IA COMPLIANCE PROGRAM ESSENTIALS

Michelle L. Jacko, Esq., CSCP: Managing Partner, Jacko Law Group, PC
CEO, Core Compliance & Legal Services, Inc.
T: 619.298.2880 / E: michelle.jacko@jackolg.com

I. INTRODUCTION – INVESTMENT ADVISERS ARE FIDUCIARIES

The relationship between a registered investment adviser and its clients, and the obligations of the adviser in that relationship, is a fundamental consideration for the compliance function of the investment adviser. Thus, your challenge is to understand your firm's relationship with clients and identify those areas of your firm's business that present potential conflicts of interest between the firm, its principals, and employees on the one hand, and the firm's clients on the other. This requires an assessment of the risks facing the firm so that compliance policies, procedures and programs may be designed to avoid or at least mitigate conflicts of interest and disclose such risks to clients. Your role as compliance officers is of paramount importance to your firm and protection of its investors. To perform your role, compliance officers must understand the fundamentals of the Investment Adviser Act of 1940, as amended (the "Advisers Act").

II. INVESTMENT ADVISER COMPLIANCE PROGRAMS

To assist in developing effective compliance programs, the Securities Exchange Commission ("SEC") adopted Rule 206(4)-7 of the Advisers Act, which requires investment advisers registered with the Commission to:

- Adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws;
- Review those policies and procedures annually for their adequacy and effectiveness of their implementation; and
- Designate a Chief Compliance Officer ("CCO") to be responsible for administering the policies and procedures.

A. Written Policies and Procedures

Firm policies and procedures provide the hallmark to a compliance program. They should be reasonably designed to prevent violations of the Advisers Act and the various SEC rules thereunder. In fulfilling this responsibility, the firm must implement a compliance system to which both management and all associates are committed fully and which has the effect of fostering a compliance oriented environment within the firm.

Your procedures should be tailored to your organization. Each policy should have an "owner" who is responsible for maintaining and overseeing the procedure associated with that policy and offering input as to the effectiveness of those internal controls.

B. Testing Policies and Procedures: The Annual Review Program

The annual review of your firm's compliance policies and procedures is the best method to survey the compliance program and identify areas in which to improve. The SEC gives particular attention to risk-based approaches and seeks evidence of thorough reviews which identify gaps and corrects issues that are identified.

C. Role of the Chief Compliance Officer

The person who is appointed to be the CCO of the organization should have the following attributes:

- Be competent and knowledgeable of securities regulations governing investment advisers;
- Have full responsibility and authority to enforce compliance policies;
- Have sufficient seniority and authority to compel others to adhere to policies; and
- Earnestly pursue violations.

Typically within the organizational framework, the CCO is responsible for:

- Identifying and resolving significant compliance issues that arise;
- Ensuring that the compliance policies and procedures are comprehensive and appropriate for the business model;
- Formulating control procedures to gauge the effectiveness of existing internal operational processes;
- Reviewing books and records to make certain that they are maintained for the requisite number of years;
- Identifying material weaknesses in policies and procedures and reporting significant compliance issues to senior management; and
- Conducting an annual review of compliance procedures and recommending policy changes as appropriate.

III. THE FUNDAMENTALS OF COMPLIANCE

For a Compliance Officer, understanding the fundamental processes of your business is crucial for proper compliance management. To advance your knowledge and achieve such comprehension:

- Learn About Your Firm;
- Understand Your Compliance Program; and
- Conduct an In-Depth Annual Review.

A. Learn About Your Firm

Begin by reviewing your firm's registration and business documents to gain a clear understanding of the products and service offerings available to your clients as well as any associated fees that are assessed. Next, ensure that these offerings are disclosed on the firm's registration and client documents. Focus on marketing materials, Forms ADV, and client agreements for details concerning material information regarding your organization, including any conflicts of interest.

