and practical, and this report would not be possible without their contributions.

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Background and Goals

In April 2007, ACA Compliance Group, the Investment Adviser Association, *IM Insight,* and Old Mutual Asset Management conducted the second annual investment management compliance testing survey.

The goals of the survey were:

- **To allow firms to benchmark their compliance testing practices against those of other firms;**
- **To collect ideas for new testing techniques that can be used by firms in future testing efforts;**
- **To assess compliance testing trends over time within a variety of specific areas, such as personal trading, soft dollar arrangements, and business continuity planning;**
- **To identify practices that appear to have become (or may become) prevalent industry practices; and**
- **To assess the impact of current and proposed regulations on advisers' businesses.**

The survey was conducted online. We invited CCOs and other compliance professionals at SEC-registered investment advisers to participate in the survey. Participants were asked to provide only one response per firm. The responses of 457 participants were analyzed in preparing this report. Responses were submitted on an anonymous basis. Responses to certain questions total to more than 100%, reflecting the fact that respondents were permitted to provide more than one answer to each question.

The format of the survey allowed respondents to share their thoughts about a number of topics in narrative form. This report reflects many of these written qualitative responses. Although anecdotal, these narrative responses may provide useful insight into practices at specific firms.

"Thanks for the survey. It did make me think about some things that I need to revise or improve."

"Extremely eye opening. I am seriously deficient regarding continuity plans."

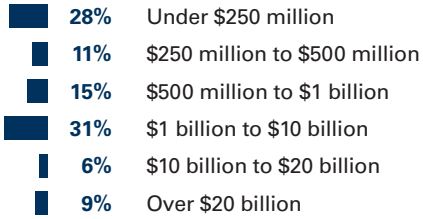
"This was one of very few surveys I have participated in that I was glad I did. Very helpful!"

Core Demographics

A wide range of firms were represented in the survey, from sole proprietorships to large, national firms. The typical firm:

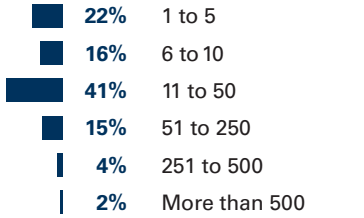
- had between $1 billion and $10 billion in assets under management – 31% of firms
- had between 11 and 50 employees – 41%
- was not affiliated with any other entity – 63%
- had been in business between 5 and 25 years – 62%

What is your firm's total AUM (assets under management)?



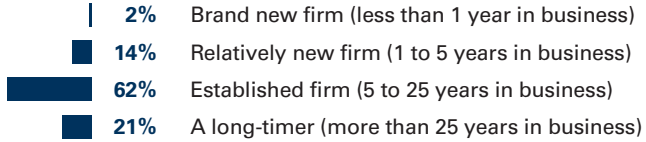
28%	Under $250 million
11%	$250 million to $500 million
15%	$500 million to $1 billion
31%	$1 billion to $10 billion
6%	$10 billion to $20 billion
9%	Over $20 billion

How many full and part-time employees are employed by your firm?



22%	1 to 5
16%	6 to 10
41%	11 to 50
15%	51 to 250
4%	251 to 500
2%	More than 500

How would you describe your firm?



2%	Brand new firm (less than 1 year in business)
14%	Relatively new firm (1 to 5 years in business)
62%	Established firm (5 to 25 years in business)
21%	A long-timer (more than 25 years in business)

Most firms provided advisory services to a variety of clients:

- primarily high net worth individuals (typical account size $1 million or more) – 48% of firms
- institutional investors (endowments, corporations, state/local plans, etc.) – 45%
- ERISA clients – 38%
- registered investment companies – 37%
- private investment funds (e.g. hedge funds or private equity funds) – 31%
- primarily retail individuals (typical account size $1 million or less) – 25%
- wrap program manager – 17%

Small firms were well represented: 28% had less than $250 million in assets under management and 22% had five or fewer employees.

As noted, 63% of the firms were not affiliated with any other entity. Of those that were affiliated with another firm, the most common affiliations were with a broker-dealer (24%) or another investment adviser (16%).

Compliance Program

Key findings:

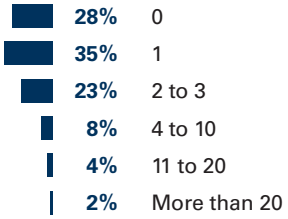
- **For most firms, the term "compliance department" is an overstatement. Most firms have, at best, one full-time employee dedicated to compliance matters.**
- **The CCO at the vast majority of firms wears multiple hats and performs a significant amount of non-CCO functions.**
- **At the vast majority of firms, testing revealed only minor compliance issues.**
- **Although not required by the Advisers Act compliance program rule, many firms prepared a written report to memorialize their annual review process. These firms took a wide variety of approaches to preparing the report and accompanying documentation.**

Compliance staffing

Most advisory firms have a small compliance staff, with the firm's CCO typically wearing two or more hats.

At about a third of the firms (35%), only one employee was engaged full-time in legal and/or compliance functions. At more than a quarter (28%), *no one* was engaged full-time in the legal/compliance role. Only 14% of the firms reported more than three full-time legal/compliance employees.

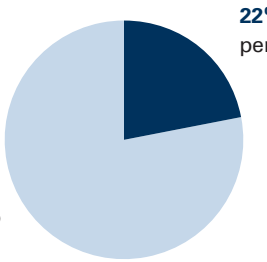
How many employees at your firm are engaged full-time in legal and/or compliance functions?



Interestingly, even some of the largest firms represented in the survey had a small legal/compliance staff: Of the firms that reported over $20 billion in assets under management, 29% had fewer than four full-time legal/compliance employees.

Significantly, 78% of the firms indicated that the CCO wore two or more hats, performing non-CCO functions such as COO or CFO.

Does your firm's CCO perform a significant amount of non-CCO functions (for example, by also serving as COO or CFO)?



22% – No, our CCO solely performs CCO functions

78% – Yes, our CCO wears two or more hats and performs other non-CCO functions

Culture of compliance

Firms used various methods to demonstrate that they had developed and promoted a culture of compliance:

- the CEO or President was immediately apprised of material compliance issues/breaches – 77%
- the CCO was one of the most senior executives – 68%
- the firm conducted annual (or more frequent) employee compliance training – 65%
- senior management participated in SEC inspections, such as by participating in the opening interview – 65%
- the CCO or other compliance personnel attended various committee meetings (such as best execution committee meetings) – 64%
- the CCO reported directly to the CEO or President – 64%
- the CCO met periodically with the CEO or President to discuss compliance issues and initiatives – 63%

While the survey confirmed that most firms have taken proactive steps to develop a culture of compliance, it also revealed, conversely, that about a third of firms have not incorporated these commonly-recommended approaches into their compliance program.

