

INVESTMENT ADVISER **Compliance Update**

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I. SEC ADOPTS REVISIONS TO CUSTODY RULE (a Summary)

The SEC has adopted amendments to Investment Advisers Act Rule 206(4)-2. The SEC also adopted interpretative guidance for independent public accountants in connection with the revised custody rule. The revised custody rule may require SEC registered investment advisers (subject to specific facts and circumstances) to: (1) have a reasonable belief that your clients' custodians directly send account statements to them; (2) engage an independent public accountant to conduct a surprise examination in 2010; (3) obtain or receive from an affiliated qualified custodian an internal control report in 2010; (4) include in the notice to clients required by the custody rule when you open a custodial account and upon changes, and in subsequent client account statements, a legend urging clients to compare account statements sent by the custodian with those sent by the adviser; (5) engage an independent public accountant that is registered with, and subject to inspection by, the PCAOB (Public Company Accounting Oversight Board), if you advise pooled investment vehicles and rely on the rule's annual audit provision, for audits of fiscal years beginning on or after January 1, 2010; and (6) Provide additional information on Form ADV regarding your custody practices (Form ADV revisions scheduled for Fall 2010).

The Amended Rule requirements become effective on March 10, 2010. Specific requirements include: (1) advisers and/or their reps that serve as trustee and/or have check writing authority will continue to be deemed to have custody under the Amended Rule. However, unlike the current Rule that provided exemptions for the surprise CPA examination requirements (i.e., statements sent by the unaffiliated qualified custodian directly to the grantor, beneficiary, client at least quarterly, etc), the Amended Rule now requires the adviser to annually engage an independent CPA to commence an initial annual surprise examination no later than December 31, 2010, and to file the corresponding initial Form ADV-E no later than April 30, 2011; (2) advisers that have physical custody of client assets (i.e., assets are not held by an unaffiliated qualified custodian) will be required to conduct a (a) surprise examination **and** (b) dependent upon whether or not the custodian and the adviser are "operationally independent", a custody control review conducted by a PCAOB accountant; and (3) an adviser to a private investment fund is not subject to either requirement so long as the fund assets are held by a unaffiliated qualified custodian and the fund provides an annual certified conducted by a PCAOB registered and inspected accountant.

Advisers that continue to maintain assets with an unaffiliated qualified custodian and debit their fees from such custodian will not be subject to the surprise exam or custody control review processes so long as qualified custodian continues to send account statements directly to the client, at least quarterly, that reflect the amount of the fee debit

Unfortunately, the SEC did not consider many issues that are germane to advisers (serving as Trustee for the adviser's own 401k plan, the impact of an unaffiliated Co-Trustee, passing on the expense of the surprise exam to the affected trust/client, etc.). The SEC has advised Stark & Stark that it intends to issue future guidance-the timing of which is uncertain. Also unfortunate is that like most Rules, the content can be quite confusing and is subject to nuance and very limited, but difficult to discern, exceptions.

Please Note: The above discussion is a Summary **only**. Should you have any questions regarding the applicability of the Amended Rule to your practice, we remain available to address same. Stark & Stark will continue to follow-up with the SEC to obtain further guidance to the extent it is willing to provide same prior to publication of its anticipated formal guidance.

II. COMPLIANCE WITH THE MASSACHUSETTS STANDARDS FOR THE PROTECTION OF PERSONAL INFORMATION OF RESIDENTS OF THE COMMONWEALTH (201 CMR 17.00)

As previously reported, Massachusetts statute 201 CRM 17.00, which went into effect on May 1, 2009, requires that every business that owns or licenses personal information of a resident of the Commonwealth of Massachusetts develop, implement and maintain a comprehensive **Written Information Security Program** (“WISP”) to protect the personal information of such persons. The statute establishes standards to be met by every business with personal information of a Massachusetts resident. The deadline for the implementation of a compliant security program is March 1, 2010.

