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April 13, 2009

## Case demonstrates how preparation can avoid an exam from unraveling

A portfolio manager has been barred by the SEC from the industry for one year in a case that illustrates how far awry events can run when a firm isn't quite ready for examiners.

The one-year penalty fell upon **Diane Keefe**, former portfolio manager at **Pax World Management Corp.** in Portsmouth, N.H. According to the [SEC](#), Keefe claims to have invented the concept of a mutual fund focusing on "socially responsible investing in companies that issued high yield bonds." Her attorney, **Robert Knuts**, partner at **Allen & Overy** in New York promises an appeal and criticizes the SEC judge for deciding the case prior to a formal hearing.

You may recall Pax World settled an unrelated case with the SEC last year ([IA Week](#), Aug. 4, 2008) for buying at least 10 securities that failed to meet investors' expectations by not being socially responsible.

Pax World's CEO **Joe Keefe** (no relation to Diane) took the job in 2005, long after the SEC began the exams that led to both cases. He cleaned house and improved compliance, drawing praise from the [Commission](#). Before we detail these compliance changes, some history is in order – pulled from the SEC Enforcement Division's and Knuts' accounts.

### History

Pax World received news in the summer of 2003 that SEC examiners were coming for a routine exam. Trouble  
*(Naughty Notes, continued on page 2)*

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## Roundtable on short selling planned as Commission votes to propose new rule

The hubbub around short selling has persuaded the SEC to possibly adopt a new rule. The Commission voted unanimously April 8 to propose a rule containing two options for policing the trading activity.

You will get 60 days to comment once the proposal is formally published, plus the Commission plans an industry roundtable on the issue May 5, so a final rule is likely months away. It seems the SEC will include much variation in the two options to give the industry the widest latitude to vote for its most favorable mechanism.

"Even before I arrived at the SEC, I heard from hundreds of investors concerned about short selling. Clearly, the practice of short selling has both strong supporters and detractors," SEC Chairman **Mary Schapiro** said at the meeting. Some of that pressure has come from Congress, concerned shorting exacerbated last year's market turmoil ([IA Week](#), April 6, 2009).

Here are the two options to be proposed:

*(Shorting Proposal, continued on page 2)*

## A few suggestions to jazz up your annual review after a rocky year

Compliance officers face an obligation each year to review their firm's policies and procedures. While RIAs are under no legal obligation to produce an annual review report (in contrast to investment companies, which are), it has become a best practice to commit your review to writing and to share it with firm executives (see story, page 4).

When you consider the fact that the SEC recommends the annual review "should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates," and changes in regulations, you could feel overwhelmed in recalling the year 2008 was.

But resist the temptation to throw too much – rumors and stock manipulation, short selling, custody concerns, due diligence, et al – into your review, especially when time, money and staff may be tight.

*(Annual Review, continued on page 4)*

## Shorting Proposal (Continued from page 1)


**1. Bid or price test.** The former would be based on a national best bid price (a modified uptick rule) and the latter on the last sale price or tick (the uptick rule). The proposed uptick rule would be similar to the old one and would include exceptions to “promote liquidity and foster the workability of the proposed rules without undermining the effectiveness of the proposals,” according to the SEC.

**2. Circuit breaker.** This would prohibit anyone from short selling a security for the rest of the trading day once that stock drops a certain percentage. **Erik Sirri**, director of the Division of Trading and Markets, told Commissioners in his final public meeting before leaving the SEC that that percentage could be 10% or some other number.

The circuit breaker option could further be divided among three choices: (a) halt short selling of a security for the rest of the trading day if the stock suffered a severe price decline; (b) place a price test based on the national best bid for a security undergoing a steep price decline for the rest of the day; or (c) require a short sale price test based on the last sale price for that damaged security for the rest of the day. The SEC refers to this latter option as a circuit breaker uptick rule.

Each of the primary options – bid/price test or circuit breaker – would include exemptions.

The Commission also proposed amendments to Reg SHO that would require a broker-dealer mark a sell order “short exempt” if the seller relies on an exception to a short sale price test restriction or a circuit breaker rule.

The [uptick rule was repealed](#)  in 2007 but the Commission “decided to re-evaluate the issue due to extreme market conditions and the resulting deterioration in investor confidence,” it said.

Some commissioners expressed skepticism that short selling should be declared the market’s demon. Commissioner **Kathleen Casey** asked if the proposed rule would have made any difference in the markets of the last 18 months or “are we engaging in merely a political exercise?”

Others asked the industry for empirical data to support their views.

