iad INTERNAL AUDITORS DIVISION
SECURITIES INDUSTRY ASSOCIATION
SIA

Audit Guideline #24

Investment Adviser Activities

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SECURITIES INDUSTRY ASSOCIATION
INTERNAL AUDITORS DIVISION
AUDIT GUIDELINES COMMITTEE

INVESTMENT ADVISER ACTIVITIES AUDIT GUIDELINE

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I. BACKGROUND

The numbers and types of investment advisers have increased dramatically since the Investment Advisers Act of 1940, the primary federal statute regulating investment advisers ("Advisers Act"), was initially adopted. This fact, along with the phenomenal success of mutual funds, the rapid development of the financial planning industry and the enormous growth in pension plan assets throughout the 1990's ensures an increasingly influential role for investment advisers in today's financial markets.

The SEC adopted new rules and rule amendments to the Advisers Act in July 1997. Therefore, as a result of the Investment Advisers Supervision Coordination Act the regulation of investment advisers was split between the SEC and the states. In general, the new rules divided regulation of investment advisers between the SEC and the States. For advisers that manage assets of more than $25 million or advise a registered investment company, (i.e., a mutual fund), registration with the SEC only will be required. These firms would not register with states, although their representatives would register in states where they have a place of business. Advisory firms with under $25 million in assets under management must register with the states where the principal office and place of business is maintained and such other state(s) where they may conduct business. They will not have to register with the SEC. For those advisory firms located in the states that do not currently have investment adviser registration requirements SEC registration will be required.

The Advisers Act was enacted, at least in part to strengthen the fiduciary nature of the relationships between advisers and their clients. The Supreme Court has stated that Section 206 of the Advisers Act establishes federal fiduciary standards to govern the conduct of investment advisers. The SEC has stated that investment advisers owe their clients several specific duties as fiduciaries. According to the SEC, the fiduciary duties include the provision of advice that is suitable for the client, full disclosure of all material facts and potential conflicts of interest, utmost and exclusive loyalty and good faith, best execution of client transactions, and the exercise of reasonable care to avoid misleading clients.

One of the important provisions of the Advisers Act and state securities laws, calls for the registration of investment advisers with their State or the SEC. Once registered, the adviser must comply with the regulations promulgated under the Advisers Act or applicable state law. Allowing for certain exemptions, an adviser is defined in Section 202(a)(II) of the Advisers Act as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

A. State Registration/Registration of Investment Advisers

Many states require that investment adviser representatives be (one or more of the following):

i. registered or licensed;

ii. qualified by examination or experience only; or,

iii. added to Form ADV (Schedule D) with the amendment filed with the state.

However, the definition of an investment adviser representative varies greatly from state to state. In some states, any individual who solicits clients for an adviser must be registered as an agent of that adviser. In other states, only those who actually provide investment advice must be agents. An in-depth review of individual state registration requirements must be conducted by an investment adviser prior to soliciting business in any state in which the firm and/or individual is not registered.

B. Advisory Contracts

The Advisers Act regulates the following specific aspects of an investment adviser's advisory contract with clients. With some exceptions, an investment advisory contract may not provide for compensation based on a share of capital gains or appreciation. In addition, advisory fees of 3% of more should be cleared with the Compliance Department. (It should be noted that unless an adviser is providing a specialized type of advice such as account management of options portfolios, any fee of 3% or more is higher than the norm and should be disclosed to their clients.) An adviser should consider providing, and when appropriate provide, pro-rata refunds of pre-paid advisory fees. Advisers should not have provisions in their advisory agreements which state that all fees are non-refundable. Advisory contracts must state that they cannot be assigned without the client's consent nor can they bind a client to waive their rights to the adviser's compliance with any provision of the securities law (i.e. hedge clauses).

C. Anti Fraud Provisions

Section 206 of the Advisers Act and their rules prohibit fraudulent activities by investment advisers. This section applies to all investment advisers whether or not they are required to be registered. Section 206 and the other applicable anti-fraud provisions of the federal securities laws (namely, Section 17 of the Securities Act of 1933 and Section 10 (b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder) prohibit misstatements or misleading omission of material facts and fraudulent acts and practices in connection with the purchase or sale of securities or the conduct of an investment advisory business. However, unlike the other statutes mentioned, the Advisers Act does not require a transaction to have occurred for actionable fraud to have been committed. An investment adviser is a fiduciary who owes his clients undivided loyalty, and is prohibited from engaging in activity in conflict with the interest of any client. A breach of an adviser's fiduciary obligations constitutes a violation of the anti-fraud provisions of the Advisers Act. This fiduciary obligation imposes upon an investment adviser a duty to deal fairly and act in the best interest of the clients. (Such duty imposes upon an investment adviser numerous responsibilities including the duty to render disinterested and impartial advice; to make suitable recommendations to clients in light of their needs, financial circumstances and investment objectives; to exercise a high degree of care to ensure that adequate and accurate representations and other information about securities are presented to clients; and to have an adequate basis in fact for his or her recommendations, representations and projections.)

D. Supervision

Section 203(e)(5) of the Advisers Act authorizes the SEC to take appropriate action against an investment adviser if the adviser or any person associated with the adviser "has failed reasonably to supervise, with a view to preventing violations of the provisions of "the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Commodity Exchange Act, the Investment Advisers Act of 1940, the rules or regulations under any of those statutes or the rules of the Municipal Securities Rulemaking Board." The Section further provides that "no person shall be deemed to have failed reasonably to supervise any person if - there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with." Particular controls will vary from adviser to adviser, depending on factors such as size, method of operation, internal structure, and type of client (e.g., mutual funds). However, certain principles will govern the creation of any adviser control system.