The statute requires that the **WISP** designate at least one employee to maintain a comprehensive information security program. The program must identify and assess reasonably foreseeable risks to the security and confidentiality of every electronic or paper record containing personal information. The program must also self evaluate and improve. Several key points identified in the statute include the requirement that the **WISP** define security policies for the transportation of records containing sensitive information outside of the business and that any contracts with third-party services providers be entered into with appropriate measures in mind to protect sensitive personal information.

The **WISP** must also provide for technically feasible and economically reasonable computer security safeguards. The **WISP** must address secure user protocols; including basic security measures such as User IDs and identifiers, password requirements (length, character requirements, ect.) and restricted access points. The **WISP** must also define the business’ encryption policy, including the encryption of all personal information stored on portable devices or transmitted across public networks or via wireless networks.

Questions regarding the WISP should be addressed to Stephen A. Galletto at (609) 895-7394 or sgalletto@stark-stark.com

III. HAVE YOU PERFORMED AND DOCUMENTED YOUR “REQUIRED” SEC ANNUAL CHIEF COMPLIANCE OFFICER REVIEW

Please remember that pursuant to the requirements of Rule 206(4)-7, each advisory firm must have already completed an initial annual review of its compliance policies and procedures. The purpose of the review is to ascertain the extent to which the firm’s current policies, as well as the procedures implemented to effect the policies, require amendment. The review should be conducted by the Chief Compliance Officer, or his/her designee, who should consider the following four items in addition to other relevant issues:

- Compliance matters that arose during the previous year;
- Changes in the advisory firm’s business;
- Changes in the activities of any of the firm’s advisory affiliates; and,
- Changes in the regulations applicable to the advisory firm, including changes to the Investment Advisers Act of 1940, and Rules promulgated thereunder.

Please be cognizant that the SEC’s new focus on internal risk assessment could impact your firm’s policies and procedures. It is advisable that this annual review requirement be memorialized in an organized and coherent manner.

We prepare a proposed Annual CCO Review as part of performing mock audits.

IV. RISK ASSESSMENT AND THE SEC AUDIT – Are you Prepared for an SEC Examination?

As any RIA who has been through a recent SEC examination can attest, the SEC's latest document request lists takes a "one size fits none" approach by requiring the production of many items that are unfamiliar or inapplicable to most investment advisers. While many of these items are not required by the Adviser's Act, RIAs are well advised to comply with the requests rather than face the possibility of longer, more frequent SEC inspections.

Some of the items requested that have caused the most confusion for RIAs include questions regarding the "risk management process". Most investment advisers tend to think about risk in terms of investments and portfolio management. However, the SEC also requires that advisors assess risk relative to operational and compliance risks. We advise RIAs to perform an Annual Risk Assessment as part of its Annual CCO Review (*see* discussion below), each of which should be provided to the SEC during a regulatory examination.

We address these risk assessment matters (as well prepare a Risk Assessment) as part of performing mock audits.

V. THE IMPORTANCE OF A MOCK AUDIT -COMMON DEFICIENCIES FROM STARK & STARK MOCK AUDITS

As many of our clients are aware, Stark & Stark attorneys have conducted mock examinations throughout the United States and Canada for the past 20 years. Although the result of our examinations vary between firms, common deficiencies include:

- Substantive contradiction between key documents (ADV vs. Advisory Agreements vs. Policies & Procedures)
- Recordkeeping violations
- Questionable advertising practices (including website)
- Composite performance violations
- Failure to address previous exam deficiencies
- Insufficient and/or incomplete personal securities transactions documentation
- Violations of Codes of Ethics
- Inaccurate and/or Obsolete Form ADV disclosure
- Insufficient and/or obsolete Policies and Procedures
- Inaccurate and/or obsolete investment advisory agreements
- Firm registration and notice filing violations
- Investment adviser representative registration violations
- Weak internal controls that could lead to liability and/or regulatory exposure

We remind our clients that compliance is an ongoing responsibility. The rules that govern an adviser's activities are subject to change and we remain available to assist with internal compliance reviews or with resolving any compliance issues.