Sirri chastised those who contend the solution is simply to bring back the uptick rule. “Markets have changed enough so that you can’t put back the effect of the old uptick rule,” he said. ■

## Naughty Notes (Continued from page 1)

began when the firm’s compliance officer **Janet Spates**, in preparation for the visit, “contacted Keefe and told her that the High Yield Fund had an ‘Investment Committee’ that was supposed to meet at least two times a year and that Spates needed to have a record of the meetings.”

Spates, who declined to comment to **IA Week**, made several mistakes. She wrongly assumed that the SEC had asked for the records. She also incorrectly assumed minutes would be needed from each of the investment committee meetings. But her biggest error was one of miscommunication. Spates wanted information on the committee of the High Yield Fund’s board of directors, while Diane Keefe left the discussion believing Spates was asking about the investment committee, according to Knuts.

Diane Keefe, who worked in New York, obliged by faxing Spates 11 pages “of handwritten notes” of the meetings “with fictitious dates,” the SEC states. The SEC enforcement staff ultimately determined these meetings never actually occurred.

*(Naughty Notes, continued on page 3)*

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## Naughty Notes (Continued from page 2)

Knuts says his client was simply responding to a request from the compliance officer and that Diane Keefe recognizes she made “a substantial error in judgment,” according to Knut’s [legal filing](#) . “Keefe believed that it would be helpful to document, to the best of her recollection, informal conversations” with the two other principals on the investment committee. She didn’t “appreciate at that time” that the notes “could be viewed as misleading.”

### Some strange turns

Here the case begins to take some strange turns that aren’t fully explained by various sources. Examiners in 2003 are given a folder labeled “Adviser Materials,” but for some reason the handwritten notes aren’t inside.

Then, in August 2004, the SEC announces it’s returning for an unrelated exam tied to market timing. Upon learning of the second exam, Diane Keefe comes clean to her bosses about the handwritten notes from a year earlier. They respond by demoting her and cutting her salary by \$50,000.

Sometime later the company notifies the SEC about Diane Keefe’s actions. It was during this second visit that examiners find the portfolio violation that the advisory firm settled last year.

Diane Keefe finally parts the company in December 2007 – with one side claiming she was fired and the other saying she resigned. Diane Keefe couldn’t be reached and Knuts declined to reveal her whereabouts. He has argued in her defense that handwritten notes shouldn’t be regarded as required records or advisory materials under the Investment Company Act. The SEC judge rejected this argument.

### Lessons for other firms


Beyond the need for open and clear communications in a firm, one lesson may be to employ an on-site CCO. At the time of the 2003 exam, Pax World hired a New York attorney as its CCO. Another lesson is “compliance really has to be in your [firm’s] DNA,” says Joe Keefe, who emphasizes his company had no role in any wrongdoing by Diane Keefe.

Yet the firm did permit trades that violated investors’ wishes. To prevent a repeat, Pax World introduced an automatic hard-stop in the firm’s pre-trade compliance system that prohibits a portfolio manager from purchasing a security that hasn’t been pre-screened as meeting investor restrictions.


The SEC had previously noted Pax World replaced its

senior management, including the CCO, and two portfolio managers, and developed a new compliance manual. Joe Keefe also says the firm has improved testing and procedures. ■

## Schapiro talks third-party audits for investment advisers

In a speech April 6 in Washington, SEC Chairman **Mary Schapiro** listed several “potential reforms” she’s looking at, including requiring that “certain investment advisers have third-party compliance audits to ensure their compliance with the law” ([IA Week](#) , April 6, 2009).

She also spoke of the possibility of mandating that those who custody assets “undergo an annual third-party audit, on an unannounced basis, to confirm the safekeeping of those assets.”

Another possible reform would be the harmonization of investment adviser and broker-dealer regimes “so that investors who use either can expect a uniform level of professionalism and accountability,” [Schapiro told](#)  the **Council of Institutional Investors** April 6.

Some of these reforms would require congressional legislation, she told the attendees. Among the other possible reforms she discussed:

- √ Registering hedge fund advisers, and potentially the hedge funds themselves.
- √ Requiring more disclosure from credit rating agencies, including potentially the assumptions underlying their methodologies, fees received from issuers, and factors that could change ratings.
- √ Overseeing more vigorously the credit default swaps market, including considering reporting and recordkeeping rules that do not exist today.
- √ Enhancing the standards applicable to money market funds.
- √ Providing investors in municipal securities with the same type of disclosure and investor protections as are provided to investors in other securities.
- √ Enhancing disclosure around asset-backed securities. ■

This story first appeared as breaking news at [www.iawatch.com](http://www.iawatch.com) on April 6. Read breaking news at our Web site. Also register for our webinars and other events, including our just-announced May 5 webinar on spotting and resolving Conflicts of Interest. Click [here](#) to register. ■

## Annual Review (Continued from page 1)

“Sometimes people get a little carried away on hot topics,” says **Veronica Stork**, CCO at **Trilogy Global Advisors** in New York. “Just because something is a hot topic doesn’t mean it’s a big issue for your firm.” For instance, short selling is trendy but Trilogy doesn’t engage in short selling, so it needn’t be part of Stork’s annual review.

