

Compliance Review

Ongoing Compliance Updates for Independent Investment Advisors

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Considerations for Outsourcing Compliance

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I. Introduction

In the post–Dodd-Frank regulatory world, investment advisers seeking to meet the expectations of the Securities and Exchange Commission (“SEC”), or of other regulators, face a common challenge:

How do we manage our business, stay on top of all the regulatory requirements and changes, and still meet our day-to-day compliance responsibilities?

This article discusses the factors investment adviser firms must consider when determining whether to tackle regulatory and compliance issues internally or outsource aspects of their compliance program.

Insights from the 2011 RIA Benchmarking Study

In September 2011, Charles Schwab & Co., Inc. published an article that contained insights from the company’s most recent RIA Benchmarking Study.¹ Not surprisingly, the article noted that “[i]ncreased reliance on outside experts for compliance has been a strong trend, not only reducing expense but lowering the risks of overlooking or misinterpreting evolving requirements.” The article went on to note that advisers have similarly increased their reliance on outsourcing for back-office operational functions, with more than a 40% increase in outsourcing since Schwab conducted its last benchmarking study, in 2010.

Many of these findings may indicate that investment advisers have scalable businesses and that outsourcing numerous functions, including regulatory and compliance matters, helps to create that scale.

The 2011 RIA Benchmarking Study concluded the following:

Between 2010 and 2011, compliance outsourcing increased substantially, from 27% of firms to 38%, with the highest amounts of outsourcing occurring at small and midsize firms.

- Wealth managers with \$25MM–\$250MM in Assets Under Management (AUM) were most likely to outsource compliance, in the range of 44%–51% of firms. This percentage decreased to 22% for firms with over \$1B in AUM.
- Money managers with \$50MM–\$100MM in AUM were most likely to outsource compliance (59%). This percentage decreased to 29% for firms with \$100MM–\$500MM in AUM and to 6% for firms with more than \$500MM in AUM. Firms with \$25MM–\$50MM in AUM outsourced 43% of the time.
- For both types of firms, the peak use of compliance outsourcing was for firms with \$50MM–\$100MM in AUM, with wealth managers at 51% and money managers at 59%.

- Overall compliance savings resulting from outsourcing were estimated to be 26% compared with the cost of doing the same function in-house.

The traditional model of tackling everything internally has been gradually losing ground to the paradigm of outsourcing for efficiency. Typically, the individuals devoting their time to compliance at smaller or midsize firms wear multiple hats. It makes sense that for many of these firms, outsourcing compliance functions would leave firm employees with more time to focus on managing client investments and cultivating new business. In addition to strategically outsourcing compliance, many firms are also recognizing the benefits of outsourcing other aspects of their business. The rise in popularity of “turnkey asset management providers” (TAMPs), for example, is evidence that advisers are looking for external solutions to help build their business. This trend reflects the evolution of an industry in which regulations and complexity are increasing.

Investment advisers often ask themselves: What aspects of my compliance program are appropriate for outsourcing?

As the “Anatomy of a Top-Notch Compliance Program” diagram on page 3 indicates, there are certain elements of a compliance program that require sensory input from someone on the ground who has a solid understanding of the firm’s operations. The proper implementation of a compliance program also requires knowledge, expertise, and energy. We will use this anatomy analogy throughout this article to outline the basic elements of a compliance program and some of the more and less suitable reasons to outsource.

II. History and Evolution of Outsourcing Compliance

The SEC adopted Rule 206(4)-7 (the “Compliance Program Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) in late 2003. Under the Compliance Program Rule, it is unlawful for an SEC-registered investment adviser to provide investment advice unless the firm has adopted and implemented “written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.”

Prior to the adoption of the Compliance Program Rule, a firm’s policies and procedures were not subject to the same level of SEC and regulatory scrutiny as they are today. In fact, at that time, the Advisers Act only referred to “established procedures” solely from a supervisory standpoint. Section 203(e)(6) of the Advisers Act has long stated:

For the purposes of this paragraph no person shall be deemed to have failed reasonably to supervise any person, if—

- (a) 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
- (b) 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.

Prior to the rule going into effect in 2004, investment advisers required help with certain regulatory requirements, including Form ADV maintenance, state or SEC registration processes and examinations, insider trading procedures, and books and records requirements.

