

Surviving an SEC Audit after Madoff

Tuesday, May 19, 2009

Moderated by Jim Pavia and Evan Cooper

Sponsored by:



InvestmentNews

Moderators and panelists



Moderator

Jim Pavia
Editor
InvestmentNews



Moderator

Evan Cooper
Deputy Editor
InvestmentNews



Panelist

Kevin J. Hermening, CFP
Managing Partner
Hermening Financial Group LLC



Panelist

Glenn G. Kautt, CFP, EA, AFIA
President, Chairman and Chief
Investment Officer
The Monitor Group Inc.



Panelist

Richard Marshall, J.D.
Partner, Investment Management
and Securities Litigation Groups
Ropes & Gray

InvestmentNews

Kevin J. Hermening, CFP

Managing Partner

Hermening Financial Group LLC



- For nearly 20 years, Kevin Hermening has operated his own financial planning firm, an independent firm with a focus on comprehensive financial planning, tax planning and investment management.
- Mr. Hermening is an independent investment adviser and registered representative with First Allied Securities Inc. and also manages his firm as the branch office of First Allied Securities, an Advanced Equities Co. As the principal of the local office of supervisory jurisdiction with First Allied Securities, he supervises other planners affiliated with his branch office.
- Mr. Hermening is also an investment adviser representative with Hermening Advisory Services LLC, and dually-licensed with First Allied Advisory Services Inc. These affiliations permit him to offer investment securities products and investment advisory services as a fee-based planner.
- He is a member of the Financial Planning Association, several local civic organizations, including the Wausau Area Chamber of Commerce, and has served on the Board of Directors of Junior Achievement.
- From 1993 to 2000, Mr. Hermening hosted “Your Business, Your Money, and You,” a weekly hour-long live radio broadcast on talk radio 1230 (AM) WXCO, with a focus on area business, the economy and financial planning.
- Mr. Hermening is an accomplished public speaker, having addressed more than 3,000 audiences nationwide over the past 25 years, often about his experiences as the youngest of the 52 Americans held hostage at the U.S. Embassy in Iran for 444 days from 1979–1981.
- At present, he is pursuing an MBA. Mr. Hermening has been involved in national, state and local politics for many years, and has twice been a candidate for the U.S. House of Representatives and the Wisconsin State Legislature.

- **Hermening Financial Group LLC and Hermening Advisory Services LLC (SEC Registered RIA) are not affiliated with First Allied Securities Inc**
- Operating as a fee-based adviser – approximately 70% fee-based income (30% commission)
- Formed independent RIA, February 2005, and operated as state-registered as assets transitioned from commission-based and corporate RIA to independent RIA, and until managed assets exceeded SEC registration threshold
- May 2007, SEC Registration finalized (this was required within 90 days from the time of the annual updating amendment following reaching the assets threshold)

Operating in an RIA-Friendly Broker-Dealer Environment

- Few broker-dealers permit independent RIA operations; most require affiliation with the BD's corporate RIA
- Opportunity to form independent RIA is dependent upon systems and oversight capabilities of BD
- Most BDs neither have the capability nor the desire to allow their affiliated Registered Representatives the opportunity to have this Outside Business Activity (OBA)
- Important to find a firm that has a visionary view of the brokerage, product, financial planning, and investment advisory marketplace
- Our RIA works closely with the BD's corporate RIA department

Operating in an RIA-Friendly Broker-Dealer Environment

BD should have procedures for:

- Initial permission when establishing independent RIA
- Reviewing (and quasi-approval of) documents (ADV, Compliance Manual, etc.)
- Reviewing (and quasi-approval of) advertising materials
- Reviewing (and quasi-approval of) fee structure, reporting, billing, trading systems, custodial arrangements, etc.
- Some BDs require compensatory arrangement with independent RIA

Outside Consultants Assist in Operating an Independent RIA...and in Preparing for an SEC Audit

- Hermening Advisory Services LLC retains the services of an outside consultant – National Compliance Services (NCS)
- NCS is responsible for assisting us with compliance, registration, document updates, becoming knowledgeable about changes to pertinent laws
- Some firms add consultancy services for on-site office reviews and “mock audits”

