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# Improving Adviser Compliance Controls

*By Michael R. Weissmann and E. David Hwa*

Since the SEC adopted Investment Advisers Act Rule 206(4)-7 in December 2003,[1] its Staff has worked diligently with the industry to define and develop robust compliance programs. The Staff has suggested that one way to enhance compliance is by returning to "first principles." In February 2006, Lori Richards, the SEC's Director of the Office of Compliance Inspections and Examinations, put it this way: [O]ne only has to look at [the SEC's] enforcement actions and deficiencies found in exams to draw the conclusion that the application of fiduciary duty is not as embedded in many firms' cultures as it could be. In fact, I'm far from certain that all advisory firms understand their fiduciary obligations, and how they apply in the context of their own operations.[2]

Ms. Richards summarized "five major responsibilities" owed by an adviser to its clients: "(1) to put clients' interests first; (2) to act with utmost good faith; (3) to provide full and fair disclosure of all material facts; (4) not to mislead clients; and (5) to expose all conflicts of interest to clients."

Meeting the firm's fiduciary responsibilities cannot be left only to management or to the compliance department. Since, as Ms. Richard noted, the firm's fiduciary responsibilities are broad and varied, virtually any employee of the firm can influence or affect the firm's fulfillment of these major responsibilities. A "Culture of Compliance" is needed where all adviser employees put the interests of the clients first, act in good faith in all interactions undertaken on behalf of clients or that impact clients, do not mislead clients, and make fair and full disclosures of all material facts and relevant conflicts of interest.

There are no one-size-fits-all solutions to improving compliance controls.[3] However, by thinking critically about the scope of the duty the firm owes to its clients and the manner in which those responsibilities are communicated to its employees, advisers can become better at identifying and resolving compliance issues.

**From the Top Down – Tone at the Top**

A "Culture of Compliance" begins with the tone at the top of the organization. This includes the firm's senior management, and, where it is a separate group, oversight by the firm's board of directors. Firm management (with board approval and support) must set the tone for the entire firm.[4]

Keeping their policies and procedures up-to-date is one concrete way firms set a tone of compliance. The firm must also hire, and retain, individuals competent in understanding and effecting the compliance function and related oversight roles. Firms should adopt a Code of Conduct that applies to all employees, even those who are not directly involved in the firm's investment activity and thus not necessarily covered by the Code of Ethics. A Code of Conduct might cover issues such as use of email, use of firm resources, speaking with the press, outside business activities and personal investments. Training and consistent, even-handed, enforcement of applicable policies and procedures – including the Code of Conduct – will raise compliance awareness and, hopefully, adherence.

At the same time, the firm should be conscious of the conflict between the firm's desire to be profitable and its fiduciary responsibility to put clients' interests first. Management should set performance and

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**IA COMPLIANCE CONTROLS**
*(Continued from page 1)*

incentive compensation targets that are reasonable and realistic, and that encourage sound long term management practices, rather than impose undue pressure to achieve short term results or otherwise act in ways that are contrary to the clients' interests.

A Culture of Compliance can also be fostered from the top in a number of other ways. Management demonstrates its integrity to its employees by following and enforcing the firm's policies, establishing new policies when needed, and regularly providing employees with policy clarifications and guidance. Management should also try to introduce compliance topics in regularly scheduled meetings (including sales meetings), rather than saving them for special compliance meetings. This emphasizes that compliance is an integral part of the firm's business, not merely a once a year or once a quarter concern. Similarly, management must react promptly, and appropriately, to problems raised by their employees, so as to encourage the employees to identify issues and notify management as early as possible.

Of similar importance to advisers with a separate board is that management shows it is receptive to the board's oversight and engages the board in meaningful dialogue about the firm's business, problems that have emerged, and conflicts of interest that have been identified. Management's process for addressing conflicts of interest should include reporting to the board on steps that have been taken and, when necessary, seeking its assistance and guidance in resolving the more difficult issues that may arise.

**Across the Firm**

Even if firm management succeeds in instilling in its employees the right tone, putting in place an effective compliance infrastructure remains a substantial task. An effective compliance program does at least four things: (1) it assesses risks; (2) it develops and communicates appropriate policies and procedures to address those risks, (3) it monitors the firm's implementation and compliance with the polices and procedures so that gaps can be identified and filled, and (4) it adapts to reflect experience and changes in the firm's business or in the regulatory environment.