The purpose of a compliance program is to prevent and detect violations of federal and state securities laws, and to ensure that the investment adviser's fiduciary responsibilities are carried forth. Therefore, the adviser should maintain and enforce procedures and have systems providing safeguards against inadvertent violation of laws, rules and regulations, and against those employees who may be tempted to engage in improper conduct. In addition, the state(s) in which the firm is registered may impose supervisory responsibilities.

E. Nonpublic Information

Section 204A of the Investment Advisers Act of 1940 requires that every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser. The SEC, as it deems necessary or appropriate in the public interest or for the protection of investors, has adopted rules or regulations that require specific policies or procedures reasonably designed to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934 of material, nonpublic information.

F. Personal Trading

The personal trading and investment activities of employees of investment advisory firms are the subject of various federal securities laws, rules and regulations. Underlying these requirements is the fiduciary capacity in which an investment adviser acts for clients. A fiduciary has a duty of loyalty to clients which requires that the adviser act for the best interests of the clients, disclose any conflicts of interests and always place the clients' interests first and foremost. When investment advisory personnel invest for their own accounts, conflicts of interest may arise between the client's and the employee's interests. The conflicts may include taking an investment opportunity from the client for an employee's own portfolio, using an employee's advisory position to take advantage of available investments, or front-running, which may be an employee trading before making client transactions thereby taking advantage of information or using client portfolio assets to have an effect on the market which is used to the employee's benefit.

The securities laws and regulations that cover the personal trading and investment activities of advisory personnel include: a) the anti-fraud provisions (Section 206) of the Advisers Act which prohibits any scheme, practice, transaction or a course of business that operates as a fraud or deceit on a client; b) Form ADV and Rule 204-3 requirements which provide that an adviser disclose its practices and its interests in client transactions among other things; c) recordkeeping requirements (Rule 204-2(a)(12) of the Advisers Act) for the personal trading of advisory representatives, and d) requirements for a code of ethics for advisers to investment companies.

G. Trading Practices

Investment advisers are required to have order memoranda (trading ticket) that meet minimum SEC requirements. In addition, SEC examiners routinely ask for files and documentation relating to trading errors and any written procedures regarding trading and/or allocation; the examiner may then attempt to determine if these procedures are being followed. Trading practices must be fair to customers, with a fair and reasonable allocation system. Trading encompasses fiduciary obligations, best execution, soft dollar and other issues. The auditor should review the adviser's trading practices to ensure that the traders are adhering to the firm's policies.

A registered investment adviser may not, directly or indirectly, either as principal for their own account or as broker-dealer for a third party sell securities to or purchase securities from a client account unless (i) the adviser provides specific disclosures in writing to the client and (ii) receives the client's consent prior to the transaction. In addition to principal trade disclosures there are also specific requirements related to agency cross transactions that the auditor should review if the adviser engages in this type of trading.

As fiduciaries, investment advisers are required to put their clients' interests ahead of their own. This duty is especially evident when it comes to correcting errors made in placing trades for client accounts. As part of a standard examination of an investment adviser, an SEC or state examiner will typically review trading errors to determine if the client was in any way disadvantaged in the error-correction process.

H. Soft Dollars

The SEC has issued an interpretive release (Release 34-23170 4/23/86) on Section 28(e) of the Securities Exchange Act of 1934 with respect to soft dollars. Section 28(e) provides a safe harbor for persons who exercise investment discretion over accounts to pay for research and brokerage services with commission dollars generated by account transactions. Money managers have disclosure obligations concerning brokerage allocation practices and the use of commission dollars. The controlling principle to be used to determine whether something is research is whether it provides permissible assistance to the money manager in the performance of his investment decision-making responsibilities. Section 28(e) requires the money manager to make a good faith determination that the value of research and brokerage services is reasonable in relation to the amount of commissions paid. Where a product/research has a mixed use (research and non-research), a money manager should make a reasonable allocation of the cost of the product according to its use. The portion that provides assistance to a money manager in the investment-decision making process may be paid for in commission dollars, while those services that provide administrative or other non-research assistance to the money manager (such as computer hardware, management systems integrating trading, execution, accounting, recordkeeping and other administrative matters, such as performance measurement) are outside the section 28(e) safe harbor and must be paid for by the money manager using its own funds.

An adviser shall not be deemed to have acted unlawfully, or to have breached a fiduciary duty by reason of causing an account to pay more than the lowest available commission, if the adviser determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided. Conduct outside of the safe harbor of Section 28(e) may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities laws. The focus, for the auditor, should be to determine whether the product or service provides lawful and appropriate assistance to the adviser's investment decision-making process.

I. Advertising

Rules promulgated under Section 206(4) of the Advisers Act pertain to "advertisements." The SEC has defined advertisements to include any written communication directed to more than one person, or any notice or other announcement in any publication or by radio or television which offer any analysis, report or publication concerning securities or used to determine when to buy or sell securities or which securities to buy or sell; or any graph, chart, formula or other device used to determine when to buy or sell any securities or which securities to buy; or any other investment advisory service. In addition, there are also specific requirements for the use of performance information in any advertising or marketing materials.

