DAY PITNEY LLP

alert

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SEC Crackdown On Investment Adviser Compliance Deficiencies

Introduction

The Securities and Exchange Commission (the "SEC") is cracking down on firms with compliance deficiencies under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Although three SEC enforcement cases announced on November 28, 2011, involve extreme disregard by the particular investment adviser firms, these cases are sobering evidence of the penalties that may follow for advisers (and even for Chief Compliance Officers personally) that disregard SEC compliance.

These cases are particularly timely for advisers to hedge funds and private equity funds. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), advisers to funds of significant size will be required to be registered under the Advisers Act. All SEC-registered advisers will need to have in place appropriate compliance programs and procedures prior to March 31, 2012.

The three cases illustrate the fact that investment advisers have often been called to task by the SEC for not remedying matters identified in a prior deficiency letter. Moreover, in one case, the SEC took the adviser to task for using an "off the shelf" manual that was not properly tailored to its actual business and for not evolving its compliance program as the firm's business changed and grew. In two of the three cases (in the third, the adviser agreed to cease operations), the advisers were required to provide copies of the SEC Order to their clients.

For details of the three cases, please see the following link to the SEC release: http://www.sec.gov/news/press/2011/2011-248.htm.

Increased SEC Initiative On Compliance

In its November 28, 2011, release, the SEC stated, "These cases stem from an initiative within the SEC Enforcement Division's Asset Management Unit to proactively prevent investor harm by working closely with agency examiners to ensure that viable compliance programs are in place at firms."

This proactive approach signals an increased focus by the SEC on ensuring compliance by investment advisers with the Advisers Act and its Rules. "Not all compliance failures result in fraud, but many frauds take root in compliance deficiencies," stated Robert Khuzami, Director of the SEC's Division of Enforcement. "That simple truth underlies our renewed

Related practice areas:

Private Equity and Investment Funds

Broker-Dealers, Investment Advisers and Commodities Firms

For more information, please contact any of the individuals listed below:

R. Scott Beach [CT]
rsbeach@daypitney.com
(203) 862 7824

Jeffrey A. Clopeck [MA]
jaclopeck@daypitney.com
(617) 345 4612

Henry Nelson Massey [NJ, NY]
hmassey@daypitney.com
(973) 966 8105

Jeffrey Plotkin [CT, NY]
jplotkin@daypitney.com
(203) 977 7547
(212) 297 5815

David A. Sussman [NJ]
dsussman@daypitney.com
(973) 966 8251

Shawn T. Wooden [CT, NY, DC]
stwooden@daypitney.com
(860) 275 0157

focus on identifying and charging firms and individuals that fail their legal obligations to maintain adequate compliance programs."

Lessons To Be Learned

The SEC's recent enforcement actions indicate it is taking a proactive approach to protecting investors by demanding strict conformance with the Advisers Act's compliance requirements, and imposing personal liability where the conduct is egregious. Dodd-Frank ushered in sweeping reform and change to investment adviser regulation, which requires many previously unregistered investment advisers to become appropriately registered in the first quarter of 2012. Registration is but the first step of the process. SEC-registered investment advisers must put in place thorough, custom-tailored and ongoing compliance policies and procedures in order to satisfy their requirements under the Advisers Act. The Day Pitney attorneys listed to the right are available to discuss the intricacies of these compliance requirements and help develop an appropriate compliance program for your investment advisory business.

Some Details of the Enforcement Actions

OMNI

In the Matter of OMNI Investment Advisers Inc. ("OMNI") and Gary R. Benyon (who was charged individually for personal failures in performing his responsibilities as Chief Compliance Officer), the SEC charged OMNI, among other things, with failing to establish, maintain and enforce a written code of ethics, as required under Advisers Act Rule 204A-1, and also with failing to maintain and preserve certain books and records, as required by Advisers Act Rule 204-2(a)(10). In 2007, the SEC examined OMNI and issued a deficiency letter noting several issues, including OMNI's failure to conduct an adequate annual review of its compliance program.

With respect to Mr. Benyon, the SEC found that he failed to perform virtually any compliance responsibilities after being named Chief Compliance Officer. Mr. Benyon was living in Brazil at the time. In particular, in response to an SEC subpoena, OMNI produced client advisory agreements with Mr. Benyon's signature evidencing his supervisory approval when, in fact, Mr. Benyon had never reviewed the documents and had signed the documents with incorrect dates one day before the documents were produced to the SEC.

As a result of these violations, both OMNI and Mr. Benyon were censured by the SEC. Mr. Benyon agreed to pay a $50,000 penalty, and agreed to be permanently barred from acting within the securities industry in a compliance or supervisory capacity and from associating with any investment company. OMNI also agreed to provide a copy of the SEC's Order to each of OMNI's advisory clients that existed at any time between September 2008 and August 2011.

Feltl

In the Matter of Feltl & Company, Inc. ("Feltl"), the SEC charged Feltl, a dually-registered broker-dealer and investment adviser, for, among other things, engaging in hundreds of principal transactions with its advisory clients' accounts without making the proper disclosures and without obtaining consent, in violation of Section 206(3) of the Advisers Act. This

Jonathan R. Morris NY, CT
jmorris@daypitney.com
(212) 297 5806

Jane Helen Broderick NY, NJ
jbroderick@daypitney.com
(212) 297 5831

Samuel A. Jennings CT, NY
sjennings@daypitney.com
(617) 345 4652

failure also resulted in Feltl charging undisclosed fees to its clients participating in its wrap fee program by charging both wrap fees and commissions, which violated Section 206(2) of the Advisers Act.

The SEC stated, “Feltl’s compliance breakdown was caused by its failure to invest necessary resources in the firm’s advisory business as it changed and grew in relation to its brokerage business.” On December 9, 2010, the exam staff issued a deficiency letter to Feltl, noting Feltl’s compliance failures and its failure to disclose and obtain client consent in transacting principal trades. During this time period, Feltl maintained one compliance manual that encompassed both the brokerage and advisory businesses. This off-the-shelf manual essentially treated its brokerage and advisory accounts the same for compliance purposes.

Due to these violations, Feltl agreed, among other things, to pay a $50,000 penalty, disgorge more than $142,000 to be returned to its advisory clients, and to provide a copy of the SEC’s Order to past, present and future clients.

Asset Advisors

In the Matter of Asset Advisors, LLC (“Asset Advisors”), the SEC determined that, in May 2007, Asset Advisors adopted written compliance policies and procedures only after the SEC’s exam staff alerted Asset Advisors to its previous compliance failures. Thereafter, Asset Advisors failed to fully implement a compliance program, taking minimum steps to satisfy its compliance obligations only when the exam staff notified it of an impending exam.

Even after Asset Advisors adopted a code of ethics, the SEC found the firm failed to maintain and enforce the code by failing to collect written acknowledgments of the code’s receipt from supervised persons and failing to periodically collect from access persons the required securities reports. In particular, the SEC noted that “Despite its promise to devote the proper time and resources to its compliance program, the firm waited until November 2009 to amend the compliance manual to incorporate comments made by the exam staff during the 2007 exam. Aside from distributing the amended manual and holding its semiannual meeting, Asset Advisors did nothing to train staff or to implement the manual’s amended policies and procedures.”

As a result of these deficiencies, Asset Advisors agreed to pay a $20,000 penalty, cease operations, deregister with the SEC and, with client consent, move its advisory accounts to a firm with an established compliance program.

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