Important to understand that the firm – not the consultant – has ultimate responsibility to remain compliant with the law

- SEC will not hold the consultant responsible for any deficiencies
- Consultant needs to be accessible during audits for assistance in responding to auditor’s inquiries

The audit

- May 2008 Initial SEC on-site audit (12 p.m. Monday – 12 p.m. Friday)
- Preview letter arrived two weeks prior to audit dates
 - Document request
 - Digital format required
 - Ongoing follow up by auditors in advance of arrival
- Audit process involved mostly requests for additional data, documentation, filings, signature verifications, inquiries related to trading discretion, risk tolerance, adherence to Investment Advisory Agreements
- Staff handled most details (interviews, discussions, requests for additional materials)
- Auditors requested just a single one-hour interview with owner

Audit follow-up

- SEC audit follow-up letter arrived four months after audit
- Additional materials were requested during this time period
- Final letter arrived December 2008

Post-mortem for our RIA

Valuable lessons learned

- Upfront preparation critical
- Be prepared to invest a lot of time, particularly for the initial audit (staff time, primarily)
- Be prepared to adapt to changes in audit direction (both auditors appeared to be requesting different material on similar topics simultaneously)
- Don't try to steer the audit; the auditors had a plan when they arrived, knew what they wanted to review, and knew what hot-button issues they wanted to discuss with staff and me
- Be patient when waiting for their responses

Operational changes included:

- Update and simplify our Compliance Manual
- Reduce the number of our advisory service offerings
- If you have it in writing – you better be doing it!
- Keep things general

Glenn G. Kautt, CFP, EA, AFIA

President, Chairman and Chief Investment Officer
The Monitor Group Inc.



- Glenn Kautt oversees the firm's day-to-day operations and has been engaged in financial planning and consulting since 1981.
- He is a member of the Financial Planning Association and the National Association of Enrolled Agents, a graduate fellow of the National Tax Practice Institute and an Accredited Investment Fiduciary Analyst.
- Mr. Kautt is a former chairman of the Financial Planning Association of the National Capital Area and is a member of the board of trustees and chairs the investment committee for the Foundation for Financial Planning.
- As a recognized financial planning expert, Mr. Kautt has been named repeatedly by Worth, Mutual Funds and Medical Economics magazines as a top investment adviser. Washingtonian magazine recently again named him to their list of top financial professionals in the Washington metro area, and J.K Lasser's New Rules for Estate and Tax Planning continues to note Mr. Kautt on their "Top Professional Advisor" list. His firm was named as one of the "Best Managed Financial Planning Firms" in the United States for four consecutive years.
- Mr. Kautt is a columnist for Financial Planning magazine. He is a former member of the editorial advisory board for the Journal of Financial Planning and contributes to that publication. He is regularly quoted in USA Today, Newsweek and The Wall Street Journal.
- Mr. Kautt authored the book "Stochastic Modeling: The New Way to Predict Your Financial Future" (Monitor Publishing Co., 2001) and has contributed to other books. He appears on television, including PBS, CNBC, CNN, Fox News and Bloomberg, and speaks on financial planning and wealth management.

For this discussion, it's important to note...

- The Monitor Group, Inc. is fee-only, not “fee-based” or “fee-offset.”
- As a result, The Monitor Group, Inc. is a Registered Investment Adviser, and subject only to SEC audits and regulations. They do not fall under the purview of NASD/FINRA.
- Because of this, some of The Monitor Group, Inc.’s comments will not apply to broker dealers and registered representatives regulated by FINRA/NASD.

An on-site exam by the SEC in September 2006 resulted in no discrepancies

- Go to: www.TheMonitorGroup.com/sec for the two article series titled “Hello, I’m From The SEC” and “ SEC Part Deux” published in Financial Planning magazine. Click on the button on the front page entitled “SEC Articles.”
- In the discussion, the Center for Fiduciary Excellence (CEFEX) was referenced. Click on the button “Fiduciary Matters” to download a white paper given to clients and prospective clients regarding why it’s important they consider a fiduciary relationship.

