ACA COMPLIANCE GROUP

INVESTMENT ADVISER ASSOCIATION

IM Insight

OLD MUTUAL

# 2008 Investment Management Compliance Testing Survey

## Summary Report
June 30, 2008

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# Introduction

**Rule 206(4)-7 under the Investment Advisers Act of 1940, the "compliance program rule," requires SEC-registered investment advisers to adopt and implement compliance policies and procedures, appoint a chief compliance officer (CCO), and conduct an annual compliance review. The SEC designed the compliance program rule to allow advisers to flexibly tailor their compliance program to their particular business.**

Although the rule has been in place for almost five years, many advisers continue to fine-tune and improve their policies and procedures and annual review process. Among other things, firms add to or refine their "forensic" tests to analyze information over time in order to identify unusual patterns. Moreover, as the annual review process identifies areas of potential weakness or risk, firms adjust their compliance programs accordingly. This continual adjustment and improvement is in line with the SEC staff's expectation that advisers' compliance programs not be static.

The results of these ongoing efforts are demonstrated in this year's survey results. Most of the firms reported that their culture of compliance has improved, even in the face of increased compliance costs and resource constraints. Still, based on the high number of SEC deficiency letter comments relating to the annual review, many firms could do better. According to Gene Gohlke, an associate director in the SEC's Office of Compliance Inspections and Examinations, about half of all advisers examined during the period June 1 through August 31, 2007 received a deficiency letter comment relating to their annual review process.

At the SEC's November 2007 CCOutreach National Seminar, the SEC staff released a helpful list of forensic tests for use by advisers, to encourage firms to further improve their compliance programs. The document, titled "Forensic Measures for Funds and Advisers," provides valuable insight into what SEC examiners will be looking for during examinations.

Similarly, this survey is intended to provide the investment management industry with insight as to what other advisory firms are doing in the realm of compliance testing, and to provide different 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 the testing ideas presented in the survey were drawn from suggestions made by OCIE staff during the SEC's CCOutreach seminars, as well as from industry participants. The survey results should be helpful to any compliance professional who has wondered whether his or her firm is conducting the right kinds of tests in the right areas, or how the firm compares to its peers when it comes to compliance testing.

This year's survey revealed that advisers have been faced with compliance challenges, but nonetheless have adapted their compliance programs and enhanced the scope of their testing efforts to respond to OCIE's outreach initiatives as well as to industry developments. For example, this year's survey revealed that:

- Compliance costs have increased at a majority of firms (65%).
- At many firms, compliance resources are barely adequate (30%) or insufficient (26%).
- A majority of firms (64%) reported that their firm had one or fewer employees working full-time in the legal and/or compliance functions.
- Despite those challenges, 58% of firms reported that their culture of compliance had improved over the past year.
- There has been a sharp increase in the number of firms that test for insider trading. In our 2005 survey, only 20% of firms tested for insider trading. Last year, that percentage doubled to 40%. This year, the number doubled again, with 83% of firms now reporting that they test for insider trading.

The survey organizers would like to thank the more than 400 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 March 2008, ACA Compliance Group, the Investment Adviser Association, Old Mutual Asset Management, and *IM Insight* conducted the third 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 focus areas, such as soft dollar arrangements, gifts and entertainment, and insider trading;**
- **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 409 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 those questions.

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 responses may provide useful insight into practices at specific firms.

*"For as much as I like seeing and learning the various forensic tests that could be performed, it makes me nervous that we are not testing as thoroughly as perhaps we should be in all areas."*

# Core Demographics

Again this year, a wide range of firms were represented in the survey, from small firms to multi-billion dollar firms. The firms were diverse both in terms of assets under management (AUM) and number of employees. The typical firm:

- had between 11 to 50 employees – 37%
- had been in business between 5 and 25 years – 66%
- had one, or fewer than one, full-time employee in the legal and/or compliance functions – 64%

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

| | |
|---|---|
| 32% | Under $250 million |
| 13% | $250 million to $500 million |
| 12% | $500 million to $1 billion |
| 28% | $1 billion to $10 billion |
| 5% | $10 billion to $20 billion |
| 11% | Over $20 billion |

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

| | |
|---|---|
| 26% | 1 to 5 |
| 16% | 6 to 10 |
| 37% | 11 to 50 |
| 16% | 51 to 250 |
| 2% | 251 to 500 |
| 4% | More than 500 |

**How would you describe your firm?**

| | |
|---|---|
| 2% | Brand new firm (less than 1 year in business) |
| 13% | Relatively new firm (1 to 5 years in business) |
| 66% | Established firm (5 to 25 years in business) |
| 19% | A long-timer (more than 25 years in business) |

Small firms were well-represented: 32% had less than $250 million in assets under management and 26% had five or fewer employees.

The majority of firms (85%) were established firms with at least five years of business operations.

Overall, the demographics of firms participating in this year's survey was similar to those of participants in last year's survey, with the notable exception of asset size: Most firms managed relatively fewer assets. For example, the percentage of firms with under $500 million of AUM increased 15% from last year's survey (compare last year's 39% to 45% in this year's survey).

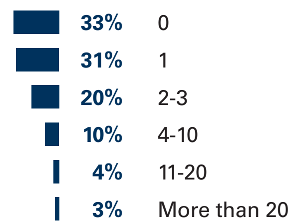
# Compliance Program

## Key findings:

- At most firms (64%), no more than one full-time employee works in the legal and/or compliance functions.
- Most CCOs (79%) wear two or more hats, performing additional non-CCO functions.
- At most firms (65%), compliance costs have increased over the past year.
- 44% of firms reported having fully sufficient resources devoted to compliance.
- A majority of firms (58%) indicated their culture of compliance has improved, most commonly as a result of a change in attitude among firm personnel.
- About one half of firms (49%) that added a new compliance initiative since January 1, 2007 reported that it was as a result of their annual review.
- Most firms (59%) do not define a “significant” or “material” compliance event in their compliance procedures.
- Testing uncovered “significant” issues at only 6% of firms, while at 69% of the firms, testing revealed only minor issues.

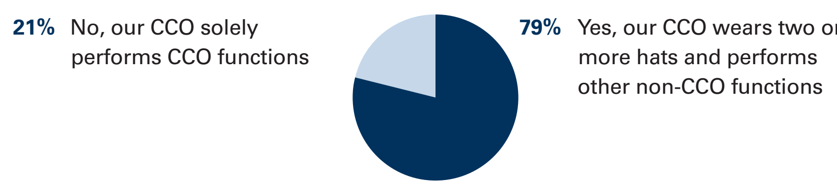
This year’s survey again confirmed that at most firms, the “compliance department” actually consists of one individual, if that. A majority of firms (64%) reported that their firm had one or fewer employees working full-time in the legal and/or compliance functions.

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




The survey also confirmed that the typical CCO performs other, non-CCO functions.

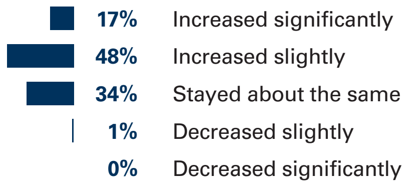
**Does your firm’s CCO perform a significant amount of non-CCO functions (for example, by also serving as CCO or CFO)?**



## Compliance Costs and Resources

At most firms, compliance costs have increased over the past year.

**Since January 1, 2007, have your firm's compliance costs increased?**




Many firms indicated that their compliance resources, such as budget and staffing, are barely adequate or even inadequate. 30% of firms had "barely" enough compliance resources, and a significant 26% of firms indicated that they could use more compliance resources. On the other hand, 44% said that they had sufficient resources devoted to compliance.

Not surprisingly, firms that reported a relatively greater increase in costs were more likely to express concern about the adequacy of their compliance resources. For example, of the firms that felt their compliance costs had increased significantly, 29% said they could use more resources. In contrast, of the firms where compliance costs stayed about the same, only 21% said they could use more resources.