Results of testing

At 8% of the firms, compliance testing uncovered significant issues. However, at the overwhelming majority of firms (73%), testing revealed only minor compliance issues. And a significant minority of firms (19%) reported that testing revealed *no* compliance issues.

These percentages generally correspond to the number of firms that receive deficiency letters following an SEC examination. In 2006, for example, 81% of the investment adviser inspections conducted by SEC examiners resulted in a deficiency letter.

Interestingly, small firms were more likely than their larger counterparts to conclude that they had no compliance issues. For example, of the firms that reported that testing had not detected any issues, 67% were small firms (under $500 million of assets under management) but only 5% were large firms ($10 billion or more assets under management).

	Small firms: under $500 million AUM	Large firms: $10 billion or more AUM
Significant issues detected	23%	29%
Minor issues detected	32%	17%
No issues detected	67%	5%

Similarly, firms that did not have full-time legal or compliance staff were more likely to conclude that they had no compliance issues.

	No full-time legal/compliance staff	One full-time legal/compliance staff	Four or more full-time legal/compliance staff
Significant issues detected	14%	37%	26%
Minor issues detected	24%	34%	16%
No issues detected	49%	36%	0%

Timing of testing

The majority of firms (57%) indicated that they conducted compliance testing on an ongoing, rolling basis. A significant 30%, however, conducted their testing annually, at the end of the twelve-month annual review period. It is quite possible that at least some of these firms are, in fact, testing throughout the year, but simply have not recognized their activities as such. It is worth noting that senior SEC officials have encouraged firms to adopt an ongoing, rolling approach to testing. OCIE associate director Gene Gohlke, speaking at the SEC's 2006 CCOutreach National Seminar, observed that for large and medium-sized firms, ongoing testing is "probably the only way" to conduct the annual review, given the continual introduction of new products and personnel at firms of this size.

As a general matter, how often does your firm conduct compliance testing?

30%	Annually, at the end of the 12-month annual review period
11%	Quarterly
2%	Monthly
57%	On an ongoing, rolling basis

Notably, firms that tested on an ongoing, rolling basis detected a greater number of compliance issues than those that tested annually.

	Annually, at the end of the 12-month annual review period	On an ongoing, rolling basis
Significant issues detected	7%	9%
Minor issues detected	67%	72%
No issues detected	26%	18%

Outsourcing

Most firms (67%) had not outsourced any compliance testing to an outside vendor. 20% had outsourced at least a portion of their compliance testing, and 12% had outsourced most or all of their testing.

"We need help [in preparing an annual review written report]; the task is beyond a two-person office with client relationships and investments to manage."

Documentation

Nearly all firms documented the annual review in some manner:

- workpapers (evidencing tests) – 49%
- lengthy written report – 46%
- short memorandum – 37%
- informal notes (summarizing tests) – 30%

Only 3% of the firms did not document the annual review.

In narrative responses, survey respondents described a variety of additional methods of documenting the annual review. Matrices appeared to be a particularly popular tool. Respondents described the following forms of documentation:

- an 11-page report in a matrix format, which was "much more than a memo, but not a verbose, lengthy report either";
- an Excel checklist "covering all applicable areas of compliance (i.e., sections of compliance manual), with supporting worksheets detailing items for attention, problems, and/or revisions made to policies and procedures, as well as items for follow-up";
- a "short memo and chart indicating areas reviewed, whether any problems were found, recommendations for change, and sign off by the CEO"; and
- a "grid of thirty compliance items listing controls, testing, findings, recommendations, senior management sign off, and CCO sign off."

Other methods of documenting the annual review, as described in narrative responses, included:

- updating the compliance manual;
- amending disclosures, agreements, and procedures;
- updating and annotating compliance checklists;
- creating a memo specifically describing the annual review meeting;
- keeping memos sent to employees found to be in violation of the firm's policies;
- keeping a calendar of tests;
- keeping quarterly reports to the board of directors;
- keeping copies of compliance committee meeting minutes; and
- creating files for each aspect of compliance, detailing the status, process, and actions taken to further compliance.

Reporting – annual review

At the vast majority of firms (93%), senior management was apprised of the results of the annual review. The following constituencies also were notified:

- corporate board of directors – 31%
- outside counsel – 19%
- independent private or mutual fund directors – 18%
- clients or investors – 6%
- third-party consultants – 6%
- advisers, sub-advisers, and/or wrap sponsors – 6%
- service providers – 2%

In addition, a number of respondents stated that their firm provided a general overview of the annual review and testing results to all employees at their firm. "All employees are made aware of the review and its findings," said one respondent, who represented a small firm (1 to 5 employees). Another respondent, from a medium-sized shop (11 to 50 employees), noted that even the firm's support staff was apprised of the review's results.

Most firms (66%) did not have a policy on whether and how they would respond to a request for the results of the annual review by a third party, such as a prospective client, consultant, or business partner, because they had not yet received such a request.

Of the 151 firms that *did* have such a policy:

- 59% would provide a summary of the annual review documentation to the third party;
- 21% would orally discuss the annual review with the third party, but would not provide the third party with any written materials;
- 19% would provide a copy of the actual annual review documentation to the third party;
- 9% would allow the third party to review the annual review documentation in the firm's office, but would not permit the third party to leave with a copy of the documentation; and
- 3% would refuse to provide a copy of the annual review report or otherwise discuss it.

A number of respondents indicated that the issue would be decided on a case-by-case basis. "It depends on who is asking," said one. A "business partner is different than a prospective client," said another. One respondent described an evolving process: Initially, the firm attempted to discuss the results of the annual review orally. Due to client demand, however, the firm ended up preparing a written summary report and plans to continue preparing summary reports going forward. Another respondent noted that the annual review report contained confidential client information and therefore would not be shared with anyone except regulators.

Reporting – SEC deficiency letters

Interestingly, half of the firms (50%) had not received a request for a copy of any SEC deficiency letter and therefore did not have a policy on whether and how it would respond to such a request.

Of the firms that *did* have such a policy, potential responses varied. The most popular approach, reported by 38% of the 225 firms that did have a policy in this area, was to provide a copy of the SEC's deficiency letter upon request along with a copy of the firm's response.

	Actual documents	Summary only
Deficiency letter only	**7%**	**9%**
Deficiency letter plus firm response	**38%**	**23%**

In addition, of the firms that did have a policy in this area:

- 20% would orally discuss the deficiency letter's contents with the third party, but would not provide the third party with any written materials;
- 9% would allow the third party to review the deficiency letter and/or response in the firm's office, but would not permit the third party to leave with a copy of the documentation; and
- 3% would refuse to provide a copy of the letter or otherwise discuss it.