However, if the trends correspond to risks in your firm, it would be wise to weave them into your program, believes **John Schrier**, an investment management and tax lawyer in Scarsdale, N.Y.

Recent examinations on the West Coast have focused so intently on due diligence and outside business activities that **Michelle Jacko**, CEO of **Core Compliance & Legal Services** in San Diego, recommends firms consider these issues in their annual reviews. She reports examiners are even asking for personal banking records to root out improper commissions.

**Amy Lynch**, president, **Frontline Compliance** in Alexandria, Va., recommends you incorporate custody questions into your reviews. Ask custodians who has access to your clients’ monies and what controls they have in place to ensure only authorized persons can gain access.

If there are areas of your firm that lost personnel in the last year, you may want to devise tests to be sure compliance risks haven’t increased in those areas, recommends Schrier. For example, if staff left who had reviewed e-mails or marketing materials, you probably should beef up tests in these areas.

And try some “informal testing,” suggests Stork. For example, poke around people’s garbage cans at the end of the day to see whether what they’re throwing out would have been better bound for the shredder “to protect confidentiality.”

**TIP:** This year create a file and place in it throughout the year stories about hot topics. This file could make next year’s annual review that much easier. ■

### Grade these ideas for annual review tests from your peers

The annual review this year at **Sectoral Asset Management** in Montreal took longer and was more detailed than usual. One reason: CEO/CCO **Jerome Pfund** tried something new. He took an SEC document request letter from **IA Week** and pretended it was real – to test the firm’s ability to respond.

The annual review at **Chase Investment Counsel Corp.** in Charlottesville, Va., includes a section on possible

regulatory changes expected later this year, says **Catherine Farrar**, senior VP/Compliance Officer. She wanted senior staff to know what might be coming. A mock audit conducted last November aided Farrar’s review. “They found what we expected them to find; that our processes are working,” she says.

Ambitious describes the tweak to **James Jones’** annual review and testing processes. The COO/director of operations at **SPC Financial** in Rockville, Md., poured trades from 500 discretionary accounts into Excel in a bid to uncover any hidden bias by traders. “It’s just a voluminous task,” he says.

He has heard the SEC may be interested in looking at accounts that stray two standard deviations from the firm’s performance composite. Because of all the market volatility last year, he has set up the Excel file to tag any trades outside one standard deviation. His analysis goes deeper than his usual yearly examination for any signs of front-running or allocation issues.

Perhaps you aim for a test around valuation. Extract a sample of accounts to see if market values match between your firm’s portfolio records and its custodian’s, recommends **Michelle Kennedy**, consultant with **Compass Compliance Services** in Greenwood, S.C. “Any bond market values over the tolerance level (\$1.00)” should be questioned, she writes in an e-mail. Investigate multiple pricing discrepancies to minimize future problems. You may also entertain hiring a third-party pricing service, if only for the “end of month” valuation period, she adds.

### Reconciliation

Kennedy also favors a sampling to confirm accounts reconciled from the previous billing period. If problems appear, understand why the accounts didn’t reconcile properly and how to fix the issue. **TIP:** Don’t have the same person doing each month’s reconciliation. Kennedy recommends you alternate the task. She also believes the CCO should “randomly select a few accounts (monthly or quarterly) and request the portfolio administrator to provide evidence of the accounts reconciling.” Another good idea would be to review the client file or blotter for posting date entries, she says. ■

#### Share a story idea

Contact Publisher **Carl Ayers** at 301-287-2435 or [cayers@iaweek.com](mailto:cayers@iaweek.com). I guarantee you dozens of your peers face the same challenges as you. ■



## Personal trading: Pre-clearance questions to consider for your program

A good code of ethics contains a specific policy directed at personal trading. Enforcing your rules can be helped by asking the right questions with your pre-clearance procedures.

Here are some questions others use – and visit our Web site for an even more [extensive list](#), courtesy of **Tony Turner**, a principal at **Financial Tracking** in Greenwich, Conn. The sophistication of the questions/statements guarantees any firm will find some that fit its business.

**TIP:** “Make disclosures and certifications and attestations very convenient for the employee to complete,” recommends Turner.

Some firms put every request for a stock transaction through a decision tree, e.g., is the security on a restricted list, notes **John McGovern**, a securities consultant in New York. Among his favorite pre-clearance questions:

- What are pre- and post-trading windows on the buy/sell side?
- Is it a thinly traded stock?
- Does my current “access” position place me in an apparent conflict of interest?

