



# **CREATING A MANAGEABLE & DEFENSIBLE RECORDKEEPING SYSTEM**

**25<sup>th</sup> Annual  
NRS SPRING CONFERENCE  
FT. LAUDERDALE, FLORIDA**

**April 21, 2010**

# SPEAKERS

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# AGENDA

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- Know the Advisers Act Books and Records Rule requirements – The Basics
- Discuss practical tips for meeting the books and records requirements
- What do SEC Examiners expect?
- What are SEC Examiners finding?
- Most common record keeping deficiencies
- Tips for avoiding common deficiencies
- Discuss Risk Assessments and best practices

# The Basics:

## Section 204-2 of Advisers Act

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- Every investment adviser shall make and keep for prescribed periods such records as the Commission, by rule, may prescribe as necessary. All records (as so defined) of investment advisers are subject at any time, to reasonable **periodic, special, or other examinations** by representatives of the Commission...

# The Basics: Rule 204-2 Summary

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- Rule 204-2 is organized into 10 paragraphs: (a) through (j).
  - (a): Firm and client records to be retained by **all** investment advisers.
  - (b): Additional records that must be kept by an adviser with custody of client funds or securities.
  - (c) & (d): Records to be maintained for portfolios it supervises or manages.
  - (e), (f) & (g): Retention requirements of records maintained under paragraphs (a) through (d).
  - (h): Permits an adviser who is also a registered broker-dealer to substitute and rely on similar records maintained under the Securities and Exchange Act of 1934.
  - (i) Defines “discretionary power” for purposes of the rule.
  - (j): Recordkeeping requirements for a foreign adviser.

## The Basics: Rule 204-2(a)

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- (a) Every investment adviser shall make and keep **true, accurate and current** the following books and records relating to its investment advisory business:
- Not a static process - new records added, aged records preserved as prescribed or discarded

# The Basics: Records Retention Period

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- In general, records must be maintained for five years after the end of the fiscal year during which either the last entry was made or the last usage of the record occurred, and
- ...the first two years in an accessible office of the investment adviser.

# The Basics:

## Records Retention Period (cont.)

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- **Exceptions:**
  - Partnership/LLC/Corporate Records
    - (i.e. Articles; Charters; Minute Books; Stock Ledgers; etc.)
    - *At Least 3 Years After Termination*
    - *(... effectively forever for ongoing entities)*
  - *Performance documentation*
    - *(i.e. calculations & account statements & reconciliation)*
    - *At Least 5 years after the last usage of the earliest performance information*  
*(... effectively forever, because performance of “since inception” covers all periods and all information!)*

# Practical Tips

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- Regulators can and do request records that are not otherwise required
- Many of the records requested, that are not otherwise required, are logically incidental to required records
- If they request and you don't have them, don't panic
- If you do have them, they are entitled to review them (whether a Rule 204-2 required record or not)
- Likewise, if you retain records longer than required, regulators are entitled to review any records that exist
- You cannot destroy old records (or any records!) after you have been informed of an upcoming examination

# Examiners' Objectives

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- What are examiners looking for in books & records review?
  - Indications of compliance with all regulatory & fiduciary requirements that pertain to the adviser
  - Information to substantiate risk management and control processes
  - Compliance and control-related documents
  - Information that determines whether the firm's compliance program and controls are effective/ineffective
  - Meeting recordkeeping requirements

# Practical Tips

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- Other useful records to keep
  - Information about firm's control and compliance processes
    - Risk Assessment Summary
    - Operations manuals
  - Information that can demonstrate system of controls is effective
    - Exception/alert reports
    - Compliance checklists
    - Management reports (Annual Review Summaries)
    - Compliance workpapers
    - Compliance self assessments
    - Consultant's reports related to compliance

# Recordkeeping Deficiencies

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- Records are incomplete or inaccurate
- Required records are not maintained
- Records are not kept or retained as required

# Recordkeeping Deficiencies

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1. Incomplete Order Tickets & Memoranda
2. Incomplete Code of Ethics Records & Reporting
3. Nonexistent or Deficient Solicitors' Agreements, Disclosure Documents or Client Acknowledgements
4. Absent/Dated Corporate or Financial Records
5. Insufficient Documentation Supporting Performance Advertising.
6. Incomplete Records of Form ADV Annual Offer and Delivery
7. Inadequate and/or not Current Client Lists

# Retention & Retrieval Electronic Storage:

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- **An adviser can maintain required records in either paper or electronic format.**
- **For electronic recordkeeping, Rule 204-2(g) under the Advisers Act generally requires the following:**
  - Records must be arranged and indexed in a way that permits easy location, access, and retrieval.
  - Records must be provided promptly to the SEC upon request.
  - A duplicate copy of the records must be separately stored, on any medium allowed by the rule, for the time required for preservation of the original record.
  - Records must be maintained in a manner that will reasonably safeguard against loss, alteration, or destruction.
  - Access to records must be limited to authorized persons and proper SEC staff.
  - Any reproduction of electronically stored records must be complete, true, and legible as original when retrieved.

# Electronic Storage: Email, IM & More

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- E-mail correspondence & records:
  - Prior SEC request letters
    - “Please provide all e-mails, including their corresponding attachments, sent and received by the following individuals during the indicated time periods. Please provide emails in their native electronic format (e.g., pst. format if using MS Outlook)”
- Instant messaging
- Blackberry, etc.
- Cell phone messaging
- Social networking

## Record Management Tips

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- Either Supervisors or a Records Manager has oversight responsibility for record retention...who will determine/assign responsibility for each required record and monitor compliance.
- Prepare a record maintenance spreadsheet which tracks locations of documents and responsibilities
- Remind all employees of responsibility for either electronically or manually retaining required records.
- Maintain well organized files, documents and procedures: organize periodic review / document clean-up for the firm to ensure that records are kept on a current basis and contain true and accurate representations of facts.

