Annual Reviews and SEC Compliance Programs

Mark Berman, CompliGlobe Ltd[1]

September 15, 2020

The first quarter each year for an SEC registered investment adviser ("RIA") is a busy time. An RIA must fund its FINRA Flex-Funding Account, prepare and file its annual amendment to Form ADV Parts 1, 2A and Form CRS (Part 3) and send Form ADV Part 2A and Part 2B and, if applicable, Form CRS and the Regulation S-P Privacy Notice, to its clients.

This is an opportune time for the chief compliance officer ("CCO") to conduct or cause to be conducted the annual review ("AR" or "annual review"). Completing the annual review before revising and filing Form ADV (and sending it to clients) provides an opportunity to coordinate and complete these tasks at one time.

Planning your AR in Q4, starting in January and finishing before you file your annual Form ADV amendment is good practice.[2] If you complete your AR and the other tasks noted above and file before the end of Q1, well done! Do not wait for the last minute.

What does an RIA have to do?

Rule 206(4)-7[3] under the Investment Advisers Act of 1940 ("Advisers Act") imposes three compliance requirements upon an RIA.

First, an RIA must adopt and implement written policies and procedures "reasonably designed" to prevent violations by it and its Supervised Persons[4] of the Advisers Act and the rules thereunder.

---

[1] **Mark Berman**, founder and CEO of CompliGlobe, advises and conducts training programs for investment managers, hedge funds, issuers, regulators and multinational banks and brokers in the USA, Europe and Asia on SEC practice, UK and SFC issues and cross-border regulatory, compliance and AML matters. Mark was a lawyer with the SEC's Division of Corporation Finance and the Division of Market Regulation. He was a lawyer with the London Stock Exchange. He wrote *An Introduction to Hedge Funds* (2007 Risk Books). He edited and contributed to *SEC Regulation Outside the United States* (7th ed. forthcoming) and *Hedge Funds and/or Prime Brokers* (3rd ed. forthcoming). He founded, chairs and speaks at "SEC Regulation Outside the United States", "SEC Basics", "CCOs and SEC Examinations" and "How to Navigate a Prime Brokerage Agreement". He was a candidate for nomination as SEC Commissioner.

[2] We discuss the AR and its steps for an RIA with a December 31 fiscal year end. Firms with a different fiscal year end – March 31, June 30 or September 30 – would shift dates and deadlines accordingly.

[3] 17 CFR 275.206(4)-7.

[4] "Supervised Person" is defined in Advisers Act Section 202(a)(25) as a partner, officer, director (or someone holding a similar status or performing a similar function) or employee of an RIA, or a person who provides investment advice on the RIA's behalf and is subject to the RIA's supervision and control. 15 U.S.C. § 80b-2.

Second, the RIA must designate a CCO. The Rule 206(4)-7 adopting release[5] states that a CCO must be knowledgeable, competent and empowered with authority to administer the compliance program. Much has been written about the liability of CCOs: you'll find insights into the SEC's views on CCO liability in speeches given by Mary Jo White, former Chair; Andrew Donohue, former Chief of Staff; and Andrew Ceresney, former Director of the Division of Enforcement,[6] and a recent speech.[7]

Third, every RIA must conduct a review its written policies and procedures ("WPPs") annually "to determine their adequacy and effectiveness". The AR should focus on matters that arose during the year, changes in the business and personnel and developments in law and regulation. The AR is a review and analysis of the adequacy and effectiveness of WPPs, how these performed during the year and how you used the output of your monitoring tasks and forensic testing to validate the WPPs and address issues *as they arose*. You should document and keep a record of your AR[8] to prove that you complied with Rule 206(4)-7(b).

Examiners from the SEC's Office of Compliance Inspections and Examinations, "OCIE", will review the records of your AR to evaluate what you have or have not done and how you used the findings.

Failing to conduct an annual review can result in an Enforcement action. The SEC has sued RIAs for not doing this. *IIA*[9] is a noteworthy case because the SEC found in an examination that IIA "failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, and … failed to conduct an annual review of the adequacy of such compliance policies and procedures."[10]

---

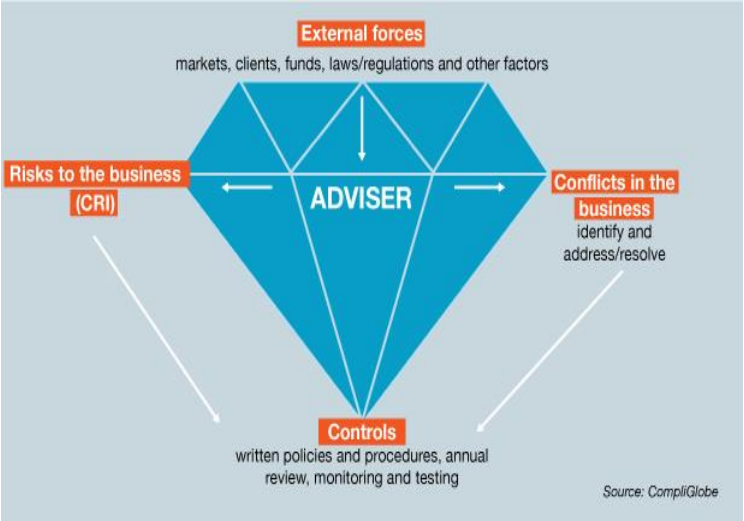
[5] "Compliance Programs of Investment Companies and Investment Advisers", Advisers Act Release 2204, 68 F.R. 74714, 74720 (December 24, 2003). https://www.sec.gov/rules/final/ia-2204.pdf *("Compliance Release").*
[6] Speeches by: Andrew Donohue, SEC Chief of Staff (14 October 2015), (Donohue Speech), (October 19, 2016), (https://www.sec.gov/news/speech/remarks2016.html); Andrew Ceresney, SEC Director of the Division of Enforcement (May 20, 2014), (Ceresney Speech), (November 4, 2015), (Ceresney 2015 Speech); and SEC Chair Mary Jo White, "Remarks at National Society of Compliance Professionals National Membership Meeting" (October 22, 2013), (https://www.sec.gov/News/Speech/Detail/Speech/1370539960588).
[7] "Costumes, Candy and Compliance": speech by SEC Commissioner Hester Pierce (October 30, 2018), www.sec.gov/speech.
[8] Under Advisers Act Rule 204-2, RIAs must keep records "documenting the investment adviser's annual review of those policies and procedures conducted pursuant to [Rule 206(4)-7(b)]". 17 CFR 275.204-2.
[9] *In the Matter of Institutional Investor Advisers, Inc*., Admin Proc 3-18303 (December 8, 2017), https://www.sec.gov/litigation/admin/2017/33-10443.pdf ("*IIA*").
[10] *IIA*, note 9 *supra*, ¶ 26.

The best place to start: a bespoke Advisers Act compliance program

Your WPPs must be *bespoke*. You can't have an "off the shelf" WPPs or a law firm precedent.[11] If OCIE see this, it will issue a deficiency letter or, if severe, make an Enforcement referral.

The "reasonably designed" language in Rule 206(4)-7 means the following.

- The SEC expects that an RIA will identify and record the risks in its business in a Compliance Risk Inventory ("CRI") and review and update this regularly.
- The SEC requires that the RIA will identify the material conflicts of interest in its business and the means to address (mitigate) them, record these in a Conflicts Log and review and revise these regularly – and disclose them in its Form ADV Part 2A.
- The RIA must use the CRI, Conflicts Log entries, the Advisers Act and the rules thereunder and other relevant legal and regulatory requirements as the basis for its WPPs. Generally, each policy and procedure should address a risk, conflict or requirement of law or regulation.
- The RIA should validate WPPs by using the output of monitoring tasks, forensic tests and the AR.



