

Kicking the Tires on Your Annual Compliance Review

By Mark D. Perlow, Michael L. Sherman, Christine A. Schleppegrell and Sam H. Scarritt-Selman, Dechert LLP*

The start of the new calendar year is an excellent occasion for investment advisers to consider the key role of the annual review within their broader compliance program under the Investment Advisers Act of 1940 (“Advisers Act”). Much can happen in a year, and advisers must consider any significant business and regulatory developments and determine whether and how to adjust existing processes, policies and procedures to meet changing circumstances.

1. Background

Rule 206(4)-7 under the Advisers Act (the “Compliance Rule”) requires not only that investment advisers put into place written policies and procedures “reasonably designed to prevent” violations of the Advisers Act and its related rules, but also that advisers review the adequacy and effectiveness of these policies and procedures at least annually and designate a Chief Compliance Officer (“CCO”) to administer those policies and procedures and the annual review. The annual review is a critical component of the Compliance Rule and of a strong compliance program; it helps assure the effectiveness of an adviser’s policies and procedures and reinforces the CCO’s and compliance department’s role in overseeing compliance and implementing related policies and procedures.

2. Questions to Consider Before You Start Your Annual Review

What, then, makes for a good annual review? The SEC historically has offered little direct guidance on this question



Mark D. Perlow, Partner,
Dechert



Michael L. Sherman,
Partner, Dechert



Christine A. Schleppegrell,
Senior Associate, Dechert



Sam H. Scarritt-Selman,
Associate, Dechert

and, because there is no one best way to conduct a formal annual review, an adviser might first consider a few threshold issues:

- 1) *Who* is reviewing?
- 2) *When and how frequently* are they reviewing?
- 3) *What* are they reviewing?

a. *Who is reviewing?*

The Compliance Rule does not require that the CCO be the sole party conducting the annual review. Rather, the CCO is responsible for administering the compliance program, but can delegate tasks to other employees (both inside and outside the compliance department) or to external, third party consultants. In fact, many advisory firms with more than one person in their compliance department will involve persons other than the CCO in their annual review. Thus, the CCO retains ultimate responsibility for overseeing the review and assuring its adequacy.

In-house personnel, such as portfolio managers, traders and operations staff, often will be best positioned to conduct portions of the annual review, as they will be more familiar with the firm’s operations as they relate to their particular function. Outside counsel’s or consultants’ perspectives may contribute to an adviser’s annual review, such as where an adviser seeks to replicate a full SEC examination or discovers novel legal questions requiring specialized expertise.

The extent to which involving personnel outside the compliance department or an independent third party can add value to a review may be firm-specific. For example, a large firm with complex business activities might have the resources to retain a third party to conduct the review, but may also have in-house compliance staff with sufficient capacity to conduct the review internally. Similarly, a smaller advisory firm may benefit from enlisting outside personnel for the annual review but might also be resource-constrained and/or cost-conscious.

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b. When and how frequently are they reviewing?

In most cases, an “annual” review is not a single, isolated exercise occurring only once a year but, rather, represents the culmination of ongoing reviews throughout the year. Although Rule 206(4)-7 requires only that policies and procedures face review on an annual basis, a once-a-year, self-contained review satisfying only this minimum requirement may not reflect best practices, and may fail to timely catch a weakness, breach or needed change.

An ongoing review protocol typically includes both periodic and event-driven triggers for review and testing. Periodic triggers prompt an adviser to subject at least some aspect of its policies and procedures to scrutiny at regular intervals throughout the year, such as on a quarterly or semi-annual basis. Event-driven triggers, by contrast, prompt an adviser to review the adequacy of its compliance program in view of specific occurrences (e.g., a new rule or interpretation, change in business practice, or “red flag”). The scope of compliance testing may also vary – transactional testing focuses on specific actions or occurrences to detect related compliance issues, often on a contemporaneous basis while forensic testing often casts a broader net to identify patterns of activity best assessed by analyzing patterns of activity over a period of time or which may lie below the surface.

A combination of periodic and event-driven reviews throughout the year, with both transactional and forensic forms of testing, provides an adviser with a more current, detailed and accurate sense of its compliance program in relation to the environment in which it operates, and provides greater opportunity to promptly address concerns.