IMPORTANT: Mock audits conducted by non-law firms are subject to disclosure and/or turnover to state and federal regulatory authorities (including the SEC) and plaintiff's attorneys. Only audits (and written/verbal communications) provided by a law firm are privileged and thereby excluded from such turnover.

VI. IMPORTANT EMPLOYMENT-RELATED ISSUES FOR INVESTMENT ADVISERS

In these challenging economic times, many companies continue to face tough decisions regarding employee retention and layoffs. More and more, employers are contemplating the reduction of hours, reductions in salary and, in some instances, the use of furloughs to avoid the necessity of having to terminate employees. Such decisions, however, – even well intended ones – can be fraught with legal consequences. For example, the selection of employees for termination or reductions in force may give rise to wrongful termination claims. If facing layoffs and intending to offer severance, therefore, it is important to utilize a severance agreement that provides your company with the appropriate release to reduce and/or eliminate exposure to wrongful termination and other claims. Similarly, reductions in salary, work hours, and the use of furloughs could jeopardize the status of non-exempt employees or violate state wage and hour laws. Often any change in schedule/pay will require specific, advance written notice to employees and consideration of (and perhaps revisions to) existing employment agreements, policies and/or handbooks. With a minimal amount of advance review and consideration of available options, employers can minimize their risk of exposure to liability while optimizing the benefits provided by these often-difficult decisions.

As many continue to struggle, others are taking advantage of the marketplace to hire new employees, form new associations, or otherwise plan for future growth. As always, it is imperative to protect your company's most important assets – its clients, relationships and employees – with appropriate policies; including confidentiality and non-disclosure policies and agreements and, often, restrictive covenant agreements against competition and/or solicitation.

Whatever your business needs or directions, these times have brought considerable change to the employment landscape. Accordingly, it is wise to seek the advice of legal counsel prior to making or implementing decisions to layoff employees or alternative work policies to ensure compliance with relevant – and often changing – laws.

VII. THE IMPORTANCE OF SUCCESSION PLANNING

Stark & Stark has significant expertise in assisting investment advisory firms throughout the country with succession planning. Virtually all investment advisory firms should have an up-to-date Buy-Sell Agreement. A Buy-Sell Agreement should accomplish a number of important objectives for an investment advisory firm, including: (1) providing a mechanism for the orderly transfer of the business; (2) establishing a valuation mechanism which avoids disputes between owners as well as possible disputes with the Internal Revenue Service; (3) reducing possible disputes between owners, an owner's heirs, and possible unwanted business partners to whom an ownership interest in the company may otherwise be transferred; and (4) providing financial security to a deceased or disabled owner's family.

It is important that an investment advisory firm's Buy-Sell Agreement be reviewed periodically to make certain that it is properly customized to the needs of the investment advisory firm and its owners, as well as to make certain the agreement meets the requirements of current tax laws. Two of the most important areas of periodic review are the valuation provisions in the Buy-Sell Agreement and the funding of the buy-sell arrangement set forth in the Buy-Sell Agreement. Valuation formulas based upon earnings can become obsolete and should be updated periodically based upon changes in a company's accounting and compensation practices. Funding of the buy-sell arrangement should also be periodically updated to avoid a situation where there is a gap between the value of the company and the available funding.

Another aspect of the Buy-Sell Agreement that should be reviewed periodically is the agreement's structure. Typically, Buy-Sell Agreements are structured as either a redemption agreement, a cross-purchase agreement, or hybrid agreement. It is important to review the structure of a Buy-Sell Agreement to determine if a different structure would be more beneficial in light of the corporate alternative minimum tax on life insurance proceeds. In addition there are also basis considerations to take into account when reviewing the structure of a Buy-Sell Agreement, in order to avoid serious income tax consequences.

Lastly, a periodic review of a Buy-Sell Agreement should include a careful review of the triggering events which either allow or require a transfer of ownership. While most Buy-Sell Agreements adequately deal with the death of an owner, it is equally as important to make sure that the Buy-Sell Agreement adequately covers other triggering events such as disability, voluntary termination of employment and involuntary termination of employment.