## Record Management Tips (cont.)

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- Timely sorting of trade records for any given day in appropriate files
- Educate all employees about record maintenance and retention requirements (esp. trading personnel).
- Insure all prior deficiencies were and are currently addressed - avoid recidivism !
- Be prepared to explain and document the firm's process for managing the risks to which its clients are exposed which includes the firm's system of internal controls.

## Record Management Tips (cont.)

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- Do not lie, stonewall or destroy records. SEC staff must get accurate and complete information.
- You may limit an examiner's access to personnel files, information and business areas.
- You should review materials before delivering to regulators and maintain copies of all requested and provided materials.
- Bates-stamp documents provided remotely & request FOIA confidentiality treatment.
- Establish a record retention policy that includes off-site storage and periodic destruction requirements.

# Risk Assessment

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- **SEC OCIE CORE INITIAL REQUEST FOR INFORMATION:\***
  - On-going Risk Identification and Assessment
    1. Inventory of compliance risks that forms the basis for policies and procedures and notations regarding changes made to the inventory.
    2. Documents mapping the inventory of risks to written policies and procedures.
    3. Written guidance provided to employees regarding compliance risk assessment process and procedures to mitigate and manage compliance risks.
  - \*OCIE Investment Adviser Examinations: Core Initial Request for Information  
(<http://www.sec.gov/info/cco/requestlistcore1108.htm>)

# Risk Assessment

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- RISK ASSESSMENT BEST PRACTICES
  - Identify compliance and business risks
  - Map to compliance policies
  - Assign risk rankings
  - Identify controls / procedures
  - Identify gaps / testing
  - Assign responsibilities
  - Consider Risk Committee
  - Review periodically / Annual Review

# Risk Assessment

2006 CCO Outreach REGIONAL SEMINARS  
INVESTMENT ADVISER CASE STUDY  
DISCUSSION GUIDE

**BASIC SCENARIO**

SEC Registered Advisers, Inc. ("SRA") has \$47 million under management. It also:

1. Employs four staff; all of whom work from the same location
  - o The sole owner of SRA manages all portfolios
  - o One employee places all orders
  - o One employee serves as director of marketing and CCO
  - o One employee provides clerical assistance
2. Invests all client portfolios exclusively in no-load, unaffiliated mutual funds through the fund platform of a large, nationally-known broker-dealer

Potential Risks	Examples of Quality Control Processes and Compliance Policies and Procedures to Mitigate Risks	Examples of Review Procedures and Forensic Tests Performed	Required Disclosures/Good Practice Disclosures
As a result of its ownership and operational structure, SRA does not have the ability to establish adequate separation of functions.	SRA's owner's close involvement in firm operations is an adequate substitute for an extensive separation of functions.	Because certain functions are performed and reconciled by the same individual, SRA implements review procedures whereby another individual test checks such functions. This provides comfort that functions are performed accurately.	Form ADV includes disclosure regarding Registrant's officers. Any special circumstances that result from SRA's organizational structure are also disclosed.

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- \* [www.sec.gov/info/cco/cco\\_matrixguide.pdf](http://www.sec.gov/info/cco/cco_matrixguide.pdf)



# Risk Assessment

## NRS MODEL RISK ASSESSMENT REVIEW

### Compliance Program / Risk Assessment Review - 2009

Rule 206(4)-7 of the Investment Advisers Act requires that investment advisers adopt and maintain a formal compliance program including written policies and procedures, designation of a Chief Compliance Officer ("CCO") and annual reviews to assess the adequacy and effectiveness of the program. As part of our Compliance Program, ABC Asset Management, LLC ("ABC") has considered applicable regulations, factors that present risk, potential and actual conflicts of interests and developed policies and procedures to address these areas and assigned responsibility for these risk areas and for conducting appropriate reviews as coordinated by the CCO. This risk assessment will be reviewed and revised, as appropriate, in light of changes to the firm, its business or its affiliations, among other things, as part of each annual review conducted pursuant to Rule 206(4)-7. Risk rankings are based upon a scoring system of 1 to 5 (low to higher risk).

Risk Area	Risk Issues	Likelihood Scale (1-5) ("L")	Impact Scale (1-5) ("I")	Risk Ranking (L+I-2=RR)	Controls/Procedures Disclosures	Gaps Discovered (Date)  Follow-up Required (If Applicable)	Supervision Responsibility	Summary of Testing/Reviews
<b>REGULATORY COMPLIANCE RISK</b>								
ADVERTISING (SEE ALSO PERFORMANCE)	<ul style="list-style-type: none"> <li>- Inaccurate, misleading or false advertising</li> <li>- Marketing materials making claims that are inconsistent with other firm disclosures</li> <li>- Unapproved materials</li> <li>- Dated materials</li> <li>- Rule/no act. by violations</li> <li>- Client claims</li> </ul>				<u>CONTROLS/PROCEDURES:</u> - Individual review by piece - CCO approval - Marketing approval - Man. Dir. approval - Approved library - Legal review  <u>DISCLOSURES:</u> - N/A	-	- CCO - Dir. Marketing - ABC Mgmt.	<ul style="list-style-type: none"> <li>- Item-by-item</li> <li>- Reviews as new materials developed</li> <li>- Annual check to determine all materials reviewed prior to use</li> <li>- Annual review of website</li> </ul>
ADVISORY AGREEMENT	-				<u>CONTROLS/PROCEDURES:</u> -  <u>DISCLOSURES:</u> -	-	-	-
AGENCY CROSS-TRANSACTIONS	-				<u>CONTROLS/PROCEDURES:</u> -  <u>DISCLOSURES:</u> -	-	-	-



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# QUESTIONS?



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