## Culture of Compliance

Despite the increased cost of compliance and the strain on resources, most firms reported positive changes to their culture of compliance. 58% of firms said that their culture of compliance had improved, with about a quarter of those firms reporting "dramatic" improvements. 41% indicated that their firm's culture of compliance had remained the same. Only a handful reported that their firm's culture of compliance had declined.

Survey respondents who reported that their firm's culture of compliance had improved were asked to provide written descriptions of what, exactly, had improved. Their anecdotal responses typically fell into one of seven categories:

**Firm-wide buy-in.** The most commonly-cited feature leading to an improved culture of compliance was, essentially, a change in attitude among firm personnel. About 45 respondents noted changes relating to improved employee buy-in. One respondent reported an "increased awareness of compliance impact on all team members," noting that "it's not just the CCO's job anymore." Other respondents repeated that theme, with comments such as: "Everyone is more aware," "Everyone is more on the same page," and "Everyone is wearing their compliance 'hat.'" One respondent noted that "compliance has tried to 'team up' with the marketing group and work together towards a common goal, rather than being seen as the 'no person.'"

In a similar vein, several respondents attributed their firm's improved culture of compliance to an increased willingness by employees to ask questions and offer up compliance suggestions. "More employees [are] appreciating compliance issues, asking questions, bringing issues to compliance's attention," said one respondent. "Individuals are more likely to proactively seek compliance help and input, and are more likely to think to include compliance at the early stages of developing a new product [or] strategy," said another.

Other respondents described the increased role of the compliance function in their firm's day-to-day business activities. Compliance is included in "all meetings" and is used "as a sounding board when discussing new initiatives," said one respondent. Another said that the compliance department was involved "early" in the consideration of new business ventures and hires, with compliance being a "primary consideration" when evaluating changes.

Interestingly, a handful of respondents cited a change of the CCO's role within the organization — or even a change of the individual serving as the CCO — as leading to increased buy-in. "The new CCO is not viewed as an adversary as much as previously," said one.

**Staffing changes.** Another significant factor leading toward an improved culture of compliance was heightened staffing of the compliance function, cited by about 30 firms. For example, one respondent said that the CCO role had become a full-time position, when previously, it had been a part-time role. Other respondents described transferring the CCO role to a more senior person within the firm or the hiring of additional compliance officers to support the CCO.

**Tone from the top.** Not surprisingly, improved support for compliance from firm leadership was mentioned by about 20 respondents as leading to an improved culture of compliance. "The CEO and CIO have always been very compliance oriented, but the support for compliance has increased slightly and the 'tone at the top' has been communicated to the next level of managers, who are now more cooperative with compliance," said one. "Management has at last bought in to the concept of compliance as a necessity rather than a nuisance," said another.

**Training.** About 16 firms reported that increased training contributed to their improved culture of compliance. Respondents cited a variety of approaches, such as "Lunch and Learn" sessions and "Compliance Road-Shows." Several noted that compliance training was conducted on a monthly basis.

**Mock audits.** About 15 respondents noted that their firm's culture of compliance had improved following a mock audit by a third-party consulting firm. The use of outside experts, said one respondent, "has helped to educate employees and to give them a greater appreciation for compliance."

**SEC inspections.** Interestingly, a visit by SEC examiners served as the catalyst for improving the culture of compliance at about ten firms. "A recent SEC exam has provided the inducement for all staff to realize the gravity of the compliance program," said one respondent. "After an SEC exam, the firm respects the work being done in compliance to a higher degree," said another. "We had our first SEC examination and because of that, the attitude of members of the firm has changed significantly and we have been able to institute programs to enhance the culture of compliance," said a third. One respondent said the SEC exam "brought to light the 'Truth and Facts' about what has been talked about with compliance. I was not kidding — everyone is on the same page now."

**"Plain English" policies and procedures.** About ten respondents noted that their firms had revised their compliance policies and procedures to make them more user-friendly. That, they said, led to an improved culture of compliance.

Respondents also shared unique practices or experiences that they believed led to an increased culture of compliance:

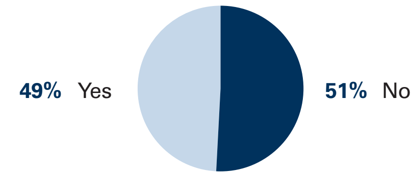
- One respondent's firm now includes a compliance component in annual employee performance evaluations.
- Another reported that a violation discovered during an internal review resulted in a renewed focus on compliance.
- One respondent reported that the first meeting for all new employees is a compliance orientation.
- Lastly, one respondent indicated that the recent poor economic environment has led to a desire to avoid compliance problems, so as to avoid having to deliver any additional negative news to clients. "Since the market turmoil that really took hold in the markets in early August 2007, there is a heightened focus on investment performance for our clients," said the respondent. "In such an environment, nobody wants to use goodwill with clients for anything other than performance discussions."

As noted, a handful of respondents indicated that their firm's culture of compliance has declined. "It is not a priority," said one such respondent. "It is considered that once the policy manual was complete, the job was done." Interestingly, several of these respondents indicated that the growth of their firm was a factor in decreasing emphasis on the compliance function. "Strategic growth has pushed [our] focus to processing and servicing clients, learning new systems, increasing efficiencies. Compliance training and awareness has less priority," said one. Another respondent indicated that with a larger number of employees, it was more difficult to schedule compliance training.

## Compliance Policies and Procedures

Many firms reported making significant changes to their compliance policies and procedures. About half (49%) of firms reported making a material change to their written compliance policies and procedures since January 1, 2007. The other half reported that their firm's written compliance procedures had remained essentially the same.

**Since January 1, 2007, has your firm made any material changes to its written compliance policies and procedures?**




Of the firms that reported changes, 85% made an amendment to an existing procedure; 63% added a brand new procedure; and 18% deleted an existing procedure.

In providing anecdotal explanations of the changes, a number of respondents pointed out that they continuously review and revise their written policies and procedures. "We keep refining," said one respondent. "In some cases we added procedures, in others where a process did not work as envisioned, we either delete or revise," said another. Several respondents noted that their policies and procedures had been revised to make them more user-friendly and/or better reflect their firm's business. "We did not change the actual procedures, but updated how we talk about them — plain English," said one respondent. "We significantly streamlined several procedures because of the difficulty living up to the original procedure established in 2004 and how it was not appropriate for our firm's business," said another. "The changes to our procedures were to make them more specific to our actual practices," said a third.

Some respondents noted that their policies and procedures had been amended to address new areas of business, with hedge funds/alternative investments a frequently-cited new product area. One respondent indicated that growth had prompted the revision: "After using our initial compliance manual for two years it was time for a revamp. We updated to be sure [that] what was in the manual was what we were actually doing. We've doubled in size in the last two years and the old way of doing and storing checklists and compliance just didn't work."

Common policies and procedures cited by respondents as being changed over the past year included:

- code of ethics;
- trading and brokerage;
- business continuity;
- advertising (including GIPS); and
- annual review/testing.

## New Compliance Initiatives

Heeding the SEC's instruction that compliance programs should not be static, a significant 63% of respondents reported that their firm had implemented a new compliance initiative since January 1, 2007. Many of these new compliance initiatives consisted of additional forensic tests, training, and/or new or modified policies and procedures.

*"If you do not add something yearly, sometimes quarterly, you'll fall behind."*

Given the SEC's scrutiny of insider trading over the past two years, it was not surprising that several of the respondents reported new training and testing initiatives focusing on that area. One respondent's firm implemented a new test of comparing the firm's most profitable trades to news events. Another said that the firm identified "insiders" in its unregistered funds, placed more scrutiny on relationships with industry professionals, and enhanced e-mail surveillance to review for insider trading. Other areas of SEC focus also resulted in new compliance initiatives for firms. "We are more vigilant of tracking locates for short selling and ensuring that we comply with all the rules surrounding short sales," said one respondent.

Training initiatives were common, with several respondents describing monthly compliance training events. One held a "compliance corner," consisting of a monthly five to ten minute presentation on a particular compliance issue. Another described a "monthly review of one or two sections of [the] policies and procedures manual at team meetings." One survey respondent described the implementation of a "fun and interactive training program."