II. AUDIT OBJECTIVES

The general objectives of an investment adviser audit should include but not be limited to the following:

- Determine the adequacy and reasonableness of the adviser's books and records to ensure that they maintain accurate and current information relating to the investment adviser's business consistent with regulatory requirements.
- Determine that written policies and procedures are maintained and updated accordingly and that they accurately reflect the adviser's current operations. (In addition, ensure that these procedures cover principal and agency cross trades in advisory accounts.)
- Verify that Form ADV Part II or certain written disclosure statements are provided to the clients in a timely manner and that all written agreements (or copies thereof) entered into by the investment adviser with any client conform to the appropriate provisions of the Advisers Act. (The Advisers Act requires that the advisor maintain records that disclosure statements are provided to new clients and annually offered to all clients.)
- Determine that the adviser is properly registered with the SEC or states and where required and that once registered, the adviser complies with the regulations promulgated under the Advisers Act.
- Verify the accuracy of all disclosures (Form ADV Part I and II or other disclosure brochure) made to the public and ensure that they accurately reflect the adviser's current businesses, personnel and policies.
- Determine the fiduciary nature of the relationship between the investment adviser and its client and ensure that it is intended to "eliminate, or at least expose, all conflicts of interest which might influence an investment adviser — consciously or unconsciously — to render advice which was not disinterested."
- Determine that the fiduciary duties of the investment adviser include the provision of advice that is suitable for the client, and that full disclosure of all material facts and potential conflicts of interest are disclosed. In addition, determine that the adviser provides the utmost and exclusive loyalty and good faith, best execution of client transactions, and the exercise of reasonable care to avoid misleading clients.
- Determine that a compliance program is in effect to prevent and detect violations of federal and state securities laws, and to ensure that the investment adviser's fiduciary responsibilities are carried forth.
- Determine that the adviser maintains and enforces supervisory procedures and has the appropriate systems that provide safeguards against intentional or inadvertent violation of laws, rules and regulations, and against those employees who may be tempted to engage in improper conduct.
- For managed accounts, determine that a compliance program is in effect to prevent and detect violations of investment guidelines/ restrictions as per firm policy or client specifications.
- For mutual funds, determine that a compliance program is in effect to prevent and detect violations of investment requirements/ restrictions as per the fund's prospectus.

III. RISKS

- The major basis for judging investment manager performance is the "prudent man" rule that states "an investment manager satisfies investor protection requirements if, investing customer assets, he is acting as a prudent man would." In addition, under ERISA, delegated fiduciaries must discharge their duties solely in the interest of the participants and beneficiaries (see ERISA section 404(a)(1). Risk exists when an investment manager invests in a product that is clearly unsuitable or fails to diversify assets for an investor (e.g. puts fifty percent of a conservative retirees assets into a managed commodity fund).
- States as well as the federal government (SEC) exercise regulatory authority over investment advisers and are increasing reporting and licensing requirements and examination visits to enhance investor protection. Firms face regulatory risk if they fail to comply with a patchwork of state regulations as well as SEC rulings.

- Firms face regulatory risk if they do not have the appropriate compliance systems in place that provide safeguards against intentional or inadvertent violations of federal and state securities laws, rules and regulations, and if they do not have an independent party (e.g. Compliance Department) that develops, implements, and verifies control procedures to ensure that the firm resolves all areas of weaknesses identified in previous SEC/State examination reports.
- Firms also face risk if they do not comply with the extensive disclosure requirements, rules for calculating financial measures (e.g. returns, yields, net asset values), investment limitations, and regulations relating to credit quality of money market investments. In addition, the firm may face certain risks if their stated policy is to comply with AIMR performance presentation standards and these standards are not followed. It should be noted that performance records and disclosures are an area of regulatory interest.
- A good reputation for making clients money is a critical factor for a firm in the asset management business. Many published sources rate the performance of investment managers. The result of these reports can cause customers (particularly the more sophisticated ones) to move their assets to get a better return.
- Firms manage conflict of interest risk by establishing procedures for authorized personnel to approve all recorded transactions and activities and developing written supervisory directives and responsibilities that are periodically updated to reflect current practices.
- The sales practices of brokers is a major source of risk. Controlling the sales practices of registered representatives who maintain an investment advisory business is critical. Therefore two risks that may result from brokers' sales practices are (1) the sales reps may select an unsuitable product for a customer and (2) the sales rep may (knowingly or unknowingly) misrepresent product features, performance risks or returns.

IV. CONTROL POINTS

- Books and records relating to the investment adviser's business are accurate and current.
- Written disclosure statements and agreements are provided to the clients in a timely manner and conform to the appropriate provisions of the Advisers Act.
- Registrations or notification filings for the firm and registrations for investment adviser representatives have been filed with the appropriate Federal or State governing authorities.
- Disclosures made to the public are accurate and timely and reflect the adviser's current operations.
- A fiduciary relationship exists between the investment adviser and its clients which requires disclosure of all material facts and potential conflicts of interest.
- The appropriate compliance program/systems and sanctions are in effect that provide safeguards against intentional or inadvertent violation of federal and state securities laws, rules and regulations, and against those employees who may be tempted to engage in improper conduct.
- To ensure that investment advisers and funds are properly registered, controls should be implemented to prevent/detect investment advisers from initial or ongoing servicing of clients and/or from selling shares in states in which they are not registered.
- Supervisory directives and responsibilities are in writing and are periodically updated to reflect current practices.
- Appropriate segregation of duties exist between management, traders, support and legal/compliance personnel.
- Systems utilized have proper control functions.

V. AUDIT PROCEDURES

1 Books and Records

Section 204 and Rule 204-2 provide that investment advisers "...shall make and keep true, accurate and current..." certain listed books and records relating to the investment adviser's business. Paragraph (e) of the rule specifies the books and records which all investment advisers are required to keep. The internal auditor should ensure that each of the records required under Rule 204 (2) of the Act are maintained by the firm.