**Assess the Risks**

The first step in any compliance program is to identify conflicts of interest and other factors creating risk exposure for the firm and its clients.[5] The SEC, in adopting Advisers Act Rule 206(4)-7, specifically listed ten areas of potential risk that must be addressed by each adviser in its compliance program.[6] Indeed, the deficiencies most frequently cited by the SEC staff[7] – deficient disclosures, deficiencies in portfolio management, deficiencies with respect to monitoring employee personal trading, deficiencies in performance calculations, and deficiencies in brokerage arrangements – are all on this list. Beyond these specific areas, conflicts of interest are most likely to emerge wherever the adviser faces strong incentives – financial or otherwise – to act against the best interests of its clients.[8] These areas deserve additional and closer attention by the adviser.

Keeping compliance efforts in these first ten areas current, and identifying conflicts in other areas, depends on management and the compliance staff developing sources of reliable internal and external information about the firm's business, its clients, the industry, and the industries and areas in which the firm and its clients hold financial stakes. Identifying conflicts of interest is a firm-wide responsibility, not just the responsibility of the compliance staff. Each part of the business, including portfolio managers, traders, the sales organization, and employees involved in outsourcing arrangements, may have relevant information about possible conflicts. The compliance effort can be improved – and its importance emphasized – by engaging the business groups in efforts to identify conflicts, and providing them with ways to report relevant information or developments. Compliance's role will then be to collect information from these sources, to analyze and review it, and to provide it timely to the "right people," so they can work with the CCO to set the compliance priorities for the compliance staff to implement.

**Develop and Communicate Policies and Procedures**

Once identified, two ways to address a conflict of interest are (1) eliminate the arrangements or activities that create the conflict or (2) disclose the conflict fully and fairly and then manage the adviser's activities so that the conflict is treated consistent with the disclosures.[9] The SEC advocates what it calls "Activist Compliance;" a program that actively and continually seeks to identify conflicts of interest and changes in regulations, and responds with corrections and adjustments utilizing the latest technology, enforced by a skeptical compliance staff that seeks to prevent and detect misconduct.[10]

Compliance controls should

be selected and developed by considering, in light of the adviser's compliance objectives, the nature of the conflict and whether the conflict should be eliminated or disclosed and monitored. Elimination of a conflict will often require an undertaking by management and, where applicable, the board, to revise affected aspects of the firm's business structure. For example, the adviser might hire additional personnel or change reporting lines so employees are not supervising and reviewing their own work product. Similarly, a firm may seek new vendors or renegotiate or update existing agreements or arrangements to eliminate conflicts.

Most conflicts are dealt with by a combination of written policies and procedures and through disclosures. These components should be considered jointly. While the implementation of a policy may mitigate a conflict of interest, it does not absolve the adviser of the obligation to disclose the conflict to its clients. As the SEC staff has noted, the most frequent violation they encounter is a failure by advisers to make adequate disclosures.[11] Firms should conduct periodic in-depth reviews of their form ADV, along with all other written materials provided to clients and to the public, and compare these disclosures against the firm's actual business operations. In addition, the firm should disclose any new conflicts or material changes as soon as they arise or come to light, even if it requires updating the form ADV or making an updated disclosure to clients earlier than the adviser otherwise would. Policies and procedures, in turn, should be constructed with disclosure in mind so that the business is managed in a way that is consistent with the disclosure.

The particular nature of the policies and procedures a firm develops vary widely from firm to firm, and will depend greatly on the size of the firm, the complexity of its business, and, most importantly, the nature of the conflict at issue. Which procedures are appropriate and the level of automation the SEC would expect to find depends first on the nature of the adviser's business (e.g. advising mutual fund wrap accounts versus a quantitative small cap equity strategy), then on the size of the task and the feasibility of a particular solution. This point can be amply illustrated by examples from several areas that have attracted recent regulatory attention.