Form ADV: In accordance with Section 203A(a) of the Advisers Act , most commonly an investment adviser is required to register with the Commission if the adviser has assets under management of $100 million or more, or if it acts as an adviser to a registered investment company. Form ADV Part 1 is electronically submitted to the SEC, with annual updates thereafter, through the Investment Adviser Registration Depository ("IARD"). These filings are designed to provide the SEC and your clients with the most current information about your firm. Therefore, be sure that the firm maintains complete and current filings at all times.

Form CRS and Part 2 of Form ADV must be furnished to prospective clients prior to, or contemporaneously with, the signing of the Agreement with Adviser for advisory services, and provided whenever there is a material change. In addition, Form ADV Part 2, which contains specific information about the adviser and its officers and associates who are engaged in the business of providing investment advice to clients, must be offered to existing clients at least annually. A record of the offer must be maintained by Adviser.

Advisory Client Agreements: Rule 205 of the Advisers Act does not require that agreements between an adviser and its clients be in writing. However, it should be the policy of Adviser that none of its advisory services will be performed unless a written agreement has been executed by the client and a principal of Adviser. If the adviser does enter into a written agreement with its clients, three specific disclosures must be made: (1) Whether compensation to the adviser is based on capital gains or appreciation in client's account; (2) The adviser's expressed prohibition against assignment of the contract for advisory services without consent of the client; and (3) Notification to the adviser's clients should any change occur in adviser's partnership structure.

B. Understand Your Compliance Program

Every investment adviser registered with the SEC is required to adopt written policies and procedures reasonably designed to prevent violation of federal securities laws. Below are the required policies and procedures that every SEC registrant must maintain as appropriate.

1. Codes of Ethics

Codes of Ethics: Rule 204A-1 of the Investment Adviser's Act of 1940 requires investment advisers to adopt Codes of Ethics ("Code"). The rule requires an adviser's Code to set forth standards of conduct, which should include personal trading rules, how to protect against use of material inside information, insider trading prohibitions, gift policies and escalation procedures for Code violations. Each Code also should set forth a standard of business conduct that the adviser requires of all supervised persons, such as an acknowledgement of compliance with federal securities laws.

2. Proxy Voting

Proxy Voting: In January 2003, the SEC adopted Rule 206(4)-6 that requires SEC registered investment advisers that exercise voting authority over client proxies to disclose their proxy voting policies and procedures to clients. Such Advisers are required to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of their clients and to disclose to clients information about those policies and procedures. In addition, the adviser must disclose how clients may obtain information on how the adviser voted their proxies.

3. Portfolio Management Processes

Portfolio Management: In establishing client accounts, the adviser should obtain and document basic investment information about the prospective client in order to assure that portfolio recommendations are suitable. Such information includes:

- Client investment objective
- Level of client's risk tolerance
- Client's time horizon for investing
- Client's income and net worth
- Assessment of suitable portfolio assets
- Analysis of the advisory services appropriate for client investment needs
- Reallocation strategy based on market shifts
- Sector and market allocations
- Client restrictions and guidelines for investments

Each portfolio manager should use the above information to monitor the ongoing activity in the client's account and ensure that such activities are in accordance with the financial requirements and investment objectives obtained from documented client interviews.

4. Trading Practices

Best Execution: By definition, "best execution" refers to a well-designed trade execution process made with the intention of maximizing the value of client portfolios under particular circumstances at a given time. In selecting a broker to execute client securities trades, an adviser must consider the full range and quality of broker services, including execution capability, commission rate, value of the research provided and responsiveness to the adviser. An adviser is not obligated to merely get the lowest possible commission cost, but rather is required to determine whether the transaction represents the best qualitative execution for a client's accounts.

Soft Dollars: Soft Dollars refer to an arrangement under which a money manager pays for certain brokerage and/or research products or services through commission revenue rather than through direct payments (hard dollars). Typically, issues involve the actual or potential self-interest of the investment manager. These conflicts of interest must be disclosed or consented to in advisory contracts, disclosure documents (such as in prospectuses or Form

ADV Part 2), and comply with the safeharbor provisions provided for in Section 28(e) of the Securities Exchange Act of 1934.

