Compliance Corner

— *By: K. Susan Grafton**

Assessing Your Risk Assessment Program: Is Your Review Current?

Rule 206(4)-7 under the Investment Advisers Act of 1940 (the "Advisers Act") requires registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act by the adviser and any of its supervised persons within the meaning of Advisers Act section 202(a)(25) (*i.e.,* partners, officers, directors, or other persons performing similar functions or with a similar status, employees, or other persons who provide investment advice on behalf of the adviser). The adviser's policies and procedures must also be reasonably designed to detect and promptly address any violations that occurred.

Advisers Act Rule 206(4)-7(b) requires investment advisers to undertake an annual review to determine the adequacy and effectiveness of their procedures in light of internal and external developments affecting the firm. Accordingly, risk assessments to determine the adequacy of an adviser's compliance policies and procedures are not a one-time exercise and should be conducted at least annually, or more often if warranted by changes in circumstances, such as a compliance event, material business expansion, or significant regulatory development.

Establishing The Review Protocol

1. Identify responsible personnel

The size and complexity of an investment adviser and its business will inform who should conduct the review. Smaller firms may well determine that it is appropriate for the compliance department, under the direction of the chief compliance officer ("CCO"), to conduct the review. Larger advisers may find that it is beneficial to establish a standing risk committee that is responsible for directing the performance of the annual review, and also for meeting periodically to consider and address business, compliance, operational, financial, and reputational risks. If significant compliance issues have been identified or if there have been significant changes in the adviser's organization or activities, it may be appropriate for the adviser to retain an outside firm to perform a risk assessment review.

2. Gather relevant documents

To prepare for the review, the responsible personnel will want to compile a file of relevant information, including, if applicable:

- Copies of the current Form ADV, brochure, if applicable, and polices and procedures, including its Code of Ethics.
- The last annual review, including any planned remediation.
- Communications with the SEC, particularly any deficiency letters or examination reports, and any undertakings.
- Employee or client complaints.
- Internal reports or documentation relating to a compliance event and planned remediation.
- Relevant supervisory or compliance logs, deficiency reports, or similar other documentation.
- Management reports.
- A checklist of relevant legal or regulatory developments that are required to be reflected in the adviser's policies and procedures
- Copies of current disclosures and marketing materials.
- Negative news articles or publicity.

3. Determine who should be interviewed

A list should be developed of the personnel who should be interviewed. The list should not be limited to compliance professionals, but should include relevant business, operations, technology, and financial personnel who are knowledgeable about changes in the adviser's activities as well as events that should be factored into the review. Business personnel should include portfolio managers, investment committee members, trading personnel, and research analysts.

Identifying Risks and Conducting the Review

Each adviser must develop procedures tailored to its particular organizational and ownership structure, activities and client base, operations, conflicts of interest, and other compliance risk factors. Advisers should promptly update their procedures to reflect any developments and should use the annual review to confirm that its policies and procedures are current and effective, that any changes were implemented as required.

In conducting an annual review, investment advisers should consider internal and external developments over the past year, evaluate the compliance risks that they pose for the adviser, and determine that it has appropriate controls for managing and mitigating these risks. *See, e.g.,* the SEC staff's "Risk Inventory Guide," available at http://www.sec.gov

Continued on page 15

/info/cco/red_flag_legend_2007.pdf, which identifies 12 of the risks that investment advisers typically experience as part of their day-to-day operations. In addition to testing the effectiveness of procedures since the last review, advisers will want to confirm that new developments have been reflected, including:

1. Organizational and personnel changes

An investment adviser should regularly confirm that it has addressed any organizational or personnel changes, if needed. Among other things, an adviser will want to:

- Confirm that its Form ADV is updated to reflect new ownership or affiliate relationships resulting from a merger, acquisition, reorganization, or similar transaction.
- Revise disclosures as necessary to reflect any additional conflicts of interest as a result of organizational and personnel changes.
- Update policies and procedures as needed to reflect developments. For example, if an adviser is acquired, and its new parent company has a broker-dealer that engages in market making, or will execute orders on behalf of the adviser, the adviser will need to implement appropriate procedures for obtaining client consents.
- Review its Form ADV, organizational chart, and policies and procedures to ensure that relevant personnel changes are reflected and that any gaps in management or supervision resulting from new business lines or employee departures are addressed.