*Personal trading*: A starting point for mitigating the risk of personal trading that conflicts with client interests is adopting a written policy that defines the transactions and the types of trading that are prohibited, either by law (*e.g.* front running) or by firm policy (*e.g.* short-swing trading, IPOs, options trading, and short selling). Firms should then develop procedures to enforce these policies, such as requiring employees to provide signed compliance verifications, requiring employees to maintain accounts at affiliated custodians or to designate the firm to receive duplicate account statements or confirms, and requiring all or some employees to pre-clear trades. The particular means by which a firm monitors employees' trading depends on the number of employees, the amount of trading in which they engage, and whether that trading is in securities or products that may create conflicts with the investments made on behalf of clients. For some firms, automation of these reviews will be necessary, while some smaller firms may be able to conduct manual surveillance.[12]

*Gifts and gratuities*: The firm should start with a clear gifts and gratuities policy that explains the conflicts gifts can create by influencing employees to act contrary to their clients' interests and then specifies what can and cannot be given or accepted. An effective policy might addresses specific types of common gifts (*e.g.* meals, tickets to sporting events) as well as providing generally applicable guidelines, and designating individuals to whom an employee may turn for guidance. Accompanying procedures will usually include gift reports, and may, in some instances, require pre-approval from a supervisor or a compliance officer. Again, the extent to which this process is automated will depend on the firm's size, the nature of its business, and the number of reports or approvals at issue.

*Material nonpublic information*: Here a written policy is needed that emphasizes the legal prohibition on using this type of information – for personal gain, for trading on a client's behalf, or to pass on to others. The firm should then establish appropriate information barriers and walls, develop watch lists and restricted trade lists, and build reports to monitor for trading in these securities. The complexity of the policy and the need for automated monitoring vary greatly. Advisers situated within diversified financial service firms with investment banking operations, for example, may be more likely to come in contact with material non-public information, and may, therefore, need more extensive policies and monitoring than do small stand-alone advisers.

*Brokerage*: A firm's brokerage

*(Continued on page 4)*

**IA COMPLIANCE CONTROLS**
*(Continued from page 3)*

policy will define the characteristics of an approved broker, as well as any considerations or exceptions that might apply for specialty products. Its procedures for qualifying a broker-dealer might describe the types of due diligence to be gathered about, for example, the firm's ability to deliver best execution and the overall services being offered, who may approve a relationship, and should include mechanisms to identify and disclose any conflicts.

*Valuation*: The risk associated with valuation arises principally in dealing with illiquid securities that are difficult to value. Firms trading only easily valued securities (*e.g.* mutual funds, exchange traded securities) may face few valuation issues and need only limited policies and procedures. Other firms will require policies and procedures that not only explain the importance of arriving at an accurate valuation, but also identify the types of securities at issue, specify acceptable methods to reach a valuation for each type of security, and describe how the process will be overseen. The procedures should be consistent with any disclosures, and might include measures – such as a valuation committee – to limit conflicts by separating the portfolio managers from these valuation decisions.

In each instance the goal remains for the firm to efficiently and effectively meet its fiduciary obligations to its clients in light of a particular conflict.

**Monitoring**

A final component of an effective compliance program – and a requirement for compliance with both Rule 206(4)-7 and Rule 38a-1[13] – is a process that assesses the quality of the compliance system's performance over time. A robust monitoring program will include procedures to conduct and document periodic, systematic evaluations of all aspects of the adviser's compliance control systems. Principally, the evaluation must assess whether the existing policies remain consistent with the regulatory requirements and cover all aspects of the adviser's business.

A thorough review, however, should also look closely at other measures of the system's effectiveness, such as whether senior and line management have accepted control responsibility, rather than merely delegating responsibility to the CCO, compliance staff or subordinates, whether control deficiencies are reported to upper management, whether issues that are reported are corrected on a timely basis, and the extent to which the firm can demonstrate that compliance controls are consistently and timely monitored by management and compliance.

The SEC also encourages the use of forensic testing. These are tests that, rather than repeating established compliance tests, validate those tests by assessing, quantitatively over time, whether portfolio results match the expectation that clients will be dealt with fairly.[14] Trading and allocations are common areas for forensic testing since it is possible, for example, to measure quantitatively correlations between the volume of fund-share sales by a particular broker-dealer and the level of trading done through that broker-dealer. Forensic testing can, similarly, analyze the allocation of investments between funds with performance-based fees and funds without performance-based fees.[15]

The effectiveness of the monitoring program can also be improved by giving careful thought to who conducts the review. The personnel assigned should have appropriate responsibilities, business experience, and knowledge of the organization's affairs. In some instances their review may also be improved by operational separation – and insulation – from affected adviser personnel. Groups like internal audit, or even external auditors or consultants, who have direct lines of communications both with the CCO and with senior management, may provide the most effective monitoring of certain sensitive business functions.