The goal of more frequent testing is to make compliance testing more effective and more efficient, reducing the pressures associated with having to review an entire compliance program all at once, where breadth of review and depth of review can be more difficult to

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balance. Testing more frequently makes it easier for the adviser to draw big picture conclusions and react quickly when warranted.

Although they may not be aware they have an *ongoing review protocol*, most advisers already conduct reviews and tests during the year (whether to satisfy specific requirements or to further a robust compliance program) that can form building blocks for the annual review. For advisers without (or who do not realize they have) such a protocol in place, establishing an ongoing protocol for the year to come during each year’s annual review can allow testing to be scheduled in a manner taking into account the adviser’s other regulatory or business obligations, such as Form ADV updates or board reports. Additionally, some firms will have an annual compliance meeting that includes all supervised persons, facilitating information sharing across different groups within an advisory firm and helping to identify risks and business changes.

c. What are they reviewing?

Lastly, there is the question of which substantive areas should an adviser’s annual review address. At the most fundamental level, the scope of coverage should reflect the adviser’s compliance risk profile. However, since a given adviser’s compliance risk profile will reflect firm-specific characteristics and the changing regulatory landscape, the precise topics for an annual review will vary from firm to firm and year to year. Nev-

ertheless, there are certainly topics all advisers may want to consider, such as fees, disclosures, conflicts of interest, marketing/advertising and regulatory filings, as well as new products, client types and business lines. In addition, the scope of review for each component or topic can be focused or comprehensive and not every element needs to be reviewed (in detail) every year. Accordingly, an adviser may generate a risk profile inventory or matrix, which can help the adviser to identify the compliance concerns most relevant to the firm and which SEC staff will expect to see.

Another valuable tool is the list of examination priorities published annually by the SEC’s Office of Compliance Inspections and Examinations (“OCIE”). While these examination priorities are not exhaustive, advisers may find them instructive when allocating resources. CCOs should consider at least addressing each examination priority in any written report or other work product memorializing the annual review, even if only to say why it is inapplicable to the adviser. Core areas of concern for the examination staff have recently included issues relating to: disclosure, electronic investment advice, wrap fee programs, ETFs, branch offices, senior investors, municipal advisors, never-before-examined advisers, clearing agencies, national securities exchanges, regulation systems compliance entities, anti-money laundering programs, transfer agents and cybersecurity.

3. General Steps for Conducting the Annual Review

a. Gather documents and data:

Start with last year’s annual review and then consider the firm’s code of ethics, last SEC exam (including any deficiency letters), risk matrix/assessment, testing calendar and results or summaries of results, list of compliance incidents/policy violations that occurred in the last year, summaries of regulatory develop-

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ments and guidance from the last year (e.g., OCIE's exam priorities, SEC risk alerts and guidance updates, recent enforcement actions).

b. Identify risks specific to the adviser's business: Conduct a risk assessment and determine which areas of the business create greater regulatory risks, considering changes to the business in the last year (e.g., adding a new product or client type). This list will be used to determine whether changes should be made to the compliance program. See the IAA's Risk Assessment Guide, Questionnaire and Identification Chart available on its website.

c. Determine topics: After inventorying business and regulatory developments, consider where the firm faces greater risk and create a list of areas, if any, that will need to be added to the adviser's testing regimen.

d. Analyze testing and monitoring results: The adviser's compliance program may involve periodic testing and monitoring of certain programs on an on-going basis.

e. Review policies and procedures, disclosures: Re-read all policies and procedures and disclosures to ensure they are consistent with the operations of the advisory firm.

f. Perform additional testing or review: The preceding steps may identify areas where additional testing or review is merited. Conduct any such review or testing and document the findings, just as one would do for the ongoing tests and reviews performed throughout the year. This might also be a good opportunity to "Test the Test" by reviewing previously performed testing on a sample basis to assure tests are designed and executed in a manner likely to produce the desired results and identify relevant issues.

