

SEI Compliance Advantage
CCO Forum

Effective Compliance Monitoring and Testing

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Effective Compliance Monitoring and Testing

Overview

- What are the sources of the compliance monitoring and testing requirements?
- What does it mean to monitor and test a compliance policy?
- How can my firm develop a plan that will result in an effective compliance monitoring and testing program?
- How should my firm implement the plan?



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Sources

Adopting Release for Rule 38a-1 and Rule 206(4)-7:

- An adviser's compliance policies and procedures should employ “compliance tests that analyze information over time to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions....”
- Rule 38a-1 requires “funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices.”
- “Under Rule 38a-1 a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades.”



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Sources

SEC staff statements:

- *“We must always stay in motion, testing our systems, asking if they are good enough, and thinking of how they can be improved. Your compliance program cannot be static. It can’t be ‘done,’ ‘on the shelf,’ or ‘fixed.’”* -- Lori Richards, Remarks before the National Society of Compliance Professionals National Membership Meeting, Oct. 25, 2005.
- *“Advisers should be asking new questions — such as, how could my employees come into possession of material non-public information? How could this information be abused? What procedures can I put in place to prevent it? And, what tests can I employ to determine whether there are indications of insider trading at my firm? These are the questions that examiners too will be asking.”* -- Lori Richards, Remarks before the IA Compliance Best Practices Summit 2008, Mar. 20, 2008.



Effective Compliance Monitoring and Testing

Meanings

Monitor Daily or ongoing review of the compliance policies and procedures and the activities addressed by those policies and procedures.

Test Submit the compliance policies and procedures to examination in order to determine their effectiveness (ability/inability) in preventing or in detecting compliance violations.



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Develop a Plan

Goal What is your firm trying to achieve by monitoring and testing its compliance policies and procedures?

- Monitoring: Did the trades that your firm conducted for its client accounts today comply with the objectives and restrictions of those accounts? Did those trades comply with your firm's allocation policy?
- Testing: Did the test prove that the policy is effective in preventing a compliance violation? YES or NO
- Bottom Line: Verify that the compliance policies and procedures work in addressing your firm's risks and conflicts



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Develop a Plan

Status Check: After five years, where is your firm?

- Has your firm documented (e.g., in a chart) its risks and conflicts?
- Has your firm mapped those risks and conflicts to those specific compliance policies and procedures designed to address them?
- Has your firm described how each policy is monitored and tested and the frequency of such monitoring and testing (e.g., daily, weekly, quarterly, annually)?



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Develop a Plan

Status Check: After five years, where is your firm?

- Has your firm completed its annual reviews?
- Did those annual reviews identify any compliance gaps (e.g., any practice that differs from the stated policy or new business areas with new or additional risks and conflicts)? Were those gaps addressed?
- Has your firm been examined by the SEC in the last five years? What were the results, and has your firm followed through on its statements to the SEC staff?

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Develop a Plan

Create or modify your firm's compliance monitoring and testing chart.

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



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Develop a Plan

- In the chart, identify what compliance processes are automated.
- To the extent possible, automate the monitoring/testing process:
 - Portfolio Management System (see column 2 of chart)
 - Computer/email system (create a compliance calendar in Outlook with automatic reminders for specific tests).



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Develop a Plan

- Identify specific tests for each compliance policy.
- Forensic tests identified by the SEC's Office of Compliance Inspections and Examinations (www.sec.gov/info/cco/forensictesting.pdf)
- Investment Adviser Association's *Compliance Control: Monitoring and Testing Guide*



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Develop a Plan

Risk areas covered by those sources:

- Portfolio management and trade allocation
- Brokerage arrangements and execution
- Valuation
- Personal trading
- Safety of client assets
- Marketing and performance advertisements
- Investment advisory fees
- Contingency planning
- Privacy and safeguarding client records and information
- Anti-money laundering
- Cash solicitation arrangements
- E-mail
- Proxy voting

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[Investment Adviser]
Compliance Monitoring and Testing Program

Test #	Activity/Risk Rating (likelihood of occurrence/potential impact)	Relevant Rule/Authority/Statutory Source	Responsibility	Requirements	Description of Test/Process	Frequency
1.	Advertising [Medium/Medium]	Section 206, Rule 206(4)-1	[Name]	<p>An “advertisement” is any notice, circular, letter or other written communication addressed to more than one person or any notice or announcement in any publication or by radio or television that offers any analysis, report or publication regarding securities, any graph, chart, formula, or other device for making securities decisions, or any other investment advisory services.</p> <p>The following practices are specifically prohibited:</p> <ul style="list-style-type: none"> • the use of testimonials; • the use of past specific recommendations; • references to charts, graphs, formula or other similar devices; and • the use of the term “free of charge.” <p>Advertisements that include performance information require special consideration.</p>	<input type="checkbox"/> Spot check completeness of Adviser records of all advertisements, marketing pieces, RFP responses and other communications to clients and prospective clients. <input type="checkbox"/> Review records to confirm that marketing material has complied with any pre-approval or other internal process. <input type="checkbox"/> Review performance calculations of sample performance advertising to ensure performance was calculated accurately. <input type="checkbox"/> Spot check items on the Adviser’s website. <input type="checkbox"/> Review third-party records (e.g., custodial, brokerage statements) to confirm data used in advertising.	<input type="checkbox"/> Annually <input type="checkbox"/> Annually <input type="checkbox"/> Annually <input type="checkbox"/> Quarterly <input type="checkbox"/> Annually
2.	Advisory Contracts [Low/Medium]	Section 205	[Name]	<p>Advisers Act prohibitions:</p> <ul style="list-style-type: none"> • assignment (without client consent) • performance-based fee (with certain exceptions) • waiver of compliance with the Advisers Act or any available right of action against the Adviser. <p>Obtain client consents (and make related disclosures) for:</p> <ul style="list-style-type: none"> • affiliated brokerage; • agency cross transactions; and • investments in affiliated funds. 	<input type="checkbox"/> Spot check advisory contracts to ensure that they comply with the requirements of the Advisers Act (e.g., non-assignment provision). <input type="checkbox"/> Compare sample client statements with client consents obtained in corresponding advisory contract. <input type="checkbox"/> If there was a change in the partnership, verify client notification.	<input type="checkbox"/> Annually <input type="checkbox"/> Annually <input type="checkbox"/> Annually



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Develop a Plan

Missing a test:

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



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Implement the Plan

- Distribute the Compliance Monitoring and Testing Chart to personnel in your firm. Request feedback.
- Require ownership of compliance. Persons responsible for monitoring and testing a policy should acknowledge their receipt of the chart and their responsibility.
- Stress documentation/verification of testing.



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Implement the Plan

- Use a Compliance Calendar
- Review the Compliance Monitoring and Testing Chart during each annual review. Update the chart as necessary.
- Ultimate test – SEC examination or failure that leads to breach of fiduciary duties to clients.