However, the last several years have seen a dramatic increase in industry regulations. With the Compliance Program Rule, the code of ethics rule, privacy rules at both the federal and state levels, changes to the custody rule, and other new regulations, such as Dodd-Frank, investment advisers certainly have a larger compliance mandate than they did 10 years ago. The resulting additional compliance program components—such as the annual compliance review and updates to the firm’s policies and procedures—are time-consuming, elaborate projects to manage; advisers require full-time dedication to keep up.

Some firm principals have found that they can focus on their business while meeting their compliance mandates by outsourcing certain tasks to third-party, independent-thinking compliance counselors who spend significant amounts of time immersed in practical applications of compliance and regulatory

issues. Compliance outsourcing can bring focused brains, strong cores, high energy, and good balance and agility to a firm's compliance program.

For some firms, the proof is in the results, or lack of results, of their regulatory examinations. While sometimes more infrequent than would be expected, regulatory examinations can be difficult, time-consuming, and stressful. An investment manager cannot expect to accomplish a high level of effectiveness without working towards this goal over a period of time. Advisers who take the time and expend the resources to develop an effective compliance program often find that it helps their business. In fact, the further memorialization of policies and procedures that businesses actually use is a part of the Compliance Program Rule mandate.

While some firms have been tempted to outsource their entire compliance program, at least one director of the SEC's Office of Compliance Inspections and Examinations has expressed wariness about outsourcing the entire role of the Chief Compliance Officer ("CCO").² A firm's CCO must be competent, knowledgeable, and empowered to administer and implement the firm's compliance program. In addition, the CCO has the "boots on the ground" responsibility of being part of the firm's day-to-day operations and spending a reasonable amount of time overseeing the compliance program.

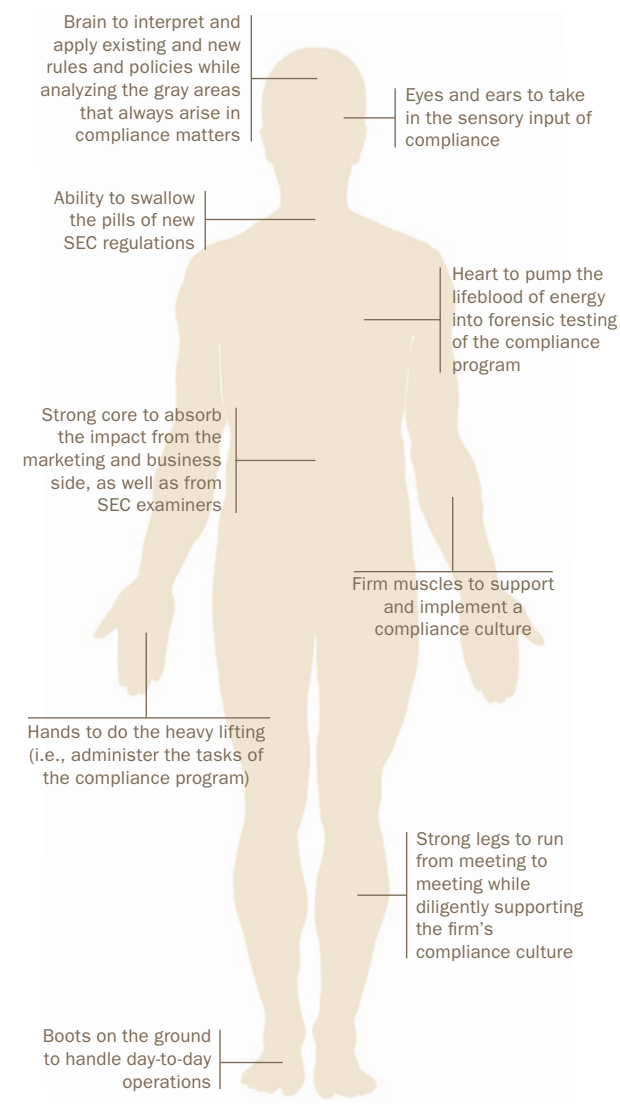
The SEC's Compliance Program Rule does not on its face preclude or prohibit any form of outsourcing. Certain aspects of a compliance program—such as conducting the annual compliance review, assisting with risk assessment, or helping to maintain policies and procedures and Form ADV documents—can benefit from outsourcing. An investment adviser that outsources all or part of its compliance tasks should find value in what is received back in exchange for its payments.

