

# Compliance Review

Ongoing Compliance Updates for Investment Advisors

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## Compliance Monitoring and Testing

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Investment advisers have a responsibility to monitor and test their compliance policies and procedures. In its release adopting Rule 206(4)-7 under the Investment Advisers Act of 1940, the Securities and Exchange Commission (“SEC”) stated that an investment adviser’s policies and procedures should employ “compliance tests that analyze information over time” to determine the effectiveness of the compliance policies and procedures. This article discusses what it means to monitor and test compliance policies and procedures and how investment advisers can develop a more comprehensive compliance monitoring and testing program. It also discusses the various types of compliance tests, where investment advisers can find examples of specific compliance tests and how to approach developing a test that has not yet been created for a specific compliance policy.

### Monitoring and Testing

In its simplest form, an investment adviser monitors its compliance policies by keeping track of, or checking, the policies on a continuing basis. As the Investment Adviser Association (“IAA”) noted in its *Compliance Control: Monitoring and Testing Guide*, monitoring involves the daily, or ongoing, review of policies and the activities addressed by those policies.

An investment adviser tests its compliance policies by submitting them to such examination or evaluation in order to determine their ability, or inability, to detect compliance issues. In other words, the results of testing should prove whether the policies are effective in preventing the activities that the policies were designed to prevent.

### Developing a Compliance Monitoring and Testing Plan

By now, investment advisers should have (i) completed a risk assessment of their advisory business; (ii) identified their business and compliance risks and conflicts of interest; (iii) developed, adopted and implemented compliance policies and procedures to address those risks and conflicts; and (iv) completed at least three annual reviews of their compliance policies and procedures. Many investment advisers have also mapped their business and compliance risks and conflicts to those compliance policies and procedures that are designed to address those risks and conflicts.

In connection with the annual reviews of the compliance policies and procedures, the chief compliance officer or compliance department may have reviewed how specific policies were monitored (e.g., on a daily, monthly or quarterly basis) and

administered tests with respect to some of the investment adviser’s compliance policies and procedures. A frequent deficiency in many annual reviews, however, is written evidence or proof (other than a written report describing the annual review and its results) that the investment adviser monitored and tested each of its compliance policies and procedures. The creation of a written record is critical to show that monitoring and testing occurred.

To facilitate the creation of a written record, investment advisers should create and implement a monitoring and testing plan. In creating the plan, an investment adviser should, for each compliance policy, identify those procedures designed to monitor and test the policy. By including each of its compliance policies in the plan, the investment adviser will be compelled to address those areas (such as brokerage arrangements and trade execution, allocation of investment opportunities, personal trading, insider trading, pricing and fair valuation, safeguarding client assets, marketing, record retention and filings, and service providers) identified by the SEC staff as important to test and review.

The plan should identify the compliance policy or procedure, how the policy is monitored, the frequency with which the monitoring occurs, how the policy is tested, the frequency with which those tests are performed, and who is responsible for conducting the tests. Figure 1 provides an example from an investment adviser’s monitoring and testing plan.

In creating a plan, an investment adviser should examine its annual reviews and incorporate into the plan all monitoring and testing procedures described in those reviews. The plan should reflect concern for those activities presenting the highest risk to an

investment adviser’s business. For example, those compliance policies addressing high risk activities should be tested more frequently. The plan can reflect a “culture of compliance” by, among other things, requiring personnel other than compliance personnel to administer compliance tests.

After creating a plan, the plan should be distributed to necessary personnel. In addition to simply distributing the plan, the investment adviser should form policies to require accountability for personnel who receive the plan. For example, personnel may be required to acknowledge the receipt of the plan through a signature, as well as by representing to the chief compliance officer that they have read and understand the plan.

### Automated Monitoring and Testing Procedures

Most investment advisers attempt, to the extent possible, to automate compliance monitoring. For example, many investment advisers incorporate client investment restrictions into their portfolio management systems. When a portfolio manager enters a securities transaction for multiple clients into the system, the system automatically identifies those clients for which the transactions cannot be effected. Although the use of automated systems can be helpful, it is important to note that most compliance tests require additional analysis by an individual.