The compliance program

- Focused by design on our key risk areas.
- All process, procedures and checks are built around these five key risk areas.
- SEC liked our program and our 2006 examination went well.
- We did not use a boilerplate compliance book or manual. Those things are of little practical use, could be problematic during an audit, and cost money without any real return.
- As a fee-only RIA, we developed our own compliance program. This saved money and time, focused us on our key risk areas, and is much easier to manage on a regular ongoing basis.

The compliance program is built on five key risk areas

- 1) Suitability of Investment Policy
 - 1) Investment policy review is on each client review meeting agenda
 - 2) The firm and each relationship manager maintains a log of clients which have been reviewed each year.
- 2) Trade Errors
 - 1) Daily trade reconciliation
 - 2) Maintain an error file with details of each error. We average about 10 per year out of around 6,000 trades.

The compliance program is built on five key risk areas

3) Insider Trading

- 1) 80% of our trading is mutual funds, about 13% ETFs, and occasionally we unwind concentrated stock positions for new clients.
- 2) Tax loss trading for clients is documented.
- 3) Code of ethics uses SEC language, CFP, CPA and CFA code language.
- 4) Quarterly monitoring of accounts at 3rd party custodians.
- 5) Employee disclaimers and disclosures on all outside trading.

4) Competitive Pricing on Commissions

- 1) We document our annual pricing negotiation with custodians.
- 2) We developed a list of key intangibles custodians offer, which override simple cost comparisons of transaction charges.

The compliance program is built on five key risk areas

5) Adherence to Regulatory Initiatives

- 1) We participate in CCO Outreach programs to stay abreast of where the SEC is currently focusing.
- 2) We read industry publications, including *Investment News*.
- 3) We review custodian provided articles and research on compliance issues.
- 4) We have discussions with our professional study group.



The Madoff scandal caused The Monitor Group, Inc. to re-examine the key risk areas identified in the program.

How do we document we are not Madoff, do not employ an Madoff-type investments and won't get caught in a Madoff-like situation in the future?

The risk areas in the Madoff scam were:

- Custody
- Proprietary Products
- Performance Reporting
- Trading and Monitoring (self reporting)



The Monitor Group, Inc. determined that two of these apply to them and has added them to the key risk areas:

Custody (in a few cases we are trustee on a client trust account)

- Increased transparency – improved communications to beneficiaries
- Increased documentation and record retention

Performance Reporting

- Increased documentation and data source disclosures
- Increased disclosure in our Annual Compliance Review of our GIPS-compliant reporting

There have been no changes to protocol; rather, documentation has increased

A few words on the future of fiduciary standards

CEFEX Certification

- More realistic/pertinent than SEC Examination, using ISO 9001-like standards
- Detailed fiduciary standards
- Due diligence processes
- Documentation requirements

What is the CEFEX examination process?

- Questionnaire and document submission
- On-site exam by independent auditor
- Follow up questions
- Certification granted by CEFEX committee
- Only 30 or so firms have the certification—it's like the platinum version of the Good Housekeeping Seal of approval

The Monitor Group offers clients a white paper entitled *Fiduciary Matters*

- Discusses what is a fiduciary?
- Describes the fiduciary investment process
- Gives a framework for determining if an advisor is acting as a fiduciary
- Provides references for more information
- Go to www.themonitorgroup.com for a copy. Click on the button on the home page: “What is a fiduciary and why should you care?”

Richard Marshall, J.D.

**Partner, Investment Management and Securities Litigation Groups
Ropes & Gray**



- Since entering private practice, Mr. Marshall has conducted compliance reviews and provided compliance counseling for investment companies, investment advisers, hedge funds and broker-dealers. He has represented individuals and regulated entities in inspections, investigations and litigation against the Securities and Exchange Commission, self-regulatory organizations, state securities regulators and U.S. attorneys' offices.
- Mr. Marshall has created hedge funds. He has provided advice on the creation of new products for investment companies, investment advisers, hedge funds and broker-dealers and counseled them on regulatory matters.
- Before joining Ropes & Gray, Mr. Marshall had been senior associate regional administrator in the New York office of the SEC. In that position, he supervised a staff of 70 that conducted inspections of investment companies and advisers in the New York region and oversaw enforcement matters related to those entities.
- Mr. Marshall has also been a branch chief in the SEC's division of enforcement in Washington, D.C.
- He co-authored an article titled, "SEC adopts controversial anti-fraud rule with potentially sweeping implications," published in Bloomberg Corporate Law Journal, Fall 2007.
- He is a member of the American Bar Association. Mr. Marshall also sits on the editorial board of the Journal of Financial Regulation & Compliance.