Interestingly, a number of firms implemented new compliance initiatives designed to ensure the accuracy of client fees. One respondent's firm reported a new annual audit of client fees. Another described a "global billing review" designed to detect "dramatic changes in the amounts clients are charged."

Another repeating topic was the focus on compliance with clients' investment mandates, account objectives, and investment restrictions. One respondent said that monthly summaries of client accounts were reviewed at team meetings. Another said that the firm engaged in "more frequent testing of client trading patterns relative to their investment objectives." A third respondent described running performance comparisons of all households with the same investment objectives. "We hope to compare the outcome of each [adviser's] decision-making abilities given client restrictions and to ascertain if any cherry picking of investment opportunities is occurring," said that respondent. Another described a "global performance review" to see if clients invested similarly have similar returns.

*"I am constantly trying to look at things in new ways."*

Some respondents noted that their compliance initiatives involved reaching out to their peers. One firm polled CCOs at major fund complexes and at hedge funds about e-mail surveillance procedures. Another participated in a local working group with several large advisory firms comparing codes of ethics provisions (personal trading, gifts, and charitable and political contributions) with the "goal of learning from each other."

*"We've tried to add some quantifiable tests to show we are complying with our policies and procedures. Our firm is small and we think this is overkill, but we are wary of encountering criticism when we are visited by the SEC."*

When asked to identify the impetus for their new compliance initiatives, firms cited a variety of causes. Most commonly, the firm's annual review (49%) identified an area for improvement.

**What triggered the new compliance initiative? (check all that apply)**

| | |
|---|---|
| **49%** | Our annual review identified an area for improvement |
| **43%** | We learned that regulators are focusing on a particular area and we wanted to pro-actively address it |
| **39%** | An informal, internal compliance review revealed an area for improvement |
| **38%** | Our risk assessment process identified an area for improvement |
| **21%** | We learned that our peers and/or competitors have implemented similar initiatives |
| **19%** | Our outside counsel or consultant pointed out an area for improvement |
| **14%** | Our firm entered a new line of business |
| **13%** | An SEC examination pointed out a deficiency in our procedures |
| **9%** | Our conflicts assessment process identified an area for improvement |
| **15%** | Other |

Anecdotally, respondents pointed to a variety of additional triggers. One noted that there was a concern within the firm that "much had changed since the last audit," but that there had been "no concerted effort to date to completely implement the compliance program." Another respondent noted that the firm had not been examined by the SEC "in several years" and wanted to be prepared for its next examination. One said that the new initiative was designed to save money; another said it was simply "the right thing to do in the context of a pro-active compliance program."

Of the 38% of firms that had not added any new compliance initiatives, most (79%) explained that the primary reason was that their existing compliance program was adequate. A handful of firms pointed to other reasons, such as other priorities standing in the way (9%), not enough time (6%), or not enough personnel to implement the initiative (5%). Interestingly, no firm cited lack of money in the budget as a reason for not adding new compliance initiatives. And only two respondents cited lack of buy-in and support by senior management as a reason why a new compliance initiative had not been implemented.

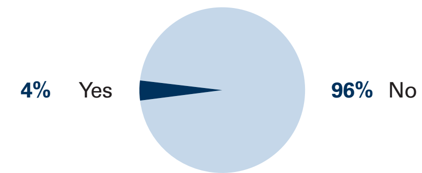
One respondent noted that while the firm had not actually added any new initiatives, "it seems like my forensic skills improve with each year" and correspondingly, "the review is more detailed each time."

*"Changes have been more evolutionary than revolutionary. We have a mature compliance program, but continue to find ways to make workflow more effective and efficient, implement additional controls or oversight, and adjust training to make it more meaningful to staff, improve documentation of existing processes, and augment testing protocols."*

## Reduction in Compliance Initiatives

Only a small number of firms reported that they had cut back on one or more previous, existing compliance initiatives.

**Since January 1, 2007, has your firm cut back on one or more previous, existing compliance initiatives?**




Of the 16 firms that cut back on a previous compliance initiative, the most commonly cited reason (31%) was that the initiative was too burdensome from a human resource perspective. Other respondents reported that the initiative was ineffective (19%), inefficient (13%), or duplicative (6%). Only one respondent reported that a compliance initiative was cut because it was too costly from a budget perspective.

One respondent's firm scaled back its anti-money laundering procedures. The respondent noted that the original AML policy and procedures "were simply too intense" because they were based on the type of AML program that a brokerage firm would be required to implement. The respondent said that the firm found that the AML program "was simply not accomplishing anything." Another respondent said that review of e-mails was reduced from monthly to quarterly. "We consider this a very low risk area," said the respondent. A third respondent reported that soft dollar analysis was curtailed.

*"We will change our proxy voting policy so that we no longer vote proxies. It has become time and cost prohibitive for us to keep up with the processes as required by the SEC. Our clients often hold positions in assets that we do not direct. We end up having to vote proxies for hundreds of securities while the securities universe for our strategies is comprised of only fifty or so positions. The clincher is no one has ever asked how we vote a proxy and we have spent hundreds of hours keeping up with the information."*

## Compliance Issues Revealed

Compliance testing uncovered "significant" issues at only 6% of firms. At the large majority of firms (69%), testing revealed only minor issues. At 25% of firms, no issues were detected.

| | Significant issues | Minor issues | No issues |
|---|---|---|---|
| 2008 | 6% | 69% | 25% |
| 2007 | 8% | 73% | 19% |

Like last year's survey, this year's survey found that 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, 69% were small firms (under $500 million of assets under management), but only 4% were large firms ($10 billion or more of assets under management).

| | Small firms: under $500 million AUM | Large firms: $10 billion or more AUM |
|---|---|---|
| Significant issues detected | 39% | 22% |
| Minor issues detected | 36% | 20% |
| No issues detected | 69% | 4% |

Similarly, firms that did not have full-time legal or compliance staff were significantly 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 | 22% | 30% | 22% |
| Minor issues detected | 25% | 32% | 20% |
| No issues detected | 57% | 27% | 3% |

## Self-reporting

The majority of firms (68%, or 17 firms) that had detected a significant compliance issue said that they did not report the issue to the SEC and did not intend to raise it during their next SEC examination, because they had resolved the issue internally. The fact that a firm has chosen not to self-report to the SEC should not be taken as any indication that the firm is not a highly-compliant firm. There is no regulatory requirement that advisers self-report compliance issues to the SEC. While a firm may not self-report to the SEC, it may report the matter internally to senior management, an outside board, and/or to clients. Moreover, it may memorialize the finding in its annual report.

Another 20% (5 firms) said that they did not self-report the issue, but plan to raise it at the start of their next SEC exam. Only 3 firms (12%) said that they had reported the matter to the SEC. Two of those firms categorized it as a positive experience, but one indicated that there were some negatives to the experience.

## Definition of "Significant" or "Material" Compliance Event

Most firms (59%) said that their compliance procedures do not define what a "significant" or "material" compliance event is. 27% said that their procedures track the definition of "material compliance matter" in the Investment Company Act compliance program rule, Rule 38a-1. Another 13% reported that their firm had developed its own definition of what a "significant" or "material" compliance event is.

According to OCIE associate director Gene Gohlke, the SEC staff conducted an internal survey of examination results from the summer of 2007 and found that about 86% of a group of registrants (primarily consisting of SEC-registered advisers, but including a small number of fund complexes) had not defined what a material compliance event meant for their firm. 8% of firms simply cited the definition in Rule 38a-1, he said. Only 6% created their own definition of a "material compliance event." In presenting the SEC's survey results at a fall 2007 compliance conference, Gohlke encouraged firms to define what a "material compliance event" was for their organization. Of course, there is no actual requirement that investment advisers define a "material compliance event" in their compliance procedures.