When it adopted Rule 206(4)-7, the SEC stated that an RIA must ensure that its WPPs are based on and address Advisers Act requirements (and other relevant provisions of law and regulation) as well as the risks and conflicts of interest in its business – this is the "reasonably designed" language. The SEC will expect you to *demonstrate* this. In other words, you must prove that your WPPs are mapped to reflect the Advisers Act, relevant laws and regulations and your risks and conflicts. Not doing it means inadequate WPPs, will result in a Deficiency Letter or, if severe, may lead to an Enforcement action, as several RIAs have learned.[12]

[11] *See e.g. In the Matter of Consulting Services Group, LLC and Joe D. Meals*, Admin Proc 3-12863 (October 4, 2007), https://www.sec.gov/litigation/admin/2007/34-56612.pdf ("pre-packaged" compliance manual).
[12] *See e.g. In the Matter of Dupree Financial Group LLC*, Admin Proc 3-17616 (October 5, 2016), https://www.sec.gov/litigation/admin/2016/ia-4546.pdf; and *Western Asset Management Company,* Admin Proc 3-15689 (January 27, 2014), https://www.sec.gov/litigation/admin/2014/ia-3763.pdf ("*WAM*"). More cases involving the Advisers Act and the rules thereunder may be found on the Division of Investment Management page under "Litigation" at https://www.sec.gov/investment/im-litigation.html.

Are there other requirements?

In addition to having a risk-based compliance program, adopting a Code of Ethics pursuant to Advisers Act Rule 204A-1 and complying with other Advisers Act requirements, every RIA must file an annual amendment to its Form ADV Parts 1 and 2A, and Form CRS, 90 calendar days after year-end, deliver or offer to deliver to its clients Form ADV Part 2A and Part 2B[13] and, if required, Form CRS and the Regulation S-P Privacy Notice within 120 days after year-end.[14]

Every RIA has on-going responsibilities. Conducting the AR, reviewing and updating the CRI and Conflicts Log, updating and filing the Form ADV annual amendment (and, when necessary, filing an "other than annual" amendment for material changes) and updating and delivering two other documents are exercises that relate to each other. With proper planning, an early start and a clear understanding of what is expected, this is manageable and achievable in a short timeframe.

What will you do to achieve this in a timely manner? If you plan and set the groundwork now for the AR to start early and finish this and your document review and revisions during February for an early or mid-March filing, you will succeed. If not, you may struggle.

I'm a non-U.S. RIA – what applies to me and what do I do?

An RIA must comply fully with all requirements of the Advisers Act and the rules thereunder – and other applicable U.S. laws, rules and regulations.

The SEC and the SEC Staff have taken the view that, in limited contexts, the "substantive provisions" of the Advisers Act and the rules thereunder may not apply to a non-U.S. RIA that does not have direct "U.S. person"[15] clients, that is, U.S. persons with separately managed accounts ("SMAs") and where U.S. persons are present only as investors in non-U.S. private funds (the private fund is the client, not the underlying investors). If a non-U.S. RIA manages an SMA for a U.S. person, all the requirements of the Advisers Act and the rules thereunder apply. OCIE has stated in some deficiency letters that a non-U.S. RIA must complete an annual review even if it does not have any direct U.S. person clients. If you are such an RIA, avoid the possibility of a deficiency finding and conduct a proper annual review.

Be prepared: *Even in the COVID-19 environment, OCIE is examining RIAs. RIAs have been examined in countries where previously OCIE had not conducted examinations, for example, in South Korea and Singapore. Switzerland is on the radar screen. Be ready. Know OCIE's Risk Alerts[16] and IM Guidance,[17] and learn lessons from SEC Enforcement actions.[18]*

---

[13] We suggest delivery as well as a covering e-mail or letter explaining each of the material changes from the previously filed and delivered Form ADV Part 2A and, if applicable, Form ADV Part 2B.
[14] We suggest sending the Regulation S-P Privacy Notice with Form ADV Parts 2A and 2B.
[15] The definition of "U.S. person" (some call this "U.S. client") is based upon residency as this term is defined in Rule 902 of Regulation S under the Securities Act of 1933. 17 CFR 230.902.
[16] These are available at https://www.sec.gov/ocie, click on "Risk Alerts" under "Office Resources".
[17] These are available at https://www.sec.gov/investment/im-guidance-updates.html.
[18] These are available at https://www.sec.gov/investment/Article/litigation.html, https://www.sec.gov/litigation/admin.shtml and https://www.sec.gov/litigation/litreleases.shtml.

Are you COVID-19 compliant?

COVID-19 is a serious issue that will have repercussions for some time. Have you identified and handled COVID-19 related issues: BCP and IT security, preventing "information leakage" and protecting confidential client information, working remotely/remote access security and supervising staff, protecting assets, handling conflicts of interest, identifying issues related to valuations and fee calculations, handling required filings and market movements? Have you reviewed your activities against the just published Risk Alert on COVID-19 compliance issues?[19] The Division of Trading and Markets has posted on its website page a response to COVID-19,[20] as have the other Divisions and Offices, and see www.sec.gov/sec-coronavirus-covid-19-response.

Planning makes perfect

As you approach your annual review, keep in mind that the SEC charges you, as it noted in the *Compliance Release*, to consider "significant compliance events, changes in business arrangements and regulatory developments."

- To address compliance events, review the output of your monitoring tasks and forensic testing and entries in the breaches log, the trade errors log, the Code of Ethics breaches log, the complaints log and any findings, letters or other feedback from clients, third parties or regulators during the year. What did you learn from these and how did you use the results? Probe shortcomings. Look for patterns and outliers. *Review* the areas that had the most issues the prior year. Not doing this is a red flag.
- For changes in business, consider the impact of new staff, new or changed investment strategies, the launch of new funds or products, M&A activity (it happens!) and anything that has an impact upon your business.
- For regulatory developments, review what you did when a law, rule or regulation changed – for example, when the SEC adopted Form ADV amendments in 2016[21] and Form CRS in 2019,[22] how did you implement those requirements?
- How did you prepare and file Form CRS, and did you consider the OCIE Risk Alert on compliance with Form CRS?[23]
- How does the Standard of Conduct Interpretation[24] impact you and your clients?
- Do you follow proposed rule amendments and the comments that are filed in response to proposals? Are you prepared for the forthcoming amendments to the advertising rule and the cash solicitation rule?[25]

---

[19] "Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers" (August 12, 2020), https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf.
[20] "Response to COVID-19" (modified August 27, 2020), www.sec.gov/tm/trading-markets-response-covid-19.
[21] "Form ADV and Investment Advisers Act Rules", 81 F.R. 60418 (September 1, 2016), https://www.govinfo.gov content/pkg/FR-2016-09-01/pdf/2016-20832.pdf.
[22] "Form CRS Relationship Summary: Amendments to Form ADV", 84 F.R. 33492 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12376.pdf.
[23] "Examinations that Focus on Compliance with Form CRS" (April 7, 2020), https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf.
[24] "Commission Interpretation Regarding Standard of Conduct for Investment Advisers", 84 F.R. 33669 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.
[25] "Investment Adviser Advertisements; Compensation for Solicitations", 84 F.R. 67518 (December 19, 2019), https://www.govinfo.gov/content/pkg/FR-2019-12-10/pdf/2019-24651.pdf.

- Are you current with interpretations on proxy voting?
- Read and digest SEC speeches, press releases and public statements – in particular, note a seminal SEC Staff speech on conflicts of interest.[26]
- Ensure that you understand and implement SEC and SEC Staff interpretations.[27]
- Know what "confidential client information" is ("non-public information" in the Rule 204A-1 definition of Access Person), monitor and enforce your Code to prevent its misuse and, if this occurs, address it in a swift, proper, proportionate and firm manner.[28]
- Read and understand Risk Alerts. These are posted on OCIE's home page, and the topics include COVID-19 (cited above), issues arising in managing private funds,[29] LIBOR transition,[30] principal and agency cross trading,[31] compliance, supervision and conflicts of interest,[32] safeguarding customer information and information storage,[33] compliance,[34] best execution,[35] cybersecurity,[36]

[26] "Conflicts, Conflicts Everywhere!", Speech by Julie M. Riewe, Co-Chief, Asset Management Unit, SEC Division of Enforcement (February 26, 2015), http://www.sec.gov/investment/im-guidance-2015-03.pdf.