One respondent suggested that the response to a request for a deficiency letter would depend on how hard a requestor pushed. If a summary would suffice, said the respondent, the firm would summarize the letter and its response. However, if a "significant" requestor "refused" the summary, the firm would provide the actual deficiency letter and response. Another respondent's firm provided copies of the deficiency letter to consultants engaged by the firm and the firm's business partners, but when it came to clients, would "only discuss the findings and remedies."

"We have not had a deficiency letter but have discussed verbally comments that were given during our review."

Code of Ethics: Personal Trading

Key findings:

- **Although large numbers of firms conduct a wide variety of personal trading tests, many advisers do not perform basic tests routinely conducted by SEC examiners when reviewing personal trading. Anecdotal evidence suggests that many of these firms do not view personal trading as a high-risk area.**
- **Only a relatively small number of advisers ban personal trading outright.**
- **Most firms allow their employees to conduct personal trades through any broker, although many require duplicate copies of account statements and confirms to be provided.**

Although large percentages of firms conducted a wide variety of personal trading tests, a surprising number of firms did not perform basic personal trading tests routinely conducted by SEC examiners:

- 94% of the firms did not compare the performance of personal accounts to that of client accounts. However, they may be comparing performance on a trade-by-trade basis: 48% manually compared personal trades to client trades, and 13% used an automated system compare personal trades to client trades.
- 51% did not compare employee pre-clearance approvals to executed personal trades.
- 49% did not take steps to determine which access persons did not timely file holding and transaction reports.
- 37% did not compare information on employees' confirms and account statements to employees' holding and transaction reports.

How do you test personal trading? (check all that apply)

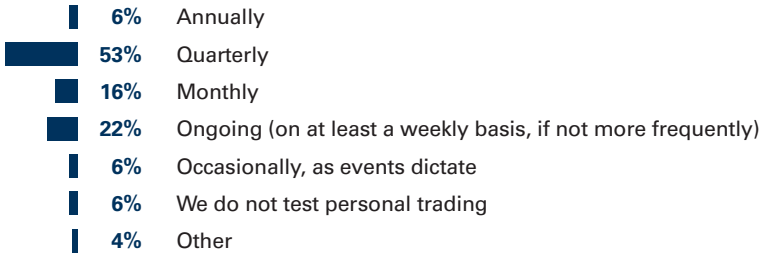
64%	We review the list of access persons and confirm that all new employees are aware of their reporting obligations
63%	We compare information on employees' confirms and account statements with employees' filed holdings and transaction reports
51%	We determine which access persons did not timely file their quarterly transaction reports and holdings reports
49%	We compare employees' preapproval forms with their executed personal trades
48%	We manually compare personal trades with client trades
30%	We check employees' trading patterns over time
27%	We seek compliance certifications
23%	We sample employees' trades and review each trade in the sample for compliance with applicable code of ethics restrictions (e.g., blackout period, pre-clearance, etc.)
13%	We use an automated system to compare personal trades with client trades
9%	Other
6%	We back-end test to see whether employees' trades should have been offered to clients
6%	We compare performance of personal accounts with performance of client accounts
6%	We hire a third-party firm to test personal trading
6%	We do not allow any personal trading except in low-risk securities such as unaffiliated open-end mutual funds, ETFs, government securities, etc. and therefore perform minimal testing
4%	We do not test personal trading
0%	We hire a third-party firm to identify employees' unreported brokerage accounts

Why aren't more firms performing these tests? A number of respondents, in their written narrative responses, indicated that they did not view personal trading as a high-risk area for their firm, either due to the quality of their employees or the nature of their investments. "We are only a two-person shop with a highly-tuned sense of fiduciary responsibility," said one respondent. Given the small number of employees involved, said another, personal trading was a matter of "judgment" and "no more science is required."

Other respondents cited their firm's investment strategies: "We deal only in no-load mutual funds and therefore have no personal trading issues," said one. "We use open-ended mutual funds in our accounts so personal trading is not a big issue," echoed another. "As a firm with fewer than ten employees and with no discretion over client assets … personal trading is not a high-risk area," said a third.

At the other end of the testing spectrum, several respondents indicated that each and every personal trade at their firm was subject to review: "Every personal trade, other than those that are defined as de minimis, requires pre-approval," said one respondent, who described that approach as "100% testing." One respondent noted that "pre-clearance occurs daily"; another stated that all personal transactions were reviewed. Indeed, 22% of the firms tested personal trading on an ongoing basis (weekly, if not more frequently).

As a general matter, how often does your firm test personal trading?



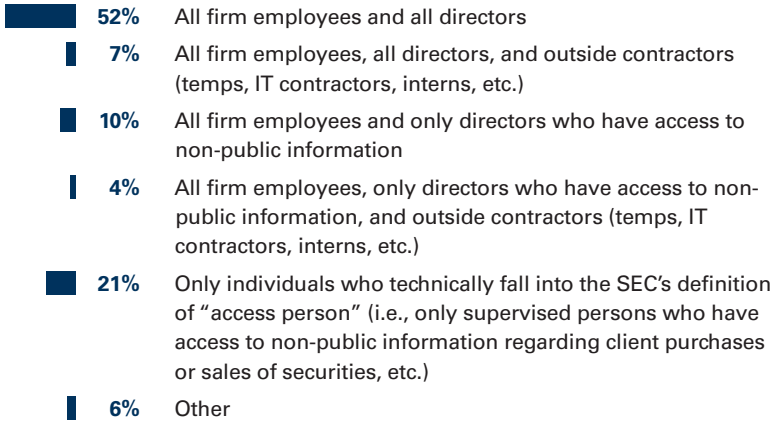
6% of the firms did not permit personal trading, except in low-risk securities such as unaffiliated open-end mutual funds or government securities. And 6% of the firms stated that they do not test personal trading, period.

"We receive monthly statements and review these for areas of concern. If there is a trade of concern, we then compare that against our clients' trades to ensure that there is no conflict."

Access persons

Firms took varying approaches to defining "access persons" in their code of ethics. At about half of the firms (52%), the definition included all firm employees and all directors. At 21% of firms, however, the definition tracked the definition in Rule 204A-1, which includes only employees with access to information about securities recommendations. 10% of firms defined the term to include all firm employees and all directors, except for directors who do not have access to non-public information. Presumably, those firms are prepared to rebut the presumption in Rule 204A-1 that all of an advisory firm's directors are "access persons."

How does your firm's code of ethics define "access persons"?



Brokerage accounts

67% of the firms allowed their access persons to trade at any brokerage firm. Several respondents noted in narrative responses that their firm required employees who traded at an outside firm to provide duplicate confirms and statements from those outside brokerage accounts. A number of respondents whose firms were dually-registered as broker-dealers noted that employees were required to trade through their firm. At a quarter of the firms (25%), access persons were allowed to trade only at certain specified brokers that supplied the firm with copies of statements and confirms.