With Gohlke's remarks in mind, it is interesting to consider the range of definitions of a "significant" or "material" compliance event presented by survey respondents in their anecdotal responses. Some simply described it as any event that is deemed "significant" or "material" by the CCO at the time of the event. "It includes any issue [that] the CCO determines, in conjunction with legal counsel, could result in potential harm to clients and/or is a repeat problem that could be considered a regulatory rule violation," said one respondent.

Other respondents defined "significant" or "material" compliance events as those that resulted in a monetary loss, either to the firm or its clients. Examples of these definitions included events "where compensation is payable to the client," events that result in a "significant dollar loss, due to an error," or events that result in "losses estimated to be more than U.S. $10,000."

*"A material compliance issue will be defined as a breach of a securities rule or regulation, a willful violation of a firm policy or procedure, including the code of ethics, or another action by an employee that risks harm to a client or the firm's reputation."*

Respondents presented a number of additional, unique examples of definitions of what would constitute a "significant" or "material" compliance event for their firm, such as an event that:

- "creates a conflict of interest with our clients;"
- "I would be embarrassed to have anyone I know hear or read about;"
- the firm's outside compliance consultant deems significant;
- "could cause a significant fine or suspension of an individual;"
- "may impact the standing of the firm with the SEC;"
- results in a change to the firm's policies or procedures;
- results in a "major regulatory violation;"
- represents "a material weakness, which if left unmitigated could expose us or our clients to the risk of financial loss, the risk of violation of a federal or state securities law, or the risk of damage to our reputation;"
- is "reportable to the firm's board of directors;"
- "that may cause harm, which may or may not be financial, to a client's account;"
- is "likely to result in a regulatory enforcement action;"
- "violates ADV disclosures;"
- "clearly is counter to our policies and procedures;"
- is "indicative of a systemic weakness;"
- represents "a 'gap' that needed a solution;"
- is a reportable event for "SOX, SEC audit, or mock audit;"
- "may have a high profile with regulators;" or
- "would cause us to fall short of our fiduciary obligations to a client."

# Best Execution

## Key findings:

- **Most firms (91%) test for best execution for equity trades.**
- **Of the firms that trade fixed income securities, only 35% conduct testing for fixed income best execution.**
- **A large majority (70%) of firms have a best execution committee.**
- **Relatively few firms (17%) have engaged a third-party service provider to evaluate execution quality.**
- **Almost half of firms (48%) do not accept client-directed brokerage arrangements.**

### Testing Best Execution on Equity Trades

The overwhelming majority of firms (91%) test for best execution for equity securities transactions. The most commonly cited tests for best execution included:

- Maintaining an approved brokers list that is periodically reviewed by portfolio managers, traders, and/or compliance personnel (59%);
- Attempting to negotiate commission rates with brokers (44%);
- Reviewing brokerage commission reports prepared in-house (38%);
- Comparing disclosures made to clients about the firm's execution policies with actual practices (32%);
- Comparing the brokers used against the firm's approved brokers list to confirm that only approved brokers were used (30%);
- Informally discussing commission rates with industry peers (30%) or "comparison shopping" commission rates with other brokers (29%) to see if actual rates paid were reasonable;
- Reviewing patterns of trading errors to assess broker quality (28%);
- Reviewing same day trades (27%);
- Reviewing brokers' execution quality against the quantity of brokerage allocated to each broker (27%); and
- Evaluating execution quality using VWAP (Volume-Weighted Average Price) or similar benchmarks (25%).

Notably, two of the more basic execution tests — reviewing trade error patterns to assess broker quality and reviewing brokers' execution quality against the quantity of brokerage allocated — were performed only by about a quarter of firms (28% and 27%, respectively). And while 59% of firms maintained an approved brokers list, only about a third (30%) tested to see that only brokers from that list were used.

Few firms reported reviewing patterns of order flow to identify conflicts of interest. 17% indicated that they review patterns of order flow against soft dollar products and services provided by brokers, and 9% review against gifts and entertainment received from brokers. Only 14% of firms reported reviewing patterns of order flow to look for other potential conflicts of interest indicating favoritism, such as order flow to reward a broker for referrals, to compensate the broker as part of a revenue sharing arrangement, or to direct compensation to an affiliated broker.

9% of firms reported that they do not test for best execution for equity trades. Most of these firms noted in their narrative responses that they do not engage in any equity trading, because they manage a fund of funds, invest client assets only in mutual funds or in fixed income instruments, or utilize sub-advisers. Of the two firms that utilize sub-advisers, one indicated that it reviews the sub-advisers' executions, the other requires its sub-advisers to certify that they test for best execution.

## Best Execution Committees

Although the SEC staff has repeatedly recommended that firms consider establishing a best execution committee, nearly a third of firms (30%) have not done so. Of the firms that have a best execution committee, 58% reported that their committees meet quarterly, 20% meet annually, 7% meet monthly, and 14% meet on an ad hoc basis, as needed.

## Third Party Services

The vast majority (83%) of firms have not engaged a third-party service provider (such as Plexus, AbleNoser, or Elkins/McSherry) to evaluate execution, although 11% of those indicated that they are considering hiring such a provider in the future. Of the 17% of firms that have engaged a service provider to review their executions, 61% found the third-party review only "somewhat" helpful. A third (34%) found the review "very" helpful. A handful of firms (6%, or 4 firms) reported that the review was "not at all" helpful. Most of the firms that engage a service provider to review executions do so on a quarterly basis (70%). A small minority (12%) do so on an annual basis.

## Testing Fixed Income Best Execution

65% of firms engage in fixed income trading. Of those, only 35% specifically test for fixed income best execution. Those firms use various methods of testing, including:

- on a pre-trade basis, seeking additional quotes for each trade (59%);
- on a post-trade basis, reviewing execution using comparable trades made by the firm (32%);
- on a post-trade basis, spot checking documentation regarding contemporaneous dealer quotes (31%);
- on a post-trade basis, reviewing execution using TRACE data (25%) or MSRB data (18%); and
- on a pre-trade basis, seeking additional quotes for a sample of trades (17%).

In their narrative responses, firms reported a variety of other tests to assess fixed income best execution, such as:

- Using third party vendor reports, which compare executed trades against reported trades in the market;
- Comparing executed trades to bid/ask information reported by pricing services;
- Subjecting fixed income trades to a quarterly review by the firm's best execution committee; and
- Obtaining feedback from individual portfolio managers and the firm's back office.

*"Testing for prices in fixed income trading is difficult given such factors as size of the trade and odd lots. We may get a better price than the market shows if we trade in a large block or a worse price if we trade in an odd lot. It is unclear that focusing our time and energy on such comparisons is efficient and effective. While we generally compare execution price against the price compiled by our pricing team, we focus more on trading patterns for individual [portfolio managers], use of electronic means, conflicts of interest, and ratings provided by [portfolio managers] and the back office."*

## Client–Directed Brokerage Arrangements

Almost half of firms (48%) do not accept client-directed brokerage arrangements. Of the remainder, 24% almost always accept client direction without any limits, while 28% accept client direction, but generally with limits. Such limits include caps on the amount of brokerage that will be placed subject to the client's direction, generally no more than 25 to 30% of the client's total brokerage. 11 firms limit client direction by subjecting the instruction to the adviser's ability to seek best execution. Several respondents said that their firm does not accept mandatory direction levels. Other firms limit client direction to brokers that the firm uses or from whom the firm can obtain adequate trading records.

Several respondents noted that their firms discourage clients from directing brokerage. "We discourage it because we have always found that clients end up paying higher commissions when they trade away, but will do so if they insist," said one. Many respondents said that they accept client direction only after providing appropriate disclosure about the potential negative consequences of directed brokerage. Some respondents noted that they additionally require their clients to expressly consent to client-directed arrangements via signed acknowledgements. One respondent's firm sends an annual letter to clients that have directed brokerage describing the negatives of the arrangement. "Clients are asked to acknowledge by returning a signed copy of the letter," said the respondent.