SEC Inspections of Advisers

- SEC inspection powers
- Targeting inspections
- Conduct of inspection and key aspects of SEC inspection techniques
- Possible outcomes of an inspection (deficiency letter, enforcement referral, letter closing the examination)
- Current SEC priorities
- New SEC inspection request letter
- Most frequent deficiencies

Surviving an inspection

- Plan ahead
- Control the process
- Advocate your case
- End the inspection quickly
- Do not lie to the SEC
- Preserve confidentiality

Criticism of the SEC inspection program

- Industry complaints and allegations
- Fears and rumors

SEC Inspections of Advisers

I. SEC Inspection Powers

- A. The power of the SEC to inspect the records of a registered investment adviser was upheld in SEC v. Olsen, 354 F.2d 166, 170 (2d Cir. 1965), against a challenge based upon the Fourth Amendment: “The legislative history of the 1960 amendment to the Investment Advisers Act which gave the Commission power to require that records be kept and made available for inspection indicates Congress felt it was necessary for effective regulation in this field. . . . ‘Such records assume the characteristic of quasi-public documents and their disclosure may be compelled without violating the Fourth Amendment.’”
- B. Amendments adopted in 1975 “authorized the SEC to examine ‘[a]ll records’ maintained by the affected entities [investment advisers and broker-dealers]. Thus, the agency’s examination authority was no longer tied to its books and records authority.” Thus, “[f]ollowing the 1975 Amendments, the Commission has taken the position that its examination authority ‘is unconditional except for the requirement that any such record examination be ‘reasonable.’”

SEC Inspections of Advisers

II. Targeting Inspections

- A. The SEC has implemented what it calls a “risk based” method for targeting registrants for inspections.
- B. According to the SEC, targeting is based on the following factors: “analyzing examinations themselves. One important element we consider is "significant findings" from our prior exams. . . . In addition to these analyses, all examination staff also monitor news, new products and activities of firms, recurrent problems, trends, academic studies, and information they just "hear on the street". This information is shared with all other examination staff through memoranda, emails, monthly conference calls, and meetings with SEC examination staff nationwide. It is used in risk assessment as we continually reassess examination priorities and the firms selected for examination. OCIE also receives significant risk focusing information from other SEC offices. . . . We also have frequent consultations with bank regulators and discuss risk-related matters with state securities and insurance regulators. And of course, we have numerous discussions with the industry and have learned a great deal from open communications on significant issues.”

SEC Inspections of Advisers

III. Conduct of Inspections

- A. The inspection is conducted at the registrant's offices and the SEC staff's offices. At the registrant, the SEC reviews the records requested and typically questions the registrant's personnel about them. This portion is known as the "fieldwork" portion of the inspection. The SEC continues its inspection in its offices, reviewing the information it gathered during its on-site visit to the registrant.
- B. The techniques the SEC employs for conducting "risk based" inspections are still evolving. In general, these inspections incorporate an assessment of the registrant's "compliance culture" and an effort to identify activities of the registrant that may be poorly controlled or that expose public investors to the risk of significant losses.
- C. Key Aspects of SEC Inspection Techniques
 1. Most registrants receive two to three weeks advance notice before the SEC arrives.
 2. Much information must be provided when the SEC arrives.
 3. Many key personnel – CEO, CCO, CIO, CFO, head trader – are routinely interviewed.
 4. Electronic information – e-mails, trading data, web site content – is always requested.
 5. Many SEC requests are ambiguous or overbroad. These requests should be clarified or narrowed.

