CORE COMPLIANCE & LEGAL SERVICES, INC.
SOLUTIONS FOR TODAY'S BUSINESS

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REGULATION BY FOOTNOTES

The financial industry is one of the most highly regulated industries in the United States. Over the last 80 years, some of the most notable regulations enacted by Congress include the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940 (the "Advisers Act"), the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 and the Jumpstart Our Business Startups Act of 2012. These Acts generally consist of the most widely applicable regulations governing U.S securities firms and each regulation has corresponding rules that have been promulgated by the Securities and Exchange Commission ("SEC"). Combined, these rules and regulations are commonly referred to as "federal securities laws."

In order for compliance professionals to efficiently administer compliance within their firms, they must read and become familiar with the specific federal securities laws that pertain to their firm's business. However, since many of these laws have been in existence for over seven decades, reviewing the text of each rule no longer provides all the requirements that must be followed. Importantly, for a large majority of the federal securities laws, the SEC has issued additional guidance by way of no action letters and/or interpretive releases, which serve as integral components and also should be considered.

Additionally, it is just as important to review the final releases issued by the SEC upon adoption of a rule. These documents are usually quite extensive and contain detailed information regarding the final rule, including a summarization of the comments received from the industry and the SEC's considerations of such comments. Each release also contains important footnotes, which due to their location can be easily overlooked or forgotten. These bits of information generally help clarify and/or explain the referenced text, but in some cases they include SEC guidance and additional requirements, which if missed, could actually result in an SEC deficiency being levied.

Examples of Important Footnotes

Reflected below are three examples of important footnotes contained in final releases of rules adopted by the SEC under the Advisers Act, along with a comparison of the text of each rule.

Example One: Proxy Voting – Rule 206(4)-6 of the Advisers Act[1]

> Footnote #24 - *"Of course, the pre-determined policy must be designed to further the interests of clients rather than the adviser. Thus, an adviser could not, consistent with its duty, adopt a pre-determined policy of voting proxies in favor of the management of companies with which it does business. We recognize, however, that in many cases, voting policies are not sufficiently specific to determine how the vote will be cast."*

This footnote highlights that an investment adviser cannot have a blanket policy to always voting with management. Notably, without this footnote's guidance, the applicable text of this rule only requires that the adviser's procedures be "*reasonably designed to ensure that you vote client securities in the best interest of clients…"*. Consequently, it is imperative to consider fn. 24 when developing the firm's proxy voting policy to ensure that the firm's protocols are consistent with the SEC's expectations as set forth in the rule.

Example Two: Compliance Program – Rule 206(4)-7(b) of the Advisers Act[2]

> Footnote #15 - *"Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the adviser's fulfillment of its duty of best execution), or an analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities)."*

This footnote outlines what the SEC commonly refers to as "forensic testing," which is something the Commission expects investment advisory firms to perform as part of their annual review process. Without this footnote's guidance, the applicable text to this rule merely states that investment advisory firms must: "*Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation.*" Without this guidance, firms may not appreciate the SEC's expectations for analyzing the effectiveness of the compliance program to see if it is being circumvented through trends and analysis studies conducted over time.

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[1] Final Rule Release for Rule 206(4)-6: Proxy Voting by Investment Advisers: Release No. IA-2106 January 31, 2003 (http://www.sec.gov/rules/final/ia-2106.htm).

[2] Final Rule Release for Rule 206(4)-7: Compliance Programs of Investment Companies and Investment Advisers - Release Nos. IA-2204IC-26299 December 17, 2003 (http://www.sec.gov/rules/final/ia-2204.htm)

Example Three: Custody – Rule 206(4)-2 of the Advisers Act[3]

> Footnote #21 - *(in part) "We believe that accessing account statements through the [custodian] website merely confirms that they are available. If an adviser does not take additional steps to determine whether account statements were sent to clients, or that clients obtained statements through the website, the adviser would have an inadequate basis for forming a reasonable belief, after due inquiry, that the qualified custodian sends account statements to clients."*

This footnote outlines that an investment adviser cannot confirm statement delivery to clients by website access alone. Without this footnote's guidance, the applicable text of the rule merely states that an adviser must have a "*reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients….*" Absent the footnote's guidance, advisers may not necessarily understand that it is not enough to confirm access to a client's account statement vis-à-vis the custodian's website; the SEC expects more (such as verification through conversations with clientele).

Conclusion

Chief Compliance Officers are charged with the on-going responsibility of having a clear understanding of the federal securities laws that regulate the firm's business practices. In carrying out such responsibility, it is very important to remember that the "devil is in the details." Be sure to review all pertinent information that has been issued by the SEC including rule releases, no action letters, interpretive and concept releases, enforcement actions, and investor education information. Conveniently, all this information can be found at one location, the SEC's website at www.sec.gov.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

Author: Tina Mitchell, Lead Compliance Consultant; Editor: Michelle L. Jacko, CEO, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

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[3] Final Rule Release for Rule 206(4)-2: Custody of Funds or Securities of Clients by Investment Advisers Release No. IA-2968 December 30, 2009 (http://www.sec.gov/rules/final/2009/ia-2968.pdf).