*"We strongly try to avoid any directions, but business realities sometimes require us to be flexible. If we get an instruction, we work with the client to understand whether the instruction is 'subject to best execution' and whether we can meet their objectives based on their guidelines."*

*"Most clients that direct brokerage pay higher commissions and the execution is poor. We point this out to the client. Some care, some don't."*

## Testing of Client-Directed Brokerage

Significantly, almost half of the firms that accept client-directed brokerage arrangements (47%) do not conduct any additional monitoring or testing of client-directed brokerage arrangements.

Of the firms that do test in this area, the following tests were utilized:

- Sampling files of clients with directed brokerage arrangements for documentation evidencing receipt of *initial* disclosures about the effects of directed brokerage on execution (32%)
- Comparing average client commissions for client-directed accounts with average client commissions for non-directed accounts (27%)
- Sampling files of clients with directed brokerage arrangements for documentation evidencing receipt of *periodic* disclosures about the effects of directed brokerage on execution (13%)
- Sampling transactions in client-directed accounts to determine whether the firm traded away or used step-outs to seek best execution, where appropriate (11%)

In their narrative responses, respondents noted additional monitoring and testing approaches to client-directed brokerage arrangements:

- Annually mailing the Form ADV Part II, containing the firm's client-directed brokerage disclosures, as well as an annual letter to each client that has directed, confirming the percent that the client has directed and providing "*Mark Bailey*" disclosures;
- Testing client-directed accounts for best execution;
- Checking that percentage limits have been complied with;
- Using a third-party vendor to monitor best execution in client-directed accounts as well as non-directed accounts;
- Reviewing commissions charged by the client-selected brokers; and
- Monitoring executions to make sure that the correct client receives the commission credit.

## Trade Order Entry

Of the firms that accept client-directed brokerage, 64% do not have a policy on trade order entry with respect to client-directed accounts. Of those that do have a policy, 43% rotate client-directed accounts with non-directed accounts. 23% always trade client-directed accounts last. 34% of firms identified "other" policies, such as step-outs, pro rata, random order, and FIFO.

# Pricing and Valuation

## Key findings:

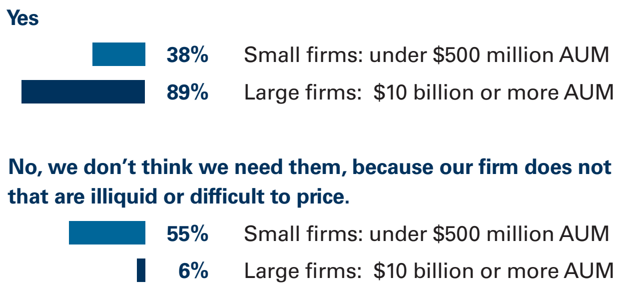
- **89% of larger firms have valuation policies, in contrast to 38% of smaller firms.**
- **60% of firms do not have a formal valuation committee.**
- **19% of firms reported that their investment professionals are the only persons involved in the valuation process.**

## Valuation Policies and Procedures

60% of all firms maintain valuation policies and procedures. Of those that do not, 91% indicated that they do not maintain valuation policies and procedures because they do not believe they need them, as they do not invest in illiquid or difficult to price investments.

Not surprisingly, smaller firms were significantly less likely to have valuation policies and procedures than their larger counterparts. 89% of larger firms (with $10 billion or more under management) reported that they had policies and procedures in this area, compared to only 38% of smaller firms (less than $500 million under management).

**Does your firm maintain fair valuation policies and procedures?**



### Recent Credit Market Turmoil and Valuation

19% of firms indicated that, since August 2007, the credit market turmoil has had an impact on their pricing and valuation process. Of those, however, most (96%) have been impacted only slightly and have experienced isolated issues. Only three firms reported experiencing significant pricing issues to the extent that they did not know how to value some of their investments. Interestingly, 11% of the firms that stated their pricing and valuation process has been impacted slightly do not maintain any valuation policies and procedures.

### Reliance on Independent Third Party Pricing

Half of the firms (50%) indicated exclusive reliance on third party service providers for pricing and valuation, stating that their firm personnel do not influence the third party's prices. In their anecdotal responses, several participants noted the importance of having multiple pricing sources. "We use IDC for pricing our equities and when they don't have a price, we use Yahoo or Bloomberg's price," said one. "When not provided by our pricing service, the quotes/values are sometimes available in other public sources (Internet)," said another. A third respondent described a "waterfall" of pricing sources: "We rely on prices that come from independent vendors (such as IDC) as a first preference. If not available, we'll move to quotes from two approved brokers. If not available, we'll move to quotes from one approved broker."

*"Abacus prices [are used] daily and we use Mellon prices at month-end."*

15% of firms responded that they engage a third party to fair value investments that are illiquid and/or that do not have a readily available price, or in situations where the firm is concerned that a given price may be inaccurate.

*"We rely on independent third-party sources wherever possible, but maintain an independent pricing function. We have internal oversight and [a] challenge process as a backstop and double check on those prices that come from vendors or brokers. To the extent that we can't get a price or otherwise believe that a fair value is appropriate, we take the obligation to develop such a valuation."*

Despite the potential conflicts of interest in doing so, 19% of firms reported that their investment professionals are the only persons involved in the valuation process, because they have the most intimate knowledge of the investments and the markets.

In their narrative responses, many respondents explained that their firms use an independent pricing source, such as a custodian, fund administrator, prime broker, and/or pricing vendor, as their primary pricing source, but that they will step in and internally value investments in certain circumstances. For example, one firm said that it will use an independent pricing vendor if market quotes are readily available, but will value internally, through its in-house valuation committee, if market quotes are unavailable or deemed unreliable.

*"If IDC or a broker-dealer is unable to provide price, we fair value subject to the review and approval of the Valuation Committee."*

## Valuation Procedures

**To the extent your firm conducts valuation internally (i.e., does not simply rely on an administrator's or custodian's price), what policies and procedures does your firm use? (check all that apply)**

| | |
|---|---|
| 47% | We rely on dealer quotes provided by various broker-dealers with which we do business |
| 45% | We rely on information from similar transactions in the market |
| 26% | We use models to fair value illiquid or hard-to-price investments |
| 25% | We rely on dealer quotes provided by the counterparty that we originally purchased the investment from |
| 24% | We permit our investment professionals to challenge prices only with oversight from the legal or compliance department. No overrides are made without prior legal or compliance department approval |
| 13% | We price everything at cost until it is disposed of |
| 6% | We permit our investment professionals to independently challenge prices, but they must notify the legal or compliance department(s) after any overrides are made |

In their narrative responses, respondents provided a range of methods for determining whether internal fair valuation is required:

- "Specific thresholds are set for variance between tape pricing and desk pricing. Should the difference between the two exceed the threshold (which varies from .5% for highly liquid to 5% for international) the desk pricing is reviewed and if supported used instead of tape pricing."
- "We rely on the managers (in cases of private equity) and only question further when we have reason to believe that it is not in keeping with our other experience. Also, we mark up from cost only very judiciously — with hard evidence of value increase. We write down more easily."
- "We conduct fair valuations in conjunction with our service providers (fund accountants) when they are unable to price a security or the price has been stale for a period of five or more days."
- "We take the last prices from exchanges where securities are traded; if market price is not available, the valuation committee determines fair value, with input from the investment team; we also use third party factors for valuation of foreign securities based on significant movement in a domestic broad-based index."

## Valuation Committee

Only 19% of firms reported that they have a formal valuation committee. At another 22% of firms, one of the firm's other standing committees (such as the firm's compliance committee or investment committee) is responsible for overseeing the firm's valuation policies and practices. A significant 60% of firms reported that they do not have a valuation committee.

*"We have an internal valuation committee, where the members of the committee are not directly related to the performance of the fund. We meet regularly with each of the portfolio managers to discuss, review, and approve fair values."*

## Valuation Testing

Firms reported using a wide range of methods to test valuation policies and procedures, with no clear consensus emerging. 31% of firms indicated that they compare the prices obtained from multiple sources to evaluate any level of pricing dispersion. 28% said that they compare the methods actually used for valuation with the firm's written policies and procedures and client disclosures. 27% reported that they review valuations reported on client statements against valuations used on the firm's internal systems (such as to determine performance or calculate fees) to ensure consistent valuations are used.