[27] See, e.g., "Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers" (August 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf,

[28] *In the Matter of Brahman Capital Corp*., Admin Proc 3-18295 (December 5, 2017), https://www.sec.gov/litigation/admin/2017/ia-4819.pdf; and *In the Matter of Parotish Gupta, et al*., Admin Proc 3-18296 (December 5, 2017), https://www.sec.gov/litigation/admin/2017/ia-4820.pdf.

[29] Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

[30] "Examination Initiative: LIBOR Transition Preparedness" (June 18, 2020), https://www.sec.gov/files/Risk%20Alert%20-%20OCIE%20LIBOR%20Initiative_1.pdf.

[31] "Investment Adviser Principal and Agency Cross Trading Compliance Issues" (September 4, 2019), www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Principal%20and %20Agency%20Cross%20Trading.pdf.

[32] "Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest" (July 23, 2019), www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf.

[33] "Safeguarding Customer Records and Information in Network Storage – Third Party Security Features" (May 23, 2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf.

[34] "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (February 7, 2017), https://www.sec.gov/ocie/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

[35] "Compliance Issues Related to Best Execution by Investment Advisers" (July 11, 2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf.

[36] "Cybersecurity, the SEC and You (SEC website page) https://www.sec.gov/spotlight/cybersecurity; "Cybersecurity Examinations" (August 7, 2017), www.sec.gov/files/observations-from-cybersecurity-examinations.pdf; "Cybersecurity: Ransomware Alert" (July 10, 2020), https://www.sec.gov/files/Risk%20Alert%20-%20Ransomware.pdf, and a May 2017 Risk Alert under the same name, www.sec.gov/files/risk-alert-cybersecurity-ransomware-alert.pdf; "2015 Cybersecurity Examination Initiative" (September 15, 2015), www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf; "OCIE Report on Cybersecurity Examinations (February 3, 2015), www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf; "Investment Management Update" (April 2015), www.sec.gov/ investment/im-guidance-2015-02.pdf; and "OCIE Cybersecurity Initiative" (April 15, 2014) www.sec.gov/ ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf. See also "Statement on Cybersecurity" by SEC Chairman Jay Clayton (September 20, 2017), and related materials, https:// www.sec.gov/news/public-statement/statement-clayton-2017-09-20.

outsourced CCOs,[37] Codes of Ethics,[38] fees and expenses,[39] whistleblower compliance,[40] supervision,[41] the cash solicitation rule,[42] business continuity planning[43] and others.

- Enforcement actions are lessons learned.[44] These cases are brought for good reason. Do not become a test case or the next case.
- Are your IT, identify theft red flags and cybersecurity controls operational, current and tested, and how do you respond to hacks, breaches and intrusions – a failure to do may result in an SEC Enforcement action.[45]
- Learn from Investment Management ("IM") Guidance – see, for example, guidance on financial conflicts of interest relating to RIA compensation.[46]
- Understand lessons learned from the non-U.S. broker-dealer cases, i.e., if you are not an SEC registered broker-dealer, other than as narrowly set out in Rule 15a-6 FAQ 9[47] you should not take U.S. resident client orders to buy or sell securities.[48]

---

[37] "Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers" (November 9, 2015), https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf.

[38] See "Personal Securities Transactions Reports by Registered Investment Advisers: Securities Held in Accounts over Which Reporting Persons Had No Influence or Control", IM Guidance 2015-03 (June 2015), http://www.sec.gov/investment/im-guidance-2015-03.pdf.

[39] "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers" (April 12, 2018), https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[40] "Examining Whistleblower Compliance" (October 24, 2016), www.sec.gov/ocie/ announcement/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf.

[41] "Examinations of Supervision Practices at Registered Investment Advisers" (September 12, 2016), OCIE Supervision Risk Alert.

[42] "Investment Adviser Compliance Issues Related to the Cash Solicitation Rule" (October 31, 2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf.

[43] "Business Continuity Planning for Registered Investment Advisers, IM Guidance 2016-04 (June 2016), https://www.sec.gov/investment/im-guidance-2016-04.pdf.

[44] *See e.g. In the Matter of SignalPoint Asset Management LLC* et al, Admin Proc 3-15955 (July 2, 2014) (RIA did not disclose control relationships and conflicts of interest), www.sec.gov/litigation/admin/2014/34-72515.pdf; *In the Matter of Blackrock Advisors, LLC and Bartholomew A Battista*, Admin Proc 3-16501 (April 20, 2015) ("Blackrock") (failure to disclose conflict of interest concerning outside business activity of portfolio manager and compliance failures with respect to outside business activities), www.sec.gov/litigation/admin/2015/ia-4065.pdf; and *In the Matter of the Bennett Group Financial Services, LLC*, Admin Proc 3-16801 (September 9, 2015) (misstatements in AUM and returns), www.sec.gov/litigation/admin/2015/33-9910.pdf.

[45] *Voya Financial Advisors Inc,* Admin Proc 3-18840 (September 26, 2018) (policies and procedures to protect customer information and prevent and respond to cybersecurity incidents not reasonably designed to meet these objectives), https://www.sec.gov/litigation/admin/2018/34-84288.pdf.

[46] "SEC Staff Guidance: Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation" (October 18, 2019), www.sec.gov/ investment/faq-disclosure-conflicts-investment-adviser-compensation.

[47] "FAQs Regarding Rule 15a-6 and Foreign Broker-Dealers" (updated/modified April 14, 2014), https:// www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm.

[48] *In the Matter of Bank Leumi le-Israel B.M., Leumi Private Bank, and Bank Leumi (Luxembourg) S.A.,* Admin Proc 3-17631 (October 18, 2016), https://www.sec.gov/litigation/admin/2016/34-79113.pdf. Please see our note on this case and the article "When is an Investment Adviser a Broker-Dealer?" at www.compliglobe.com under "Publications" or ask us for a copy.

- "Cherry picking" (selective allocation) is deemed to be fraudulent, manipulative and deceptive, and must be avoided at all costs.[49] Do not think that the SEC cannot discover this – the SEC Staff used data analytics to detect suspicious trading patterns and cherry picking.
- Disclose material conflicts of interest and the means to address (mitigate) them.[50]
- If required, be aware of the need to file suspicious activity reports (initial and continuing).[51]
- Ensure that valuations are based upon disclosed methodologies and are accurate and tested – the SEC sued one non-U.S. adviser for "internal controls failures that led to the overvaluation of a fund's assets and inflated fee revenue …".[52]
- Have, follow and check (independently), policies, procedures and a methodology for fee calculation and billing matters – the *Equitas* case[53] presented these and other issues.

Understand how the SEC and the SEC Staff handle issues such as big data/alternative data, covered in informal SEC Staff guidance and laws and regulations and a topic of examinations, and ESG.[54]

No RIA can afford not to read these, understand what occurred and ask: *could this happen to us*?

