CCLS CORE COMPLIANCE & LEGAL SERVICES, INC.

Risk Management Update
July 2014

THE IMPORTANCE OF PERFORMING A RISK ASSESSMENT

Regulatory Efforts Focus on Registrant's Risk Assessments

In May 2014, Andrew Ceresney, the Securities and Exchange Commission's ("SEC") Director of the Division of Enforcement, spoke about using his current role to "promote a strong, empowered legal and compliance presence at firms."[1] In his speech, he emphasized, "[those] companies that have done well in avoiding significant regulatory issues typically have prioritized legal and compliance issues, and developed a strong culture of compliance across their business lines and throughout the management chain."

As part of the National Examination Program, the SEC requests, as part of its initial document production, copies of any risk assessment performed during the period. The Staff wishes to gain a better understanding of how registrants are determining risks within their organizations, and then acting upon them once detected.

Similarly, the SEC is expending its own resources towards performing risk analytics in an effort to not only determine which firms may pose higher risks to the financial system, but also to identify firms and its associated persons who are circumventing securities laws. Newly opted technologies such as the National Exam Analytics Tool (commonly referred to as "NEAT") is used by examiners to literally slice and dice trade data to help determine whether abuses such as insider trading or non-adherence to firm policies on investment allocations and aggregations is occurring. Another resource being used includes the Market Information Data Analytics System ("MIDAS"), which collects millions of records of trading data and analyzes it in order to give the SEC a better understanding of market events and trends and provide deeper insight into the functionality of the US financial markets.

With the Commission's increasing focus on compliance and market risks, it is imperative for firms to prepare for their next examination by performing a risk assessment. A risk assessment will help to identify those areas that require prioritization and enhancement of controls, pinpoint those policies and procedures that require enhancement and may lessen vulnerabilities by identifying problems prior to an SEC examination.

How to Perform a Risk Assessment

All SEC registered firms must establish and maintain policies and procedures reasonably designed to prevent violations of federal securities laws. These policies and procedures should reflect the practices of the business and be customized to address those compliance risks that the adviser faces.

---

[1] *See* http://www.sec.gov/News/Speech/Detail/Speech/1370541872207

To begin the process, each adviser should identify the unique set of risks for their organization. Many times this is accomplished by looking at each area of the business and discussing with area managers the risks within their department. Findings can be captured in a risk matrix, which should set forth the identified risk, how those risks are being managed, what is the categorization of that risk (high, medium or low) and what changes need to be made. This process is commonly referred to as a "Gap Analysis" or "Risk Inventory." While historically these types of analyses were performed by the firm, more and more firms are opting to engage an independent third-party to perform this assessment to get a more unbiased view towards existing firm practices.

Once these risks are identified, they need to be properly mitigated and managed. When trying to determine a Firm's risks, some of the topics and questions a Firm may consider include:[2]

- ***Risk Assessment***
  Do you have processes and internal controls in place to help detect and address risks?
- ***Compliance Policies and Procedures***
  Are your compliance policies and procedures designed to mitigate, manage and control your Firm's specific risks?
- ***Quality Control and Forensic Testing***
  Do you conduct periodic testing of your compliance program to determine areas that your policies and procedures may have been circumvented?
- ***Role of the CCO and Other Compliance Staff***
  Is your CCO knowledgeable regarding the Advisers Act?
- ***Conflicts of Interest***
  Does your CCO perform both compliance and operational roles, if so how are the conflicts of interest managed appropriately?
- ***Disclosures***
  Are disclosures about your compliance program written in such a way that clients are fully informed?
- ***Information Handling***
  When conducting your annual review, how do you safeguard (from destruction, loss, alteration, compromise) the information received as a result of the review?

How A Risk Assessment Differs From An Annual Review

A Risk Assessment differs from an Annual Review in that an annual review tests the effectiveness of your current policies, procedures and internal controls. On the other hand, a Risk Assessment identifies risks that a Firm faces and then mitigates those risks by disclosing them, enhancing internal controls and updating compliance policies and procedures to mitigate or eliminate the identified risk.

---

[2] For more topics on this subject, *see* http://www.sec.gov/info/cco/adviser_compliance_questions.htm

Conclusion

In his May 2014 keynote address, Ceresney stated, "at the end of the day…legal and compliance officers who perform their responsibilities diligently, in good faith, and in compliance with the law are ***our partners*** and need not fear enforcement action. In fact, we want to use our enforcement program to support your efforts." The SEC understands and appreciates that all firms face risks. Their expectation is for its registrants to be proactive to ensure that they are in compliance to the best of their ability and that they have taken reasonable steps to protect their clients' investments and treat them fairly. A risk assessment is a great tool to analyze and accomplish just that.

For more information, please do not hesitate to contact us at (619) 278-0020.

Author: Brooke Freitas, Compliance Analyst; Editor: Michelle L. Jacko, CEO, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.