24% said they compare their valuations with the recent sales prices obtained in the market by others for the same or similar investments. 23% of firms reported that they review all transactions involving fair valued investments, including cross transactions and principal transactions.

Respondents anecdotally reported a variety of other testing methods, including:

- Comparing price feeds from Reuters and Bloomberg;
- Using Check Free-APL for valuation and reconciling to broker statements at month-end;
- Comparing fair value prices to the price at which trading resumed or sales price, if applicable;
- Comparing prices derived from the firm's independent pricing vendor with those used by the client's custodian, with differences reviewed for reasonableness;
- Having the clearing firm value holdings;
- Using cost basis;
- Retaining an outside consultant to test policies and procedures quarterly;
- Using shadow pricing and NAV tolerance reports; and
- Relying on experience.

*"We deal with 18 custodian banks and run price comparisons between them."*

*"We use a second pricing source and verify all prices at the end of the quarter. Looking for stale prices, we run on three consecutive days a price change report from the portfolio accounting system and verify that all holdings priced. Items that do not price are reviewed and compared to Bloomberg's price history data."*

# Anti-Money Laundering

## Key findings:

- Although investment advisers are not currently required to have an AML program, most firms (61%) have adopted some or all of the typical components of an AML program internally. 32% of firms follow the AML program of an affiliate or a third party. Only a small percentage of firms (7%) have not adopted any aspect of an AML program.
- Most firms conduct AML training and testing in-house.
- Half of the firms have an AML compliance officer; of those firms, 97% indicated that this individual also serves in another role within the organization – most typically as the chief compliance officer (73%).
- Almost a third of firms (30%) assess their clients for AML risk. However, 14% of those firms indicated that they do not undertake any enhanced due diligence on clients deemed to be higher risk from an AML perspective.

### Development of an AML Program

In 2003, the U.S. Department of the Treasury proposed a rule that would require all SEC-registered investment advisers to establish an anti-money laundering program that includes: (1) the development of internal policies, procedures, and controls designed to prevent the firm from being used for money laundering; (2) the designation of a person responsible for the AML program; (3) an ongoing employee training program; and (4) independent testing of AML program compliance.

The investment adviser AML rule proposal is still pending. Consequently, there is no current formal requirement for advisers to adopt AML policies and procedures. Nonetheless, most firms (61%) have adopted internal AML policies and procedures to address either some or all of the typical components of an AML program. An additional 25% indicated that they do not have an AML program, but rather rely on a business partner, such as a custodian or administrator, to conduct AML reviews. 6% follow the AML program of one of their affiliates. Only 7% of firms do not have an AML program and do not rely on another entity to provide AML services.

**Which best describes your firm's AML program?**

| | |
|---|---|
| 45% | We have our own internal AML program, complete with written policies and procedures |
| 25% | We do not have an AML program, but we rely on one of our business partners to conduct AML reviews (e.g., our custodian or administrator) |
| 16% | We do not have a full-fledged AML program, but we do have some components of an AML program |
| 7% | We do not have an AML program and we do not rely on any other entity's AML program or reviews |
| 6% | We do not have an AML program, but we follow the AML program of one of our affiliates (e.g., an affiliated broker-dealer, bank, mutual fund, or insurance company) |

A majority of the larger firms (those managing $10 billion or more) have their own internal full-fledged AML program (62%), as opposed to an AML program implemented by an affiliate or third-party. In contrast, only 39% of smaller firms (those managing $500 million or less) reported having their own full-fledged AML program. Interestingly, 8% (5 firms) of the larger firms reported having no AML program whatsoever.

## AML Compliance Officer

About half of firms (52%) have an AML officer who is responsible for monitoring and implementing the AML program. At virtually all of those firms (97%), the AML officer wears at least one other hat. The most common dual roles for AML officers were CCO (73%), COO (17%), CFO (11%), General Counsel (7%), and/or Chief Risk Officer (5%).

## AML Training

Most firms (60%) provide their employees with AML training. 72% of those firms provide AML training to all employees across the firm as opposed to targeting certain affected groups (20%) or particular employees (9%). Not surprisingly, many larger firms conduct more focused AML training: of the firms with over 50 employees that provide AML training, 42% reported that they focus the AML training on certain groups or employees, rather than conducting firm-wide training. In contrast, at smaller firms (those with 10 or fewer employees), training only selected employees or groups was less common: Only 19% of smaller firms reported taking that approach.

The majority of firms (82%) conduct at least some level of AML training in-house, while 20% of firms outsource some or all of their AML training to a third-party. 12% of firms employ a combination of in-house and outsourced training. Several respondents indicated that they use the on-line AML training resources that are offered by the Financial Industry Regulatory Authority (FINRA).

**Who provides the AML training (check all that apply):**

| | |
|---|---|
| 82% | We do it in-house |
| 13% | We outsource some of our AML training to a third-party firm |
| 9% | We rely on one of our affiliates |
| 7% | We outsource all AML training to a third-party firm |
| 3% | Other |

Respondents reported providing AML training by way of annual (54%) and ad-hoc (33%) in-person meetings. 32% of firms used computerized training methods and 36% distributed written training materials. At 16% of firms, employees attend third-party seminars, webcasts, or conferences. Firms anecdotally reported incorporating AML training into their overall compliance meetings and training sessions and providing training upon employment.

*"Certain employees may receive additional or specialized AML training from [our] affiliate depending on their function."*

## Testing the AML Program

Most firms (87%) that have an AML program test it. Of the firms that review and test their AML program, 63% conduct their own testing, while 17% engage a third-party consultant or outside counsel. 20% reported that an affiliate or business partner is primarily responsible for reviewing and testing the AML program. The breakdown of testing in-house versus relying on a third-party appears consistent at both smaller and larger firms.

The most common types of tests conducted by respondents included:

- Confirming that AML training was conducted for all appropriate employees each year (64%)
- Monitoring transactional flow in accounts for suspicious AML activity (43%)
- Sampling client files to confirm that proper (Customer Identification Program) CIP procedures were followed (43%)
- Sampling client files to review the validity of a client's risk assessment (27%)
- Confirming that Suspicious Activity Reports (SARs) have been filed when warranted (23%)
- Interviewing employees to assess their understanding of the AML program (19%)
- Confirming that reports were filed for any cash transactions over $10,000 (16%)

Firms reported conducting other types of testing, including:

- Conducting OFAC checks both initially for new clients and periodically thereafter for existing clients;
- Conducting a monthly conference call with a service provider as well as an annual due diligence visit;
- Reviewing the AML program as part of the annual review;
- Confirming that training has been conducted in accordance with the firm's policies and procedures;
- Reviewing transactions;
- Requiring annual certification by employees that they have read the procedures; and
- Confirming that appropriate client identification information has been obtained and entered into the firm's database.

*"We flag all foreign nationals or citizens living abroad for extra transaction scrutiny."*

At 10% of firms, no one tests the AML program. Interestingly, a number of respondents indicated that they did not believe that much AML testing was necessary, given the nature of their firm, transactions, and client base. "We are a small firm working with a limited number of clients who we know very well," said one respondent. "We do not accept cash," noted another. Similarly, a respondent stated that the firm does not "open those kind of accounts to begin with."

## AML Risk Assessment Process

Only 26% of firms risk weight their clients and conduct enhanced due diligence on any high risk clients. An additional 4% indicated that they risk weight each client but do not undertake enhanced due diligence on clients deemed to be high risk. On the other hand, 27% of firms do not assess each client for AML risk but do conduct enhanced due diligence on clients under certain circumstances. 42% of respondents do not assess the AML risk of or conduct enhanced due diligence on their clients, with two-thirds (66%) of these respondents explaining that they believe they only have low risk clients.

Not surprisingly, more than half (56%) of the larger firms (assets over $10 billion) that responded to this question assess their clients for AML risk.