III. Key Compliance Program Components Suitable for Outsourcing

As the anatomy diagram indicates, a top-notch compliance program requires "boots on the ground" expertise from the CCO. The CCO is expected to be

intimately familiar with all aspects of the firm and to use all available "body parts" to run an effective program. Some of the "body parts" illustrated in the diagram are inherently suited for outsourcing, and doing so can be cost-effective.

Anatomy of a Top-Notch Compliance Program



Following are some areas of a firm's compliance program that may be appropriate considerations for outsourcing:

A. Annual Compliance Review

While there is no single format that can be labeled the best method for conducting a firm's annual review, as required by the Compliance Program Rule, some firms choose to develop a template, while others pay for "off-the-shelf" solutions or

borrow from other firms' existing templates. Since the annual review is deemed to be a critical component of an SEC-registered adviser's compliance program and is subject to review upon examination, it is important for a firm to devote an appropriate amount of time to conducting an adequate review.

Investment advisers should take the following into consideration, among other things, when contemplating outsourcing the annual review:

- (i) Has my firm devoted enough time and resources to testing the adequacy of our compliance program during the year?
- (ii) Does our CCO have the appropriate background to understand what the SEC is looking for when it inspects the firm's annual review?
- (iii) Will an outside consultant be able to help uncover compliance gaps or other risks that might otherwise go unnoticed?

The SEC has stated that it uses the annual review during an exam as a barometer of a firm's understanding of its own enterprise risks. Since the annual review is subject to inspection by the SEC, it is often used as a gauge by which the SEC determines whether and where to probe deeper into a firm's operations to look for potential deficiencies. Therefore, ensuring that the finished product will meet SEC expectations is a critical step in convincing the SEC staff during an exam that the firm's compliance program is robust.

An outsourced solution may be an appropriate answer to this particular task, as third parties that have seen a wide spectrum of investment management clients may be particularly suited to focus on riskier aspects of an adviser's business. At a minimum, an annual review by an outsourced firm should begin with a review of documents ahead of an on-site visit. Shortly thereafter, a summary of the outsourced provider's findings and recommendations should be sent to the adviser, along with an offer of assistance to correct the deficiencies. Typically, the pre-review stage consists of requesting the adviser's most current policies and procedures, code of ethics, and risk assessment, as well as a sample advisory agreement, an organizational chart, and copies of the most recent SEC examina-

tion deficiency letter and the firm's response. Then, when the outsourced provider is on-site, they can conduct interviews of key personnel and perform tasks such as the following:

- Reviewing trade blotters to test for patterns of inappropriate allocations or favoring certain client accounts, or to detect patterns in trade errors
- Reviewing the firm's documented process for testing its best-execution obligation and its soft-dollar commitments or directed brokerage arrangements
- Reviewing regulatory filings and comparing them with securities portfolio information provided in the trade blotter and in client account statements
- Reviewing marketing and advertising material and comparing it against internal records to verify accuracy of the statements made to clients or prospects
- Reviewing code of ethics compliance, including the reporting of personal securities transactions against client transactions and verifying the firm's systems are adequate
- Assessing the firm's commitment to technology and identifying potential vendor solutions
- Conducting a targeted review of employee emails to detect behavior that may be inconsistent with the firm's policies and procedures
- Reviewing risk management and exception reports to identify deviations from stated investment objectives or restrictions

The task of documenting the annual review is delicate, since deficiencies that go unaddressed can come back to haunt the firm during its next SEC visit. A bad scenario is for an adviser to document problems and then do nothing to remedy them. An appropriate process may involve the outsourced provider liaising with the firm's CCO to implement suggested changes or modify the firm's processes to correct material problems.

Consider an example in which a firm discovers during the annual review that, despite having a stated allocation methodology for investments across client accounts, investments are not being

allocated accordingly. The outsourced provider can provide assistance drafting tailored procedures to address the allocation processes, suggest technological solutions that the firm might not have been aware of, or recommend alternative allocation methodologies that have worked for other firms with similar investment strategies.

While it is certainly possible to accomplish this in-house, outsourcing allows new ideas to enter the firm’s thought processes—and the outsourced provider can do some of the heavy lifting. In short, by assisting with the annual review, the outsourced provider provides the “protein” to support the CCO’s muscular system.