Since certain registered broker-dealers and members of national securities exchanges must maintain specified standards of financial responsibility under the Commission's Rule 15c3-1 of the Securities Exchange Act of 1934 or applicable rules of the exchanges of which they are members, the rule exempts from its requirements registered broker-dealers subject to and in compliance with the Commission's Rule 15c3-1 by paragraph (b) (2) of that Rule, provided that "such broker-dealer is in compliance with all rules and settled practices of such exchange imposing requirements with respect to financial responsibility and the segregation of funds or securities carried for the accounts of the customers."

If an investment adviser has custody or possession of securities or funds of any client, the records required to be made and kept above shall also include:

- A journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for such accounts and all other debits and credits to such accounts.
- A separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each such purchase and sale, and all debits and credits.
- Copies of confirmations of all transactions effected by or for the account of any such client.
- A record for each security in which any such client has a position, which record shall show the name of each such client having any interest in each security, the amount or interest of each such client, and the location of each such security.

1. Obtain the adviser's list of clients by account number. (If the list does not identify accounts which may be traded on a discretionary basis, obtain from the adviser a list of such accounts.)
2. Select a sample of client accounts from this list to be reviewed. (Two samples should be selected, one for discretionary accounts and one for all other accounts.)
3. Obtain the customer statement for the accounts selected. Select a sample of transactions from these statements to be reviewed.
4. Obtain the customer files for the selected accounts and review the written advisory contracts plus all other written contracts or account documents.
5. Obtain the order tickets for the transactions selected above, and review the tickets to determine that the following information has been noted:
   a) identity of the person who recommended the transaction
   b) identity of the person who placed the order
   c) date order was entered
   d) account for which the order was placed (name and account number)
   e) any modifications or cancellations of the original order
   f) a designation if the order is discretionary (or whether solicited or non-solicited if a non-discretionary advisor)
   g) the terms and conditions of the order
   h) identity of the broker/dealer
   i) whether the order is a "principal" transaction. (For testing of principal trades - see principal trades section.)
6. Test documentation supporting modification or cancellation of the order by:
   a) Reviewing the adviser's error reports and determining that each has been sequentially numbered, that no numbers in the sequence have been omitted, that each has been properly approved, and that an adequate explanation has been given.
      i) Trace the amount of each error report to the adviser's error account, and determine that all items on the account are supported by an error report.
   b) For each of the customer statements for error corrections, trace each error correction noted on the customer statement to the supporting documentation.
7. Test compliance regarding the maintenance of written communications by performing the following (originals are required):
   a) Obtain a copy of the procedures used to monitor compliance.
   b) For a sample of the transactions selected review the customer file for documentation to support:
      (i) a recommendation to buy or sell
      (ii) cash receipts or payouts
      (iii) security receipts or deliveries
      (iv) statements for custodians
   c) Review the customer files or complaint file and any other related files in their entirety to determine if all complaint letters are on file.
8. Obtain a copy of all mailings or communications offering the adviser's services and either a copy of the list of addresses or a description of the list and its source.
   a) Review each written communication that recommends the purchase or sale of a specific security, to determine that it contains the reasons for the recommendation or has a background memorandum which states the reasons.

9. Obtain a copy of the procedures used to identify and report securities in which the firm or the adviser has acquired a beneficial ownership, and a copy of each quarterly report completed.
    a) Test the propriety of each report by determining that all required information has been included, and by tracing sample items selected at random to the report.
10. Obtain a copy of the procedure used to maintain a copy of each written disclosure statement (Form ADV or other disclosure brochure) given to present or prospective clients, plus a record of the date on which each was given or offered on an annual basis.
    a) Document annual offer of Form ADV.
11. Evaluate the compliance program in effect to prevent and detect violations of investment guidelines/restrictions as per firm policy or client specifications for managed accounts.
12. Evaluate the compliance program in effect to prevent or detect violations of investment requirements/restrictions as per the mutual funds' prospectus where applicable.
13. Obtain a copy of records for all terminated accounts and the dates of termination.
    a) Ensure written documentation is on file from the customer requesting the termination.
    b) Ensure that the account is terminated in a timely manner in accordance with the adviser's policies and procedures.
    c) Determine that any fees paid to the adviser prior to termination are refunded to the customer and documentation is maintained supporting the calculation of the refund.

2. Custody of Client Funds [Rule 206 (4)-2]

A registered broker-dealer may be considered exempt from Rule 206 (4)-2. The following requirements and procedures are applicable to audits of investment advisers who are not broker-dealers and, as such, are not exempt from Rule 206 (4)-2. The auditor should review the adviser's files to determine that:

1. Each client's securities are kept segregated, marked to identify each client, and held in safekeeping free from risk of destruction or loss.
2. All clients funds are deposited in one or more bank accounts:
    (i) which contain only client funds,
    (ii) in the name of the adviser as trustee for the client, and
    (iii) the adviser must maintain a separate record showing the name and address of the bank, dates and the amounts of deposits and withdrawals, and the exact amount of each client's beneficial interest in such account.
3. All clients are notified in writing immediately after the adviser accepts the client funds, of the place and manner where the client's assets will be maintained; clients must be further notified of any changes in these arrangements.
4. The adviser sends to all clients not less frequently than once every three months an itemized statement showing the client's assets in the adviser's custody at the end of the period, and all credits and debits during the period.
5. All funds and securities are verified by actual examination at least annually in an unannounced inspection by an independent public accountant.