### Types of Compliance Tests and Specific Tests

The SEC staff, the IAA and other organizations have described various types of tests that can be utilized by an investment adviser to test its compliance policies and procedures. These testing methods include transactional, periodic and forensic testing. Transactional tests are conducted around particular

Compliance Policy or Procedure	How is the policy monitored?	Frequency of Monitoring	How is the policy tested?	Frequency of Testing	Person Responsible for Testing
Compliance with client investment restrictions	Investment restrictions for each client are entered into the investment adviser’s portfolio management system, which monitors the investment adviser’s compliance with the restrictions.	Daily (pre- and post trade)	Compare a sample of client transactions and holdings against corresponding client restrictions.	Quarterly	Portfolio Manager

Figure 1

activities (e.g., a daily comparison of employees' personal trades with the firm's trade blotter). Periodic testing is performed at certain times to verify compliance with legal requirements and internal procedures (e.g., a quarterly review and inventory of employees' personal securities transaction reports). Forensic testing is used to analyze information and trends over time, including identifying unusual patterns in data (e.g., a review of employees' most profitable personal securities transactions and comparison to profitability of clients' trades). Forensic testing can be important because it may identify problem areas that other types of testing would not be able to detect.

In November 2007, the SEC's Office of Compliance Inspections and Examinations posted a list of forensic tests on the SEC's website (available at [www.sec.gov/info/cco/forensictesting.pdf](http://www.sec.gov/info/cco/forensictesting.pdf)). The list includes forensic tests for the following risk areas:

- Portfolio management and trade allocation;
- Brokerage arrangements and execution;
- Valuation;
- Personal trading;
- Safety of client assets; and
- Marketing and performance advertisements.

Investment advisers should incorporate these forensic tests into their monitoring and testing plan to the extent applicable to their advisory business. Additional tests covering the risk areas listed above and the following risk areas are included in the IAA's *Compliance Control: Monitoring and Testing Guide*:

- Investment advisory fees;
- Contingency planning;
- Privacy and safeguarding client records and information;

- Anti-money laundering;
- Cash solicitation arrangements;
- Email; and
- Proxy voting.

Although the tests described by the SEC and the IAA are comprehensive, there may be instances when a compliance test has not been developed for a specific compliance policy. In such instances, investment advisers should develop a test to verify the effectiveness of the policy by, among other things, answering the following questions:

- What risk or conflict is the compliance policy designed to address?
- What will prove whether the policy is effective or ineffective?
- How can the investment adviser verify in writing that it has examined the policy?

As noted above, and as the third bullet illustrates, an important aspect of the monitoring and testing program is documentation. For example, the compliance test set forth in Figure 1 requires the investment adviser to compare a sample of client transactions and holdings against corresponding client restrictions. The written documentation providing evidence that such a test was conducted would necessarily contain a list of transactions (e.g., on a trade blotter) and holdings (e.g., on an account statement) for a specific period for a random sample of clients and a list of investment restrictions for those clients.

In addition to the various types of testing described above, there are other methods that can be used to verify the effectiveness of compliance policies and procedures. These additional methods include interviewing key employees, observing activities,

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administering compliance questionnaires and obtaining employee certifications. As with any testing procedure, a written record should be established to document these additional methods used.

### Conclusion

Like many burdens imposed on regulated entities, the monitoring and testing aspects of an investment adviser's compliance program can be addressed through planning. Once a plan is created, evaluating whether the investment adviser's policies and

procedures are sufficient to detect and correct compliance issues is a surmountable task. Preparing a monitoring and testing plan is also important in minimizing the burden of the annual review process. During the annual review period, the investment adviser's compliance personnel can focus on updating existing compliance policies and adding new compliance policies and monitoring and testing procedures to address those updated or new policies, rather than administering compliance tests with respect to existing policies.

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