Code of Ethics: Gifts and Entertainment

Key findings:

- **While most firms have a written gift and entertainment policy, a surprising number of those firms—35%—had conducted no specific testing to determine compliance with that policy. However, 16% of those firms prohibited gifts and/or entertainment altogether.**
- **Firms are concerned about their employees' receipt of gifts. Many firms have established a dollar limit on the value of any business-related gift that a firm employee can receive, with $100 being a popular limit.**
- **Firms appear to be somewhat less concerned about gift-giving than they are about gift-receiving. Fewer firms set a dollar limit on the value of gifts to be provided. For the firms that did set a limit, $100 was a popular choice.**
- **Firms are more flexible when it comes to business entertainment. Most firms have not set a dollar limit with respect to providing or receiving business entertainment. Many of these firms appear to have established a "reasonableness" standard for business entertainment.**

The majority of respondents (85%) reported that their firm had a written gift and entertainment policy. An additional 7% reported an unwritten policy pursuant to which employees knew that they needed to check with a supervisor in questionable situations.

Despite recent SEC scrutiny of advisers' gift and entertainment practices, a surprising 35% of firms that had a written gift and entertainment policy reported that they performed no testing whatsoever to determine compliance with that policy. However, 16% of those firms prohibited gifts and/or entertainment altogether. Of the relatively few firms that had an unwritten gift and entertainment policy, where employees check with a supervisor in questionable situations, 73% reported that they conducted no testing in the area.

At most firms (70%), the gift and entertainment policy was part of the firm's overall code of ethics.

A significant number of firms had not established any dollar limit for determining whether gifts and entertainment could be provided or received by their firm. Firms were more inclined to impose specific dollar limits on receiving gifts, and least inclined to impose such limits on providing entertainment: While 70% of the firms had established a dollar limit for receiving gifts, only 21% had established a dollar limit for providing entertainment.

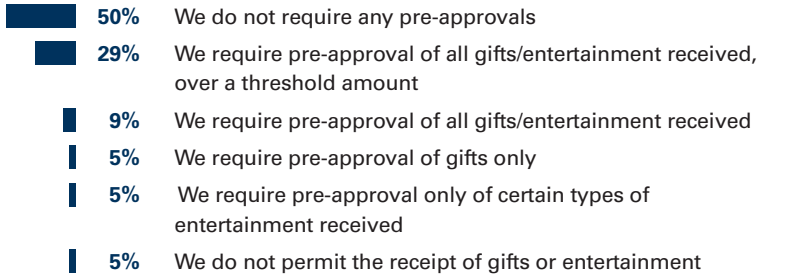
	Strictly prohibited	No dollar limit	$100 maximum	$250 maximum	$500 maximum
Gifts provided	8%	46%	31%	3%	2%
Gifts received	8%	23%	48%	5%	3%
Entertainment provided	6%	73%	9%	2%	1%
Entertainment received	6%	62%	15%	4%	2%

Many firms used a "reasonableness" standard to determine the appropriateness of gift and entertainment practices in particular situations. One respondent said that entertainment was provided "when appropriate and suitable under the circumstances," and "meet[s] the standards of ethical conduct and [does] not violate applicable laws and regulations." Another respondent's firm used a "smell test," a third applied "common sense." One respondent noted that an exception was made for gifts and entertainment to and from family members and to and from clients who had an existing social relationship with the recipient or provider prior to becoming a firm client.

"We do not give gifts to our clients. At the most we may take them to lunch or to golf."

Half of the firms (50%) did not require any pre-approvals of gifts and entertainment received. While 9% required preapproval of *all* gifts and entertainment, 29% required pre-approval only of gifts and entertainment over a threshold amount. Other firms required pre-approval of only gifts or only entertainment.

Does your firm require pre-approval of gifts/entertainment received?



A small minority of firms had a special gift and entertainment policy for certain types of clients. 8% had a special policy for ERISA clients and 8% had a special policy for government officials. Only 4% of firms, however, had a special gift and entertainment policy for both ERISA clients and government officials. In narrative responses, several respondents indicated that while their firm was sensitive to issues with respect to gifts and entertainment provided to ERISA clients and government officials, their firm had not prepared a specific policy in this area.

A number of respondents indicated that they had special policies for union officials. For example, one respondent reported a policy of "generally seek[ing] to avoid making LM-10 disclosures for Taft-Hartley clients."

Half of the firms (49%) kept a gift and entertainment log, and a third (31%) reviewed the log as part of testing compliance with their firm's gift and entertainment policies.

How does your firm test compliance with your gift and entertainment policy? (check all that apply)

31%	We review our gift log
28%	We seek employee certifications
25%	We interview firm employees to confirm their understanding of our gift and entertainment policy
18%	The employee's supervisor monitors gift/entertainment activity
13%	We review patterns of gifts/entertainment over time by employee
9%	We review patterns of gifts/entertainment over time by vendor/client
5%	We review patterns of brokerage order flow versus gifts/entertainment received from brokers
5%	We conduct focused e-mail searches that target employees' receipt of undisclosed gifts and entertainment
2%	If applicable, we compare LM-10s to LM-30s
0%	The compliance department sends a "mystery" gift to one or more firm employees, to see if they follow the requisite procedures
0%	We contact the firm's most commonly-used broker-dealers (i.e., top quartile) to obtain a log of all gifts and entertainment provided to our firm and employees by those broker-dealers

Code of Ethics: Political and Charitable Contributions

Key findings:

- **Most advisers do not have any written policies regarding political or charitable contributions.**
- **Of the firms that do have such policies, relatively few require pre-clearance or reporting of contributions.**

65% of the firms did not have any written policy regarding political contributions. Even more (78%) did not have written policies regarding charitable contributions. Larger firms were more likely than smaller firms to have written policies covering contributions. For example, 70% of the firms with $10 billion or more in assets under management had a written political contribution policy, while only 28% of the firms with less than $250 million had such a policy.

Among firms that had a political contribution policy, 46% prohibited political contributions by their firm. 23% prohibited employees from making political contributions to officials related to clients or potential clients. 11% prohibited employees from making contributions unless the employee is able to vote for the official.

What is your firm's policy on political contributions? (check all that apply)

65%	We do not have a written policy on political contributions
16%	Our policy prohibits our firm from making political contributions
8%	Our policy prohibits our employees from making political contributions to officials related to clients or potential clients
5%	We require pre-clearance of all political contributions
5%	We require reporting of all political contributions
5%	Other
4%	Our policy prohibits our employees from making political contributions unless the employee is able to vote for the official
3%	We require pre-clearance of political contributions to officials related to clients or potential clients
3%	We require reporting over threshold limits
2%	We require certifications
2%	We require pre-clearance of political contributions to officials for whom the employee cannot vote
2%	We require reporting of political contributions to officials related to clients or potential clients
1%	We have a policy related to specific states and localities

"We allow employees to make contributions but they must be done as individuals rather than as representatives of the firm. Employees must avoid any appearance of corporate sponsorship or endorsement in connection with any election."