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g. Make findings and recommendations: Approach making findings with a view towards identifying how to remedy problems arising during the course of the review. For example, if a problem is determined to be recurring, look at what the adviser did previously and evaluate what did and did not work.

h. Document the review: Adviser CCOs are not required by Rule 206(4)-7 to prepare a written report of the annual compliance review. However, as a practical matter, the SEC staff will request to see documentation of the adviser's annual compliance review. Also, under the Advisers Act books and records rules, advisers must retain any records made in the process of documenting the annual review, even if a written report is not generated. At a minimum, this documentation should include: the period covered by the review; the steps taken in the review; who conducted the review; what generally was found in each of the areas reviewed; what follow-up was taken in response to items found or changes recommended in the review; and the proposed and actual timeline for addressing items flagged in a review. By documenting the review in such a manner, each annual review will help inform future reviews, forming a valuable feedback loop.

i. Addressing issues: Consider how to address violations of law and policies and procedures, including reporting to upper management and what ad-

ditional policies and procedures should be put in place. Consider the following steps:

- Gather facts related to an alleged instance;
- Be mindful of when and whether to engage outside counsel;
- Consider the rights of employees when a potential violation of law is involved;
- Conduct a comprehensive review;
- Determine whether there was an actual violation;
- Be careful about how a potential violation is documented until the CCO is aware of the scope of the problem; and
- Follow through and close the loop on any open issues.

j. Prepare for Next Year: Update the firm's risk profile and begin designing next year's review.

4. Enforcement Activity

The importance of the annual review is reflected in SEC enforcement activity, not only against advisory firms that failed to conduct an annual review but, often, also against the firm's CCO. In recent years, the SEC has charged a number of advisers and CCOs with violations of Rule 206(4)-7 where the adviser has not conducted its annual review in a timely manner. These include:

- In *Matter of LKL Investment Counsel LLC and Mark H. Love*, IA Rel. No. 4846 (Jan. 3, 2018), the SEC settled charges against an adviser and CCO, alleging there had been no formal annual review of the compliance program for seven years.
- In *Matter of Southwind Associates of NJ Inc., William Scott Villafranco and Anthony Laperuta*, IA Rel. No. 4834 (Dec. 22, 2017), the SEC settled charges against an adviser and its CCO where the CCO neither conducted any annual reviews nor took

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any steps to ensure that a review was conducted. The adviser had engaged an outside consultant who had made recommendations that the adviser never implemented, even though, according to the SEC, the adviser had the resources to do so.

- In *Matter of Aria Partners GP, LLC*, IA Rel. No. 4991 (Aug. 22, 2018), the advisory firm “mistakenly relied on third parties, including a fund administrator and fund auditor, to raise any issues” instead of conducting an actual review.
- In *Matter of Institutional Investor Advisers, Inc.*, IA Rel. No. 4824 (Dec. 8, 2017), the SEC charged a violation of Rule 206(4)-7 where the adviser allegedly never conducted any annual review of its compliance program but, instead, drafted and presented to the board of trustees of its sole client sin-

gle-paragraph annual letters “indicating that an annual compliance review...had been conducted.”

These enforcement actions serve as a reminder that, no matter the cause of an adviser’s failure to conduct its annual review, the SEC will treat such a failure as a violation of Rule 206(4)-7.

5. Conclusion

CCOs, when designing and conducting reviews, should craft a program that reflects the contours of the adviser’s compliance risk profile, business and operations, is efficient and effective and, more broadly, is responsive to existing and emerging compliance concerns. An adviser who designs and conducts a solid annual review will find it has already taken substantial steps towards ensuring preparedness for whatever

compliance issues may come its way in the coming year.

**Mark D. Perlow and Michael L. Sherman are Partners, Christine A. Schleppegrell is a Senior Associate, and Sam H. Scarritt-Selman is an Associate in Dechert’s Financial Services Group. Mr. Perlow can be reached by email at mark.perlow@dechert.com or by phone at 415-262-4530. Mr. Sherman can be reached by email at michael.sherman@dechert.com or by phone at 202-261-3449. Ms. Schleppegrell can be reached by email at christine.schleppegrell@dechert.com or by phone at 202-261-3357. Mr. Scarritt-Selman can be reached by email at sam.scarritt-selman@dechert.com or by phone at 212-698-3842. This article is for general information purposes and is not intended to be and should not be taken as legal advice. IAA*

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Red Cedar Investment Management, LLC – East Lansing, MI

S Squared Technology, LLC – New York, NY

Sequoia Financial Group – Akron, OH

SoFi Wealth, LLC – San Francisco, VA

The Coury Firm – Pittsburgh, PA

The Huntington Investment Company – Columbus, OH

Yeske Buie Inc. – Vienna, VA

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Red Oak Compliance Services – Cedar Point, TX