The annual review is not a "yes, we have it" or a "tick the box" exercise

Do not treat your AR as a "validate the Compliance Manual exercise" or "let's see if we have what we need". Do not send your WPPs to someone and ask for an update. Do not write an "all is OK, no changes this year" memo to the Board of Directors. Do not be complacent. Do not skip an annual review or conduct a "do we have it?" checklist. The person(s) that conduct(s) the AR must bring together all the materials that comprise the Advisers Act compliance program and review, evaluate and analyze them, free from influence and with adequate time and resources. The review must include not only the current WPPs but all changes made during the year, why they were made and how they were or were not adequate and effective – document when and why these changed or did not change, and how they were or were not adequate and effective. It should include all regulatory filings including Form ADV and, if necessary, any Form PF, Form 13F, Schedule 13G and Form 13H

---

[49] *SEC v. RRBB Asset Management, LLC, et al.*, Civil Action No. 2:20-cv-12523 (D. NJ filed September 10, 2020), https://www.sec.gov/litigation/complaints/2020/comp24894.pdf; *In the Matter of Laurel Wealth Advisors, Inc.*, Admin Proc 3-19387 (August 26, 2019), www.sec.gov/ litigation/admin/2019/ia-5330.pdf; and *SEC v Michael Bressman*, D. Mass (September 12, 2018), www.sec.gov/litigation/comp-pr2018-189.pdf.

[50] *MVP Manager LLC*, Admin Proc 3-19334 (August 13, 2019), www.sec.gov/litigation/admin/2019/ia-5319.pdf; and *Robare Group Ltd*, Admin Proc 3-16047 (November 7, 2016), www.sec.gov/litigation/2016/ia-4566.pdf.

[51] *Wells Fargo Advisers, LLC*, Admin Proc 3-18279 (November 13, 2017), www.sec.gov/2017/34-82054.pdf.

[52] *See In the Matter of GLG Partners, Inc. and GLG Partners, L.P.*, Admin Proc 3-15641 (December 12, 2013), www.sec.gov/litigation/admin/2013/34-71050.pdf.

[53] *In the Matter of Equitas Capital Advisors, LLC, Equitas Partners, LLC, David S. Thomas, Jr, and Susan Christina,* Admin Proc 3-15585 (October 13, 2013) (despite repeated warnings from OCIE, Equitas engaged in over billing and under billing certain clients, negligently making false and misleading disclosures to clients and potential clients about historical performance, compensation, conflicts of interest and prior examination deficiencies, failing to conduct required annual reviews and failing to maintain written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. The CEO and the CCO were charged with aiding, abetting and causing violations). www.sec.gov/litigation/2013/34-70743.pdf.

[54] See e.g. Recommendations of the SEC Investment Advisory Committee Relating to ESG Disclosure" (May 21, 2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/esg-disclosure.pdf. ESG is one of OCIE's examination priorities – see "2020 Examination Priorities (January 2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

filed or amended. Complacency, unaddressed items, outliers and patterns, failing to act to prevent recidivist behavior and ignoring red flags are regulatory hot spots.

Ask: W*hen our business, laws or rules and regulations or clients changed, what did we do? How adequate and effective were our WPPs and, if they were not, what did we change and how?*

Although not required by Rule 206(4)-7 as it is for an SEC registered investment company ("RIC") under Rule 38a-1 under the Investment Company Act of 1940 ("1940 Act"), give the results of the review to the Board of Directors and senior management for their consideration and action. Issues arising from the review should be addressed as a priority. Compliance train all staff.

What are my options for an annual review?

You may conduct your annual review any way you prefer, as long as you do it! Your choices are:

- concentrated annual review – once a year;
- rolling topical review – pick one or two topics each month and review them, or use your quarterly reviews to cover the review of all policies and procedures and assemble the results at least once a year; or
- event-driven review – when a compliance event occurs or a law or rule or regulation or the business changes, review the policies and procedures in question.

You can leverage your Advisers Act annual review with another exercise, such as the NFA Annual Questionnaire, but you must examine each policy and procedure against Advisers Act standards.

For the newly registered RIA, the first annual review is to be completed after it has been operating as an RIA for one year. An RIA that has not been registered with the SEC for a full year can still conduct an AR but should at least conduct an interim review to help ensure that it implemented its policies and procedures in a proper manner.

Step by step

You have options. You might wish to approach your annual review this way.

1. Keep a list of all developments as they occur – new strategies, new portfolio managers, open/ closed lines of business, changes to your firm, new, amended or rescinded laws, rules or regulations, Enforcement actions, administrative actions – such as the SEC Staff no-action letters

addressing issues under MiFID II,[55] recommendations of the Investor Advisory Committee at its July 2019 meeting, court cases and so on. (If developments are material or involve line item disclosures in Form ADV, remember to amend your Form ADV as required.)

2. Assemble materials – WPPs, Code of Ethics,[56] results of monitoring and testing, change control (versions of WPPs and Code of Ethics changed during the year), training materials, breaches log, trade errors log, Code of Ethics violation log and other materials. Don't forget last year's annual review and how you addressed the issues that arose out of that.
3. Take each development in #1 and ask: "when these occurred, how did the materials in #2 stand up? Did I need to make changes and, if so, did I put these into effect? Did I use the output of my monitoring and testing the right way? Did I amend my Form ADV when required?"
4. Using this approach, review each policy and procedure to confirm whether, during the year, it was adequate and effective, and how.
5. When you determine whether a policy or procedure was adequate and effective, #4, do not just state your finding/conclusion – *document your analysis with facts and evidence.*
6. Compliance train staff.
7. Amend your Form ADV and, if required, Form CRS, and distribute them to clients.
8. Change when/as required, build your compliance calendar … and begin the process again!

A valuable exercise is to validate all disclosures in Form ADV and reconcile them to your WPPs – are they true, are they identical and how are they being administered, reviewed and enforced. Next, identify how you used the results from a monitoring task or forensic test for each policy or procedure to validate that WPP.

No matter what your approach, be sure that you review each policy and procedure.

What is adequate and effective?

An annual review is a review and analysis of the adequacy and effectiveness of your WPPs.

Adequate: Adequate means that your WPPs are reasonably designed and reflect risks, conflicts of interest, Advisers Act requirements and other applicable legal and regulatory requirements – and the risks and conflicts in your business. For example, an RIA that effects transactions in equity securities on a discretionary basis will have best execution policies and procedures. You must disclose in your Form ADV Part 2A (and in your WPPs) the factors used to seek and to measure best execution and the criteria used to select brokers with whom you place orders.[57]

Adequate means that the WPPs and Form ADV disclosures reflect identified risks and conflicts of interest and the means to address (mitigate) them. WPPs are dynamic, not static, and you must keep them and your Form ADV disclosures 4Cs compliant: materially correct, current, clear and concise. The current, accurate factors that the trading desk (or portfolio managers who trade) use when

[55] "SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions", SEC Press Release 2017-200 (October 26, 2017), https://www.sec.gov/news/press-release/2017-200-0, with links to the three no-action letters. See also "SIFMA" – Advisers Act Section 202(a)(11), (November 4, 2019), https://www.sec.gov/investment/sifma-110419.

[56] We consider a Code of Ethics to be a written policy and set of procedures under Rule 206(4)-7.

[57] *See Fidelity Management & Research Company and FMR, Co., Inc*., Admin Proc 3-12976 (March 5, 2008), https://www.sec.gov/litigation/admin/2008/ia-2713.pdf (failure to, *inter alia*, disclose broker selection criteria and best execution factors in Form ADV Part II (as it was then known – now called Part 2A)).

selecting a broker and placing an order. How accounts are opened. How trades are bunched and allocated. Requirements for supervision. How client mandates are amended, and investment objectives and restrictions are recorded and followed. Code personal account dealing requirements. Social media use requirements.

To check adequacy, validate all Form ADV disclosures, WPPs and CRI and Conflicts Log entries against actual practices. Ask whether the factors or desk procedures changed and remain relevant to your business. If they have changed, did you amend your Form ADV Part 2A disclosure and WPPs and change your monitoring and testing plan – if not, why not? If you send orders solely to an affiliated broker, have you disclosed this conflict of interest in your Conflicts Log and Form ADV Part 2A and do you require it to provide you with data with which to evaluate whether it achieved best execution for you? If these are based on your business and the risks and conflicts arising from it, and Advisers Act and related SEC pronouncements (interpretations, no-action letters, exemptions and lessons learned from Enforcement actions), and changes are made at the right time, these would probably be adequate.