    [A certificate describing the annual examination and the results thereof must be filed with the SEC.]
6. All arrangements are disclosed that may deem the adviser to have custody. (The adviser may be deemed to have custody by directly debiting the advisory fees from client accounts, acting as a trustee for an advisory account, acting as a general partner for an investment partnership or certain other situations.)
7. Foregoing the rule and 1-6 above do not apply if the adviser is also registered as a broker-dealer and
    (i) subject to and in compliance with Rule 15c3-1 or
    (ii) if the broker-dealer is a member of a securities exchange whose members are exempt from 15c3-1 and the broker-dealer is in compliance with the exchange rules regarding financial responsibility and segregation of client funds.

3. Preservation of Records

1. Ascertain whether or not the adviser's books and records are retained in an easily accessible location for a period of not less than five years. In addition, the auditor should ensure that the records are located in the adviser's office for the last two years.
2. Obtain copies of any log which indicates the location of these books and records.
3. Review the log(s) to determine that all records, which are to be retained, are included on the inventory.

4. Physically observe to insure the following:
   a) Two year's worth of records are in the office of the adviser.
   b) The adviser has means for viewing microfilm (or other forms of stored documentation) and producing a hard copy on the premises.
   5. Review the physical safeguards over computer records; determine their adequacy and that backup is stored offsite.
   6. Inquire about inactive adviser services and the location of records for such services.
   7. Ascertain that the adviser has an adequate business contingency plan in effect.
      a) Obtain a copy of the plan and ensure that it is current and that it addresses all of the relevant areas of the adviser's operations.
      b) Ensure that all personnel are familiar with the plan.

4. Reporting Requirements [Rule 204-2]

1. Inquire about any changes in the adviser's activities or personnel that might make its Form ADV inaccurate.
2. If the information contained in an application for registration as an investment adviser (or in any amendment thereto), becomes inaccurate for any reason, the adviser must promptly file an amendment on Form ADV correcting such information.
   a) Obtain the most recently filed Form ADV Part I and II (Schedule I) and ensure that they contain updated information pertinent to the adviser.
   b) Ascertain that it was filed with the SEC within 90 days after the end of the adviser's fiscal year.
3. Determine if there are any reporting responsibilities for 13(f) 13D or 13G Reports.
4. Review any regulatory, disciplinary and litigation item if it is required to be reported.

5. Written Disclosure Statements [Rule 204-3]

Rule 204-3 under the Advisers Act requires registered investment advisers to provide certain written disclosure statements (Form ADV Part II or other disclosure brochure containing at least, the information required in Form ADV Part II) to their clients and prospective clients. *A thorough review of the adviser's disclosure statement should constitute an important portion of an IA review not only because it is a major requirement of the Act but also because it provides an unambiguous record as to some of the representations and required disclosures the adviser has made to his clients and prospective clients.*

1. Obtain a copy of the disclosure statement currently in use.
2. Examine the brochure furnished each client and prospective client to determine if it contains at least the following information:
   a) advisory services and fees (including negotiated fees) — a description including the basis of compensation;
   b) types of clients — types of clients for which the adviser generally provides investment advice;
   c) types of securities — types of securities concerning which the adviser generally provides investment advice;
   d) methods of analysis, sources of information, allocation procedures and investment strategies;
   e) education and business standards — general standards of education and business background which the adviser requires of their employees; (other than employees whose function are solely clerical or ministerial);
   f) education and business background — adviser must set forth the name, age, formal education after high school, and, for the preceding five years, the business background of each advisory representative who determines or approves investment advice to clients;
   g) other securities industry activities (i.e. if the adviser is registered as a broker-dealer, etc.).
3. If the adviser uses a brochure other than the Form ADV Part II compare the information contained in the disclosure statement to Form ADV Part II for consistency, accuracy and completeness.
4. Verify that the representations made in the disclosure statement concerning the manner in which the adviser conducts business are consistent with the adviser's day-to-day methods of operation.
5. Determine procedures for supplying current or potential clients with the disclosure statement.
   a) Indicate the individual responsible for providing clients with the disclosure statement.
   b) Indicate the individual(s) responsible for reviewing and insuring that the disclosure statements have been sent to and received by the client.

6. Review the customer file for each of the accounts selected, and document that each of these accounts has been furnished with a brochure:
   a) within 48 hours of entering contract or at time of entering contract, if the client has a right to cancel within five days, by reviewing the new accounts checklist, and
   b) annually offered a brochure (when offered annually, it must be delivered within seven days of receipt of a client's request.)
   7. If the adviser sends information via electronic delivery, review the procedures in place to monitor and control this form of delivery. In addition, ensure that the adviser conforms to SEC interpretive releases relating to the delivery and disclosure requirements through the use of electronic media.
   8. If the adviser sponsors or offers a wrap fee product, review the Schedule H Wrap Fee Disclosure Document.