Here’s a sample of Turner’s statements for employees to answer prior to pre-clearance:

- √ I do not have “material non-public information” about this security.
- √ I do not have confidential or sensitive information learned in the course of my duties for \_\_\_\_\_ about this security that is relevant to my decision to transact in this security.
- √ The intended transaction is not a short sale (or is a bona fide hedge against an existing position).
- √ The intended transaction is not an investment in an IPO or initial offer of bonds with warrants.
- √ The intended transaction is not a form of spread betting.
- √ The intended transaction is not a transaction in a derivative or other financial instrument that has the effect of evading the requirements of the company’s personal trading policy.
- √ I do not have knowledge or reason to believe that this security is under consideration for imminent purchase or sale by a fund manager for a client account.
- √ I have not within the past 60 days engaged in an

opposite direction transaction in the security for which I seek pre-clearance. ■

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## Acquisitions form one strategy to weather uncertain times

It began over lunch last May. **David Bottoms**, founder of **Oaktree Asset Management**, an RIA in New York, invited **Peter Raimondi**, president & CEO of **Banyan Partners**, an RIA in Palm Beach Gardens, Fla., to a meal to talk about Raimondi taking over Oaktree’s operations in nearby Boca Raton.

“He was interested in hiring me,” Raimondi recalls. By the time the check arrived, the two men were considering another idea: Raimondi buying Oaktree.

This was a heady reversal, considering Banyan Partners’ AUM stood around \$40 million while Oaktree’s towered over it at \$250 million. But Raimondi was intent on acquiring a larger firm to expand his two-year-old RIA, and Bottoms, who is in his 60s, had no succession plan.

After months of negotiations, Banyan completed the acquisition in January. Raimondi is bullish on the industry and believes “our firms are stronger together than they would be as individual standalones,” even in a “monster recession.” He concedes the economy makes nailing down an ROI difficult.

Timing hurt Bottoms and helped Raimondi. The sales price, which Raimondi declined to share, dropped 20% as the market plummeted last fall.

With the purchase came Oaktree’s name, clients and assets, but not its separate broker-dealer, **Financial Assets Corp.**, although Raimondi may add the brokerage later. Raimondi used his own capital to acquire Oaktree.

Clients learned of the change in mailed 5” x 7” envelopes that included the news, bios of Banyan staff, and a communications list.

Beyond the financials, Raimondi also looked into

*(Acquisition, continued on page 6)*

## Acquisition (Continued from page 5)

Oaktree's people. "I interviewed most of the people in the firm," he says. "That was very important." He would ask what changes would you make in the firm, what things would you not change and listen to their personal stories as he prepared them for a new owner and culture. The interviews left Raimondi so impressed, he grew even more confident the combined firms would work.

The Boca Raton office will be moved to Banyan's headquarters, Raimondi will travel often to New York and Bottoms has agreed to stay on for at least three years.

## Compliance structure

Banyan will continue to outsource most of its compliance work, although Raimondi selected Oaktree's CCO to be Banyan's as well.

The compliance, accounting and bookkeeping transitions have been made. Banyan also has changed Oaktree's investment style. It had used individual portfolio managers. Banyan employs a research and investment committee approach. Raimondi favors a committee that "puts out our investment ideas collectively."

Three members from Palm Beach Gardens and four from New York form the committee. They confer by teleconference twice a week and meet physically once a quarter. They gathered in Florida in January. ■

## Guidance on answering custody question on Form ADV

Don't let Form ADV, Part II's question about the balance sheet throw you if your firm maintains custody.

Some wonder how to answer question 14 on Part II, especially if answers provided on Form ADV, Part I acknowledge custody. Before giving you guidance, here's a reminder of the question:

**14. Balance Sheet.** *Applicant must provide a balance sheet for the most recent fiscal year on Schedule G if applicant:*

- *has custody of client funds or securities (unless applicant is registered or registering only with the Securities and Exchange Commission); or*
- *requires prepayment of more than \$500 in fees per client and 6 or more months in advance*

*Has applicant provided a Schedule G balance sheet? [yes, no]*

The answer is straight-forward if your firm is registered or applying to register with the SEC: You don't have to provide a Schedule G balance sheet and can indicate "no."

But what if your firm is applying for state registration and the state doesn't require Schedule G? It's conceivable the state would permit the firm to simply check "no" to the Schedule G question but check with your state's securities division first to be sure. ■

Read more stories from this week at [www.iaweek.com](http://www.iaweek.com). Plus, get access to new documents, including a list of Madoff assets, compliance tools, SEC speeches and releases and more. ■

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