

## Revisiting Annual Compliance Reviews

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It has been over ten years since the Securities and Exchange Commission (SEC) adopted Rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act) requiring registered investment advisers to conduct annual reviews of their compliance policies and procedures. According to recent statistics, there are approximately 11,600 registered advisers. Therefore, approximately 11,600 annual reviews should be conducted this year.

This article revisits the basic requirements of Rule 206(4)-7 (compliance rule) addressing annual reviews and the SEC staff's expectations with respect to those reviews based on information reflected in recent enforcement actions, statements of SEC staff and examination request letters. It also discusses various approaches and considerations in connection with conducting an annual review and documenting the results of the review.

### Regulatory Requirements and Expectations

The compliance rule requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violation by the adviser and its supervised persons of the Advisers Act and rules thereunder. The compliance rule also requires advisers to review, no less frequently than annually, the adequacy of the compliance policies and the effectiveness of their implementation. Thus, the basic

requirements applicable to an annual review are that it must be completed at least annually and it must assess the adequacy of the policies and the effectiveness of their implementation. Sounds simple.

An annual review cannot be conducted in a vacuum. It starts with construction of the adviser's compliance policies and procedures, which are tailored to the risks and conflicts to which the adviser is subject. These risks and related policies evolve as the adviser's business, strategies, clients and personnel evolve. So too must the annual review. Assessments of the adequacy and effectiveness of implementation of the policies require an understanding of the adviser's current business, strategies and clients and the risks and conflicts arising from those activities and relationships. These assessments also require an awareness of the latest legal requirements and regulatory developments applicable to advisers and their businesses.

### Adequacy Assessments

Adequacy assessments involve, in large part, an assessment of the scope of the policies and the overall compliance program in relation to the adviser's business and applicable legal and regulatory requirements. Answers to the following inquiries are helpful in assessing adequacy.

- Do the compliance policies and pro-

cedures of the adviser address its current business and operational practices (particularly any new practices added since the last annual review) and the risks related to those practices?

- Do the compliance policies and procedures address the latest legal and regulatory developments affecting the adviser? For example, cybersecurity has been the focus of several SEC staff alerts and speeches in the last 18 months. Has your firm adopted compliance policies addressing cybersecurity and are those policies tailored to the cyber risks that your firm confronts (arising from systems used, clients served and other factors)?

### Effectiveness Assessments

Effectiveness assessments involve two steps: (i) assessing whether each policy addresses and mitigates the identified compliance risk or risks to which it relates and (ii) assessing whether the overall program addresses and mitigates the adviser's compliance risks. Answers to the following inquiry tailored for each policy are helpful in assessing effectiveness of implementation and will necessarily derive from the results of monitoring and testing each policy and the overall program.

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- Do the policy and related procedures (e.g., allocation policy) address and mitigate the compliance risk or conflict of interest that the policy and procedures are designed to address?

Personnel conducting the annual review and seeking answers to these inquiries have to engage the advisory personnel involved in the activities or functions covered by the policy. For example, in assessing whether the adviser's IPO allocation policy is effective in ensuring that all accounts eligible to participate in IPOs do so in a fair and equitable manner over time, personnel conducting the annual review have to speak with the adviser's portfolio managers and traders who are responsible for making and effecting IPO allocations. Without such engagement, there will likely be "gaps" between practice and related disclosures/policies that can lead to a number of negative outcomes (e.g., material misstatements or omissions, examination deficiencies or worse).

Items commonly found in the SEC staff's information request lists for exams include requests for an adviser's most recent compliance assessment or annual review, a list of any third party compliance reviews performed and the adviser's compliance issues log or record of any non-compliance with the adviser's policies and procedures and any action taken as a result of such non-compliance. Recent SEC enforcement actions and settlements underscore the SEC's focus on ensuring that annual reviews are being conducted. The actions have focused on the timeliness (or lack thereof) of completing the annual reviews and the lack of evidence demonstrating the adequacy and effectiveness of the compliance policies and procedures and testing of the adviser's implementation of the policies. Some have gone further and raised questions about the individuals conducting the annual reviews, citing in one instance that the chief compliance officer (CCO) lacked experience, resources and knowledge

as to how to conduct a "comprehensive and effective" annual review. The latter point is instructive in that the SEC expects the annual compliance review to cover all of an adviser's compliance policies and procedures. The annual review cannot be limited to specific policies or to limited periods within a year.