As a general principle, investment managers should seek best net price, whether or not they actually achieve it. Although transaction costs are important, seeking best net price will help to minimize the total transaction cost and security price. However, the amount of required time and resources the adviser can devote to its execution capabilities depend on several factors, including: (1) the nature of client accounts; (2) its portfolio management turnover, trading strategies, and size of trade relative to volume; (3) practices of similarly situated money managers; and (4) the current regulatory environment.

5. Accuracy of Disclosures Made to Investors, Clients, and Regulators, Including Account Statements and Advertisements

Section 206 forbids an investment adviser from making any fraudulent, deceptive or misleading statement to investors, which includes making omissions of material facts. Disclosures in marketing materials must comply with Rule 206(4)-1, which governs advertisements, including endorsements, testimonials, third party ratings, portability of performance, performance advertising, hypothetical performance and social media. I

6. Safeguarding of Client Assets from Conversion or Inappropriate Use by Advisory Personnel

Custody of Client Assets: Should an investment adviser have custody of client assets, Rule 206(4)-2(c)(1) sets forth specific provisions for advisers to follow to protect client assets from loss or theft. Such protections include the requirement that client funds be maintained at a "qualified custodian," such as a bank or an SEC-registered broker-dealer, and the adviser must have reason to believe his or her client receives periodic reports from the custodian regarding the securities held. If the adviser, rather than the custodian, provides these accounting reports, the adviser is required to seek verification of the reports by independent accountants. These measures safeguard client assets and protect against misappropriation by advisory personnel.

7. Accurate Creation of Required Records and their Maintenance

Recordkeeping: Pursuant to Rule 204-2, investment advisers must create and maintain honest, accurate, and updated books and records relating to the adviser's business. This Rule provides guidance for advisory recordkeeping practices, including, among other things:

- Compilation of all business and accounting records;
- Client correspondence pertaining to portfolio transactions and advisory services rendered;
- Delivery of documents; and
- Policies and procedures implemented for the firm's compliance program.

All records should be updated when necessary and kept for five years with the previous two years readily accessible. Additionally, electronic data should be duplicated and backed up frequently to ensure protection from damage or destruction.

8. Valuations

Fair Valuation: Securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by the firm's management or trustees.

9. Safeguards for the Privacy Protection of Client Records and Information

Privacy Notice: An investment adviser should not disclose personal financial information about any client to non-affiliated third parties except as necessary to establish and manage the client's account(s) or as required by law. For example, a client's personal financial information may be provided to a broker-dealer or custodian providing services to and/or maintaining the client's account(s).

To safeguard the privacy of confidential information, Regulation S-P requires Advisers to adopt policies and procedures reasonably designed to:

- Ensure the confidentiality of customer records and information;
- Protect against any anticipated threats or hazards to the security of customer records and information; and
- Protect against unauthorized access or use of customer records or information that could result in "substantial harm or inconvenience" to any consumer.

10. Business Continuity Plans, Disaster Recovery, and Succession Plan

A firm's critical systems must operate during disaster or significant business interruptions so that clients can have access to their funds. Accordingly, advisers need to make advanced preparations and formulate procedures to provide an efficient means for minimizing down time in the face of a disaster or outage so that the organization may meet its existing customer obligations.

Business Continuity Plans: The SEC expects that its registered advisers adopt a Business Continuity Plan ("BCP") that addresses procedures by which loss of business may be minimized or avoided in the event of a significant business disruption. In addition, an adviser's BCP should address the firm's succession plan if the CEO, President or other critical management members become unable to oversee the business.

A BCP should address what the adviser should do if:

- The adviser's offices or facilities are destroyed, whether by natural causes or by other means;
- There is a loss of life or major injuries to personnel or equipment in an office location that disables the office's ability to conduct business; and/or

- There is a disruption of service from a critical business constituent.

All BCP critical employees must be familiar with the Plan in its entirety and be able to effectively execute procedures in the subject area assigned to them whenever the plan is triggered.

