

Morgan Lewis

IAA Compliance Workshop
San Francisco, CA

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Annual Compliance Program Reviews
November 15, 2007

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The Next Generation

- » Rule 206(4)-7 Recap
- » Enforcement of Rule 206(4)-7
- » SEC Reviews of Annual Reviews
- » 2007 Annual Review
 - Adequacy of Policies & Procedures
 - Effectiveness of Implementation
 - Written report?
 - What Next?
- » John Walsh's Suggested Chat with Management

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

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
- » Creates mechanism to address the failure of to maintain adequate compliance controls – “before that failure has a chance to harm clients or investors”
- » *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

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 feedback was provided to senior management?
 - Have they been involved?
- » What is the status of the work on any recommendations?

Annual Review 2007

- » Focus
 - Adequacy of Policies & Procedures
 - Effectiveness of Implementation
- » Develop a game plan
 - Areas to be reviewed, resources, timeline
- » 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.*

Adequacy of Policies & Procedures

- » Review Advisers Act and related rules and interpretations – and any changes
- » Review last annual review
- » 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
- » Conduct interviews
 - Do your policies and procedures reflect your real practices?

Effectiveness of Implementation

» Focus on Testing

- Review inventory of called-for tests, reviews and reports
- Verify they have been completed, documented and approved
- Consider whether others are needed based on changes since last review

» *Provide relevant information that “documents and substantiates” the effectiveness of the Adviser’s compliance program*

» *Reflects the “output” from the application of the compliance program to the daily work flows of the adviser*

» 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

Effectiveness of Implementation

- » Review past SEC deficiency letters
 - To ensure past errors have been addressed
 - And that your firm has done what it said it would do
- » Interview personnel to determine their understanding and impressions of the existing procedures
- » 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

Written report?

- » Not required by Rule 206(4)-7
 - Contrast Rule 38a-1
 - Documentation requirement under Rule 204-2(a)(17)(ii)
- » How else can you memorialize your work so you can
 - Document what you looked at and your conclusions?
 - Show the SEC your process and conclusions?

- » Alternatives
 - Formal written report – executive summary vs. detailed report
 - Review map with checklists and other documentation
 - Grid – list of controls, testing, findings, recommendations, sign off
- » Dickey issues
 - Creating a roadmap to weaknesses
 - SEC requests for privileged and confidential information in reports
 - Client requests for reports

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?
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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