22% of the firms had a written policy on charitable contributions. Of those firms:

- 42% had a committee that handled charitable contributions made by the firm;
- 38% had a special policy for handling client requests for contributions;
- 32% required employee pre-clearance of donations made in response to client requests or to client-related organizations; and
- 25% imposed dollar limits on contributions.

What is your firm's policy on charitable contributions? (check all that apply)

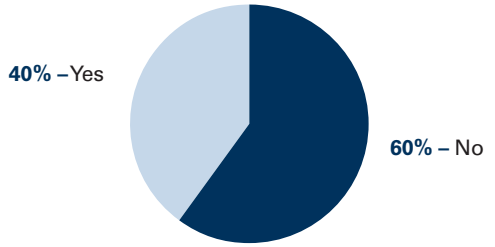
78%	We do not have a written policy on charitable contributions
9%	We have a committee that handles our firm's charitable contributions
9%	We have a special policy for handling client requests for charitable contributions
7%	We require employee pre-clearance of donations made in response to client requests or to client-related organizations
6%	We impose dollar limits on charitable contributions
3%	We require employee reporting of any donations made to client-related organizations
3%	Other
2%	We have a special policy for requests from union officials
1%	We have a policy regarding attendance at charitable events

Code of Ethics: Insider Trading

Key findings:

- **A majority of advisers do not test to detect insider trading. Anecdotal evidence suggests that many firms do not view insider trading as a high-risk area.**
- **Many firms have adopted a portfolio holding communication policy prohibiting the release of non-public portfolio information.**
- **Of the firms that do release portfolio holding information, the most popular approach was releasing quarter-end information, but only after a delay.**

Does your firm test to detect insider trading?



Surprisingly, 60% of the firms did not test to detect insider trading. This result is particularly unexpected given the SEC's recent focus on this area. Based on the narrative responses, however, some firms may have incorporated insider trading testing into broader monitoring and testing protocols. Respondents who described their firms' insider trading testing practices in narrative responses noted that trade logs, employee brokerage statements, and employee personal trading records were reviewed for unusual activity.

"We do review e-mails, all trades must have pre-approval, and we review [the firm's insider trading policy] at our annual compliance meeting which all employees attest to. But we do not have specific methods to detect insider trading."

Presumably, many of the firms that did not test for insider trading have concluded that this is not a high risk area for their firm. If that is indeed the case, it is not clear how these firms concluded that insider trading is not a high risk area: 85% of the firms had not conducted an "insider trading risk assessment" to determine how employees at their firm might become privy to material non-public information. "Our firm is only two people," said one respondent, whose firm did not conduct insider trading testing. "We handle trading together every day. Our personal culture is fiduciary responsibility ... [we] always put [the] client ahead of anything personal."

Of the firms that specifically did test for insider trading, the following tests were conducted:

- Performing an insider trading risk assessment to determine how the firm may become privy to material non-public information – 33%
- Reviewing circumstances surrounding unusually profitable trades in personal accounts – 26%
- Reviewing employee e-mail to and from "value-added" clients and investors, such as broker-dealers, investment bankers, research analysts, consultants, or lobbyists – 24%
- Testing for trading patterns in employee personal accounts around news stories – 24%
- Testing for trading patterns in client accounts around news stories – 20%
- Reviewing circumstances surrounding unusually profitable trades in client accounts – 19%

Of the firms that tested for insider trading, only 6% periodically reviewed a sample of the most profitable client trades to confirm that the trades were supported by the firm's standard investment due diligence processes. This test is routinely conducted by SEC examiners when reviewing for insider trading.

A number of respondents reported that their firm tested employee and personal trades against watch lists and/or restricted lists. Others explained that their firm reviewed all trades for unusual activity. "Our CEO has the trade blotter on his screen all day long," said one respondent. "No trade happens that he doesn't see and approve." Another respondent reported that any trade requested by a client was subject to review, as were any trades in personal accounts involving a security not being purchased or sold for clients.

52% of the firms had a portfolio holding communication policy restricting the release of non-public portfolio holding information. Most (60%) did not release such information, other than as required to report to clients and for regulatory filings. The chart below reflects the percentage of firms that released various types of information with or without a delay (e.g., release of quarter-end information immediately at the end of the quarter or, for example, after a 30-day delay).

	Delay	No Delay
Current information	**8%**	**12%**
Month-end information	**11%**	**2%**
Quarter-end information	**19%**	**4%**

One respondent described an internal firm policy as follows: "What we hold in client accounts is personal and confidential." Another respondent noted that current portfolio holding information is released only if a confidentiality agreement has been executed.

Soft Dollars

Key findings:

- **The majority of advisers try to avoid soft dollars, although a significant minority of firms do use them.**
- **Of the firms that utilize soft dollars, most do not use more than a small percentage of total client commissions to obtain third-party soft dollar products and services.**
- **Almost a quarter of firms that soft mixed-use products do not review their mixed-use allocations.**
- **Virtually no advisers participate in client commission arrangements, as contemplated in the SEC's recent interpretive release.**
- **Virtually no advisers "unbundle" full-service brokerage by attempting to place a dollar value on proprietary research.**

The majority of firms (59%) tried to shun soft dollars. These firms did not actively seek out soft dollar products and services, did not utilize unsolicited proprietary research received from full-service brokers, and generally avoided soft dollar usage to the extent they could. "We do NOT use soft dollars," said one respondent. "We don't do soft dollars, period," said another. "No one has ever offered us soft dollars," said a third. "If they did, we would refuse the offer and demand a discount for our clients instead." Nearly all of these firms (85%) did not test soft dollars, since they did not actively seek out soft dollar products and services.

A significant minority of firms (38%) did rely on soft dollars to purchase products and services within the Section 28(e) safe harbor. Only 2% operated outside the safe harbor, with disclosure to clients.

Soft dollar usage

59%	Avoid soft dollars: "Our firm does not actively seek out soft dollar products and services; to the extent we can, we avoid soft dollar usage. While full-service brokerage firms provide us with their own research materials (proprietary research) and other products, we do not request such materials, and often discard them unread."
38%	Rely on soft dollars: "We do rely on soft dollars to purchase certain products and services. We receive outside research and other products and services from third party providers, paid for by our broker-dealers within the 28(e) safe harbor."
2%	Operate outside 28(e): "We operate outside the 28(e) safe harbor, with full disclosure to our clients."

