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Risk Management Update
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CONSIDERATIONS FOR COMPLIANCE AUTOMATION

In every walk of life, manual functions are being automated and securities compliance is no exception. This trend will likely continue, and for good reason: automation can create efficiency, improve accuracy and increase capacity. In this update we will address some of the pros and cons of automating certain compliance functions and provide helpful guidance on selecting and implementing software applications.

Data-Analytics at the SEC

Very often innovations in government lag the industry but such is not the case with automation at the Securities and Exchange Commission ("SEC"). On September 11, 2014 the SEC announced the creation of a new office within its Division of Economic and Risk Analysis that will "coordinate efforts to provide data-driven risk assessment tools and models to support a wide range of SEC activities." [1] Moreover, the SEC has credited this effort with identifying violations in a recent enforcement case[2], where they stated the following:

> *"The SEC Enforcement Division has engaged in a data-driven initiative to identify potentially fraudulent trade allocations known as "cherry-picking," and this enforcement action is the first arising from that effort. Working with economists in the agency's Division of Economic and Risk Analysis, enforcement investigators analyze large volumes of investment advisers' trade allocation data and identify instances where it appears an adviser is disproportionately allocating profitable trades to favored accounts."*

In 2012, the SEC began requiring detailed reporting by private funds via Form PF and has recently proposed amendments to Form ADV asking for more data. This is consistent with the theme of "big data" [3] and the SEC's push to gather and analyze increasing amounts of information. The important question is, "what analytics are you using to enhance your compliance function?"

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[1]   *See "SEC Announces Creation of New Office Within its Division of Economic and Risk Analysis,"* SEC Press Release 2014-193 (September 11, 2014) available at
http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542914800.

[2]   *See "SEC Announces Cherry-Picking Charges Against Investment Manager,"* SEC Press Release 2015-132 (June 29, 2015) available at http://www.sec.gov/news/pressrelease/2015-132.html.

[3]   According to the SAS Institute "Big data is a buzzword, or catch-phrase, used to describe a massive volume of both structured and unstructured data that is so large it is difficult to process using traditional database and software techniques."

Compliance Automation Considerations

1. <u>Before considering various software packages evaluate your compliance system.</u>
    Compliance personnel create, implement, execute and review policies and procedures.
    Automating certain compliance tasks can help with implementation and execution, but
    the policies still need to be reasonably designed and properly monitored. There is a
    tendency to view software applications as a panacea and an all-encompassing solution but
    this is not usually the case. Compliance personnel should clearly understand the policies
    and procedures, and consider the pros and cons of automating them.

2. <u>Some functions lend themselves well to automation but others do not.</u> Functions that
    lend themselves well tend to be data intensive and/or process driven. For example, email
    archival and review, compliance calendars, personal trading reporting, AML monitoring,
    and trade surveillance are functions where there are clear benefits to automation.
    Functions where there is subjectivity such as due diligence, valuation and approvals of
    outside business activities are challenging to automate.

    Most compliance software applications have incorporated project management
    functionality for scheduling, monitoring, and reporting, a task or series of tasks. A good
    example of this is an automated compliance calendar.

    Consider alternatives to automation. Optimizing procedures, delegating and outsourcing
    can all increase efficiency and should be considered as alternatives to automation. For
    example, if email review is not a high priority and it is taking a lot of time, the sample
    size can be reduced (optimized) to gain efficiency. Delegating functions or outsourcing
    are other ways to gain efficiency and should be considered as alternatives to automation.

3. <u>Software applications are data-sensitive.</u> In most cases, the programming is fairly
    straightforward. However, issues can arise in the quality of the data needed to run the
    application. For example, to run a performance dispersion report an extensive amount of
    trade data is generally required. For this type of report, the program must have current
    holdings and all trading activity and even then the method of calculating performance
    must be considered.

    Another important consideration is the data source(s). A single data source from a well-
    established broker-dealer is not likely to be a problem but if the data is distributed among
    a wide number of brokers or the brokers are not well established, obtaining accurate data
    may be a problem. When thinking about automating compliance, consider quantity,
    quality and accessibility of the data.

4. <u>Understand the implications of implementation on a server versus a web-based solution.</u>
    Technology solutions can either be installed locally on a firm's server or delivered
    through a web-based portal. There are pros and cons to each, but for a number of users a
    web-based solution may be preferred since it generally requires less maintenance and
    security, and usually provides greater flexibility and convenience.

5.   <u>Make sure you have access to, and own, the data.</u> The way the data is formatted is important. Most data will be in a relational database. [4] If the data is in a proprietary format this can create issues with backup and portability, whereas data stored in a common format, such as SQL, [5] may be better.

Some firms have experienced problems when changing vendors and transitioning their data. Compliance should check user agreements for provisions of data ownership and make sure you have a copy of your data backed up.

Earlier we noted the trend toward big data and data analytics. Most compliance software applications house a tremendous amount of data and run pre-formatted reports and analytics. Consider the utility of being able to export your data and run customized analytics in Excel. With the ability to export your data there are very few limits on your ability to analyze your data and extract the information you want and need.

6.   <u>Perform due diligence.</u> Most advisers use an internal checklist as an important information gathering tool when performing due diligence on vendors. The checklist usually outlines a number of questions for completion and prompts the reviewer to obtain various applicable documents, such as a vendor's internal controls report (SSAE 16), business continuity plan, and various policies and procedures.

Another important consideration is the reputation of the vendor. Well known vendors are not necessarily better but they typically have less downside risk than unknown vendors and references can be extremely helpful. Many compliance consultants are in a unique position of having clients that are using a variety of products, and can outline some of the pros and cons of various applications. Finally, one key component of the due diligence process is performing a cost-benefit analysis, which will be an important factor in making a decision on which, if any, technology solution to choose.

Implementation and Execution

The decision to automate and selection of a software program are only the first steps, as the chosen technology solution(s) must be implemented and executed to be effective. Automation is a tool that requires knowledge and skill to be utilized effectively. Compliance personnel should make sure to devote the time and effort to become proficient with using the software programs. It is also critical to understand the limitations and potential weaknesses that exist in every application. Lastly, implementing technology solutions will most likely require updates to various firm policies and procedures, which also provides a good opportunity to review how the technology integrates into the firm's compliance program.

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[4]   According to www.dictionary.com**,** a "relational database" is "A relational database is a set of tables containing data fitted into predefined categories. Each table (which is sometimes called a relation) contains one or more data categories in columns. Each row contains a unique instance of data for the categories defined by the columns."

[5]   According to www.dictionary.com**,** "SQL (Structured Query Language) is a standard interactive and programming language for getting information from and updating a database.

Conclusion

Compliance is most effective when combining quantitative and qualitative factors. Machines are tools and compliance automation is a tool that, if wielded properly, can greatly enhance the compliance function. In this current regulatory environment, the decision on compliance automation is more of a question of when and not if. If this trend continues, ten years from now technology solutions will most likely be ubiquitous and more of a requirement than a choice.

For more information, please do not hesitate to contact CCLS at info@corecls.com, at (619) 278-0020 or visit us as www.corecls.com. Thank you.

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