SEC Inspections of Advisers

IV. Possible Outcomes of an Inspection

- A. **Deficiency Letter:** A deficiency letter is a summary of examination findings and can include violations of the law as well as supervisory and control weaknesses. Deficiency letters are provided to the firm at the conclusion of the examination and require it to respond within 30 days, documenting the steps it intends to take to correct the deficiencies. Deficiency letters most often result in correction of the problem, and implementation of improvements in compliance policies and procedures to prevent the problem from reoccurring.
- B. **Enforcement Referral:** When examiners find a violation of the securities laws, they must determine whether it should be referred to the Division of Enforcement staff for further investigation and possible enforcement action.
- C. **Letter Closing the Examination:** Where the staff makes no findings, at the conclusion of the examination it gives the firm a letter indicating that the examination has concluded without findings.

SEC Inspections of Advisers

V. Surviving an Inspection

A. Plan Ahead

- Once the SEC begins an inspection, there is little a registrant can do to prevent the SEC from uncovering violative conduct. Advance planning is the key to surviving an inspection. Particularly valuable is a good compliance program and regular compliance reviews or audits.
- First, establish an effective compliance system.
- Second, observe the record-keeping requirements.
- The SEC recommends the following preparation:
 - *Conduct periodic internal compliance reviews.* Firms should periodically test the effectiveness of their policies and procedures to make certain that their policies and procedures are keeping up with business, personnel and technological requirements. Firms should also ensure that their policies and procedures set an appropriate and achievable level of compliance.

SEC Inspections of Advisers

- *Ensure all required records are maintained.* Firms must know what records are required to be maintained and how and where such records are maintained. A useful tool is a comprehensive recordkeeping matrix that identifies these elements.
- *Conduct mock SEC examinations.* Proactive firms can simulate an OCIE examination by obtaining copies of recent OCIE document requests and hiring a law firm or third-party compliance consultant to conduct a mock examination. The mock examination can help a firm identify and address any deficiencies in compliance, record-keeping and internal controls before the OCIE examiners come knocking.

SEC Inspections of Advisers

B. Control the Process

- It is entirely appropriate to designate a contact person to control the inspection. All requests for information from the SEC staff should be directed to this contact person. This person will be responsible for gathering the requested information and submitting it to the SEC. The contact person should review all documents before they are produced to the SEC to ensure that irrelevant or privileged documents are not inadvertently produced. In addition, the contact person should keep a record of all requests by the SEC and of the documents that are produced in response to those requests so that it will be possible to reconstruct the information that was made available to the SEC. In addition, when the SEC requests to interview the registrant's employees, the contact person should arrange these interviews and seek to determine the scope of the proposed interviews.

C. Advocate Your Case

- First, argue your case to the inspection staff. If the inspection staff indicates during the inspection that violations have been detected, the registrant should promptly explain either why the questioned practices are legal or why they are inadvertent and isolated. Once a registrant receives a deficiency letter, it should *promptly* contact the inspection staff, either to defend the legality of questioned practices or to emphasize that any violations are unintentional.
- Second, never refuse to produce records that are subject to the SEC's inspection powers.
- Third, avoid confrontations with the SEC.

SEC Inspections of Advisers

D. End the Inspection Quickly

- First, produce requested information quickly. The longer the SEC staff waits at a registrant for requested information, the more opportunity they have to observe irregularities in the information they have already received or to think of new areas of possible inquiry. Correspondingly, quick and complete production of requested information gets the SEC staff out of the registrant's office, and on to another inspection, more quickly.
- Second, give the SEC staff proper facilities. Many registrants crowd SEC inspectors into small rooms without electrical outlets or telephones and delay the copying of requested records. These techniques only make it more difficult for the SEC staff to conclude their work and thereby prolong the inspection. They also unnecessarily annoy the SEC staff.
- Finally, pre-review of requested records must be quick. Many registrants require that counsel review any information before it is submitted to the SEC staff. This procedure is entirely appropriate, but must be performed expeditiously so that the inspection is not delayed.