Effective: Effective means that the WPPs are reasonably designed and are being followed, that Form ADV disclosures are verified and that the CRI and Conflicts Log are current, that issues are addressed as they arise, that management supervise and ensure a proper Compliance tone at the top and that WPPs and Form ADV disclosures are amended as required.

Indicators of WPPs not being effective are issues not being addressed as they arise or are spotted but ignored. Other indicators are repeat trade errors or breaches that are not addressed or not dealt with in a proper and proportionate manner to prevent them for reoccurring. Or that problems arise and are escalated to the Board of Directors who ignore red flags or delegate but do not follow up.[58] Or that monitoring and testing is wrong or that there are unspotted or unaddressed patterns and/or outliers, or that they are identified but not addressed. Or failures to supervise that lead to repeat, unaddressed breaches or light touch remedies.

Do not wait for someone to spot these for you. Do not ignore reminders from counsel or auditors.[59] Review what trading desk staff and portfolio managers do and ensure that changes, if any, are reflected in your Form ADV disclosure and WPPs. Monitor and test to ensure that you are achieving best execution, and if you find anomalies address them forthwith. If issues arise repeatedly or are not identified, or are identified but WPPs are not changed, your WPPs can't be effective.

Your goal as an RIA is to have WPPs that prevent issues from arising and catch problems as they occur – not to spot them well after the fact, fail to uncover evidence of them or fail to act.

---

[58] *See In the Matter of Morgan Asset Management, Inc.; Morgan Keegan & Company, Inc.; James C. Kelsoe, Jr.; and Joseph Thompson Weller, CPA, Respondents*, Admin Proc 3-13847 (June 22, 2011), https://www.sec.gov/litigation/admin/2011/34-64720.pdf; ("*Morgan Asset*"), and *In the Matter of J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie W. Willis III,* Admin Proc 3-15127 (June 13, 2013), https://www.sec.gov/litigation/admin/2013/ic-30557.pdf ("*Morgan Asset II*").

[59] *In the Matter of Quattro Global Capital, LLC*, Admin Proc 3-12725 (August 15, 2007), www.sec.gov/litigation/2007/34-56252.pdf (repeated failure to file Form 13F with the SEC after having been advised to do so by outside counsel and auditors, and in spite of WPPs outlining this filing requirement).

What is *not* an annual review?

An annual review is not sending your WPPs to someone for updating. It is not a "tick the box" exam. If you are a member of a group that has two or more RIAs, do not take their WPPs for yours (absent proper Umbrella registration) or their review for yours – firms are different and you must do your own AR and keep your own records. You should not compare your WPPs against those of another RIA who you think matches your profile, follows market practice or "did OK in an SEC exam".[60] You should not use a service provider that is unfamiliar and inexperienced in the intricacies and nuances of SEC practice – actual, demonstrated SEC compliance experience and knowledge is a prerequisite. Do not give the Board of Directors a 10-minute summary that you checked the Compliance program and have nothing to report. The SEC stated in *IIA* that: "[b]etween at least 2011 and 2016, IIT's [a RIC] board received one-paragraph annual letters, signed by IIA's president, indicating that an annual compliance review of IIA and IIT had been conducted. In fact, IIA did nothing more than draft and send these letters. No reviews were conducted or documented."[61]

What policies and procedure should be reviewed?

Each of them. Each year. Distribute your WPPs and Code of Ethics to all Supervised Persons and have each sign and return to the CCO an acknowledgment attesting to the fact that they have received, read and understand the WPPs. Document compliance training. Train and re-train staff.

When the SEC adopted Rule 206(4)-7,[62] it noted the following policies and procedures (a summary):

- portfolio management processes, including allocation of investment opportunities, consistency of portfolios with client investment objectives, disclosures and applicable regulatory restrictions;
- trading practices, including procedures by which you satisfy your best execution obligation, use client brokerage to obtain research and other services ("soft commissions") and allocate trades;
- accuracy of disclosures, including account statements and advertisements;
- safeguarding client assets;
- having a business continuity plan;
- the accurate creation of required records and their maintenance in a way to secure them from unauthorized alteration or use and protects them from untimely destruction;
- marketing advisory services, including the use of solicitors;
- safeguards for the privacy protection of client records and information;
- proprietary trading of the RIA and personal account trading of Access Persons[63] – proprietary trading by an affiliate is attributable to the RIA; and
- processes to value client holdings and assess fees based on those valuations.

---

[60] After an exam, OCIE can only say no further comments, issue comments in a Deficiency Letter or make an Enforcement referral. There is no such thing as a clean bill of health, clearance or acceptance. *See "Examination Information for Entities Subject to Examination or Inspection by the Commission", SEC 2389 (6/14), https://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.*

[61] *IIA*, note 9 supra at ¶ 23.

[62] *Compliance Release*, 68 F.R. at 74716.

[63] "Access Person", defined in Rule 204A-1(e)(1), is a Supervised Person who has access to non-public information about client purchases and sales or non-public information about the holdings of reportable funds, are involved in formulating or giving advice or recommendations to clients or who have access to such non-public information. The Rule 204A-1 adopting release refers to safeguarding client holdings, so the prudent approach would be to include in your Code both the rule's requirements and the interpretative positions in this release. Keep your list of Access Persons current. *See* "Investment Advisers Codes of Ethics", Advisers Act Release 2256, 69 F.R. 131 at 132 and 133 (July 9, 2004), www.sec.gov/rules/final/ia-2256.pdf.

Market, business and legal and regulatory developments have "updated" this list – add in "pay to play", COVID-19, ESG, cybersecurity and identity theft red flags, as well as whistleblowing rules. Do your Access Persons wish to buy or sell cryptocurrencies/bitcoins or ETFs? Be current!

Not all of these are applicable to every RIA – some RIAs do not have custody or have it because a related person has custody, some only give advice but do not trade, some only make loans through private equity firms, others do not use solicitors (firms that refer or solicit clients), some send orders to affiliated brokers and require that these firms give them best execution.

Policies and procedures must be bespoke. The business plan that you created before you registered should be updated and set out the activities in which you engage and how you do these. You should have a CRI and Conflicts Log reflecting the risks and conflicts in your business upon which to base your WPPs and your monitoring and testing plan. From these you should implement, administer and enforce bespoke WPPs.

Clarify who is responsible for each policy and procedure: it is the RIA's responsibility, under Rule 206(4)-7, to adopt and implement WPPs, not the CCO. The CCO is a trusted adviser and not the doer or guarantor of compliance. This is a key benchmark when the SEC Staff examines a firm or when the Division of Enforcement investigates suspected violations of the Advisers Act and the rules thereunder. It is prudent to have the RIA via the CEO/management adopt, implement, administer and enforce all WPPs and to delegate the responsibility to certain persons to administer each policy and procedure. The CCO as trusted adviser monitors, tests, ensures that management keeps the CRI and Conflicts Log current, handles Form ADV disclosure (this is approved by management) and performs Code of Ethics analysis – and conducts other activities within his or her purview and not become a supervisor or guarantor of the RIA or its WPPs.

Be Proportionate and scalable

An annual review is a *process*. It must be proportionate and scalable. Each policy and procedure must be assessed for its adequacy and effectiveness. This includes the monitoring and testing plan. For example, for allocation, in addition to the points noted above, an RIA should verify adequacy review its policies and procedures to assess whether these are current, correct and proportionate for the trading activity in which the firm engages. For effectiveness, and in addition to the points above, the RIA would review the exceptions log for breaches, the record of changes to allocation (post-trade vs pre-trade), the output of the monitoring and testing done for this and how trading patterns have gone to validate that the policy and its procedures are working as intended or whether changes should have been made. The level of review depends upon the number of trades, securities traded, low vs high volume trades and other relevant factors. All of this would be recorded as part of the annual review – remaining true to a level of analysis proportionate to the RIA's profile.

