A publication of IA Watch

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February 17, 2014

Rep who took on his former firm and won sets his sights on his ex-lawyer

It started as a routine exam by a state regulator in 2007 and seven years later remnants of the case languish in court as a rep who says he was railroaded by his investment adviser employer seeks to clear his name.

The case offers a lesson for others, including compliance officers, to make sure that any attorney hired by your firm to represent you in a regulatory case won't put your firm's interests above yours.

Norman Meyer won a big ruling last month when **FINRA** arbitrators sided with him in saying he was fired without cause in 2008 by **Questar Asset Management** ($345M in AUM) in Minneapolis.

The firing came only a month after Meyer went against the advice of an attorney hired by the firm to represent him. According to Meyer's complaint in federal court, the lawyer, **Frank Taylor**, a shareholder with **Briggs and Morgan** in Minneapolis, violated his fiduciary duty in representing Meyer after Kentucky securities officials investigated an unlicensed rep, **Thomas Gorter**, who purportedly reported to Meyer.

Pre-testimony counseling

The day before a fateful hearing with Kentucky regulators in 2007, "Taylor urged Meyer … to take responsibility" for the firm's role in the Gorter situation. Taylor allegedly told Meyer not to mention that Questar "signed off on the advisory client paperwork, as QAM

(Rep Fights On, continued on page 5)

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Compliance staff could be seen as 'knowledgeable' employees

A new "no-action" letter from the SEC's Division of Investment Management opens the opportunity for more staff to invest in their firm's exempted private funds under the Investment Company Act. Depending upon your reading of the new letter, compliance staff also could fit the expanded definition of a "knowledgeable" employee and thus qualify to invest in their firm's 3(c)1 or 3(c)7 private fund without having to be "qualified purchasers" or count toward investor limits (**IA Watch**, Jan. 20, 2014).

"It was time for a more modern approach to the issue," says Stuart Kaswell, executive VP/managing director and general counsel at the Managed Funds Association in Washington, which provoked the no-action letter. He says the new letter advances a 15-year-old policy position from the SEC and better fits how the private fund industry has evolved.

('Knowledgeable' Staff, continued on page 2)

8 compliance tests you may want to add to your 2014 list

We asked your peers for compliance tests they'll be conducting this year. Their plans include:

1. **Staying within clients' investment parameters**. **Wasmer Schroeder & Company** ($4.5B in AUM) in Naples, Fla., has each client services manager randomly review another manager's accounts to be sure that trades are confined within each client's parameters and that fees are calculated correctly, says CCO **Josephine Haines**.

2. **Watching over the use of expert networks**. A New York adviser tracks and monitors each call with a consultant, and this year will add "additional forensic testing" around the firm's use of expert networks, says the RIA's CCO. A monthly report lists each call between an employee and a consultant. Employees are required to report the identities of all companies discussed. This year, a compliance associate will highlight any trade that was done "for any of the names that were the topic of the call," says the CCO, who will then review the results to see if additional action is warranted.

(Test Ideas, continued on page 4)

'Knowledgeable' Staff (Continued from page 1)

Over the years, many investors have asked managers if they put their own money into their fund. Some employees couldn't because they didn't fit the Investment Company Act rule's definition of "senior personnel" or one "who regularly participates in the investment activities."

An expanded definition

Now, the SEC states "we believe that an employee who does not have a senior manager title, depending on the facts and circumstances, may still be considered an executive officer under the rule if he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies."

The letter cites information technology staff, research analysts, "an attorney who regularly analyzes legal terms and provisions of investments and whose analysis or advice is material to the portfolio manager's investment decisions" and a "compliance officer who evaluates whether an investment is permitted under a Covered Fund's governing documents" as examples of personnel who could fit this expanded definition of a "knowledgeable employee."

However, employees who "merely observe committee proceedings" wouldn't satisfy the term.

"We think this dramatically moves the ball," Kaswell tells **IA Watch**. The new policy letter gives fund managers greater flexibility and strikes a fair balance while keeping out staff "who do not have the knowledge and sophistication" to invest in the firm's private offerings.

Extension to relying advisers

"The letter is helpful," agrees **David Vaughan**, a partner at **Dechert** in Washington, D.C., who calls "logical" the letter's extension of the expanded knowledgeable employee definition to a firm's relying advisers.

"Given the importance of compliance, it's not a bad idea" to include compliance staff in the opportunity to invest in their firm's own fund, says **Thomas Gallagher**, a partner at **Baker Hostetler** in New York. It would provide an additional incentive for them to stay with the firm, he adds.

A compliance officer at a New York firm who talked with **IA Watch** says he doesn't believe he would fit the expanded definition because he's not deeply enough involved in the investment side of the business.

