

Client Alert

A report
for clients
and friends
of the firm

December 2004

SEC Mutual Fund Inspection Program Places Additional Emphasis on Internal Controls, Compliance Policies and Procedures

SEC officials have said that the Commission's mutual fund examination program is placing new emphasis on internal controls and compliance mechanisms. A recent examination letter obtained by *Compliance Reporter* bears this out. The examination letter (the "Letter"), from the Commission's Northeast Regional Office ("NERO"), gives notice of the commencement of an examination of a mutual fund complex and its investment adviser. The Letter includes a 10-page list of the books, records and other information to be produced for examination by the inspection staff. The text of the Letter was published by *Compliance Reporter* on its subscriber website.

In the form published by *Compliance Reporter*, the Letter is unaddressed but dated October 4, 2004, and purports to advise its recipient of an examination to begin on October 12, 2004. The Letter, which appears to be a template, and may be a draft, provides useful insight into emerging inspection priorities for NERO and, presumably, other regional offices of the Commission. In particular, the Letter illustrates how the Commission's examiners can be expected to augment their inspection procedures to reflect the adoption of Rules 206(4)-7 under the Investment Advisers Act and 38a-1 under the Investment Company Act. These rules, which became effective on October 5, 2004, respectively require registered investment advisers, registered investment companies and business development companies to designate chief compliance officers and adopt written

compliance policies and procedures. Although the Letter relates to the inspection of a fund complex and its adviser, a substantial portion of its contents would be equally applicable to advisers outside the mutual fund industry. We, therefore, believe that all investment advisers would find it beneficial to regard the Letter as an inspection checklist to be incorporated into their compliance personnel's mock inspection procedures.

Large portions of the Letter are familiar components of the inspection letters that customarily have been transmitted by the Commission's staff to initiate the routine inspection of a fund complex and its investment adviser. However, other aspects of the Letter are innovative and many particulars of the Letter are noteworthy.

The Letter is divided into Parts A through C. Part A, headed "Request for Internal Control Information," asks the adviser to provide information that documents and substantiates the effectiveness of: (i) the adviser's "overall commitment" to establish and maintain an effective system of controls and compliance procedures and (ii) the specific risk management, control and compliance processes and procedures used in achieving 13 enumerated "important objectives" (which include, among others, minimizing the ability of a "dominant individual to override control systems" and maintaining a "strong compliance culture"). For each of the 13 specified objectives, Part A requests production of any policies, procedures and compliance manuals describing the adviser's operating and control procedures, and any documents demonstrating the effectiveness of the control process. The Letter states that "these documents should include exception reports together with documentation of follow-up work, completed compliance check lists, completed reconciliation files, management reports, documents containing supervisory approval of overrides in various areas, warning or sanction notices to staff who do not follow procedures, periodic analysis of transactions by compliance staff who are searching for patterns or

‘what if’ situations that may need further follow-up and results of any such follow-up activities, and periodic self assessments of the effectiveness of control processes such as internal audit reports.”

Part B of the Letter is a request for production, at the commencement of the examination, of documents responsive to 62 itemized categories. While many of these categories are conventional in terms of past practice, some appear to be new. Noteworthy (whether or not new) among the 62 categories are:

- A list of clients that have instructed the adviser to direct brokerage to particular broker-dealers, including the names of the broker-dealers and the client’s purpose for such direction, if known.
- Details of trades in which the adviser instructed the executing broker to “step-out” all or a portion of the transaction.
- Details regarding soft dollar arrangements to which the adviser is party, including the approximate amount of commissions needed to satisfy each such arrangement.
- The adviser’s contingency planning/disaster recovery procedures.
- For registered investment companies, copies of the policies and procedures “designed to ensure the certification” of financial statements and N-SAR/N-CSR filings, as required by the Sarbanes-Oxley Act.
- Any report or analysis concerning “possible excessive trading” by employees of the adviser in shares of registered investment companies within the complex.
- For registered investment companies, the complex’s policies and procedures for ensuring that shareholders are charged appropriate sales charges and redemption fees, and reports, spreadsheets and statements indicating that redemption fees have been correctly assessed.
- Specified information regarding each significant “regulatory/disclosure breach or issue” that has come to the adviser’s (or complex’s) attention after a specified date.
- All e-mails during a specified month for certain categories of employees.

Part C of the Letter is a request for access to nine specified additional categories of records, including all client account files.

We would be happy to discuss the Letter or related matters with you. If we can be of assistance in this regard, please contact the lawyers listed below.

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