6. Contracts (Investment Advisory Agreements) and Fees — [Section 205]

1. Review selected customer files and the investment advisory contracts and agreements, powers of attorney, and other applicable forms, to determine that they do not provide for compensation based on a share of capital gains or appreciation.
   a) If compensation is based other than on a percentage, document how compensation is calculated and consult the Compliance Department.
2. Determine how the firm calculates its investment advisory fees and insure that any and all calculations are permissible within the Act.
3. Obtain the fee schedule and a listing of all client fees and commissions.
4. Recalculate fees to ensure that they are accurate and agree to the customer's investment adviser's agreement.
5. If the advisory fee is excessive (e.g. 3% or more), obtain documentation that it was approved by the Compliance Department.
6. Determine whether or not pro-rata refunds of pre-paid advisory fees are provided when requested.
   a) Obtain a listing of terminated contracts, and test to ensure that pro-rata refunds were made in accordance with the appropriate stated policy.
7. Determine whether or not the investment advisory contract has a provision which:
   a) states all fees are non-refundable,
   b) states contracts cannot be assigned by the adviser without consent of the client.
8. Ensure that the investment advisory contract does not include hedge clauses that implies that the client has waived their right to certain legal remedies. (A hedge clause might create in the mind of the investor a belief that he has given up some legal rights and has waived or precluded from a remedy which he might otherwise have.)
9. Performance fees are prohibited if they are based on the adviser's success in managing its clients' money (e.g. sharing in capital gains and capital appreciation of a client's funds). If performance fees are allowed, the auditor should review the customer's investment adviser agreement and related portfolio account to ensure that this practice is permissible within Section 205 (a) (1) of the Advisers Act. In addition, the accounting procedures should be reviewed to ensure that performance based fees are not recognized into P & L for one year.
10. Determine if the adviser provides for fulcrum fee arrangements. (Fulcrum fee arrangements provide for a fee averaged over a specified period of time that increases or decreases proportionately with the investment performance of the client's account in relation to the investment record of an appropriate securities index). Although rare, these fees are permitted in the case of registered investment companies and in the case of certain other clients where the contract relates to over $1 million in assets. Ascertain that the adviser complies with the appropriate provisions of Rule 205-1 and 205-2 respectively. (There should be no hedge clauses limiting the adviser's liability).
11. For all new customers review the date that the contract was signed by the customer and the date the contract was accepted by the firm. Ensure that the firm did not start charging the customer their quarterly fee until after the date the contract was accepted by the firm. If the fee is prorated, recalculate the fee to ensure that it was calculated correctly.
12. If customers have affiliated mutual funds in their portfolio, review a sample of the quarterly fees charged to these customers to ensure that the affiliated mutual fund market values are subtracted from the customer's total portfolio value when computing the quarterly fee. This is permitted for ERISA accounts and under SEC guidelines it must be disclosed to the client that they will be paying two advisory fees and a description of the fees and expenses can be obtained in the prospectus for each mutual fund. (SEC No-Action letter Hornor Townsend and Kent 4/4/95)

7. *Referral Arrangements [Rule 206(4)-3]*

Many regulatory questions are raised by referral arrangements, those practices pursuant to which an investment adviser compensates someone who has referred clients to the adviser. When cash referral fees are involved, the problem areas include obtaining proper agreements and disclosures, adequate disclosure of the arrangement to the prospective client and ensuring that the adviser properly supervises the solicitation activities of his solicitor. When the referral fee is being paid to a broker-dealer, these same concerns are present. It should be noted that it is unlawful for an adviser to pay a fee directly or indirectly, to anyone for soliciting clients unless:

- a) the adviser is registered; b) the solicitor is not subject to a statutory disqualification; and c) the solicitation fee is paid pursuant to a written contract describing the terms of the compensation, the relationship between the adviser and the solicitor and certain other information and, d) written disclosure is provided to any solicited client.

1. Determine whether or not clients are obtained by third-party solicitation.
   - a) If so, obtain a listing of all authorized third-party solicitors, and test to ensure that one copy of the agreement with the individuals is retained which details the referral fee arrangements and the solicitation procedures; and that a copy of the solicitor's disclosure document is available.
   - b) Obtain a listing of all clients obtained through a third party arrangement and review applicable customer files for:
     - (i) copies of disclosure documents sent to the client by both the adviser and the solicitor and the client's written acknowledgment of receipt of the adviser's ADV Form Part II and solicitor's disclosure document,
     - (ii) any soft dollar arrangement,
     - (iii) additional expenses incurred because securities are directed to a specific broker.

8. *Personal Security Trading*

Under the books and records section of the Advisers Act (Rule 204-2 (a) (12) and (13)), investment advisers are required to maintain specific records, of the personal securities transactions of their firm, its officers, directors and employees, the spouses, minor children, and members of the households of those officers, directors and employees, as well as any securities transactions in which an officer, director or employee may have a direct or indirect beneficial interest. The rules require the reporting of all securities transactions, including listed, unlisted securities, private transactions (which include private placements, non-public stock or warrants) and securities which are not custodied (held in certificate form) in these personal reports. (It should be noted that transactions in securities which are direct obligations of the United States do not need to be reported, nor do transactions in affiliated or unaffiliated, open-end investment company shares (mutual funds), or interests in variable insurance products or variable annuities, whether affiliated or unaffiliated.

1. Determine that a system for review of personal securities transactions for all officers, directors and employees with access to investment information, and their immediate families has been implemented and maintained to determine if employees are trading on the market impact made by recommended transactions.
2. Obtain a listing of all officers, directors and employees in the department. In addition, identify all employees who are registered representatives actively engaged in servicing retail brokerage accounts.
3. Obtain a listing of all retail accounts in the name of those identified in step 1, above, or in which they hold a beneficial interest.
4. Obtain a listing of the restricted trading lists.
5. Determine whether or not any members of the department are permitted to trade in securities for their own accounts.
6. Ascertain that a signed acknowledgment and agreement to comply with the adviser's requirements is on file for all employees.
7. Ascertain that there are adequate internal procedures to supervise and monitor the reporting of securities transactions made by members of the department on their own behalf.
   - a) Obtain a copy of the procedures.
   - b) Identify who is responsible for performing this function.
8. Determine whether the adviser has a Code of Ethics. Review the guidelines/procedures set forth in the adviser's Code of Ethics and test to ascertain that the adviser is adhering to said procedures.
9. Review the adviser's employee file to determine that information related to every transaction includes the:
   - a) title and amount of the security involved;
   - b) date of the transaction;
   - c) nature of the transaction (purchase or sale);

d) price at which the trade was effected;

e) name of the broker-dealer or bank that executed the transaction.