Plus, he has concerns about compliance staff investing in a firm's fund. "It may cloud their judgment," says the compliance officer. "There might be more pressure now to just let things go" rather than to raise a potential compliance issue because the CCO has a financial stake in the fund, he continues.

Embark on an analysis

Several sources wouldn't go so far as to say the letter gives carte blanche for CCOs to invest in their firm's private funds. You'll have to make that determination based on your analysis of the letter. Gallagher wonders what would happen if a firm makes a reasoned analysis and SEC examiners later disagree – and whether this could endanger a private fund's exemptive status.

David Pankey, a partner with **McGuireWoods** in Washington, D.C., points out the new letter leaves two issues unresolved. One is a clear declaration from the SEC that "any knowledgeable employee is also an accredited investor."

The second touches on Investment Advisers Act rule

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205-3, which allows the charging of performance fees to "qualified clients." That rule speaks of treating knowledgeable employees as qualified clients, says Pankey. It wasn't addressed in the new no-action letter. Kaswell says the MFA sought to limit the letter to the Investment Company Act.

Pankey says he spoke with SEC staff after the release of the no-action letter and was told that the staff would probably interpret rule 205-3 "in a similar manner to the MFA letter analysis." ■

Specific how-to guidance found in 9 new Form PF FAQs, some preparing to file

Just in time, as many large hedge fund advisers are getting ready to file their latest quarterly Form PF by the end of the month, the **SEC** has released new frequently-asked-questions with guidance on how to answer several items on the form. These are the first new FAQs in seven months (**IA Watch**, Aug. 19, 2013).

For example, the SEC asks that information about parallel managed accounts go only into your answer to question 11, although the miscellaneous section (question 4) could serve as a location to offer additional clarity.

Repos v. Reverse Repos

Many of the FAQs step deeply into the weeds, e.g., on reporting a fund's reverse repos as the short value in the repo sub-asset class under questions 26 and 30. The SEC cautions you to "carefully review the definitions of 'Repo' and 'Reverse Repo'" in its glossary. A reverse repo is where a fund sells a security with an agreement to repurchase it at a later date at an agreed upon price. This would be considered to be a borrowing. A repo is when a fund purchases a security together with an agreement to sell it at a later date at an agreed price. This would not be considered a borrowing, says the SEC.

Click here to see all of the SEC's Form PF FAQs released over the years. ■

SEC exams: 7 tips that just might save you on your next inspection

Whether you've never been examined by the **SEC** or it's old hat to you, here are some pointers that could positively influence the final results (**IA Watch**, Feb. 10, 2014).

1. "Create a response team" to help you gather requested documents – and long before you receive the OCIE's request list, suggested **Brian Ferko**, COO at **Cipperman Compliance Services** in Malvern, Pa. He spoke during a webinar Feb. 12th. "The CCO has to drive this" process, he added.

"You want to make sure you have go-to people" in operations, investments (portfolio managers/traders), marketing/sales, accounting and financial performance reporting, IT and more, who can retrieve requested documents, Ferko advised.

Distribute the SEC's document request letter to key departments. Some firms simply print out the list and write next to various items staffers who will be responsible for them. Others type the list's contents into a Word or Excel file for tracking purposes. However you do it, create a list of who is responsible for what, said Ferko.

Hold a meeting with everyone who's on the team assembling the documents. "Go through each of the items," Ferko instructed. Make sure the employees understand their duty and deadlines. Give them an opportunity to ask questions.

2. Give examiners contact information for you (the CCO) as well as a backup person, recommended Cipperman's Managing Director **Martin Dziura**.

3. Meet ahead of time with every staffer you believe is likely to be interviewed by examiners. "Go over the ground rules with them," said Dziura. Instruct staff to answer questions factually but not to use unnecessary words, Ferko added. They should be told never to make up an answer or to give half-answers. "It just sets a bad tone," he continued.

If the staffer doesn't know an answer, he should tell the examiner he doesn't or will get back with an answer later. Firms often find trouble when a staffer, perhaps trying to be helpful, volunteers information outside his realm but ends up providing a poor answer. SEC examiners have no initial way of knowing the answer was faulty and will proceed under a mistaken impression, Ferko said.

4. Don't immediately take an examiner directly to the office of a staffer he's asked to interview. Schedule

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7 Exam Tips (Continued from page 3)

the sit down for one or two hours later, to give you time to brief the staffer. "No one ever goes into an interview cold" is Ferko's stance. [OCIE Director **Drew Bowden** addressed the bounds of CCO coaching of staff during exams in **IA Watch**'s exclusive video interview. Click here to watch the video, which runs 2:04.]