How do I document my annual review?

There is no SEC approved checklist. This is up to you. One option is to record WPPs headings, policies and procedures and applicable legal and regulatory requirements in an Excel spreadsheet and leave columns to record the source document where it's found (WPPs or Code of Ethics), work done, by who, dates, your methodology and the results. (We will be happy to provide you with samples.) Record how or why a policy or procedure is or is not adequate and effective and the action plan for

the coming year. Involve as many people as possible. Involve the CEO and management as they are responsible for "compliance tone at the top". You should involve them in your compliance training.

I'm not alone!

Multiple RIAs in a group: An RIA may be one of several registered investment advisers in a group operating in and with different markets and clients. Even if they are identical and operate in a coordinated manner, each RIA should conduct its own annual review. A non-U.S. RIA with a U.S.-based RIA affiliate can receive support from the U.S. entity but should conduct its own review – there should not be a single "group" annual review. This is because each operates in a different market and is subject to differing requirements – in a group with a U.S. RIA and, say, a Hong-Kong RIA, the former is subject only to U.S. requirements while the latter entity must comply with both U.S. and SFC requirements. A "group" AR might cover points from the top down but can miss issues.

Relying advisers: It may be the case that an RIA may have one or more relying advisers – where, relying on "Umbrella registration", a U.S.-based RIA has related advisers (whether or not they are based in the United States) in a control relationship that conduct a single advisory business with a unified Compliance program and all are registered with the SEC on a single Form ADV. (Today, this is not possible where the RIA is not incorporated and operating in a state in the United States.) Here, one annual review will suffice but it must include the primary RIA and its relying advisers. Remember, also, to document oversight for the relying advisers and carry through a check of all Advisers Act requirements, including, in particular, safeguarding confidential client information, record retention, Code of Ethics requirements and advertising.

Participating affiliates: Participating affiliates are entities in a control relationship with an RIA that are not themselves SEC registered but that provide research, advice or recommendations to the RIA for it to use for its U.S. clients. Under a participating affiliate arrangement, developed by SEC Staff no-action letters[64] and recognized by the SEC in an interpretation in a 2011 rulemaking,[65] the affiliate does not need to register under the Advisers Act if it complies with the following:

- sign a participating affiliate agreement with the RIA;
- have the RIA treat as "Associated Persons" (of the RIA) the affiliate's employees that develop or give research, advice or recommendations to the RIA for U.S. clients, and has these Associated Persons comply with provisions of the RIA's Code of Ethics as if they were Access Persons (personal account dealing and reporting);
- identify the Associated Persons in the RIA's Form ADV Part 2A;
- keep accurate books and records and make them available to the SEC in an examination (and make Associated Persons available for an interview); and
- submit to the jurisdiction of the SEC and the U.S. courts and appoint an agent for service of process.

[64] *Mercury Asset Management plc* (April 6, 1993); *Kleinwort Benson Investment Management Ltd, et al.* (December 15, 1993); *Murray Johnstone Holdings Ltd, et al.* (October 7, 1994)*; ABN AMRO Bank N.V., et al.* (July 1, 1997); *and Royal Bank of Canada, et al.* (June 3, 1998).

[65] "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management and Foreign Private Advisers", Advisers Act Release IA-3222, section II.C.4 (June 22, 2011) ("Exemptions Release"), www.sec.gov/rules/final/2011/ia-3222.pdf.

Keep the following in mind.

- Both firms must establish bona fide affiliation through "control".
- The RIA must exercise oversight over and supervise the participating affiliate – failure to supervise is actionable under Advisers Act Section 203(e)(6).
- One cannot "engineer" a participating affiliate relationship to avoid registration – this is doing indirectly what cannot be done directly (Advisers Act Section 208(d)).
- These no-action letters by their terms do not permit Associated Persons to exercise discretion. Also, the no-action letters do not permit Associated Persons to send orders to the RIA (given a facts and circumstances analysis, this may be brokerage). The participating affiliate no-action letters were issued by the IM Staff pursuant to delegated authority under the Advisers Act and deal only with matters arising under Advisers Act Sections 203 and 208(d). They were not issued by the Staff of the Division of Market Regulation ("MR", now Trading and Markets) and do not give relief under the Securities Exchange Act of 1934 ("Exchange Act") - IM had no authority to act on matters outside the Advisers Act – in particular, the Exchange Act and brokerage. This would have required action by MR and MR took no position in these letters. As such, there does not appear to be any authority under these letters or elsewhere for Associated Persons to give orders to buy or sell securities for the U.S. clients of the RIA or to manage assets on a discretionary basis.

RIAs with unaffiliated sub-advisers: Here, the RIA uses non-affiliated firms as sub-advisers. These firms might, given the facts, have as their client either the RIA or the underlying clients and must, in each situation, consider whether they themselves might be subject to Advisers Act registration. Apart from this, the RIA must exercise oversight over these firms and those activities must form an integral part of the annual review.

Sub-advisers to RICs: RIAs as sub-advisers to mutual funds or other investment vehicles registered with the SEC under the 1940 Act must include in their annual reviews a comprehensive review of all activities caught by both the Advisers Act and the 1940 Act. The requirements for an annual review under the 1940 Act are different from those under the Advisers Act and include, among other items, thorough documentation and a written report to the RIC's Board of Directors.

Code of Ethics

An AR is prime time to review your Code of Ethics. Thirty calendar days after each year end, "Access Persons" and their "Connected Persons"[66] file annual holdings report required by Advisers Act Rule 204A-1, the "Code of Ethics" rule. Take Code matters that arose during the year – reports, breaches and Code amendments – and review these. Document through analysis what occurred and what needs to be changed, if anything, or addressed, if it was not addressed at the time – not reviewing Code activity or addressing issues as they occur is itself a violation of this rule.

OCIE will expect you to have recorded in your breaches log instances of non-compliance with your Code of Ethics (and your WPPs), and action taken because of such non-compliance. This discloses

[66] "Connected Persons" (a term of art) are (1) immediate family members (and, for policy purposes, certain others such as live-in partners) (2) living in the same household and (3) sharing beneficial ownership (direct or indirect pecuniary interest) in "Reportable Securities" with the Access Person. Beneficial ownership for Code of Ethics purposes is interpreted in accordance with Exchange Act Rule 16a-1(a)(2), 17 CFR 240.16a-1.

missteps that have been uncovered, whether by your monitoring and testing, an admission or otherwise. OCIE examiners will want to see what you have done to identify and correct issues and improve your compliance program as a result, and how you will ensure that future violations do not occur. Not finding issues or ignoring them when they arise is a serious matter.[67]

Link your annual review to your Form ADV annual amendment

Reviewing WPPs, the CRI and the Conflicts Log in the annual review also helps to validate Form ADV disclosures and prepare the annual amendments.

Preparing your annual Form ADV Parts 1, 2A, 2B and Form CRS updates is not a weekend or a "save it for a quiet day" exercise. This requires time, attention, having all the relevant information to hand, doing an assessment (this links the annual review to the Form ADV review) and getting it right. Conducting a thorough annual review will generate the information that you need to help ensure that your Form ADV update accurately reflects your business.

Consider Item 2 of Form ADV Part 2A, "material changes." The instructions read: "If you are amending your brochure for your annual update and it contains material changes from your last annual update, identify and discuss those changes on the cover page of the brochure or on the page immediately following the cover page… ." Your "changes in business arrangements" and reactions to significant regulatory developments may form the basis of your response to Item 2.

Form ADV Part 2A requires that an RIA must disclose its material conflicts of interest and the means to address these. This disclosure must be clear and concise so that a reader understands clearly the conflict and how it is addressed.