The 183 firms that tested soft dollars used a wide variety of strategies:

- Reviewing each soft dollar product and service to confirm that it is "brokerage or research" covered by Section 28(e) – 72%
- Reviewing soft dollar disclosures against actual practices – 68%
- Reviewing each soft dollar product or service requested or obtained for reasonableness – 66%
- Reviewing soft dollar commission reports prepared in-house – 59%
- Comparing soft dollar brokerage allocations against target allocations – 52%
- Reviewing soft dollar commission reports prepared by the firm's broker-dealers – 51%
- Requiring written approval for all soft dollar requisitions and reviewing those approvals against actual expenditures – 50%
- Reviewing soft dollar broker-dealer quality of executions against the quantity allocated to each broker – 46%
- Checking to see that the portion to be paid in hard dollars for mixed allocations is paid correctly – 46%
- Reviewing the logistics of how the products and services are paid for to ensure that they are "provided by" the broker as specified by Section 28(e) – 46%
- Informally discussing soft dollar commission ratios with industry peers to assure that the firm is paying a reasonable soft dollar ratio – 31%
- "Comparison shopping" soft dollar commission rates to assure that the firm is paying a reasonable soft dollar ratio – 30%
- Looking for quarter-end skewing of allocations and other indications that the firm's traders may be attempting to hit a soft dollar target – 13%

Soft dollar testing is relatively wide-spread: Only 2% of the firms that actively used soft dollar products and services reported that they did not test their soft dollar policies and procedures.

Mixed-use allocations

Of the firms that relied on soft dollars, 28% had a policy of paying 100% hard dollars for items that would otherwise be mixed-use items. 30% reviewed mixed-use allocations annually, 18% reviewed them quarterly, and 4% reviewed them monthly.

Surprisingly, 23% of the firms that relied on soft dollars and softed mixed-use products did not review their mixed-use allocations.

Commission-sharing arrangements

The vast majority of firms (91%) did not participate in any client commission arrangements, such as an introducing/clearing brokerage arrangement or commission-pooling arrangement. Of the firms that did participate in such an arrangement, nearly half (49%) did not test to confirm that the arrangement meets the guidance set out in the SEC's recent soft dollar interpretive release. Of the relatively few firms (26) that participated in client commission arrangements and tested in this area, 50% said that their firm performed due diligence on the activities of brokers to ensure compliance with the SEC's release. Of those 26 firms, 7 (27%) always attempted to obtain a certification from at least one broker participating in the commission-sharing arrangement; 6 (23%) sought certifications only in questionable arrangements or where the role of the brokers was unclear.

Unbundling

The SEC has considered whether to require advisers to "unbundle" proprietary research by requiring firms to disclose a dollar value for proprietary research received from full-service brokers. Thus, it is noteworthy that the vast majority of firms (97%) did not unbundle in any context. Respondents at the minority of firms (3%) that did attempt to unbundle reported that they did so in the following contexts:

- "Informally, in an attempt to understand total expenditures, we estimate a 'pure execution' cost."
- "We have approached B/Ds recently to see if we could ascertain cost of certain research services. Most all have been reluctant to even have the discussion…."
- "We assign a value to research services provided, e.g., company managements brought in, conference invitations, access to IPOs and other offerings, and other proprietary research."
- "We have a broker vote in which the 'value' of research is given a dollar figure."
- "We place a distinct dollar value of the research received from full-service brokers."

"We have approached B/Ds recently to see if we could ascertain cost of certain research services. Most all have been reluctant to even have the discussion…."

Level of soft dollar activity

How much of a firm's total client commissions are used to obtain third-party soft dollar products and services? Of the firms that used commissions to obtain soft dollar products and services — and that were able to make the estimate:

- 33% used "minimal" amounts of total client commissions to obtain third-party soft dollar products and services.
- 34% used less than 20% of total commissions.
- 19% used between 21 and 40% of total commissions.
- 9% used between 41 and 60% of total commissions.
- 5% used more than 60% of total commissions.

Trade Allocation

Key findings:

- **Firms use a variety of methods to test trade allocations, but only when relevant to their firm.**
- **Most firms do not engage in side-by-side investing (i.e., managing hedge funds alongside mutual funds).**

Firms use a wide variety of methods to test trade allocation. The most frequent test: monitoring for trade errors, cited by nearly half of the firms (48%). Many firms reviewed all or a sample of trades, either pre- or post-settlement, as follows:

	All trades	Sample of trades
Review pre-settlement	30%	5%
Review post-settlement	22%	19%

Interestingly, only 18% of the firms reviewed initial allocations of bunched trades. Even fewer (14%) reviewed re-allocations of bunched trades.

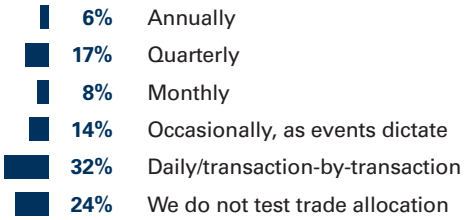
Significantly, only 6% required approval of re-allocations of bunched trades. That figure is particularly surprising given that one of the conditions in the 1995 no-action relief provided to *SMC Capital* by the SEC's Division of Investment Management staff was that trade re-allocations be subject to written approval by the firm's compliance officer no later than one hour after the opening of the market the day after the bunched order was executed.

Only 23% of the firms reviewed accounts with similar investment objectives for differences in performance, despite the fact that this test was specifically referenced in the SEC's compliance program rule adopting release.

And 24% of the firms did not test trade allocation at all. Based on respondents' narrative comments, however, there may be sound reasons for this relatively high percentage: "We do not have a centralized trading desk," explained one respondent. "Each portfolio manager does his own trading in accounts he manages. We do not bunch trades and therefore do not test trade allocation." Another reported a similar practice: "We purchase individual positions for individual accounts." Several respondents indicated that their firm invested only in instruments that do not lend themselves to bunched trades, such as mutual funds or private companies. Other respondents said that their firm did not have discretion or did not manage portfolios in-house.

Of the firms that did test trade allocation, 42% tested daily or on a transaction-by-transaction basis.

As a general matter, how often do you test trade allocation?



Side-by-side investing

Most firms (77%) did not engage in side-by-side investing (i.e., managing hedge funds alongside mutual funds or other traditional long-only investment vehicles). Even among the largest firms (with more than $20 billion in assets under management), 40% did not engage in side-by-side investing.

Of the 92 firms that engaged in side-by-side investing, the most popular test was reviewing the allocation of trading opportunities across accounts, cited by 42% of these firms. Other tests included:

- reviewing rationales for inconsistent trading decisions – 26%
- interviewing relevant portfolio managers to confirm their understanding of regulatory and compliance matters – 23%
- monitoring long vs. short positions across funds on a pre-trade basis – 22%
- monitoring long vs. short positions across funds on a post-trade basis – 22%
- testing long vs. short positions across funds on a post-trade basis – 21%

Surprisingly, of the firms that did engage in side-by-side investing, 29% did not perform any compliance tests in this area.