It is not uncommon to hear a concern that this type of compliance outsourcing is not covered by the attorney-client privilege. For SEC-registered firms and for many state-regulated advisers, completing the annual review is the fulfillment of a regulatory requirement. The task of completing the annual review and remedying compliance issues is, in fact, extraordinarily difficult to get covered by the attorney-client privilege—even when the review is conducted by an attorney. An annual review is meant to uncover compliance issues that cannot be buried under the attorney-client privilege. Nevertheless, advisers are wise to consult with their legal counsel about the scope of the privilege and the conduct of their annual review.

B. Risk Assessment

Just as they might outsource the annual review, advisers often hire outside firms to conduct a risk assessment that can be used as a practical guide to developing more robust compliance procedures. Often, advisers adopt compliance procedures that are unnecessarily burdensome in areas that pose low risks to the firm; conversely, the same set of procedures lack sufficient “teeth” to detect and prevent material risks from developing into full-blown issues. The risk assessment process strategically and methodically analyzes each substantive area of an adviser’s operations and seeks to identify material gaps or conflicts of interest that elevate a particular business function to a higher risk category. The risk assessment task is particularly well suited for outsourcing—an experienced independent provider can draw from prior experience at other firms and identify risks that are often hiding in plain view from the adviser’s personnel.

The risk assessment process is immediately viewed as a value-add by senior management, clients, and investors—it shows that the firm is demonstrating its commitment to ferreting out the aspects of the business that can potentially jeopardize the entire enterprise.³ After conducting an effective risk assessment, an adviser is armed with an outline for identifying which areas of its business require additional resources, enhanced procedures, and/or internal controls. A risk assessment can look something like the following:

Area Assessed	Risk Identification	Controls	Location of Policy	Risk Rating
Valuation	All client holdings are publicly traded, high-volume stocks	Use of custodian values, spot-check accuracy	Section 4, Valuation; Section 5, Billing Procedures	Low
Insider Trading	Trading with counterparties, value-added investors, former employees	Sign-off on insider trading policy, training, email reviews, most profitable trade review	Section 8, Insider Trading	High
Best Execution	Failure to achieve best execution because of conflicts or inefficiencies	Quarterly evaluations, third-party data, conflict identification	Section 12, Best Execution	Medium

Looking for more information on compliance or regulatory issues?

Schwab’s compliance website includes a searchable database, compliance tools and many other resources to assist you. Visit www.schwabadvisorcenter.com > News & Resources > Compliance. (See page 7 for more information.)

While this illustration is an oversimplified example, it conveys the purpose behind a successful risk assessment: to assign ratings to existing business areas and identify the controls in place to mitigate those risks. Again, experience plays a key role in the effectiveness of certain of these compliance areas. A CCO who is immersed in his or her firm's business operations is well suited to conduct a thorough risk assessment using the sensory input obtained on a daily basis. Equally, advisers that choose to outsource the risk assessment gain a valuable tool in their arsenal of compliance weapons used to combat "anatomical" deficiencies. By outsourcing the risk assessment, an adviser can uncover larger issues that are sometimes missed by those in the trenches. This broad view can be a critical step in identifying areas of an adviser's compliance program that require additional resources, or riskier aspects of an adviser's business that merit further employee training.

C. Updating Policies and Procedures/Consolidating Complex Compliance Manuals

Investment advisers are required not only to keep up with the implementation of current federal securities laws and SEC regulations, but also to keep up with interpretive guidance and other regulatory pronouncements and industry trends (such as no-action letters, FAQs, and rule releases). The average CCO often does not have the time to stay on top of all of this, particularly in the post-Dodd-Frank era.

Generally, a CCO's time is spent conducting the ongoing testing and resolution of day-to-day compliance matters. An added benefit to using outsourced providers is that they offer exposure to the way other registered advisers conduct themselves, especially with regard to developing substantive policies and procedures on major groundbreaking compliance topics (e.g., disclosure requirements, privacy regulations, fiduciary obligations, whistleblower rules, insider trading, email and social media, fair valuation, etc.). Outsourced providers support the "anatomy" of a CCO by taking on the challenge of updating the compliance manual and code of ethics in a manner that is tailored to the firm's operations.

In certain cases, a CCO with top-notch time management skills can take sections of the firm's

policies and procedures and draft tailored edits to reflect the processes by which the firm implements its larger policies. Rather than outsourcing this component, some firms choose to devote internal resources to outline the procedures that external resources simply cannot articulate without spending significant amounts of time understanding the firm's operations. This may be a viable alternative to outsourcing this aspect of the compliance program if there are sufficient resources provided to the CCO and the CCO enlists the business units' assistance in drafting the procedures.