10. Determine that this information is recorded not later than 10 days after the calendar quarter in which effected.

11. Determine that restrictions placed on the personal trading activities of specific employees are consistent with the restrictions described in the adviser's Form ADV (Item 9, Part II).

12. Review the procedures in place to prohibit the use of material non-public information (i.e., inside information Section 204A):

    a) to determine if employees traded against recommendations contained in firm publications.

    b) to determine if the adviser or its "advisory representatives" traded against securities transactions effected for managed or supervised accounts.

13. Ensure that an insider trading policy memorandum has been signed by all advisory personnel.

14. Review the restricted trading lists obtained in Step 3, above, and test to insure that customer's trades were not made against the restricted list.

9. Principal Trading

A registered investment adviser may not, directly or indirectly, either as principal for their own account or as broker-dealer for a third party sell securities to or purchase securities from a client account unless (i) the adviser first makes certain disclosures in writing to the client and (ii) receives the client's consent prior to the transaction. (This also applies to transactions done with an affiliated broker-dealer.)

1. Determine whether or not the adviser, directly or indirectly, either as principal for their own account or as a broker-dealer for a third party sells securities to or purchase securities from a client account.

2. If principal transactions are permitted, verify that for each separate principal transaction the adviser has disclosed (at a minimum):

    (i) The capacity in which the adviser proposed to act.

    (ii) The cost to the adviser of any security which it will sell to the client (or estimated resale price of the security it proposes to buy).

    (iii) The best price at which the transaction could be effected by the client elsewhere, if such a price is more advantageous to the client than the actual purchase or sale price.

    (iv) All disclosures as to costs, prices, and profit expressed clearly in dollars and cents, and not in terms of a percentage or other formula.

    (v) This disclosure and consent must be made before the completion of the transaction and received for each separate principal transaction.

10. Agency Cross Transactions

At times situations can occur in which it may be beneficial to an advisory client for the firm to execute a client's trade by "crossing" such trades with securities transactions of the firm's non-advisory clients. However, the disclosure and consent requirements with respect to principal transactions do not apply as to agency cross trades. However, the SEC has adopted Rule 206(3)-2 which sets forth the conditions that must be satisfied in order to effect these types of transactions. Therefore, if the firm engages in agency cross transactions the auditor should review the adviser's records to ensure the following:

(i) The advisory client has prospectively authorized the agency cross transaction in writing;

(ii) The firm has disclosed in writing the capacities in which it will act and the potential conflict of loyalty and responsibility it may face in effecting agency cross transactions.

(iii) Each agency cross transaction has been confirmed to the client in writing.

(iv) The account statements received by the advisory client discloses that the client may terminate the authorization provided to the firm to effect agency cross transactions at any time by written notice to the firm; and

(v) The advisory client has been provided with an annual summary of all agency cross transactions effected in his/her advisory account.

(vi) Agency cross transactions have not been effected in ERISA accounts.

11. Trading Errors

As fiduciaries, investment advisers are required to put their clients' interests ahead of their own. This duty is especially evident when it comes to correcting errors made in placing trades for client accounts. As part of a standard examination of an investment adviser, the internal auditor should typically review trading errors to determine if the client was in any way disadvantaged in the error-correction process.

1. Review the adviser's supervisory procedures to ascertain that the procedures for correcting trading errors are in place.
2. Review the adviser's file documenting the correction of trading errors. (The creation of such a file allows the adviser to periodically review all trading errors for a particular time period to ensure that they were handled quickly and correctly.)
3. Determine that when the adviser corrected an error, the client has not been disadvantaged. (The client must be "made whole.")
4. Ascertain that soft dollars have not been used to pay for correcting the adviser's trading errors.
5. Review the adviser's error-correction procedures to determine if, in correcting the error, an agency-cross transaction had not occurred. However if the auditor believes that such a transaction is warranted, the auditor should be sure that all proper disclosures are made and consents obtained, as required in Section 206(3)-2 of the Advisers Act.

12. Trade Allocations

The SEC believes an adviser may be dealing unfairly with clients in violation of Section 206 of the Advisers Act if it does not allocate securities among clients in a fair and equitable manner. Therefore, an investment adviser may not allocate trades in such a way that the adviser's own or personal account(s) receive a more favorable treatment than the adviser's client. As part of the internal auditor's review, the following should be addressed:

1. Ascertain that there is a written policy for the allocation of securities and recommendations.
2. Ensure that the policy details a formula or program for the allocation of securities and recommendations in a fair and equitable manner.
3. Select a sample of securities and recommendations that have been allocated for adherence to stated policy and procedures.
4. Review recent SEC No-Action letters for additional guidance (e.g. SMC Capital, Inc. - 9/5/95)

13. Soft Dollars

Section 28(e) provides a safe harbor for persons who exercise investment discretion over accounts to pay for research and brokerage services with commission dollars generated by account transactions. Money managers have disclosure obligations concerning brokerage allocation practices and the use of commission dollars. The controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities. Section 28(e) requires the money manager to make a good faith determination that the value of research and brokerage services is reasonable in relation to the amount of commissions paid.

1. Review the adviser's files to determine that adequate books and records concerning allocations between investment research and administrative matters (mixed use of research services) are kept. This includes current executed contracts on file.
2. Ensure that soft dollar practices and the nature of soft dollar services are appropriately disclosed in Form ADV Part II.
3. Determine the procedures in place to ensure that the adviser periodically and systematically evaluates the execution performance of broker-dealers executing their transactions.