5. The firm's CCO should sit in on the examiners' interviews and take notes of what transpires, recommended Dziura.

6. Ask that any follow-up requests from examiners after they leave your site be submitted to you in writing. Avoid conducting these follow-up meetings via e-mail, counseled Dziura. Use the phone; it allows for a more natural exchange.

7. Don't wait until your scheduled annual compliance training to address an issue that comes up, he recommended.

Editor's Note: Sign up for **IA Watch**'s webinar on SEC exams. It will be held Tuesday, March 11th. Click here to register. ■

Test Ideas (Continued from page 1)

3. **Checking to see if portfolio managers put themselves ahead of clients**. A quarterly test in place at **Boston Advisors** ($2.3B in AUM) involves importing a manager's holdings into software that calculates performance to spot significant over-performance compared with the PM's clients' holdings. "We test to make sure that they're not taking good positions for themselves," says CCO **Tanya Kerrigan**. Firm rules state a PM can't trade the same security that he trades for a client on the same day. A 14-day blackout period exists for mutual fund activity. If the software flags any concerns, "we're going to start to look into their sectors … holdings and wonder" why are these holdings not showing up in their clients' accounts, she adds.

4. **Guarding against stale pricing**. As an offshoot of the **Morgan Keegan** case (**IA Watch**, June 24, 2013), **Spectrum Asset Management** ($16.8B in AUM) in Stamford, Conn., "added some additional processes around pricing and testing" and stale prices, says CCO **Joseph Hanczor**. A new daily check falls upon the firm's compliance guideline and pricing group to compare that day's pricing against the prior day's. The group documents any prices that draw their concern and Hanczor investigates further. This largely manual process seeks to eliminate stale pricing of securities held within the firm's mutual funds.

5. **Making sure books and records retention policies are being followed**. The plan calls for visiting the off-site vendor used to store older records. "We'll pull up some of those boxes and make sure they're labeled appropriately and contain the documents as identified in their document retention procedures," says **Kevin Gleason**, senior VP of **ING Investment Management** and CCO of **ING Funds** in Scottsdale, Ariz. He also hopes to ask business unit managers for their document retention requirements to ensure they're current and match the firm's. A final check will examine if records retained on-site are stored properly.

6. Looking for performance based on a composite but that far exceeds it. A red flag would be generated if an account based on a composite varies from it by more than 300 basis points (3%), says Kerrigan. That's the outlier threshold, given that an account matching a composite's mandate should be producing a near identical performance. If not, an explanation should be in order, e.g., trade errors. This regularly conducted test is designed to spot such circumstances.

7. **Scouring for signs of favoritism**. Boston Advisors achieves this in several ways. It reviews the trade blotter or trade tickets for post-trade re-allocations. It also asks the settlement/operations department to report any portfolio manager who's given instructions for a post-trade reallocation. This could indicate favorable treatment for a cherished client or the jettison of a trade error, says Kerrigan. A pre-trade allocation occurs before the trade hits the market. By the time the trade occurs, the pricing may have shifted significantly. A portfolio manager blinded by a conflict could attempt to reallocate the trade to a client, who, say, pays a higher fee or gives

(Test Ideas, continued on page 5)

New on IA Watch's YouTube channel

Check out this 2:19 video of our exclusive interview with OCIE Director **Drew Bowden**. Here he addresses mistakes CCOs should avoid during SEC exams. PDF readers can click this video box. Print readers should go to www.iawatch.com/youtube. ■

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Test Ideas (Continued from page 4)

him significant business. If the trade goes the other way, the PM may wish to reallocate it to a less-favored client. "We're looking for anything that changes from a pre-allocation ticket to a post-trade allocation," says Kerrigan. "Any change at all is a flag that you need to look at this further."

8. **Assessing the need to monitor social media use**. **Mark Hodge**, CCO at **Walthausen & Company** ($1.1B in AUM) in Malta, New York, plans this year to ask staff to certify if they use social media for business purposes. Based on the responses, he may develop testing to monitor such usage. ■

FINRA board approves mandatory BrokerCheck link, expungement change

You'll be asked to comment on several proposed changes passed last week by **FINRA**'s Board of Governors. These include a requirement that firms "include a readily apparent reference and link to *BrokerCheck* on any member firm's website that is available to retail investors." Another change would prohibit firms from conditioning a settlement with a customer on an agreement not to oppose an effort to expunge the incident from a rep's record.

Another change that was approved and sent to the **SEC** for approval would amend FINRA's system of arbitration to define arbitrators "who worked in the financial industry for any duration during their careers" as "non-public" arbitrators. Those who "represent investors or the financial industry as a significant part of their business would also be classified as non-public, but could become public arbitrators after a cooling off period," according to FINRA.