SEC Inspections of Advisers

E. Do Not Lie To the SEC

- A provision of the federal criminal code broadly prohibits false statements to the SEC staff and other federal officers. This provision applies to oral statements as well as written representations, and also applies to unsworn oral statements. The following precautions should be observed.
- First, to repeat, be scrupulously honest with the SEC. A serious regulatory problem will only become more serious if personnel of the registrant lie to the SEC.
- Second, as noted above, keep a record of information provided to the SEC.
- Third, keep promises made to the SEC. Registrants frequently promise to take corrective action in response to deficiency letters and then fail to take the promised action. As noted above, the SEC saves all responses to deficiency letters and reviews these responses before it conducts an inspection. If a registrant failed to take the corrective action it promised to take, this can lead to an impression that the registrant is uninterested in compliance and is intentionally violating the law

SEC Inspections of Advisers

F. Preserve Confidentiality

- Information that is produced to the SEC frequently contains extremely sensitive business information such as client names, investment strategies, or salaries of key employees. Once this information is placed in the SEC's files, it is subject to disclosure to numerous sources, including production to the registrant's competitors or the press, pursuant to the FOIA. To preserve confidentiality:
- First, request confidential treatment under the FOIA.
- Second, request in writing the return of documents.

SEC Inspections of Advisers

VI. Criticism of the SEC Inspection Program

1. The industry has complained that demands in inspections have become too costly, burdensome, and intrusive.
2. Requests to CCOs to criticize their firms and supervisors have been attacked as compromising the CCO's ability to communicate in confidence with business colleagues and to develop a supportive, trusting relationship with his or her colleagues.
3. Fears persist that the SEC will use every minor violation detected during an inspection to justify an enforcement action, so that registrants are trapped between a confrontation with the inspection staff for withholding information during an inspection and helpless submission to a damaging and unwarranted enforcement action.
4. There is also a suspicion that inspections are now frequently used to gather information for pending enforcement investigations, without the procedural protections a registrant would enjoy if the information were gathered through an enforcement investigation

SEC Inspections of Advisers

5. Frequent requests by third-parties for deficiency letters have raised concerns that the SEC should not be permitted to make allegations in these letters without affording registrants fundamental due process rights, such as notice and an opportunity for a hearing to rebut any false charges.
6. Charges that SEC examiners have been lied to or unreasonably delayed in their inspections have created fears that even minor errors or delays in the production of information to the SEC could result in the most severe sanctions against registrants and their employees.
7. The SEC has been accused of conducting inspections to assess business practices that are not mandated by laws or rules and of recommending “best” business practices to registrants in deficiency letters, even though these “best” practices are not mandated by any laws or rules.

SEC Inspections of Advisers

X. Ideas for Presenting the Compliance Program to the SEC – The “Culture of Compliance” Presentation

- A. Standard SEC Request: “Soon after the staff begins its fieldwork, the staff would like to speak with at least one member of senior management to obtain an overall view of the Adviser’s organization, business, and control environment and compliance culture. Early during the fieldwork, the staff would also like to discuss, in more detail, with the Adviser’s Chief Compliance Officer and Risk Manager (if the Adviser has such a position), the overall system of controls maintained by the Adviser as well as the specific control procedures used by the Adviser.”
- B. Prepare a presentation on the firm’s “culture of compliance.” Focus on resources, lines and frequency of reporting, examples of mistakes and the firm’s responses, statements by senior management of their commitment to compliance, and openness with regulators.

Need credits?

This program has been accepted by the CFP Board for 1 CE credit.

and

Whether the market's recent turnaround is real

1 non-IMCA CIMA credit.

If you did not submit your CFP number upon registration, or need a non-IMCA CE report form, contact Diana Cheruvil, dcheruvil@investmentnews.com

***InvestmentNews* would like to
thank our sponsor:**



AMERITRADE
Institutional

InvestmentNews

Thank you for joining us.

InvestmentNews would like to thank our sponsor:



Want to continue the discussion?

*Check out the InvestmentNews **discussion board** at investmentnews.com/advisercommunity.*

Click on Webcasts to get answers to your questions!

Don't miss the next Webcast:

What this Crisis Means for Long-Term Investing: Another Look

Date: Tuesday, May 26

Time: 4-5 p.m. EST

Please view our archived Webcasts at:

investmentnews.com/webcasts

InvestmentNews