On the other hand, an outsourced provider may be an option for the task of updating a firm's policies and procedures if the CCO wears multiple hats or cannot devote the time necessary to interviewing the respective business unit leaders to produce a detailed set of procedures. In such circumstances, outsourced providers might be an ideal alternative, as they can objectively probe those business units to identify the day-to-day steps they follow in executing their job functions and then map the appropriate compliance procedures back to those steps. For example, in a smaller firm, portfolio managers or operations staff may input trade orders through a portfolio accounting system or may upload trade files to a custodial trading platform. An outsourced provider with familiarity across numerous front-end trading systems may be particularly skilled in designing procedures and cross-checks that prevent operational errors or trade errors from occurring. This "objectivity component" is a strategic consideration as a firm decides whether to outsource this aspect of its compliance responsibility.

Some firms that have been operating for a long time will often have a large, uncoordinated set of policies and procedures. Outsourced providers may provide relief to those firms by reorganizing their compliance policies and removing sections that are unnecessary while adding provisions to sections that are noticeably inadequate or are missing altogether. For example, consider an asset management division that is affiliated with a banking institution or broker-dealer firm. It is not uncommon for the policies and procedures of the advisory entity to be shared with, or borrowed from, the bank or the

written supervisory procedures of the broker-dealer. In those instances, the policies and procedures might include overly detailed operational procedures that are not necessarily appropriate for an adviser's compliance manual, or the procedures might be assembled in a manner that confuses employees or regulators. Further, as new rules are passed over time, the firm may have adopted procedures that do not fit logically within any of the existing sections of the adviser's policy manual. An outsourced provider may be an ideal solution to do the heavy lifting associated with the reorganization of the adviser's procedures and, in particular, to weigh in on the addition of critical procedures that have been omitted while recommending the deletion of older, outdated procedures that no longer belong in the adviser's manual.

D. SEC Registrations and Preparation for Examinations

As a result of SEC regulations that came into effect in mid-2011, advisers to private investment funds, venture capital funds, and private equity funds that do not otherwise qualify as "exempt reporting advisers" will be required to register as advisers in 2012. Outsourced providers are particularly well suited to assist in the preparation of an adviser's Form ADV, along with the policies and procedures, codes of ethics, and other written documents.

A strong outsourced provider can help a newly registering firm adapt to a new form of recordkeeping, and understand what is involved during an SEC examination. Many venture capital or private equity fund managers that are not currently registered as investment advisers are trying to determine whether they qualify for an exemption from registration or whether they can manage their business in a manner that continues to qualify the firm for an exemption. Firms that cannot meet any applicable exemption, or that want to prepare for the situation in which they may no longer qualify for an exemption, must register as an adviser.

In these scenarios, an outsourced provider may be uniquely positioned to spend time on-site at an advisory firm and, in doing so, mold the firm's compliance program in a manner that prepares both management and supervised persons for administering the program. Furthermore, by having an outsourced provider participate on-site, the firm will be inevitably more confident when responding to initial SEC examination requests. An outsourced provider that spends the time understanding the firm's business prior to SEC registration is positioned to assist the firm in adopting revised compliance procedures in response to SEC deficiencies after an examination. By recommending forensic tests that are successfully implemented at other firms, an outsourced provider can add value by creating compliance testing procedures for a newly registered firm that is contending with the Compliance Program Rule for the first time.

IV. Conclusion

An investment adviser must undertake its own cost-benefit analysis of using an outsourced provider, internal resources, or a combination of both to maintain its compliance program. Cost is always an issue that demands consideration, and firms usually weigh the cost of the outsourced provider against hiring a new employee or deputizing someone internally to serve as the CCO. Because of the drain on internal resources, smaller firms tend to use outsourcing for many or all of their compliance tasks, while larger firms tend to use outsourced providers to manage certain projects only, or as a litmus test to determine their level of compliance risk. Each firm must individually analyze the pieces of its compliance program to assess whether certain aspects are ripe for outsourcing. An outsourced provider that gains an intimate knowledge of an adviser's business—and that is an expert in the specific compliance issues relating to that business—may be more proactive in counseling the

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firm on industry best practices and regulatory developments. By providing on-site training and other educational opportunities, an outsourced provider offers a more well-rounded view of the compliance trends in the investment adviser community.