## AML Compliance Expenditures

Almost three quarters of the firms (74%) believe that they are spending the right amount of money on AML compliance given the potential AML risks faced by their firms. However, 19% do not know whether they are spending the right amount, too much, or too little.

## Office of Foreign Assets Control ("OFAC") Screening

Though there are no federal AML program requirements for SEC-registered investment advisers, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) administers and enforces economic sanctions programs against countries (e.g., Cuba and Iran) and groups of individuals, such as terrorists and narcotics traffickers. All U.S. persons, including investment advisers, must comply with OFAC regulations. OFAC publishes lists of sanctioned countries and persons with whom U.S. persons are prohibited from conducting business.

*"Not familiar with OFAC."*

Consistent with these regulations, most firms screen their clients and potential clients against the OFAC list (54%) or rely on the clients' custodians to conduct an OFAC check (34%). Several respondents noted that OFAC checks are documented either in their firm's client relationship

management system (i.e., ACT database) or by printing a screen shot of the checks conducted by the firm.

Almost half of firms (46%) test their OFAC screening process by sampling client names and comparing them to the OFAC list to ensure that they remain excluded. More than a quarter of respondents (26%) sample client files for documentation that the client was checked against such list. 28% of firms responded that they test OFAC screening with "other" tests, with many of those stating that they check *all* current or new client names rather than simply sample client names. The narrative responses revealed a wide range of frequency in OFAC checks of current client lists, from annually to monthly to weekly to even daily. A number of respondents stated that they rely on third party vendors, fund administrators, clearing firms, and custodians to conduct OFAC screening and testing.

Firms reported additional procedures, including:

- Checking employee names against the OFAC list;
- Incorporating the OFAC check into the new account checklist;
- Checking all clients adding or redeeming funds against the OFAC list;
- Asking the fund administrator to provide a letter outlining their procedures; and
- Running authorized signatories against the OFAC list initially and when there is a change in an authorized signatory.

*"All current and new clients are checked against the OFAC list, and will be checked on an annual basis going forward."*

# Soft Dollars — Trend Update

## Key findings:

- About two-thirds of firms (63%) do not actively seek out soft dollar products and services.
- Only 14% of firms have entered into pooled commission-sharing arrangements.
- 56% of firms reported that none of their total commissions generated are used to obtain third-party soft dollar products and services.
- 18% of firms do not use full-service brokers.
- Of the firms that use full-service brokers, the vast majority (93%) do not "unbundle" proprietary commissions.

## Use of Soft Dollars

There was a slight trend towards decreased use of soft dollar usage. 63% of firms tried to shun soft dollar usage, not actively seeking out proprietary soft dollar products and services and often discarding them unread. That represents a 7% increase from last year's survey, where that figure was 59%. 33% of firms rely on soft dollars to purchase certain products and services, down from 38% last year. A slightly higher percentage of firms operated outside of the 28(e) safe harbor (4% in 2008 vs. 2% in 2007).

**Soft dollar usage:**

**63%** 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." (Last year: 59%)

**33%** Rely on soft dollars: "We do rely on soft dollars to purchase certain products and services within the 28(e) safe harbor. In addition to proprietary research, we also receive outside research and other products and services from third party providers, paid for by our broker-dealers." (Last year: 38%)

**4%** Operate outside 28(e): "We operate outside the 28(e) safe harbor, with full disclosure to our clients." (Last year: 2%)

The vast majority (88%) of firms reported that there has been no significant change in the amount of their soft dollar usage since January 1, 2007. 9% significantly decreased their soft dollar arrangements. Only 3% reported that they significantly increased their soft dollar arrangements.

**Since January 1, 2007, has your firm changed the amount of its soft dollar usage?**

| | |
|---|---|
| 3% | We have significantly increased our soft dollar arrangements |
| 9% | We have significantly decreased our soft dollar arrangements |
| 88% | No significant change |

Of the firms that reported that they significantly decreased the amount of their soft dollar usage, 18% (7 firms) reported that they simply cut back on their consumption of previously-softed products and services. A significant 75% (30 firms) maintained the same level of consumption, but picked up most or all of the cost of the products or services themselves. Only 8% (3 firms) reported that they are passing most or all of the costs of the previously-softed products and services on to their clients in order to maintain the same level of consumption.

## Effect of SEC Interpretive Guidance

14% of firms reported that they softed fewer types of products and services as a result of the SEC's 2006 interpretive guidance (i.e., they softed a narrower range of products or services). However, most firms (73%) have not changed the types of products and services they soft. "While not related to the guidance, we have somewhat increased our use of hard dollars to pay for certain services based on other factors within the firm's brokerage budget, including the goal of lowering average commission rates," one respondent noted.

Anecdotally, one respondent noted that legal services related to activist positions are no longer softed. Another reported that Bloomberg terminals are now paid for by the firm. A third respondent said that some previously-softed services are now treated as mixed-use.

Only 14% of firms have entered into pooled commission-sharing arrangements, as permitted by the SEC's 2006 guidance. Interestingly, 38% reported that since January 1, 2007, they no longer enter into soft dollar arrangements for "mixed-use" products or services. A few firms anecdotally reported making changes in their soft dollar disclosure since the beginning of 2007.

## Level of Soft Dollar Activity

Survey participants were asked how much of their firm's total commissions for all clients were used to obtain third-party soft dollar products and services. 56% of firms reported that no commissions were used for third-party soft dollar arrangements. 25% reported using "minimal" or less than 20% of total commissions for soft dollar products and services. 14% reported using more than 20% of total commissions.

**Approximately how much of your firm's total commissions (i.e., for all clients) are used to obtain third-party soft dollar products and services?**

| | |
|---|---|
| 56% | None |
| 13% | Minimal |
| 12% | Less than 20 percent |
| 8% | 21 to 40 percent |
| 3% | 41 to 60 percent |
| 2% | 61 to 80 percent |
| 2% | 81 to 100 percent |
| 6% | I don't know |

## "Unbundling" Proprietary Commissions

Not surprisingly, the vast majority (93%) of firms that use full-service brokers reported that they do not "unbundle" proprietary commissions. Only 7% of firms that use full-service brokers attempt to place a dollar value on proprietary research. These firms reported various methods of "unbundling," including:

- Using a ratio;
- Having their investment team or others place a dollar value on the research they receive (4 firms);
- Migrating to commission-sharing arrangements (2 firms);
- Comparing commission costs from the proprietary research broker to the cost if the firm had purchased the same number of shares from a broker with the lowest commission price per share, and then assigning the difference in cost to the proprietary research (2 firms);
- Asking brokers to specify what percentage of their commission is used to pay for research;
- Using the amount that the firm would pay for the research in hard dollars (if available); and
- Informing the broker that the adviser only wanted a certain portion of the research.

Respondents described various means of soliciting internal feedback about the value of proprietary research and making brokerage allocation decisions. "We have defined commission rates for various types of execution services. Commissions on all trades are broken down into separate execution and research components. [Portfolio managers] and analysts use an on-line voting application to track/score the value of broker proprietary research. Traders use results of the aforementioned vote to determine the amount of commission that may be added on to the execution commission to compensate for the research provided. We utilize Client Commission Arrangements (CCAs) to concentrate trading with firms that provide best execution while offering the flexibility to accumulate research commission credits in pools that can be utilized to pay for third party and the proprietary research of other brokers," said one. Another reported that the firm's director of research "polls our research analysts and [portfolio managers] to determine how valuable our research services are, so we will allocate brokerage to those firms providing the greatest value."

One respondent expressed frustration at the effort: "We have tried to value it, but without any guidance from the broker it was difficult."

Interestingly, 18% of firms responded they do *not* use full-service brokers. Presumably, these firms are not presented with the problem of "unbundling" proprietary commissions.

## Testing

About half (51%) of firms responded that they do not specifically test for soft dollars, perhaps because they do not have soft dollar arrangements. More than a third (37%) indicated that testing for soft dollars has stayed about the same since January 1, 2007.