Item 6 is "performance-based fees and side-by-side management." The instructions make this sound complicated, but it requires you to identify the risks and conflicts that arise if you have clients who pay you incentive compensation alongside clients who do not pay such fees. The concern is that your firm might give performance fee clients benefits ranging from well performing IPO allocations to an unjustified share of winning trades. It is up to you to spot this and, if present, prevent it. Some RIAs respond to this with an explanation of their aggregation and allocation policies and procedures – query how this explanation alone could address the conflicts that arise out of the side-by-side issue. Any response to this item is not complete until you test your WPPs to confirm that they are working as required or, if you find exceptions or patterns, you address them and change controls to prevent recurrences. You should consider factors like client restrictions that will affect returns and analyze the performance of incentive-fee paying and non-incentive fee paying accounts managed according to the same investment style. Also, compare the performance of all accounts eligible to participate in IPOs. Understand the reasons why certain clients significantly better or worse than average, then determine if favoritism is an element.

Document your annual review

It is not an easy task to explain an undocumented annual review to OCIE, or to try to convince OCIE that you did this. Document all findings, keep your report as a required record, amend and file your Form ADV Parts 1, 2A and Form CRS, deliver Form ADV Parts 2A, 2B and, if required, Form CRS and

[67] We have published an article on Codes of Ethics that you can find at CompliGlobe articles.

the Regulation S-P Privacy Statement and update your Code of Ethics and WPPs. Implement your findings. Review monitoring tasks and forensic tests. Do not ignore or fight findings, take no action or fire the messenger. Address issues as they arise so that they do not reoccur. In an examination, OCIE will want to see your annual reviews and any report prepared by a service provider/consultant and want to know why findings were ignored or challenged, issues missed or glossed over or the messenger given a hard time. A "silent" Board of Directors, one that glosses over or ignores red flags or issues found in an AR or that are brought to its attention by the RIA or a service provider, would have demonstrated a lack of "Compliance tone at the top" and face regulatory scrutiny or even an Enforcement action.[68]

Review results with management. They, as supervisors, must ensure that the CCO has adequate resources to fulfil his or her role. In turn, the CCO must bring all matters to the attention of the CEO and management, including the Board of Directors, and not be rebuffed or turned away. Everything must be documented and if at any time the CCO feels that they do not have adequate resources or support from the RIA, the CEO, management or the Board of Directors, they must not leave a single stone unturned in their efforts to have matters resolved and be properly resourced.[69]

Regular monitoring and testing help validate your WPPs

Just as regular checking and preventative maintenance helps reduce unexpected auto repair bills, administering properly your SEC compliance program helps eliminate the possibility of unpleasant discoveries in your AR or during an SEC examination. A well-designed, maintained and resourced Compliance program will mean that your AR is not a once-a-year peek at the program that turns up embarrassing issues, gaps or cries of "how did I miss that?!" Monitoring and forensic testing is the key to validate WPPs as well as the formula for a good night's sleep.

When the SEC examines you, they will want proof that you mapped your WPPs against the risks and conflicts arising from the business. They will want to see the output of monitoring and compliance testing, including any compliance reviews, quality control analyses, surveillance and/or forensic or transactional tests performed. This should include significant findings, both positive and negative, of such testing and information about corrective or remedial actions taken regarding these findings.

Forensic testing looks for patterns or outliers. The SEC memorialized the concept in the Compliance Release when it stated that: *"[w]here appropriate, advisers' 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 quality of brokerage executions for the purpose of evaluating the adviser's fulfillment of its duty of best execution… ."*[70]

Transactional tests look at a specific act to determine if it was compliant. A transactional review might consider whether, on a given purchase of a privately offered security for their own account, an employee had obtained clearance as required by the firm's policies. Another forensic test, "10 up

---

[68] *Morgan Asset I* and *II, supra*.

[69] *In the Matter of Pekin Singer Strauss Asset Management Inc., Ronald L. Strauss, William A. Pekin, and Joshua D. Strauss*, Admin Proc 3-16646 (June 23, 2015) (CCO rebuffed when he escalated matters to the President who "dedicated insufficient resources to compliance, which contributed substantially to Pekin Singer's compliance failures"), https://www.sec.gov/litigation/admin/2015/ia-4126.pdf.

[70] *Compliance Release*, 68 F.R. at 74716 n 15.

and 10 down", compares how the 10 best and 10 worst performing purchases or recommendations performed in light of similarly situated accounts (strategy, etc.) and helps identify instances of favoritism, or "cherry picking" – giving higher paying clients better stock picks inconsistent with the allocation policy of fair and equal treatment.

A CCO should spend time with the business and operations and understand what happens; this is "observational testing." Sit with portfolio managers and with traders, ask questions and ensure that you understand the business and everyone's roles. It will give them comfort that you understand what they are doing and make it easier for them to ask questions and share information with you. Make sure that you map operational processes; for instance, the lifecycle of a trade from the research team-generated idea through settlement. Use this to confirm your WPPs.

- Compare what portfolio managers and traders do when they seek best execution – are they following the steps outlined in the WPPs and the Form ADV Part 2A?
- Are portfolio managers documenting pre-trade allocation (splits) before placing an order?
- Are personal account trades mirroring client trades?
- Are required books and records maintained as required?

Remember: *the SEC expects you as an RIA to tell the truth in your disclosures and to clients and be able to demonstrate that you are doing precisely what you disclosed you would do.*

Use forensic, transactional and observational testing regularly. Have these feature in your compliance calendar, which is a resource that plots compliance chores for the year (everyone will have responsibilities under this). It should reflect your daily (e.g. e-mail review), weekly, monthly, quarterly and annual tasks and reviews. Test regularly and your annual review will be less painful.

Mind the gap analysis

Be creative and use a variety of types of tests. Probe for inconsistencies, unexplainables and missed items and gaps. One good annual review tool is a gap analysis. This is an assessment that identifies gaps, disconnects and inconsistencies between the requirements the compliance program should have and what you have. Test for gaps between Advisers Act requirements and what you say you do (in, for instance, your WPPs and other disclosures). Then, test for the differences between what you say you do and what you do in practice. We use these to help take new registrants through the registration process and for annual reviews, mock exams and "health checks."

Be thorough

We mentioned this list of areas to be reviewed. The competent and knowledgeable CCO will leave no stone unturned.

- Are your CRI and Conflicts Log current?
- Have you reviewed your disclosure materials to ensure they are materially correct?
- Are all your disclosures 4Cs compliant – materially **c**orrect, **c**urrent, **c**lear and **c**oncise?
- Are documents consistent – WPPs, Form ADV disclosures and other internal memoranda?
- Are you current with your regulatory filings, home country and SEC?
- Have you reviewed the effectiveness of your anti-money laundering program?
- Cybersecurity – are you doing that what the SEC would expect from you?

- Have you conducted compliance training? Train staff on Code of Ethics issues, preventing the misuse of confidential client information and inside information, and the pitfalls involved with making campaign contributions and other topical matters.
- Conduct an all-hands compliance meeting (remote offices can participate via video conference) in which colleagues are encouraged to ask questions and make suggestions?
- Evaluate service providers? Third-party oversight is a must, as is the independent verification of trades, cash and assets held by custodians and other key data. When OCIE shows up, ask for: "*The names and location of all service providers and the services they perform and for both affiliated and unaffiliated providers, information about the due diligence process to initially evaluate and monitor thereafter the work provided and how potential conflicts and information flow issues are addressed."*
- DDQs and inspection reports, like a SOC 1 Report, can be effective elements of a service provider assessment. Visit the location where work is performed and conduct a substantive review.

An independent perspective is good, if used *wisely*

Some RIAs engage a third party to conduct the annual review. This works if the firm conducting the review has *demonstrated* expertise conducting annual reviews and understands SEC compliance. Your perspective should be "what does the SEC expect?" and not "what is the law in this area?" Law firms help, but they practice law and only in one jurisdiction and generally do perform compliance. When possible, consider a firm with experienced and SEC-knowledgeable compliance specialists and a track record over time with multiple clients.

