

**Risk Management Update
May 2016****ENHANCING ANNUAL REVIEWS – PRACTICAL CONSIDERATIONS FOR INVESTMENT ADVISERS AND INVESTMENT COMPANIES**

It's been over a decade since the Securities and Exchange Commission ("SEC") adopted Rule 206(4)-7 under the Investment Advisers Act of 1940, and Rule 38a-1 under the Investment Company Act of 1940. Despite the passage of time, Rule 206(4)-7 and 38a-1 (commonly referred to in the financial industry as the "Compliance Program Rules") remain the overarching core of SEC investment adviser and investment company (mutual fund) examinations.

Since the effective date of the Compliance Program Rules on February 5, 2004, the SEC has issued regulatory guidance and brought a number of enforcement cases against advisory firms and mutual funds pertaining to the different requirements under these two rules. This month's Risk Management Update focuses on some of the more recent SEC activity regarding the annual review requirement under the Compliance Program Rules and outlines various workable steps firms can take to help ensure their annual review process is sound and reasonably designed to meet both the letter and spirit of the regulations.

SEC Expectations and Recent Activity

As outlined in the SEC's release,¹ investment advisers and mutual funds are required to annually review their compliance policies and procedures to ensure adequacy. Mutual fund companies must take a step further and also review the policies and procedures of certain service providers, including investment managers, underwriters, administrators, and transfer agents, as applicable.

In 2011, the SEC's Enforcement Division's Asset Management Unit began coordinating with SEC OCIE examiners to bring actions against registered firms that don't have "viable" compliance programs in place.² Referred to as the Compliance Program Initiative, the cases brought to enforcement under this initiative to date have included, among other things, violations for either not performing annual reviews or not performing them adequately, which caused violations of other federal securities laws.

¹ See "Final Rule: Compliance Programs of Investment Companies and Investment Advisers" (Rel. Nos. IA-2204; IC-26229; File No. S7-03-03) (February 5, 2004) <https://www.sec.gov/rules/final/ia-2204.htm>.

² See "SEC Penalizes Investment Advisers for Compliance Failures" (November 28, 2011) <https://www.sec.gov/news/press/2011/2011-248.htm>.

In a Risk Alert issued in November 2015 by the SEC’s Office of Compliance Inspections and Examinations (“OCIE”),³ the staff outlined certain deficiencies it had observed during recent examinations of firms using an outsourced Chief Compliance Officer (“CCO”). Specific to the performance of annual reviews, these deficiencies included:

- Limited documentation of testing;
- Infrequent visits;
- Limited review of documents;
- Limited visibility as CCO within the firm, which effected adherence to policies and procedures; and
- Limited authority to implement changes in disclosures.

In the conclusion section of the Risk Alert, OCIE noted their hope that the observations would assist advisers and mutual funds in evaluating their compliance programs to determine weaknesses and identify certain risks.

Assessing and Enhancing the Annual Review Process

Given SEC expectations, investment advisory firms and mutual fund companies should perform periodic assessments of their annual review process and make enhancements to help ensure it remains sufficient in determining the “adequacy” of firm policies, procedures and controls in preventing violations of applicable securities regulations.

When performing assessments, compliance personnel should consider the following areas:

Scope of Past Reviews

Look at the annual review process that was performed over the last couple of years and consider what worked well and what did not. Ask the following questions:

1. Were the reviews performed throughout the year or a look back review?
2. Were all areas of the firm’s policies and procedures reviewed?
3. Were issues found and corrected in a timely manner?
4. Was adequate time spent on due diligence reviews of service providers and affiliates?
5. Did the documentation/report include enough detail to determine when the review was performed, what was reviewed, the findings, and any recommendations/corrections made?

Testing and Surveillance Process

Look at the types of testing being performed and the results produced to determine whether any gaps exist. Ask the following questions:

³ See “Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers” (November 9, 2015) at <https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf>.

1. Is the process set up to focus on the firm's risks and conflicts, in addition to requirements?
2. Is technology used to the extent possible?
3. How much of the current testing and surveillance process is set up for prevention versus detection?
4. Is testing performed at certain defined intervals throughout the year to identify trends and patterns of potential non-compliance?
5. Who has authority to change testing and surveillance protocols?
6. Are tests truly forensic in nature to see if the compliance program is being circumvented?

Evaluation Process

There are a number of core factors that should be considered each year when performing an annual review. During the evaluation process, the following questions should be asked:

1. Have there been any changes to business practices?
2. Is the firm offering any new investment strategies/products?
3. Was there a regulatory examination during the review period?
4. Did the firm have an audit or review performed by a third-party service provider?
5. Were there any changes to applicable regulations that affected the firm?

Conclusion

Importantly, annual reviews should be dynamic in order to address and adapt to the changing regulatory environment. CCOs are tasked with the responsibility of administering the firm's compliance program, which should include ensuring a robust annual review process is in place.

For assistance, please contact us at info@corecls.com, at (619) 278-0020 or visit us at www.corecls.com for more information.

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