Of equal importance to conducting these evaluations, is establishing procedures for reporting and review. Monitoring results must be distributed to the right people, and acted upon by them in a timely manner. Internal control deficiencies should be reported to senior management, and in certain instances the board.

**Conclusion**

Internal compliance controls cannot ensure success - bad decisions, poor managers, unethical behavior, collusion and override of controls can still present problems. But good controls help organizations get where they want to go while minimizing pitfalls and surprises. ❑

1. *See*, Investment Advisers Act of 1940 (Advisers Act) Rel. No. 2204 (Dec. 17, 2003). The same release also adopted Investment Company Act Rule 38a-1. That rule addresses many of the same issues and imposes many of the same requirements as Rule 206(4)-7, as well as several additional, mutual fund specific, requirements.
2. Lori A. Richards, Director, Office of Compliance Inspections and Examinations, *Fiduciary Duty: Return to First Principles*, U.S. Securities and Exchange Commission Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006) *(First Principles)*, at http://www.sec.gov/news/speech/spch022706lar.htm.
3. *See, id.*
4. *See,* Lori A. Richards, Director, Office of Compliance Inspections and Examinations, *Compliance: Some Core Principles,* National Regulatory Services Twentieth Annual Spring Compliance/Risk Management Conference (Apr. 20, 2005) (*Core Principals)*, at http://www.sec.gov/news/speech/spch042005lr.htm.
5. *See,* Advisers Act Rel. No. 2204.
6. These are (1) portfolio management processes; (2) trading practices; (3) proprietary trading and personal trading by insiders; (4) accuracy of disclosures to clients (including to fund governing entities); (5) safeguarding clients' assets; (6) creation and maintenance of required records; (7) marketing and solicitation activities; (8) valuation of clients' assets; (9) safeguarding for privacy protection of client records and financial information; and (10) business continuity plans. Advisers Act Rel. No. 2204. As the release notes, these risk areas are equally applicable to investment companies, which will, in addition, have other compliance risks that should be addressed.
7. *See, First Principles.*
8. *See*, Linda Chatman Thomsen, Director, Division of Enforcement, *Remarks Before the IA Week and the Investment Adviser Association 9th Annual IA Compliance Best Practices Summit 2007* (Mar. 22, 2007), at http://www.sec.gov/news/speech/2007/spch032207lct.htm.
9. *See,* Gene Gohlke, Associate Director, Office of Compliance Inspections and Examinations, *SEC Expectations for Regulatory Compliance,* Remarks before the Fund of Funds Forum, New York, NY (Nov. 14, 2005) (*SEC Expectations*), at http://www.sec.gov/news/speech/spch111405gag.htm.
10. *See,* Lori Richards, Director, Office of Compliance Inspections and Examinations, *Better Than 'Business as Usual',* Remarks before the National Society of Compliance Professionals National Membership Meeting, Washington, D.C. (Oct. 25, 2005) (*Business as Usual)*, at http://www.sec.gov/news/speech/spch102605lr.htm; *see also,* Lori Richards, Director, Office of Compliance Inspections and Examinations, *Compliance: Some Core Principles*, National Regulatory Services' Twentieth Annual Spring Compliance/Risk Management Conference, Scottsdale, AZ (Apr. 20, 2005), at http://www.sec.gov/news/speech/spch042005lr.htm.
11. *See, First Principles*.
12. Advisers Act Rel. No. 2256 (July 2, 2004) (Code of Ethics) ("we question seriously whether a larger investment advisory firm will be able adequately to review [personal securities] reports manually or on paper").
13. Gene A. Gohlke, Associate Director, Office of Compliance Inspections and Examinations, *Examiner Oversight of "Annual" Reviews Conducted by Advisers and Funds,* (Apr. 7, 2006), at http://www.sec.gov/info/cco/ann_review_oversight.htm.
14. *See, Business as Usual.*
15. *See,* Tom Leswing, *SEC Expects Changes in CCO Reviews This Year,* Ignites, Apr. 2, 2007, at http://www.ignites.com; Advisers Act of 1940 Rel. No. 2204, at n. 15.


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