You should strive to conduct your AR as a mock SEC examination at least once every two years.

How your annual review prepares you for your SEC examination

Whether or not examined, you must remain in full compliance with the Advisers Act and the rules thereunder. Your ultimate regulator are clients - if they are not happy the SEC will be concerned.

The SEC notifies an RIA of an examination with a telephone call and e-mail with a document request. Two weeks are given to supply the requested documents. The examiner will ask for the names of key employees to schedule interviews starting a week to 10 days after the documents are submitted. The examination might be a correspondence exam or an on-site review.

How will the CCO gather and produce the reams of information in such a short period of time? How does the CCO explain absences during the examination – "my CIO could not change her holiday dates." What happens if I do not have the requested records? What happens if I did no testing or short-cut my annual review? How will the CEO and other senior managers manage a two-hour interview with multiple examiners? What happens if the SEC uncovers something big or finds patterns, reconciliations or outliers that were overlooked or ignored?

Had the RIA and the CCO been prepared, these questions might be moot, and the exam would be handled with confidence. The key is conducting an annual review as if it were an OCIE examination.

- Keep a current OCIE examination document request (we can supply you with one) and ensure that you have all the requested documents, perform required tasks and monitor and test.
- Document all findings and address each.

- Leverage the gap analysis that you used for your SEC registration.
- Ensure that your WPPs reflect the risks in the CRI and the conflicts and the means to address them in the Conflicts Log.

A good way to prepare is the "30 minute" test: in this time, gather and analyze your breaches log, the trade errors log, the results of the two most recent ARs and Code of Ethics reports and reviews.

At the start of an examination, the SEC issues a document request list. The arrival of this list and notice of an examination is no cause for alarm if you and your firm have conducted yourself honestly and ethically and demonstrate that you have a "reasonably designed" compliance program. You would do well to use your annual review to ensure that you will be able to respond expeditiously to such a document request list when one finally — inevitably — arrives, to say nothing of testing, identifying areas for attention and fixing issues before the SEC arrives.

In an examination, the SEC "follows the money" and looks to confirm whether the RIA told the truth and is doing what it said it would do.[71] The following are representative of areas examined:

- conflicts and risk identification and resolution;
- advertising;
- business continuity, cybersecurity and identity theft;
- weaknesses in compliance and controls;
- related persons and affiliations;
- pay-to-play;
- safe keeping of client assets (custody);
- undisclosed compensation arrangements, fees and valuations;
- trading practices (allocations, best execution, broker arrangements and trading);
- Code of Ethics and personal account dealing; and
- valuations and fee calculations.

The document request list contains nearly everything that an RIA should have to satisfy its Advisers Act requirements. This includes records that you generated and kept of your annual reviews, Code of Ethics materials, advertising and breaches and trade errors logs, as well as all trades completed for clients and by Access Persons. The SEC will ask for results from forensic testing, compliance-cleared advertising and the CRI – which is referred to as *"a current inventory of the Adviser's compliance risks that forms the basis for its policies and procedures, including any changes made to the inventory and the dates of the changes."* As noted previously, every RIA requires one to be able to establish that its WPPs are "reasonably designed" (in the words of the compliance rule).

We note the impact of *WAM* where the SEC cited language from the *Compliance Release* as a warning to RIAs who do not complete a CRI and Conflicts Log and use them to design and implement written policies and procedures "reasonably designed":

[71] Remarks at *CCOs and SEC Examinations*, London (November 8, 2019): Mavis Kelly, Assistant Director, OCIE; David Bartels, Deputy Chief Counsel, Division of Investment Management; and Mark Berman, CEO, CompliGlobe Ltd.

"Rule 206(4)-7 requires investment advisers to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation" of the Advisers Act and its rules. The [SEC] has stated that an adviser's failure "to have adequate compliance policies and procedures in place will constitute a violation of our rules independent of any other securities law violation [emphasis added]." [Compliance Release, 68 F.R. 74714, at 74715]. The Compliance Release further provides that "[t]he policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred." 68 F.R. 74714, at 74716. The Compliance Release also states that "[e]ach adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks [emphasis added]."" [72]

Do not respond to the document request list with "my lawyers told me that I didn't need a CRI" or "the compliance manual we received didn't refer to it so why do this now?" Do not think that because you are outside the United States you might not have to comply with all Advisers Act requirements. An RIA must constantly evaluate and respond to the risks and conflicts it faces and adopt and implement bespoke WPPs. "Off the shelf" materials are not only discouraged but might result in an Enforcement referral. Make sure that your WPPs reflect who and what you are, your risks and conflicts and are specific and measurable, that "take into account the nature of [your] operations".[73] No one wants to have the SEC find the words "These Policies and Procedures have been created using the [name of firm] Compliance Manual Wizard", "This is the Compliance Manual of [Name of Adviser]" or contain materials that are not relevant or inconsistent.

Not identifying material conflicts of interest and the means to address them and not disclosing them in your Form ADV Part 2A would be actionable. Form ADV Part 2A disclosure must be clear and concise. Keep in mind that you may be sued if your disclosures are materially incorrect, for example, if there is a material omission such as an undisclosed conflict of interest,[74] failure to disclose conflicts or using "may" or "might" to describe possible or potential conflicts.

For more thoughts on perspectives on OCIE, you should read the speeches given by former OCIE Director Marc Wyatt,[75] former Chief of Staff Andrew Donohue[76] and OCIE Director Peter Driscoll.[77]

Do not find out about issues when the SEC arises. "CCOs and GCs should not be hearing about compliance deficiencies for the first time when the SEC visits … to conduct an examination."[78]

---

[72] *WAM*, page 6 and 7, para. 23, citing the *Compliance Release*, 68 F.R. at 74715.
[73] *Compliance Release*, 68 F.R. at 74716.
[74] S*ee Blackrock*, n. 44 *supra*.
[75] "Inside the National Exam Program in 2016", speech by Marc Wyatt, OCIE Director (October 17, 2016), www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html.
[76] "Remarks", speech by Andrew Donohue, SEC Chief of Staff (October 19, 2016), www.sec.gov/speech/html.
[77] "Remarks at SIFMA Operations Conference & Exhibition: Staying vigilant to Protect Investors", Speech by Peter Driscoll, OCIE Director (May 8, 2019), https://www.sec.gov/news/speech/driscoll-remarks-sifma-operations-conference-050819, and "How We Protect Investors", Speech by Peter Driscoll, OCIE Director (April 29, 2019), https://www.sec.gov/news/speech/speech-driscoll-042919.
[78] Remarks by Mark Berman, "Emerging Landscape of CCO and GC Liability", RCA Asset Management Thought Leadership Symposium (November 10, 2011).

Conclusion

An annual review is the time to demonstrate you comply with Advisers Act requirements and are prepared for your SEC examination. Use a document request list as a key resource and use your WPPs to form the basis of your monitoring and testing. Each policy and procedure should be tested to ensure that it is adequate and effective. If the WPPs say that you're to do something, make sure you do it as specified. If things have changed during the year and you did not amend the WPPs as developments occurred, amend them now.

Be skeptical. Make sure that you leave no loose ends or accept explanations that, on reflection, don't wash. And don't forget to ask your Supervised Persons what's working and what's not in your WPPs. Use your annual review to prepare for the day the SEC visits. Use your CRI and Conflicts Log entries to help form the basis for your WPPs. Give this special consideration in your annual review. Be proud of your SEC compliance program and your firm will be proud of you.

For more information on CompliGlobe and materials for RIAs, please contact:

Mark Berman
berman@compliglobe.com
Hong Kong + 852 8124 5181
London + 44 208 458 0152
USA + 1 917 724 5758
www.compliglobe.com