C. Conduct an In-Depth Annual Review

In accordance with the Rule 206(4)-7 (the "Compliance Program Rule") advisers registered with the SEC are required to "review, no less than annually, the adequacy of the policies and procedures (to ensure compliance with federal securities laws)….and the effectiveness of their implementation."[1]

Consider taking the following steps to conduct the Annual Review.

1. Identify Firm Risks and Question Policies and Procedures

Conduct a comprehensive assessment Conduct a comprehensive assessment of the firm's policies and procedures to ensure that they provide sufficient detail. This review should focus on whether the policy is clearly defined, whether the procedure is currently followed and if the procedure articulates roles and responsibilities for personnel to perform. In addition, the CCO should identify changes in the firm's business and consider what, if any potential conflicts of interest might exist as a result of this development. If conflicts are identified, the CCO should deliberate on what checks and balances might be needed to address those conflicts. Finally, the CCOs should consider changes that occurred in applicable regulations that might necessitate the firm to revise its policies or procedures.

2. Prepare for the Annual Review

In preparing for the Annual Review, consider, among other things:

- Establishing an annual review committee;
- Identifying business line owners to evaluate whether any changes in the firm's business had triggered new or different legal or regulatory requirements;
- Reviewing whether the firm's policies and procedures are enforced (if available, internal audit results may assist in these efforts);
- Evaluating customer complaints to help identify potential compliance issues;
- Reviewing current regulatory hot topics.

3. Perform Periodic and Forensic Tests as Part of the Annual Review

In May 2005, Gene Gohlke provided CCOs with further guidance on how the compliance review process may further identify and document risks. Gohlke suggested conducting and analyzing results from three types of tests: transactional, periodic and forensic tests.[2]

---

[1] *See* Investment Advisers Act of 1940 Rule 206(4)-7.

[2] Gene Gohlke, speech: "Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework," (May 5, 2005), available at

4. Document the Annual Review Results

There are various approaches to take in documenting the results from your Annual Review. All work papers, including GAP analysis of firm processes, exception reports, noted policy exceptions, and periodic and forensic tests results should be maintained to evidence the firm's approach to identify issues and provide resolution for any issues noted.

Most importantly, the annual review should assist CCOs in identifying firm risk-management needs and potential resources necessary for the firm's compliance program. CCOs should develop a written report to senior management that helps identify high-risk compliance areas and define what resources are needed to address these issues.

D. SEC Staff Guidance on Conducting the Annual Review

1. **SEC Staff speech: Lori Richards' general guidance**. In a speech in 2004, Lori Richards offered an overview of the steps involved in the annual compliance review.

- Step 1: conduct an **inventory of compliance obligations** under both the federal securities laws and pursuant to your disclosures to investors.
- Step 2: **identify areas of conflicts of interest**. As you approach this, think about, in very realistic terms, what could go wrong? How could clients be harmed? Write these possible problems down. Consider the types of abusive conduct that has already been identified by the SEC in enforcement actions – but be more expansive in your analysis. Think about your service providers, too, and how their conduct – or misconduct – might harm your clients. Your goal here is to identify conflicts of interest that, if unmitigated, could lead to violations of any type.
- Step 3: match existing compliance practices to your inventory of obligations and conflicts of interest and **find any gaps**.
- Step 4: **assess the effectiveness of existing compliance functions**. In this stage, determine whether a particular compliance function makes violations less likely, and results in the prompt identification of violations.
- Step 5: **identify additional compliance procedures** that are warranted.
- Step 6: **implement them**, in writing in a clear, plain English manner, setting forth the goal of the compliance procedure, the regularity with which it will be performed and who will perform it. Part of successful implementation is to make sure employees are trained and understand their role in how the compliance function is to work.
- Step 7: **test the compliance procedures**. You can only ensure your Compliance Program is working if you test all the various components – and improve any weaknesses found. You should be tweaking your program over time – not simply waiting until the annual review.[3]

---

https://www.sec.gov/news/speech/spch050505gg.htm.