12% of firms indicated that their soft dollar testing has increased. "The CIO reviews every soft dollar purchase monthly; we keep more extensive mixed-use spreadsheets; [and] we have a soft dollar committee which reviews every item on a quarterly basis," said one respondent. "We review 100% of our soft dollar arrangements and [the] CCO meets all soft brokers and is the only one to approve arrangements," said another. Other respondents reported heightened reviews of brokers and commission levels.

*"We used not to test. Now we do."*

Two firms responded that testing decreased significantly or slightly because their soft dollar arrangements were phased out altogether.

# Code of Ethics: Gifts and Entertainment – Trend Update

## Key finding:

- **Since January 1, 2007, most firms' (83%) gifts and entertainment policies have remained about the same.**

The majority of respondents (83%) reported that their firm's gifts and entertainment policy has not changed "significantly" since January 1, 2007. However, a significant minority (18%) of firms reported that their policies have been made, or will be made, more restrictive. The most commonly-implemented restrictions cited were adopting a gift log and implementing dollar limits on gifts and entertainment received and given. A typical change, as described by one respondent: "We instituted a gift log and put a $250 limit on gifts given/received in a year. Gift log includes all gifts above nominal value (except the flood of food at the holidays sent to the firm as a whole)."

Other initiatives included:

- restricting gifts to union and elected officials;
- requiring pre-clearance;
- banning gifts completely;
- conducting more testing for compliance with policies;
- providing more education for employees;
- requiring certifications from employees;
- requiring logs for political contributions; and
- adopting different standards for ERISA clients.

*"Brokers who send the largest amount of gifts undergo extra scrutiny when reviewing trades for best execution."*

A handful of firms (2%) reported that their gift and entertainment policies became less restrictive. The most common change cited was increasing the dollar value of allowable gifts annually.

**Since January 1, 2007, has your firm's gift/entertainment policy changed?**

| | |
|---|---|
| 16% | Yes, it has been made more restrictive |
| 2% | Yes, it has been made less restrictive |
| 70% | No, it has not significantly changed, and there are no current plans to change it |
| 10% | No, it has not significantly changed, but we have memorialized our previously informal policies by creating written procedures |
| 3% | No, it has not significantly changed, but we are planning to make it more restrictive |
| 0% | No, it has not significantly changed, but we are planning to make it less restrictive |

## Testing

At 56% of firms, testing of gifts and entertainment has stayed about the same. 16% of firms increased their testing significantly or slightly.

**Since January 1, 2007, has your firm's testing of gifts and entertainment changed?**

| | |
|---|---|
| 4% | Yes, testing has increased significantly |
| 12% | Yes, testing has increased slightly |
| 56% | No, testing has stayed about the same |
| 0% | Yes, testing has decreased slightly |
| 0% | Yes, testing has decreased significantly |
| 28% | Not applicable. We do not specifically test gifts and entertainment |

Firms that responded that they significantly increased their gifts and entertainment testing reported the following enhancements:

- "Gifts/entertainment is compared against brokerage commissions and expense reports;"
- "A log is routinely checked rather than periodically. A form is required to be completed in the event that access persons would like to receive or give gifts or entertainment in excess of threshold amounts stated in the existing policy;"
- "[We] review e-mail and Bloomberg for suspicious G&E;" and
- "We scrutinize each credit card transaction by each employee. We keep a detailed gift log and we question employees quarterly as to their gift giving and receiving. We require permission to be granted before an employee may accept or give a gift."

# Code of Ethics: Insider Trading – Trend Update

## Key finding:

- **83% of firms reported that they test for insider trading. This figure is double the 40% from last year and up significantly from 2005, when only 20% of firms surveyed indicated that they tested for insider trading.**

### Testing

83% of firms reported that they test for insider trading. This figure is double the 40% from last year and up significantly from 2005, when only 20% of firms surveyed indicated that they tested for insider trading.

On the flip side, 17% of firms reported that they do not test for insider trading, representing a remarkable decrease from the 60% of firms that reported in last year's survey that they do not test for insider trading. Clearly, the SEC's recent focus on insider trading has prompted firms to address this area more thoroughly.

Of the firms that test for insider trading, the majority (76%) reported that their firm's insider trading testing has stayed about the same since January 1, 2007. This result is unexpected, given that the overall percentage of firms that reported testing in this area doubled from last year. 24% of firms, however, reported that they increased their testing.

**Since January 1, 2007, has your firm's insider trading testing changed?**

| | |
|---|---|
| **63%** | No, testing has stayed about the same |
| **20%** | Yes, testing has increased |
| **0%** | Yes, testing has decreased |
| **17%** | Not applicable. We do not specifically test for insider trading |

In their anecdotal responses, survey respondents reported a variety of testing methods for detecting potential insider trading activity. Several respondents reported that they identified the top ten performing investments during the testing period and then compared trading activity in those investments around the timing of material public statements, Bloomberg news releases, "significant news stories," and/or meetings with the issuers' management. E-mail surveillance also was frequently cited as an insider trading testing tool.

A number of respondents reported that their firms had enhanced their insider trading procedures. One reported that the firm had created additional firewalls, performing back-end forensic tests to identify any "wall crossings." Another noted that the firm's policies require employees to report any potential instance of insider trading to the CCO. A third respondent reported "tons more reporting and education" in the area of insider trading.

*"We are asking employees to identify relationships (that go beyond immediate family) with other industry professionals. We have enhanced e-mail surveillance search terms to focus on names identified out of these reported relationships. We have also revised how we conduct our surveillance. While continuing daily reviews, we now conduct the review over a period of time (6 months on a specific person) to pick up on any patterns which might not surface in random daily checks."*

Several respondents cited a heightened review of personal trading as a means to prevent and detect insider trading. "We review every trade made by access persons," said one respondent. Another respondent noted that the CCO "tests all personal trades against the tape." However, as another respondent pointed out, relying on access persons to identify their outside trading accounts "places the burden of disclosure on the employee."

*"We are a small firm. Management chose to make all employees access persons and, therefore, require outside accounts to have statements/confirms sent to compliance."*

One respondent's firm "did not do anything" before the third quarter of 2007, because the CCO believed the firm was "too small" to have access to inside information. Now, however, the CCO compares personal trades as well as a statistical sample of client trades against SEC filings, company news, and industry publication news, in an effort to assess whether there is any trading that might give rise to the appearance of insider trading.

*"All investment professionals attending broker-sponsored conferences or meetings with company management are required to complete a separate form to document who they met with. We then use that information when verifying personal securities transactions."*

# About the Organizers of this Survey

## ACA Compliance Group

ACA Compliance Group is a full-service compliance consulting firm committed to offering unparalleled regulatory compliance services designed to satisfy the needs of investment advisers, private funds, investment companies, and broker-dealers. For more information, please visit www.acacompliancegroup.com.

## *IM Insight*

*IM Insight* is a weekly newsletter designed to keep lawyers and compliance officers abreast of regulatory developments and industry practices affecting SEC-registered investment advisers. For more information, please visit www.iminsightnews.com.

## Investment Adviser Association

The Investment Adviser Association is a not-for-profit organization that represents the interests of SEC-registered investment advisory firms. Founded in 1937, its membership today consists of about 500 firms that collectively manage in excess of $9 trillion for a wide variety of individual and institutional investors. For more information, please visit www.investmentadviser.org.

## Old Mutual Asset Management

Old Mutual Asset Management is the name under which Old Mutual (US) Holdings Inc. ("Old Mutual") conducts its U.S. asset management business. Old Mutual is the holding company for twenty distinct boutique firms, including asset managers that specialize in active investment strategies for institutional and individual investors. The group's parent is Old Mutual plc. For more information, please visit www.oldmutualus.com.

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ACA Compliance Group, the Investment Adviser Association, *IM Insight*, and Old Mutual Asset Management have exercised professional care and diligence in the collection and processing of the information in this report. However, the data used in the preparation of this report was provided by third party sources and the survey organizers have not independently verified such data. This report is intended to be of general interest only, and does not constitute professional or legal advice. The organizers of this survey make no representations or warranties about the accuracy of this report.