

# NSCP CURRENTS

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## Investment Adviser Compliance Programs: What CCOs Learned In the First 18-Months

By Michelle Jacko

Now that Investment Advisers' annual reviews are complete, Chief Compliance Officers ("CCOs") have the opportunity to look back and reflect upon what they learned over the last 18 months. Going back through this journey helps compliance professionals to appreciate the evolution of their compliance programs, to assess the strength of their firm's internal controls and to plan for the annual compliance review next year.

When the Compliance Program rule ("Rule")<sup>1</sup> was first enacted by the SEC in 2003, the investment adviser community pondered how it should conduct its annual review. In accordance with the Rule, advisers registered with the SEC are required to "review, no less frequently than annually, the adequacy of the policies and procedures (to ensure compliance with federal securities laws)...and the effectiveness of their implementation."<sup>2</sup>

Additionally, the Rule requires that advisers registered with the SEC keep for five years "any

records documenting the investment adviser's annual review of policies and procedures."<sup>3</sup>

One challenge CCOs immediately faced was that the SEC had not clearly defined the annual compliance review nor delineated elements to be completed in this review. However, various SEC speeches paved a path for CCOs to follow. In her 2004 speech, "The New Compliance Rule: An Opportunity for Change," Lori Richards provided guidance on what compliance staff should do to ensure that the compliance program is **dynamic**:

Compliance staff should continually be asking: Are we detecting problematic conduct with this policy? Based on what we've detected, should we alter our policy? Is there a better way to detect problematic conduct?...Were the actions we took, once problematic conduct was detected, adequate to deter problematic conduct by this individual or others?<sup>4</sup>

Upon hearing this, CCOs echoed the terms prevention, detection, correction across their investment adviser firms. Senior management learned that the CCO's objective was to create a dynamic compliance

program focused on moving the firm's compliance efforts from a corrective mode to a detective mode. Throughout the next eighteen months, the CCO would work together with the various business units to create an action plan for enhancing firm policies and procedures, where needed, to prevent violations of federal securities laws by developing stronger internal controls. It was an exciting time, with numerous committee meetings and rumblings that compliance had gotten tougher. But for many, this represented a time where the firm's risk management efforts strengthened, making the role of the CCO more important than ever before.

Next, questions arose as to the role of the CCO and the SEC's expectations of how CCOs should measure the effectiveness of their compliance programs. Through industry conferences, SEC speeches and guidance from the SEC's CCO Outreach Program, investment adviser firms began to better understand the changing complexion of the CCO and the SEC's risk-based approach to compliance programs. In 2005, Randall Lee, Regional Director of the SEC's Pacific Regional Office emphasized

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that compliance begins with the “Moral DNA” of the investment advisory firm, with “the tone at the top [as] a good indicator of whether the firm’s objective is to do the right thing.”<sup>5</sup> Once that foundation is in place, the CCO’s primary areas of responsibility are to construct and maintain effective compliance programs. This includes, among other things:

- Identifying and assessing the *risks* of the firm
- Implementing *effective* policies and procedures
- Creating policies and procedures that address and allow each risk to be effectively *managed*<sup>6</sup>

With this guidance, CCOs began constructing their compliance programs and planning for and conducting their annual reviews.

### **The Review Process**

#### **Step 1: Identifying Firm Risks and Questioning Policies and Procedures**

Many CCOs began the review process by doing a comprehensive assessment of their firm’s policies and procedures to ensure that it provided sufficient detail. These reviews typically focused on whether the policy was clearly defined, was the procedure currently followed and did the procedure articulate roles and responsibilities for what personnel performed which functions.

Concurrently with this review, the CCO also had to identify firm risks. To assess risks, CCOs evaluated the effectiveness of control procedures, including the type and frequency of supervisory reviews, what records were created to track and report the outcomes, and whether escalation procedures existed for exception or outlier results. As part of the risk assessment, the CCO reviewed past SEC deficiency letters, assessed past compliance discrepancies and

considered SEC priorities in its examination process. In addition, CCOs identified changes in the firm’s business, including new lines of products and services offered, and considered what, if any potential conflicts of interest might exist as a result of this development. If conflicts were identified, the CCO then deliberated on what checks and balances might be needed to address those conflicts. Finally, the CCOs considered changes that occurred in applicable regulations that might necessitate the firm to revise its policies or procedures.

With all of this information, the CCO now was ready to revise and enhance the firm’s policies and procedures. As part of this process, CCOs considered what controls may be needed to prevent potential violations, how to best manage each risk identified and what training may be needed for staff and third party service providers on the firm’s newly revised policies and procedures.

While CCOs had a solid understanding of how to update policies and procedures, other questions regarding the Rule remained – how does the CCO properly document the annual review? How should the CCO respond to problems that are detected? How does the CCO preserve confidentiality of the work performed? *How much* should the CCO document and in *what format* should this recordkeeping take?

#### **Step 2: Preparing for the Annual Review**

In preparing for the annual review, many CCOs considered, among other things:

- Establishing an annual review committee;
- Identifying business line owners to evaluate whether any changes in the firm’s business had triggered

new or different legal or regulatory requirements;

- Reviewing whether the firm’s policies and procedures are enforced (if available, internal audit results may assist in these efforts);
- Evaluating recent customer complaints to help identify potential compliance issues; and
- Reviewing current regulatory hot topics

From these reviews, the CCO may decide what, if any actions should be taken as part of the firm’s annual review, which may include additional focused testing.

