



## Guidance on Rule 206(4)-7 under the Investment Advisers Act The Compliance Rule

A quick review of Rule 206(4)-7 under the Investment Advisers Act of 1940 appears very straightforward and simply states:

*If you are an investment adviser registered or required to be registered under **section 203** of the Investment Advisers Act of 1940 it shall be unlawful within the meaning of **section 206** of the Act for you to provide investment advice to clients unless you:*

- 1. Policies and procedures. Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;*
- 2. Annual review. Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and*
- 3. Chief compliance officer. Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section*

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A further look at SEC guidance indicates their expectations go much further than the initial rule outlined above. Specifically, The SEC staff has emphasized that the “annual review” should really be a continuing process throughout the year. It has also said that an effective compliance program must be an “activist” program that continues to evolve. The annual review process will help you identify changes that need to be made to your compliance program to ensure that you have an effective “activist” program. This summary will cover the basic requirements of the review process and provide guidance for compiling your annual compliance policy and procedures review.

### **Areas of Review**

**Critical Areas.** In the SEC’s adopting release for the rule, the SEC identified the “critical areas” that an investment adviser should review: (1) portfolio management, including the allocation of investment opportunities among clients and the consistency of portfolios with clients’ investment objectives, disclosures and regulatory restrictions; (2) trading practices, including satisfying the duty of best execution and the use of client commissions to obtain execution, research or other services; (3) proprietary trading of the adviser and personal trading by employees; (4) the accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements; (5) safeguarding of client assets from conversion or misuse; (6) accuracy of books and records; (7) marketing advisory services, including the use of solicitors; (8) valuing client holdings and assessing fees; (9) protecting the privacy of client records and information; and (10) business continuity.

If your investment advisory firm manages investment companies, your firm's review should also cover: pricing of portfolio securities and fund shares, sales of fund shares, identification of affiliated persons, protection of non-public information, market timing and the use of brokers who sell fund shares for client trade execution.

***Risk Assessment.*** In the adopting release, the SEC staff noted that the annual review should consider (1) any compliance matters that arose during the previous year, (2) any changes in the business activities of the adviser or its affiliates, and (3) any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures. Answers to these three questions will help you identify areas, in addition to the critical areas listed above, that present risk to your firm and that you will need to review.

### **Conducting the Review**

***Questioning the Policies and Procedures.*** According to the SEC's Office of Compliance Inspections and Examinations ("OCIE") staff, during the reviews, you should question the adequacy of each policy and procedure by asking: (1) are we detecting problematic conduct with this policy? (2) based on what we've detected, should we alter our policy? (3) is there a better way to prevent problematic conduct? (4) were the actions we took, once problematic conduct was detected, adequate to deter problematic conduct by this individual or others? According to OCIE staff, examiners will assess whether the current policies and procedures are designed to detect breaches of the federal securities laws and whether the outcomes of the firm's policies and procedures substantiate that the policies and procedures have been implemented effectively.

***Testing.*** An important part of the compliance review process is testing. Reviewing samples of transactions ("transactional testing") is one effective way to test your firm's adherence to policies and procedures. For example, you would review employee personal trades when reviewing the Code of Ethics or you would review how proxies were voted when reviewing the proxy voting policy. OCIE staff has said that examiners will ask whether the firm conducts forensic testing appropriately targeted to detect hidden schemes. You can conduct "forensic testing" (also called trend analysis) by reviewing reports that show certain types of transactions over a period of time in order to identify unusual patterns. According to the Rule's adopting release, an example of trend analysis includes reviewing an analysis of the quality of brokerage executions for the purpose of evaluating the adviser's fulfillment of its duty of best execution.

***Overall Review of the Compliance Program.*** In addition to the individual reviews of each policy and procedure, you should use the annual review process as an opportunity to step back and review the effectiveness of the compliance program as a whole. According to the OCIE staff, when SEC reviewers are examining an investment adviser's compliance program, they will ask:

- Has the firm identified and compiled an account of all the current risks it faces?
- Is there a process in place that is likely to identify conflicts of interest and other risks going forward?
- Is the process for creating policies and procedures, including supervisory policies and procedures, mapped to new material risks as they emerge?

You should consider these questions when you finalize your annual review and identify any shortcomings in the firm's risk assessment process. The results of the individual policy and procedure reviews would also help the CCO identify the firm's risk areas and provide a starting point for next year's review.

### **Documenting the Review.**

Advisers are required to keep any records documenting the annual review for five years. In the adopting release, the SEC staff noted that these records are meant to be made available to the SEC and its staff and they are not subject to the attorney-client privilege, the work-product doctrine, or similar protections. Neither the rule nor the adopting release provides specific guidance on what documents advisers will need to retain. Such documentation, however, may include (1) a record of the policies and procedures you reviewed, including any changes made to the policies as a result of the review; (2) a record of the files you reviewed (such as exception reports, transaction reports, personal trading records, *etc.*); and (3) a record of interviews with personnel. You should also maintain documentation of any violations or other problems identified and the corrective action that the firm has taken.

Inadequate documentation of the work performed may lead SEC examiners to conclude that the compliance program is inadequate. On the other hand, if your compliance reviews are thorough and well-documented, the examiners are more likely to conclude that your annual review process is effective.

### **Timing of the Review**

Your RIA's annual compliance review must be completed eighteen months after your firm adopted its compliance policies and procures as required by Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Reviews should be conducted annually from the date of the initial review. Many advisors elect to simply conduct their reviews on a year end basis.

### **Reporting the Findings of the Review.**

Although there is no requirement that the adviser report the results of the annual review to anyone, OCIE staff has recommended that the CCO report the results of the annual review to senior management. A report that would be helpful to senior management would, at a minimum, contain: (1) a description of each policy and procedure reviewed; (2) a summary of the findings of the review of each policy and procedure; (3) a description of violations discovered; (4) an overall conclusion regarding the effectiveness of the policy or procedure and (5) any changes made to the changes to the policy or procedure as a result of the review.

Ideally, the CCO would prepare reports during the course of the year and present findings to management at the conclusion of each review. The SEC staff has emphasized the importance of senior management setting a firm's compliance "tone at the top."

Therefore, it is important that the CCO report the findings of the annual compliance review to senior management to demonstrate that your firm's senior management is setting the appropriate "tone." The final report should consist of a summary of each report that was prepared during the course of the year. If you have not already documented each review, this is this time to go back and summarize the work you performed over the year.

### **Planning for Next Year.**

Before you even complete your first annual report, you should begin thinking about the review process for next year. You should develop a compliance calendar based on your experiences from the first annual review. You should have a better idea for next year how much time you will need to thoroughly review each area. Build extra time into the calendar to review the areas that had the most problems this past year. OCIE staff has said that the CCO should take steps to ensure that any recommendations for improvements that flow from the compliance review are implemented as appropriate.

Therefore, you should also make sure that your compliance review calendar allows for follow-up reviews. Also consider how you spent your time and evaluate which review methods more effectively tested the adequacy of the policies and procedures. Anticipate changes to policies and procedures that will be needed next year. For example, your firm's soft dollar policies and procedures may need to be conformed to the new SEC guidance when it is finalized. In addition, if you conducted an overall review of your firm's risks and its risk assessment process, as discussed above, you should incorporate these identified risk areas into your review for next year.

### **About Compliance Outsourcing Solutions**

Compliance Outsourcing Solutions, LLC ("COS") was established to assist broker dealers and registered investment advisors implement effective compliance programs while reducing costs.

For further guidance relating to this rule or assistance in conducting your RIA's compliance review, contact Compliance Outsourcing Solutions at 704 -516-1836.