Of the 109 firms that had policies and procedures for side-by-side investing, half (50%) addressed conflicts raised by such investing under the firm's general trade allocation policies and procedures. Only 17% prohibited short sales of securities where other client accounts hold long positions in the same securities. 40% prohibited cross trades between client accounts. Interestingly, none of the firms imposed an information barrier between hedge fund portfolio managers and managers of other accounts.

Business Continuity Plan

Key finding:

- **While most firms have a business continuity plan in place, a significant number of firms have not yet tested critical components of their plan, such as a shift to a backup site or the effectiveness of the firm's emergency communication system.**

Virtually all of the firms (93%) had established a written business continuity plan. Such plans addressed the following scenarios:

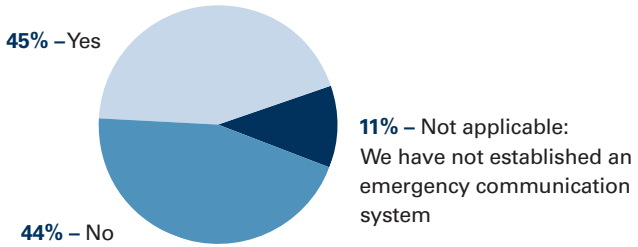
- Facility-wide outages (e.g., electrical outage, blackout, fire) – 92%
- Temporary interruption of discrete services (e.g., telephone or internet services, file server, real-time data feeds) – 89%
- Natural disasters (e.g., hurricane, earthquake, flood) – 85%
- Terrorist attack – 50%
- Death or disability of key personnel (succession planning) – 47%
- Pandemic flu – 25%

One respondent noted that rather than identifying specific events, the firm's plan addressed temporary versus permanent interruptions.

There does not appear to be an industry consensus on how often to test business continuity plans. While 28% of the firms conducted a full test of the entire plan on an annual basis, others conducted a full test every few years (5%) or a partial test on a periodic basis (annually 25%, quarterly 9%, and monthly/rolling 8%). 18% of the firms assessed vendors' ability to provide essential services during various scenarios.

Many firms do not appear to be testing key aspects of their business continuity plan. A majority of the firms (90%) had established a backup site. Of the firms that had established a backup site, however, about a third (37%) had not yet tested a physical shift of firm operations and employees to that site. Similarly, while most firms (89%) had established an emergency communication system, a significant 49% had not yet tested that system.

Has your firm tested its phone tree or other emergency communication system?



Of the firms that had not established basic business continuity measures, a significant number appear to be smaller firms. For example, of the firms that had not established a backup site, 38% were small firms (1-5 employees). Similarly, of the firms that had not established an emergency communication system, 56% were small firms (1-5 employees).

Several respondents reported that their firm's backup site consists of employee residences. One respondent pointed out that the availability of employees' residences as a backup site "is dependent on our server or PCs being available in the office."

The overwhelming majority of firms (96%) had not participated in an industry-wide disaster preparedness drill.

Perhaps most surprisingly, 25% of the firms had not tested any aspect of their business continuity plan. Of those, however, 63% expected to test the plan in the future.

Books and Records

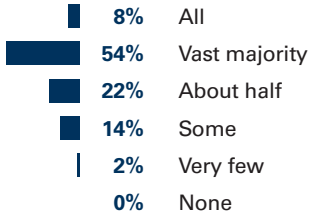
Key findings:

- **Electronic retention of business records is popular, and most firms would probably do more of it but for the time required to scan paper documents.**
- **Most firms keep all e-mail, rather than attempting to sort out and save only those e-mails that are required records.**
- **Many firms are not able to manipulate personal trading data to search for trends and exceptions, despite the SEC's "strong expectation" that they will keep personal trading records in electronic format.**
- **A significant minority of firms that permit instant messaging do not attempt to retain any of their employees' business-related instant messages.**

Electronic storage

While relatively few firms (8%) kept *all* internally-generated records in electronic format, electronic recordkeeping is clearly a common practice among advisory firms: 84% of the firms kept at least half of their internally-generated documents electronically. Electronic retention of records received from outside sources (as opposed to internally-generated documents) was slightly less common, with 76% of the firms reporting that they maintained at least half or more of externally-generated records electronically.

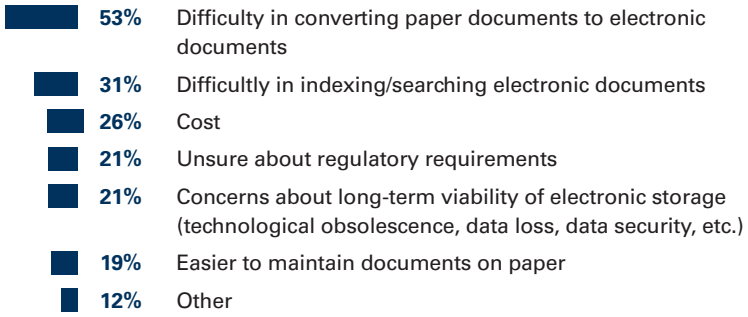
What percentage of records generated by your firm is maintained electronically by your firm?



"We have used electronic format for seven years and love it."

If electronic storage is so popular, why aren't more firms keeping more documents electronically? The most frequently cited challenge was difficulty in converting paper documents into electronic records, as indicated by 53% of the firms. "The biggest obstacle is the time it's taken to get everything scanned in," said one respondent. In addition to the time involved in scanning, several respondents indicated that employees' mindsets also presented a challenge: "Employees are resistant to change," said one. Another cited "staff willingness to accept new procedures." A third reported working at an "old firm with [an] old mentality" that "wants to keep all documents in paper."

What do you view as the biggest obstacle to maintaining more of your firm's records in electronic format?



Slicing and dicing

The ability to manipulate data, or "slice and dice," is critical to performing certain types of compliance tests. To be able to slice and dice data, records must be maintained electronically in a format that allows data manipulation.

Firms reported being able to slice and dice:

- trading data – 83%
- performance data – 80%
- portfolio management data – 79%
- client account data – 57%
- custodial data – 40%

Interestingly, only about a third of the firms (37%) were able to slice and dice data relating to personal trading. That result is surprising, given the SEC's "strong expectation" that advisers will maintain personal trading records electronically. In January 2004, when proposing Rule 204A-1, the Advisers Act personal trading rule, the SEC considered requiring advisers to keep records of access persons' personal securities reports (and duplicate brokerage confirmations or account statements in lieu of those reports) in electronic format in an accessible computer database. Electronic storage, explained the SEC, would facilitate examiners' reviews: "In all but the smallest advisory organizations, it may be impractical for the adviser or our examiners to review paper trading reports for patterns that may indicate abuse," reasoned the SEC. The Commission ultimately was persuaded by commenters that such a database would be burdensome and costly for advisers to create, and did not mandate its creation. Still, it urged advisers to maintain personal trading data electronically: "[W]e have strong expectations that most advisers will need to maintain these records electronically in order to meet their responsibilities to review these records and monitor compliance with their codes," said the SEC in its July 2004 release adopting Rule 204A-1.