### **Annual Review Approaches and Documentation**

The compliance rule does not mandate who should conduct the annual review or how it should be conducted and evidenced. As a result, various approaches have been developed in the last ten years.

#### **Who should conduct the annual review?**

As noted above, advisers have the obligation to review their compliance policies. The compliance rule does not require the CCO to conduct the annual review. Under the rule, the CCO is responsible for administering the compliance policies and procedures. Nevertheless, the CCO typically takes the lead role in conducting the annual review unless the adviser has engaged an outside service provider, such as a compliance consultant or law firm, to do so. Having the CCO lead, or at least be significantly involved in, the annual review may have certain advantages over having an outside service provider conduct the review. Typically, the CCO is familiar with the adviser's business and personnel and has working knowledge of the adviser's risks and compliance policies and procedures. Further, to the extent any compliance matters are identified during the annual review, the CCO is well situated to ensure that corrective actions are taken and completed in a timely manner.

Conversely, having an outside service provider conduct the annual review may have certain advantages. Service providers engaged in the business likely perform a number of such reviews each

year and therefore may have more experience with assessing the adequacy and effectiveness of the implementation of the compliance procedures. They may be more attuned to industry compliance practices. In addition, they may be perceived as more objective, particularly when compared to a CCO who serves in multiple roles for the adviser or is in a position to review his or her own work.

Regardless of who leads the review, most personnel of the adviser should be involved in the process. As noted above, assessing adequacy and effectiveness of implementation necessarily involves discussing (or at least reviewing) business activities with the advisory personnel performing the activity. A thorough analysis of the adviser's trading practices, for example, cannot be performed without discussing trading with the adviser's trading personnel.

#### **Should the annual review involve a one-time comprehensive review of all compliance policies and procedures or a comprehensive roll-up of multiple interim reviews conducted throughout the year?**

Approaches vary, with each having certain advantages, and are likely determined based on the size of the adviser, the structure of the adviser's compliance program and the ongoing monitoring and testing performed by the adviser throughout the year. Larger advisers seem to utilize the roll-up review approach more frequently than smaller advisers. This approach, which involves focusing on targeted compliance areas quarterly, rolling through all areas by the end of a twelve-month period and compiling all results of those reviews, typically requires more compliance personnel since they are performing routine daily/weekly monitoring and testing functions. One advantage of this approach is that it may identify a weakness or gap earlier than if assessed at the end of a twelve-month period, permitting the adviser to address the compliance matter earlier.

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Another advantage is that the annual review process may involve less time because all compliance areas will have been reviewed throughout the review period. The annual review involves re-evaluating those quarterly reviews and compiling the information and results generated throughout the twelve-month review period.

Smaller advisers seem to favor the one-time comprehensive review approach, permitting compliance personnel to focus on routine compliance items outside of the review process. An advantage to this approach is that during the annual review, the compliance personnel conducting the review obtain a holistic assessment of compliance, as each compliance policy and procedure is reviewed during the period.

Regardless of the approach used, the SEC staff expects advisers to conduct annual reviews in a comprehensive manner. Documenting the annual review, therefore, is critical to evidencing the process.

#### **How should completion of the annual review be documented?**

Although the compliance rule does not require written documents reflecting the results of the annual review, the SEC staff requests such documents in its information request list. Various approaches have been developed to evidence the annual review, each with

certain advantages relative to others. All approaches require planning and review by management and compliance personnel of the adviser.

Many advisers document their annual reviews by producing a written report similar to the CCO report required by Rule 38a-1 under the Investment Company Act of 1940. In such a report, the adviser or its CCO discusses each of the compliance areas reviewed, methods of monitoring and testing the policies, changes to the policies made during the review period, weaknesses or deficiencies, and results of the review. These reports are comprehensive and time intensive, and are typically prepared by one or two compliance personnel.

Other advisers have elected to prepare a written summary of the annual review process and general results, which is then included with an annual review matrix or other document evidencing each of the policies reviewed, personnel responsible for the review and results of the review. Testing and other materials may also be included with the summary and matrix. This approach is comprehensive and may involve less time. Under this approach, personnel conducting the annual review only prepare a summary of the process and results rather than a full written report. In contrast to the written report approach, more advisory personnel may be involved in completing the matrix.

## Conclusion

The compliance rule and its requirement to conduct an annual review of compliance policies and procedures have had a profound effect on registered advisers. As the various approaches suggest, advisers have sought to address their regulatory obligations and undoubtedly have obtained more experience with assessing the adequacy of their compliance policies and procedures and the effectiveness of their implementation.

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