A sweep exam

The SRO also announced last week that it is conducting a sweep exam to look at how firms address cybersecurity. The initiative is being undertaken because "of the critical role" IT "plays in the securities industry, the increasing threat to firms' IT systems from a variety of sources, and the potential harm to investors, firms, and the financial system as a whole that these threats pose," states FINRA. The sweep has four objectives:

1. To understand better the types of threats that firms face.

2. To increase understanding of firms' risk appetite, exposure and major areas of vulnerabilities in their IT systems.

3. To understand better firms' approaches to managing these threats, including through risk assessment processes, IT protocols, application management practices and supervision.

4. as appropriate, to share observations and findings with firms.

Expungement change

A broker who seeks to have his customer dispute information removed from the CRD system, which includes *BrokerCheck*, must obtain a court order directing the expungement or one that confirms an arbitration award containing expungement relief, states FINRA. ■

Rep Fights On (Continued from page 1)

was accepting clients brought in by Gorter without being properly licensed."

Taylor allegedly told Meyer that if he didn't take the fall then "Briggs and Taylor would not represent him."

"Meyer refused to take the blame for the situation," according to the complaint. The following day, regulators asked Meyer who signed off on the paperwork. He answered the adviser. "Taylor kicked Meyer under the table when Meyer answered this question," the complaint alleges.

Also in attendance at the regulatory meeting were Questar President **Matthew Fries**, the firm's then-CCO **Ruth Howell** and corporate counsel. Meyer's complaint alleges Taylor "initiated a surreptitious plan to terminate Meyer" following his testimony. The next month, after six years with Questar, Meyer was gone.

Taylor didn't respond to an **IA Watch** request for comment. His attorney **Jeffrey Jensen**, a partner at **Husch Blackwell** in St. Louis, says "we believe the claims are meritless" and promised a vigorous fight.

Court documents concede that Taylor and Briggs and Morgan "served briefly as" Meyer's counsel in the Kentucky matter.

Winning in arbitration

The reason alleged for Meyer's termination was not following instructions in the transfer of customer accounts and procedures for account documentation. The story that Meyer tells is shortly after the Kentucky hearing he received a box full of Gorter's account records that were "in disarray," many with "white out on them."

Meyer claims to have called Fries to ask what he should do and was told to sign the documents and return them to the adviser. Meyer's response to his termination listing in BrokerCheck reads "I brought certain matters to the attention of [Fries]" who "instructed me on how to

(Rep Fights On, continued on page 6)

Rep Fights On (Continued from page 5)

proceed and I followed his instructions to the letter."

Questar's Form ADV brochure mentions a $60,000 settlement in the Kentucky case, attributing it to "allegations that the affiliate did not adequately supervise the activities of a registered representative." Neither Fries nor Questar's current CCO returned **IA Watch** phone calls. Howell couldn't be reached. An employee said she left the firm last year.

Allegations of retaliation

Meyer challenged the termination and how it was characterized on his Form U-5 in 2009 and won last month. In the arbitration, Meyer argued the actions were a "forced seizure of his stream of income … and in retaliation for Meyer's truthful testimony before the Kentucky Office of Financial Institutions" in 2007.

Arbitrators found Meyer hadn't altered documents, that his U-5 termination listing placed him "in a false light" and ordered it removed. The attorney who represented Questar in the arbitration declined to comment to **IA Watch**. Claims of wrongful termination were resolved separately last year in an undisclosed settlement between Meyer and Questar. Court records state Questar terminated its relationship with Briggs and Morgan during the arbitration.

Meyer remains a rep in the industry. He answered written questions from **IA Watch** provided through his attorney, **David Cosgrove** of the **Cosgrove Law Group** in St. Louis. His advice: "Get your own attorney right away. Even if your BD/IA offers to pay for one for you, make sure you are allowed to pick him," answered Meyer.

He also urged peers to have "an attorney on standby that you can consult with and trust when you find yourself in a no-win situation like I did." Take notes and e-mail your understanding of what occurred during conferences and phone calls. "Assume your reps will make mistakes, and that your supervisors will be tempted to throw you under the bus. If your BD wants to come to your office and will not give you the subject matter of the meeting – beware. At least have a witness present during the meeting."

Meyer seeks $1 million, claiming Taylor's alleged actions led to the loss of clients and caused "emotional distress." Cosgrove says the legal actions have cost Meyer much. The case against Taylor and his law firm could take years, says Cosgrove. The "hands of justice move slowly," he says. ■

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