[3] *See* Lori A. Richards, speech, "Put the Compliance Rule to Work: IA Compliance Best Practice Summit" (Mar. 15, 2004) available at https://www.sec.gov/news/speech/spch031504lar.htm.

2. **SEC Staff speech: Gohlke on the CCO's role and testing.** In a memorable speech[4] Gene Gohlke distinguished between three kinds of testing that the CCO should oversee: transactional, periodic and forensic.

- **Transactional testing**: The CCO should ensure that quality control (transactional) testing is conducted to detect deviations of actual transactions from written compliance policies or standards. The results of such tests should be included on exception or other management reports and be promptly addressed, escalated when necessary, and resolved by responsible business people.
- **Periodic testing**: The CCO should undertake periodic analysis and evaluation of compliance issues found in the regular course.
- **Forensic testing**: The compliance staff should conduct forensic testing as a means for obtaining additional or corroborating evidence regarding both the effective functions of the firm's compliance program and the possible existence of disguised or undetected compliance issues. This type of testing generally compares performance to a benchmark in order to detect irregularities.[5]

E. Outstanding Considerations for Annual Reviews

1. **Consideration: use the review as a way to verify, update and weed out procedures.** CCOs are urged to link the results of the testing and reviews to the adopted written compliance policies and procedures – and to use the review to verify and update existing procedures, to delete any procedures that are not being followed, and to address any omissions and gaps. The CCO should take into consideration that the failure to follow adopted procedures can be evidence of the lack of proper supervision.
2. **Consideration: map the results of the review to prospectus and other disclosures made to clients**. As Gene Gohlke noted, the CCO should undertake "a process for regularly mapping compliance policies and procedures and conflicts of interest to disclosures made to clients so that disclosures are current, complete and informative."[6]
3. **Consideration: be careful about over-reliance on certifications**. Obtaining certifications from business unit heads and Service Providers is a "best practice." The certifications attest that the employee is responsible for particular procedures, understanding the legal and compliance

[4] *See* Gene Gohlke, speech, "Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework," (May 5, 2005), available at https://www.sec.gov/news/speech/spch050505gg.htm.

[5] Forensic testing might involve attempts to steal client information, tamper with records or simulate a disaster to test how systems reach, or calling clients to verify marketing controls. The Adopting Release discusses forensic testing: "Where appropriate, …policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns, including, for example, …an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities." See Adopting Release at n.15

[6] *See* Gene Gohlke, speech, "Managed Funds Association Educational Seminar Series 2005: Practical Guidance for Hedge Fund CCOs Under the SEC's New Regulatory Framework," (May 5, 2005), available at https://www.sec.gov/news/speech/spch050505gg.htm.

procedures, has reported all material compliance matters up to the CCO, and the employee will remain informed and continue to report compliance matters to the CCO. CCOs, however, should be cautious about over-reliance on self-certifications from the business units and Service Providers. While quarterly certifications can be a valuable tool by which a CCO can ensure that compliance reviews are occurring on a regular basis, and not just annually, certifications should not supplant interviews, walkthroughs with a checklist, document review and testing. Remember to trust, but verify.

4. **Consideration**: **focus on high risk – but don't ignore the low risk items.** Respond to red flags and follow-up.

IV. CONCLUSION

Understanding the fundamentals of investment advisory compliance is fundamental to the integrity of your firm. Good compliance is good business – and compliance is everyone's responsibility. Consider these questions to help assess the effectiveness of your investment advisory compliance system.

- How does the firm go about educating their employees to identify and address conflicts of interest? What is the firm's escalation process when a violation of firm policy occurs?
- What type of training do new employees receive on compliance policies? Are there processes in place to constantly remind all supervised persons to place the client's interests first?
- What is the firm's "culture of compliance?" What is senior management's expectation for creating ethical uniform standards of business conduct across all geographic boundaries and multiple business channels?
- What is the firm's process for updating policies and procedures and testing its compliance program? Who is responsible for reviewing the policies?
- Who is involved in the annual review process? What type of testing is conducted?