14. Supervision

1. The auditor should review the adviser's operations to be sure that they comply with the requirements of the various securities laws - federal and state - as well as other applicable laws and regulations (e.g., ERISA; Investment Company Act if adviser advises mutual funds) and should use this information to evaluate, create and document a system of controls.
2. Review the adviser's procedures currently in place to educate its personnel so that they understand the policies and procedures that make up the controls and understand their responsibility to follow those policies and procedures.
3. Review the compliance program adopted by the adviser that provides reasonable assurance that its policies and procedures are being followed and are effective. (The Insider Trading and Securities Fraud Enforcement Act of 1988 requires investment advisers to create, maintain, and enforce written supervisory procedures designed to prevent the misuse of non-public information.)
4. Some states require an adviser to have written procedures in place. Therefore, the auditor should ascertain that if the adviser is registered in the appropriate states, the adviser has

supervisory procedures designed to prevent the misuse of non-public information. (The SEC has indicated that with such procedures and a system for applying the procedures in place, no person will be deemed to have failed reasonably to supervise - thus, offering some protection from disciplinary action by the Commission for failure to supervise.)

15. Advertising (Rule 206(4)-1

Advertising (or written communications) by advisers generally must not make use of:

- Testimonials (including unsolicited testimonial);
- References to anything less than all recommendations made by the adviser during the past year or more (and even then only if accompanied by sufficient explanatory information and cautionary statements);
- Claims that investment "formulas" can be used to make investment decisions, unless sufficiently qualified; and
- Any claim or statement that is false or misleading;

1. Obtain a copy of the adviser's brochure and two copies of all other marketing literature.
2. Determine if the adviser has used any type of projections, guarantees, hypothetical or model securities portfolios or comparisons of their service with any other service or market index that may violate the anti-fraud provisions of the Advisers Act.
3. Determine if any advertisement contains testimonials of any kind concerning the adviser, advice, analysis, report or other service rendered by the adviser.
4. Determine if any advertisement or marketing literature contains disclaimers as to the reliability and accuracy of the information furnished.
5. Determine that references are not made to anything less than all recommendations made by the adviser during the past year or more.
6. Ascertain that the adviser does not make claims that investment "formulas" can be used to make investment decisions, unless they are sufficiently qualified.
7. Refer to Clover Capital No-Action letter requiring the advertising of performance after the deduction of advisory fees (net fees) among other conditions. Also see Investment Company Institute No Action letter dated 9/23/88 about gross performance information in one-on-one presentations.

VI. REFERENCE MATERIALS

1. Clover Capital Management Inc. No Action Letter (Advertising) October 28, 1986. Securities and Exchange Commission Reply. File No. 801-27041.
2. The Cooper Companies, Exchange Act [Release No. 35082] Conduct of Board of Directors.
3. Federal Legislative Memorandums (1994-1998) Investment Company Institute, Washington, DC.
4. The Investment Advisers Act of 1940 ("Advisers Act"), Securities and Exchange Commission.
5. Lemke, Thomas; Lins Gerald., eds. (1998) *The Regulation of Investment Advisers* Clark Bordman & Callaghan.
6. National Regulatory Services, Annual Conference Materials, (miscellaneous articles and presentations) 1995-1998.
7. National Regulatory Services, Investment Adviser Compliance Manual, 1998.
8. Patrick v. Securities and Exchange Commission, U.S. Court of Appeals, Second Circuit, Docket No. 93-4148, March 22, 1994). Senior Management - Failure to Supervise.
9. Risk Management In The Securities Industry, SIA/IAD
10. SALOMON Enforcement Case [Release No. 34-31554, 12/3/92] Duties of Management-Failure to Supervise.
11. Securities and Exchange Commission v. Capital Gains Research Bureau, 1963, Fiduciary Responsibilities.
12. Securities Exchange Act of 1934, Securities and Exchange Commission.
13. The SEC release on soft dollars (Release 34-23170), Securities and Exchange Commission.
14. SEC letter to Charles Lerner, Director of Enforcement, Department of Labor, dated October 25, 1988, (Trading Errors) Securities and Exchange Commission.
15. Wolfson, Nicholas; Phillips Richard M., eds. (1993). *The Regulation of Brokers Dealers and Securities Markets*. Warren, Gorham & Lambert.

THIS GUIDELINE IS INTENDED TO PROVIDE MEMBERS OF THE INTERNAL AUDITORS DIVISION WITH INFORMATION FOR THE PURPOSE OF DEVELOPING OR IMPROVING INTERNAL AUDIT PROGRAMS. THE PROCEDURES CONTAINED IN THIS GUIDELINE CONSTITUTE MERELY ONE OF A NUMBER OF METHODS WHICH MEMBERS MAY CHOOSE TO UTILIZE. THE INTERNAL AUDITORS DIVISION RECOGNIZES THAT MEMBER FIRMS MAY CONDUCT THEIR BUSINESS IN COMPLIANCE WITH LEGAL AND REGULATORY REQUIREMENTS ALTHOUGH THEY MAY EMPLOY PROCEDURES WHICH DIFFER FROM THOSE CONTAINED IN THIS GUIDELINE. THE INFORMATION IS DESIGNED TO PROVIDE GUIDANCE TO MEMBER FIRMS IN THE PREPARATION OF PROCEDURES TAILORED TO THE SPECIFIC NEEDS OF THEIR INDIVIDUAL ENVIRONMENT.