

NRS Compliance Conference
November 9 & 10, 2006

Morgan Lewis

Evaluating and Improving Annual Reviews

Chris Hardy
National Regulatory
Services

Steven W. Stone
Morgan, Lewis &
Bockius LLP

Annual Reviews Version

- Rule 206(4)-7 Recap
- 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

- Policies and procedures
 - Adopt and implement written policies and procedures reasonably designed to prevent violations, by you and your supervised persons, of the Act and its rules
- Annual review
 - Review, at least annually, the adequacy of your policies and procedures and the effectiveness of their implementation
- Procedures must
 - Reflect Advisers Act substantive requirements
 - Be reasonably designed to (detect and) prevent violations
- Review must
 - Occur at least annually
 - Assess polices and procedures’
 - Coverage of Advisers Act requirements
 - Effectiveness in implementation

SEC Reviews of Annual Reviews

- Who conducted the review?
 - Internal compliance?
 - Outside lawyers or consultants?
 - Were business people 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?
- How was the review conducted?
 - Interviews?
 - Exception reports?
 - Forensic testing?
- When were the activities reviewed?
 - Throughout the year?
 - Concentrated time period?
 - Last minute?
- 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
 - Prepare a gap analysis

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
 - 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 others
 - Review most current SEC exam letters and guidance
- Examples
 - Exception reports with documentation of follow-up
 - Surveillance reports
 - Completed compliance checklists
 - Management reports
 - Trade analyses along with any follow-up
 - Minutes of committee meetings
 - Approvals of supervisory overrides
 - Warning or sanction notices

Examples of Testing

- Incorporate transactional, periodic and forensic testing where appropriate to review the effectiveness of policies and procedures
- Example of testing personal securities transactions:
 1. Transactional Test: Pre-clearance, to compare personal trades with restrictions
 2. Periodic Test: Review completeness of personal securities transactions records
 3. Forensic Test: Compare profitability of personal trades with client trading

Examples of Testing

- Example of testing trading practices:
 1. Transactional test: Before executing trades, compare the proposed broker with a list of other pre-approved brokers and the commission with the maximum permissible commission
 2. Periodic test: Periodic reviews of brokerage allocation process
 3. Forensic test: Best execution tests such as VWAP or opportunity cost surveys

Effectiveness of Implementation

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

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
 - Have a roadmap to reflect what you looked at and your conclusions?
 - Show the SEC your process and conclusions?
- Alternatives
 - Formal written report
 - Review map with checklists and other documentation
 - Other approaches
- Dickey issues
 - SEC requests for privileged and confidential information in reports
 - Client requests for reports

What Next?

- Act on your last review
- Talk to your management
- Prepare for your next review

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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