E-mail

Survey data confirmed anecdotal reports that most firms do not sort through e-mail to distinguish between required and non-required records. 81% of the firms kept all e-mail sent to or received by employees. In contrast, 15% maintained only those e-mails required to be kept under relevant recordkeeping rules. An additional 3% kept e-mails required to be kept under relevant recordkeeping rules along with certain additional categories of e-mails.

E-mail was cited by several respondents as an insider trading testing tool. "We try to review all employee e-mail from clients, and as much employee e-mail as possible from other sources. All employees know their e-mail is not private," said one respondent, describing insider trading testing.

Instant messages

56% of the firms prohibited the use of instant messaging (IM) for business purposes. Four respondents noted that while their firm generally prohibits instant messaging, an exception is made for the firm's traders. "Only our traders are allowed to use instant messaging offered by Bloomberg," said one respondent. "We prohibit all employees from using IM except for the trading department," said another, adding that "all instant messages for the trading department are maintained."

Of the firms that permitted the use of IM for business purposes, 47% kept all instant messages sent to or received by the firm and its employees. Significantly, however, 33% of the firms that permitted IM did not attempt to retain *any* instant messages. 11% of the firms that permitted IM attempted to retain instant messages that were required records. An additional 2% kept instant messages required to be kept under relevant recordkeeping rules along with certain additional categories of instant messages.

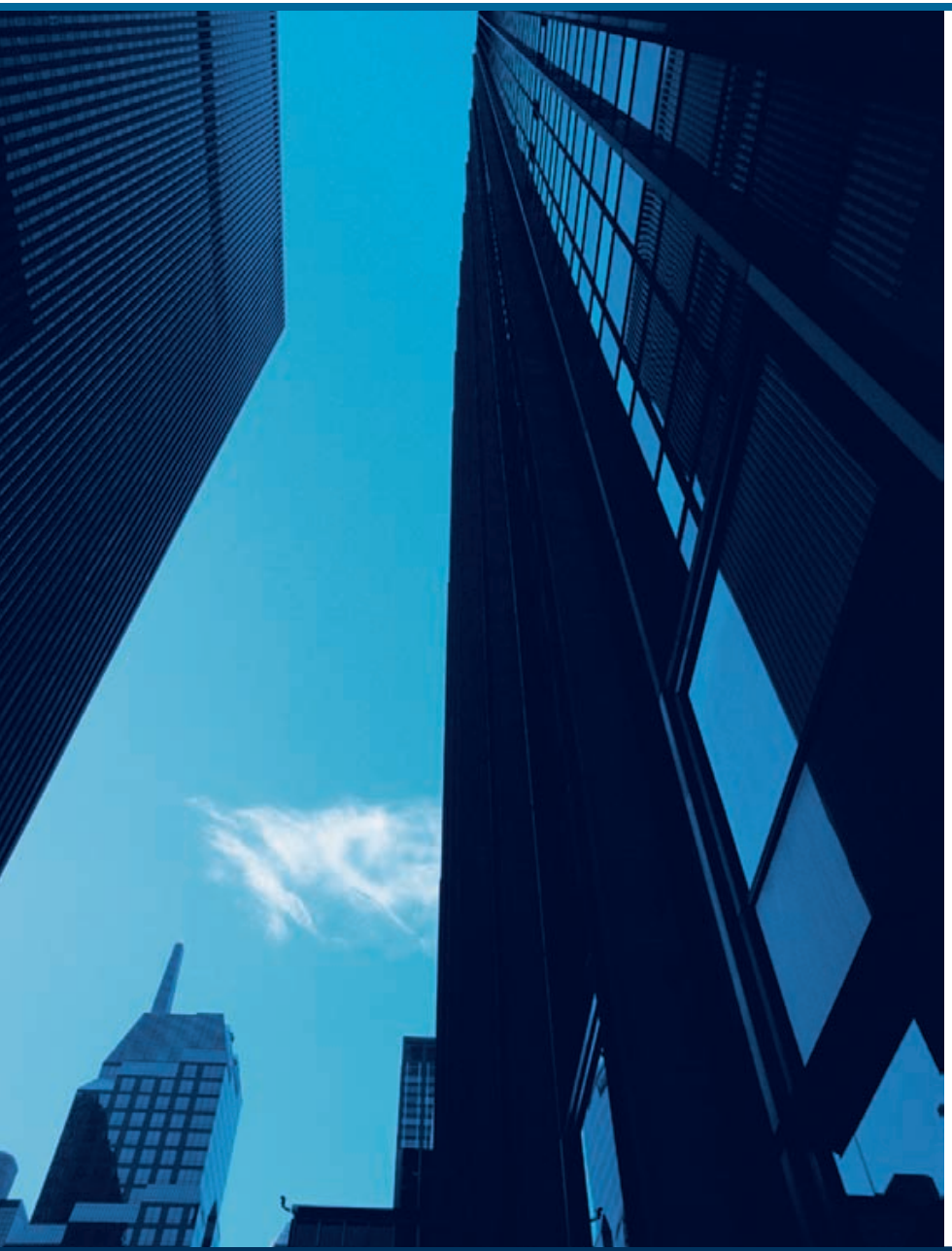
Identifying required records

As noted, many firms did not sort through e-mail and instant messages to determine which of those communications were required records. However, advisers did attempt to make this determination when assessing whether other types of records are required to be maintained: With respect to records other than e-mails and instant messages, 57% of the firms maintained only those records required to be kept under relevant recordkeeping rules. An additional 7% kept records required to be kept under relevant recordkeeping rules along with certain additional categories of records.

Notably, 38% of the firms maintained all records and documents generated by or received by the firm, regardless of whether they were required records. "We are just over two years old, so right now we retain everything," said one respondent. "When we are able, we will purge unnecessary records."

Most firms (64%) kept records only for the required period of time. However, 34% kept records indefinitely. Most firms (79%) relied on an off-site storage facility.

"We are currently reviewing and streamlining our policy with the goal of only maintaining records for the period of time required by regulations, client obligations, and business necessities."



In addition to your principal office and place of business, does your firm maintain required records in any of the following locations? (check all that apply)

79%	Off-site storage facility
25%	Third-party administrator
16%	Other
15%	Branch office
9%	Prime broker

Other off-site locations mentioned by respondents included the firm's outside counsel's office, a senior officer's residence, an affiliate's office, and a bank vault.

Interestingly, 43% of the firms that maintained all records also kept those records indefinitely. Some respondents indicated that they were reassessing this "keep everything forever" approach to records, which may present cost and storage issues down the road. "As our firm is getting larger and has been in business longer, this is something we'll need to address," said one.

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