The Schwab RIA Benchmarking Study notes a growing trend toward strategic outsourcing of compliance tasks. This trend may also be a reflection of the increasing visibility and role that the compliance

function is playing within the investment adviser community. The peace of mind that is provided by outsourcing aspects of an adviser's compliance program may be reason enough for advisers to select an outsourced provider. In an age where new regulations are promulgated with increasing frequency, the trend toward outsourcing discrete aspects of a firm's compliance program will likely continue to increase in the investment adviser community.

About the Authors

Larry Cowen has practiced investment management law for over 15 years, and now provides compliance consulting and due diligence services for investment advisers, hedge fund managers, and private equity funds. Larry drafts compliance policies and procedures, conducts annual compliance reviews and on-site mock examinations, and provides SEC registration services. He is a frequent speaker at various industry seminars, as well as at the annual Ascendant conferences and online ComplianceCasts. Mr. Cowen previously served as the General Counsel and Chief Compliance Officer of Bellatore Financial, Inc. Prior to joining Bellatore, he was Of Counsel to the San Francisco law firm of Shartsis Friese LLP, where his practice involved counseling investment advisers, hedge fund managers, and corporate clients. He was also previously the Chief Compliance Officer for a San Francisco-based hedge fund manager and a Senior Associate in the San Francisco office of K&L Gates LLP. Before relocating to the West Coast, Mr. Cowen practiced law in New York City and counseled various investment management clients, derivatives market participants, and private equity/hedge fund managers. Mr. Cowen received his BA in Philosophy and Law & Society from Binghamton University and his JD cum laude from New York Law School. He is admitted to the California and New York bars.

Keith Marks provides consulting, annual compliance program reviews, risk assessments, on-site mock examinations, and registration services to Ascendant's clients, including the investment adviser divisions of regional banks, hedge fund managers, institutional advisers, wrap fee managers, Internet-based advisers, wealth managers, and financial planners. Keith produces Ascendant's FREE Form ADV Part 2 Template. He regularly speaks to compliance professionals and advisory firm staff at in-house training programs and at various other industry association conferences. In addition, he regularly contributes compliance-related articles for inclusion in industry publications. Before joining Ascendant Compliance Management, Keith was an instructor for the Center for Compliance Professionals, and Director of Investment Adviser Services at National Regulatory Services (NRS). Keith practiced law previously as an Associate with Day, Berry & Howard LLP (now Day Pitney LLP), a Hartford, Connecticut, law firm. Keith served as a law clerk for two years in Connecticut's Supreme Court and Appellate Court. He earned his JD degree magna cum laude from Western New England College School of Law, and his BA magna cum laude from the University of Connecticut. He is a member of the State Bar of Connecticut, and is actively involved in raising funds for the Polycystic Kidney Disease Foundation (www.pkdcure.org).

¹The 2011 RIA Benchmarking Study from Charles Schwab & Co., Inc. is designed to capture trends and best practices in the independent investment adviser industry. This annual study provides detailed insights on topics such as asset and revenue growth, sources of new clients, products and pricing, staffing, marketing, technology, and financial performance. The results of the 2011 study reflect the responses of 820 registered investment advisers, collectively managing over \$300B in AUM, with 535 of the participating firms managing over \$100MM in AUM, 165 firms managing over \$500MM in AUM, and 75 firms managing over \$1B in AUM. The median participating firm had 186 clients, \$212MM in AUM, and \$1.3MM in revenue. The responses were self-reported and collected during February and March 2011.

²In June 2004, shortly after the adoption of the Compliance Program Rule, Lori Richards, then-director of the SEC's Office of Compliance Inspections and Examinations, gave the following speech and discussed the concept of outsourcing compliance: www.sec.gov/news/speech/spch063004lar.htm. Richards stated: "I am wary about whether a compliance 'rent a cop' could really be up to the task. For example, is it reasonable to expect a compliance officer in New York to be able to effectively implement and monitor a compliance program in California? Is it reasonable for a compliance officer serving 10 different fund complexes to effectively service them all?"

³A recent speech by Carlo di Florio, director of the SEC Office of Compliance Inspections and Examinations, provides an excellent summary of the notion of "enterprise risk management." The speech was given at the NSCP National Meeting on October 17, 2011, and may be viewed at www.sec.gov/news/speech/2011/spch101711cud.htm.

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