#### **Step 3: Testing**

In May 2005, Gene Gohlke provided CCOs with further guidance to the compliance review process. To help CCOs further identify and document risks, Gohlke suggested using three compliance tests: Transactional tests, Forensic tests and Periodic tests.<sup>7</sup>

Transactional compliance tests are performed around the time an activity occurs and should be part of the regular compliance system. For example, for soft dollar arrangements, a transactional compliance test would be pre-approval of all soft dollar arrangements prior to the time of execution.

The annual compliance review focuses primarily on the two remaining compliance tests. Periodic compliance tests are performed at appropriate intervals rather than concurrently with each transaction to verify compliance with relevant requirements. For example, for soft dollar arrangements, the CCO may want to periodically review trades with unusually high commissions and obtain a report of which broker-dealers are most frequently used and why.

On the other hand, Forensic compliance tests critically test an activity to determine whether there is a suspicion that the compliance system is being subverted through some means that may be difficult to detect through some other form of testing. For example, with soft dollar arrangements, the CCO may want to review the soft dollar contract to ensure that there are no “adhesion” clauses that would impact the brokerage allocation process. Next, the CCO could review the brokerage allocation process and then listen to telephone calls between the trade desk and the broker-dealer to help ensure there are no “arrangements” that would influence brokerage allocation.

CCOs found forensic testing to be the most difficult to perform and document. Often these tests may only raise suspicions but may not conclusively prove that a violation occurred. However, over time, forensic testing could help to identify and detect trends and patterns that would lead the CCO to evidence that misconduct has occurred.

Once testing is completed, CCOs had documents to support their risk assessment process. Periodic and forensic tests, internal audit reports and other surveillance efforts helped CCOs show that their risks are identified, managed and mitigated; that problems are found as they occur; that problems are resolved promptly; and those procedures at the business and compliance unit levels are performed in critical areas. Through various forms of back-up documentation such as exception reports, compliance checklists and work papers, CCOs had evidence to produce to the SEC to evidence their review of the Compliance Program. But is that enough?

#### **Step 4: Documenting the Overall**

### **Review of the Compliance Program**

To portray the “full picture” of compliance efforts, CCOs took various approaches. Most provided a GAP analysis of firm processes where exceptions were noted. CCOs documented policy exceptions, monitoring of high-risk areas, identified issues and evidenced the firm’s resolution to any issues noted. As part of the process, CCOs conducted interviews with appropriate personnel, inspected relevant documentation, observed the firm’s operations and evaluated internal controls. But how is this information best reported?

While the SEC requires every adviser to document its review of policies and procedures, only investment companies are required to provide a written report to the fund board that addresses, “the operation of the policies and procedures of the fund and of each investment adviser, principal underwriter, administrator and transfer agent of the fund...and each material compliance matter that occurred since the date of the last report.”<sup>8</sup> Nonetheless, many CCOs of investment advisers have opted to write a report as well to its senior management.

For some advisers, the annual review took the form of a brief summary report, written in “plain English” so that management was able to comprehend the issues. For others, the annual review consisted of a comprehensive list that summarized the following:

**Procedure Reviewed** (E.g. Soft Dollars)

**Findings**

**Summary and Conclusions**

**Recommended Change/Update**

**Review & Date of Review**

**Review by CCO**

**Completion Date & Final Actions**

No matter the form, the content remains the same. Most reports contain (1) a description of each policy and procedure reviewed, (2) a summary of the findings, (3) a summary description of issues and conclusions, and (4) any updates made to the policy or procedure as a result of the review. Back-up documentation supporting testing and the annual review were frequently provided in a separate report. This report included, among other things, the SAS 70, interview notes from key personnel, internal audit notes, outside consultant reports and periodic and forensic testing results.

### **Step 5: Planning for 2007 and Beyond**

Now that the first annual review is complete, CCOs are better positioned to prepare reports during the course of 2006 and to present those findings to senior management as the review is concluded. To help keep CCOs on track, think about developing a compliance calendar. By identifying those areas that were most complex, took the most time to review and/or that had the most issues, you can build an effective timeline and calendar the steps necessary to conduct a thorough review. Try to anticipate what changes may be required to your firm’s policies and procedures next year. For example, once the SEC finalizes its soft dollar guidance, you may need to update your firm’s soft dollar policies and procedures.

Most importantly, the annual review should assist CCOs in identifying firm risk-management needs and potential resources necessary for the firm’s compliance program. CCOs now should develop a proposal to senior management that helps define what resources are needed for next year. Compliance

personnel, outside consultants, development of an internal audit group, technology support and enhanced surveillance efforts should be considered and reported up to help ensure that budget dollars are secured for these efforts. By using this article to develop a “checklist” you may be able to further identify what you may want to consider in your annual review next year. Creating a systematic approach to your annual review will help build expectations, efficiencies and relationships for the CCO now and in the years ahead.

1. Investment Advisers Act of 1940 (“Advisers Act”), Rule 206(4)-7 and Investment Company Act of 1940 (“Company Act”), Rule 38a-1(a)(3).
2. Investment Advisers Act of 1940 (“Advisers Act”), Rule 206(4)-7.
3. Advisers Act Rule 204-2(a)(17)(ii).
4. Lori Richards, speech: “The New Compliance Rule: An Opportunity for Change,” (June 28, 2004).
5. Randall Lee, speech: “The SEC’s CCO Outreach Program,” (May 24, 2005).
6. Rosalind Tyson, Associate Regional Director of the SEC’s Pacific Regional Office, speech: “The SEC’s CCO Outreach Program,” (May 24, 2005)

7. Gene Gohlke, speech: “Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC’s New Regulatory Framework,” (May 5, 2005).
8. Company Act Rule 38a-1(a)(4)(iii)(A) and (B).

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