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Investment Adviser Regulation An A to Z Workshop

Compliance Officers and Compliance Programs

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Rule 206(4)-7: The Next Generation

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Rule 206(4)-7 Recap

- » Appoint a chief compliance officer.
- » Adopt and implement written policies and procedures reasonably designed to prevent violations, by you and your supervised persons, of the Advisers Act and its rules.
- » Review, at least annually, the adequacy of your policies and procedures and the effectiveness of their implementation.

The Chief Compliance Officer (CCO)

- » The CCO should be competent and knowledgeable regarding the Advisers Act and empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.
 - The CCO should have sufficient seniority and authority within the organization to compel others to adhere to compliance policies and procedures.
 - If the CCO has or takes on another organizational role, the firm should ask whether it has identified and managed any resulting conflicts of interest.
- » During SEC examinations, the CCO should expect “to discuss . . . the overall system of controls maintained by the Adviser as well as the specific control procedures used by the Adviser in the areas listed below. . . .”

Adopt and Implement Policies and Procedures Reasonably Designed to Prevent Violations

- » The rule requires that the policies and procedures be reasonably designed to prevent violation of the Advisers Act, and thus only need to encompass compliance considerations relevant to the operations of the adviser.
- » The policies and procedures should be designed to:
 - prevent violations from occurring;
 - detect violations that have occurred; and
 - correct promptly any violations that have occurred.
- » SEC examiners are finding that firms' compliance manuals do not address firms' risks, list risks that do not exist at firms or establish procedures that firms do not follow.

Enforcement of Rule 206(4)-7

- » Failure to have adequate policies and procedures in place constitutes a violation under Section 206(4) independent of any other securities law violation.
- » The Rule creates mechanism to address the failure of to maintain adequate compliance controls “before that failure has a chance to harm clients or investors.”
- » The Rule did not alter existing books and records requirements to maintain written compliance procedures in certain areas, including:
 - privacy (Regulation S-P)
 - Code of Ethics
 - voting of securities
 - solicitation activities
 - storage of electronic records

Enforcement of Rule 206(4)-7

- » *CapitalWorks Investment Partners, LLC* (June 6, 2006).
 - No written policies or procedures relating to client communications, including RFPs.

- » *Consulting Services Group, LLC* (October 4, 2007).
 - CSG failed to undertake adequate efforts to identify risk factors or specific conflicts applicable to its operations as a pension consultant and affiliated broker.
 - Example of what can go wrong with use of pre-packaged compliance manuals and procedure templates.

SEC Reviews of Annual Reviews

- » Who conducted the review?
 - Internal compliance?
 - Internal audit and consultants?
 - Were business people (operations and management personnel) involved?
- » What was reviewed?
 - All material areas of the firm's activities that could cause violations?
 - Conflicts and other compliance factors creating risk exposure?
 - How were those areas chosen – based on risk assessment?

- » How was the review conducted?
 - Interviews?
 - Exception reports?
 - Forensic testing?
 - Compliance tests that analyze information over time in order to identify unusual patterns:
 - *“Provide a list of the forensic tests performed, the dates of the forensic tests and the corresponding objectives and results of each forensic test.”*

SEC Reviews of Annual Reviews

- » When were the activities reviewed?
 - Last minute?
 - Throughout the year?
 - ongoing, rolling basis;
 - in response to compliance incidents or business events.
 - Concentrated time period – quarterly or monthly?
 - Day-to-day?
 - Work done to probe, analyze, evaluate, improve or update can be considered part of annual review – if documented accordingly.
- » What were the findings?
- » What recommendations for improvement were made?
- » How was the review documented?
- » What recommendations and feedback was provided to senior management?
- » What is the status of the work on any recommendations?

The Adviser's Annual Review

» Focus

- Adequacy of Policies & Procedures
- Effectiveness of Implementation

» Develop a game plan

- Areas to be reviewed, resources, timeline

» Review Advisers Act, related rules and interpretations and any changes

The Adviser's Annual Review: Review Risk Assessment

- » “[E]ach adviser should identify its unique set of risks, both as the starting point for developing its compliance policies and procedures and as part of its periodic assessment of the continued effectiveness of these policies and procedures.”
- » “Provide a current inventory of the Adviser’s compliance risks. If changes were made to this inventory of risks during the Examination Period, please indicate what these changes were and the corresponding date of the change.”
 - Does the firm’s inventory identify where information flows? Where funds and securities flow?
 - Does it show how for each risk, a control is in place? That the control has been implemented? Who is responsible?

The Adviser's Annual Review: Adequacy of Policies & Procedures

- » Review last annual review
- » Review past SEC deficiency letters
 - To ensure past errors have been addressed
 - And that your firm has done what it said it would do
- » Consider
 - Compliance matters that arose in the past year
 - Changes in business organization, activities and affiliations
 - Compliance risks in your business – define “material business risks”
 - SEC enforcement actions
 - Current focal areas in SEC exams

The Adviser's Annual Review: Focus on Testing

- » *Provide relevant information that “documents and substantiates” the effectiveness of the Adviser’s compliance program.*
- » *“Provide documents that contain ‘output’ from the application” of the compliance program to “the daily work flows of the adviser.”*
 - Review inventory of tests, reviews and reports.
 - Verify they have been completed, documented and approved.
 - Consider whether others are needed based on changes since last review.

- » Examples
 - Exception reports with documentation of follow-up
 - Completed compliance checklists
 - Reconciliations
 - Management reports
 - Supervisory approval of overrides
 - Warning or sanction notices
 - Results of analyses or self-assessments
 - Internal audit reports

The Adviser's Annual Review: Effectiveness of Implementation

- » Interview personnel to determine their understanding and impressions of the existing procedures:
 - Do your policies and procedures reflect your real practices?
 - Don't confine interviews to the Compliance Department: *"At various times during fieldwork, the staff will also want to interview persons responsible for such functions as portfolio management, trade execution, back office/administration, information technology, anti-money laundering and marketing."*
- » Evaluate whether the frequency of exceptions or violations has decreased.
 - Inverse of trend analysis or pattern testing used to detect patterns that may be indicative of compliance issues requiring attention.

The Adviser's Annual Review: Written report?

» How can you memorialize your work so you can

- Document what you looked at and your conclusions?
- Quickly and readily show the SEC your process and conclusions?

» Alternatives

- Formal written report – executive summary vs. detailed report.
- Review map or flow chart with checklists and other documentation.
- Grid or matrix – list of controls, testing, findings, recommendations, sign off.

» Rule 204-2(a)(17)(ii) – requires retention of “any records documenting the investment adviser’s annual review.”

» Concerns

- May create a roadmap to weaknesses.
- May contain privileged and confidential information – how to protect from inadvertent production.
- Clients may request.

John Walsh's Suggested Chat with Management

1. Did we meet all regulatory deadlines and with full compliance?
2. Did we identify compliance risk exposures created by our organization, affiliations or the way we do business, not faced by other comparable firms?
3. Can we demonstrate how specific policies and procedures address our specific risk exposures without "gaps" between risk and response?
4. Do our policies and procedures reflect our real practices? Are our real practices better or worse than what we have written down?
5. Did we bring in outsiders to look at our policies or procedures?

John Walsh's Suggested Chat with Management

6. What tests did we run to detect unusual patterns and to verify our procedures and the accuracy of specific disclosures we have made?
7. What were the worst red flags identified, and what have we done?
8. Do we have any serious compliance issues remaining open?
9. Has anyone tried to block compliance from doing its job?
10. What can senior management do to ensure that the review has a lasting and positive impact?

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