When reviewing a Buy-Sell Agreement, it is important to take into account the unique needs of each investment advisory firm, the existing relationships between owners, as well as the individual functions of each owner. It is also important to do an analysis of the underlying economics of the investment advisory firm when considering an update of Buy-Sell Agreement. If you have any questions about Succession Planning and/or Buy-Sell Agreements, or if you would like us to review your existing Buy-Sell Agreement to determine whether any updates are needed.

VIII. HAS YOUR CLIENT SUFFERED LARGE LOSSES AT ANOTHER FIRM?

Many investors seek to change investment professionals after having suffered losses at another firm (usually a wirehouse). Stark & Stark may be able to help. Our Securities Arbitration Practice Group (which generally **defends** investment industry professionals) will review and may pursue customer claims if referred to us by our clients, **and** it is **clear** that assets were not invested consistent with designated written investment objectives and/or investments were purchased that were **clearly** unsuitable. We generally limit this representation to substantial cases involving \$500,000 or more in damages.

IX. PRIVACY AND CLIENT INFORMATION SECURITY

A recent regulatory audit resulted in a comment as to the frequency with which an adviser's employees change the passwords they use to access the company network. The true gravity of this comment is found not at the superficial level where the guidance is that passwords should be changed periodically, but rather what this comment indicates. Advisory *operations*, rather than policies, are being scrutinized through the glasses of information protection and security.

While Regulation S-P has caused advisers to adopt and implement procedures to safeguard client information, many advisers viewed this safeguarding as solely a regulatory requirement. We strongly advise our clients to now consider their internal procedures in this area to be techniques of liability prevention. In fact, advisers have become parties to litigation and have received greater regulatory scrutiny as a result of thefts of their clients' non-public personal information.

All advisers should evaluate the extent to which their information safeguards and protection systems are adequate in preventing unauthorized access to client-sensitive nonpublic personal information. Identity thieves using client nonpublic personal information may be able to gain access to clients' custodial account(s) for a variety of illegal purposes, and the evidence often initially points to the client as the perpetrator. Naturally this may cause harm to the adviser-client relationship if the information leaked from the adviser.

Chief Compliance Officers should consider undertaking proactive measures in this area. As an initial matter, CCOs should conduct an annual meeting with advisory personnel to discuss identity theft and the firm's procedures to safeguard client information. The firm's information technology department should be involved with the development of any prevention procedures. Next, all employees, third-party service providers, and independent contractors should be required to enter into confidentiality agreements. Only those parties who have signed such agreements should have access to client nonpublic personal information, and their access should be limited solely to that information necessary for them to service client accounts. Lastly, although there are a number of other items to consider outside the scope of this limited discussion, clients should be alerted as to the dangers of identity theft and the measures they can take to protect their information.

REMEMBER: COMPLIANCE IS AN ONGOING PROCESS

Please remember that compliance is an ongoing and constantly evolving process. Laws and rules applicable to your practice and representatives are subject to change. Agreements and disclosure statements may require review and update due to regulatory or state law changes and/or changes in your business operations. Existing restrictive covenant agreements may no longer reflect state law changes. Please do not become complacent with respect to compliance matters. The scope of SEC examination issues continues to grow and becomes more complex. Policies and Procedures must also be reviewed and revised as required by regulatory changes and/or changes in your business operations. A ripe area for SEC deficiencies is either failure to have Policies and Procedures that appropriately reflect your business operations and/or the failure to follow them. As always, we will continue to remain available to assist with these matters.

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Should you have any questions regarding RSS, please contact our Director of Business Development Richard DeLuca at rdeluca@stark-stark.com or 609-791-7014. He regularly provides advice in RSS to Stark & Stark clients.

Stark & Stark continues to remain available, at your convenience, to assist you relative to the applicability of any of the above issues to your specific practice. As always, we can be reached directly by telephone or e-mail as listed below.



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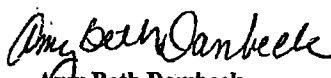
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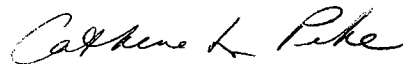
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