2. Changes in business activities or clients

The review should also consider whether the adviser needs to update its disclosures, policies, or internal controls to address conflicts of interest, or compliance and other risks, arising from changes in its activities—or its affiliates' activities—or changes in its clients or their circumstances. Care should be taken to be sure that any new strategies or activities are consistent with stated objectives or restrictions and any inconsistencies should be reconciled promptly.

Among the developments that should be considered are:

- New lines of business of the adviser or its affiliates; *e.g.*, managing separate accounts or an affiliated broker-dealer that commences market making activities.
- New or novel investments, which should be reviewed to determine whether the portfolio manager, investment committee, research analysts, and other relevant personnel have sufficient understanding of the products. Client accounts should be reviewed to determine that investments are suitable based on the client's sophistication, investment objectives, and restrictions; and that valuations are accurate. In addition, compensation practices for new products should be reviewed to make sure that any incentive-based compensation has not resulted in inappropriate recommendations.
- Changes in executing brokers, which should be reviewed for compliance with the adviser's best execution obligations and procedures, and the identification and disclosure of any conflicts of interest that potentially influenced the selection of the broker, such as receipt of allocations of initial public offerings, research, or other rewards.
- New soft dollar vendors or providers, should be evaluated to confirm that the research and other products or services received are consistent with disclosures and policies, including compliance with section 28(e) of the Securities Exchange Act of 1934, if required, and that documentation and payment procedures are similarly compliant.
- Marketing materials and disclosures for accuracy and completeness, including any performance-related claims.
- New types of clients; *e.g.,* retail clients or non-U.S. clients.
- Changes in client and counterparty ownership or credit risks.

3. Operational and financial issues

The adequacy of the adviser's operational systems, infrastructure, and financial controls should be regularly reviewed and tested at least annually to make sure that they remain effective and keep pace with overall developments at the adviser. Among other things, the adviser may wish to:

- Review whether any restructuring of the trading floor or office moves create actual or apparent risks of insider trading or misappropriation of client information.
- Test the performance of execution and order management systems, information systems, trade allocation systems, and soft dollars.
- Test the process for providing necessary disclosures and obtaining required consents if the adviser effects principal or agency-cross transactions with clients directly or through affiliates, including any new affiliates.
- Evaluate any new custodians and compliance issues that may have developed, such as incorrect calculations or deductions of fees, or the transmission of funds or securities to the adviser or its employees rather than the custodian.

4. Regulatory developments

The adviser's review should take into account legal and regulatory developments applicable to the adviser's business, confirm that the adviser's policies and procedures have been updated to reflect those developments, and verify that appropriate training has been provided to relevant personnel. The types of

Continued on page 16

 continued from page 15

regulatory developments that should be assessed include:

- Newly enacted laws and adopted rules. The review should also consider whether the adviser's procedures provide for an effective tracking mechanism for implementation and compliance dates, such as amendments to the definition of "accredited investor" under the Securities Act of 1933, and new restrictions on political contributions under Advisers Act Rule 206(4).
- Relevant SEC enforcement cases and private litigation.
- Informal SEC guidance, including staff interpretations, statements about examination priorities, and Commissioners' speeches.

5. Compliance issues

The risk assessment review should confirm that any compliance issues identified since the last year were addressed, including by:

- Reviewing compliance policies and procedures to confirm that they reflect the adviser's current organization, activities, and practices.
- Confirming that any issues identified in an SEC deficiency letter or during the course of an examination have been remedied, and that such remedial action has been documented.
- Confirming that any self-identified issues have been appropriately resolved and documented.
- Verifying that all regulatory deadlines have been met, including delivery of Form ADV.
- Confirming that all conflicts have been identified and addressed.
- Understanding any trends or patterns in exceptions or violations.

Post Review Follow-Up

Work remains after the completion of the risk assessment review. Among other things, advisers' will need to consider:

1. Documentation

Advisers Act Rule 204-2 requires a registered investment adviser to make and keep any records documenting its annual review of policies and procedures conducted pursuant to Rule 206(4)-7(b). On one hand, the adviser will want to create a record of the scope and timing of its review and testing and document its remediation of any identified compliance issues and implementation of any other recommended controls. On the other hand, careful consideration should be given to the detail included in the adviser's written report because the SEC staff and potentially some clients will request a copy of the report. Accordingly, the report should be prepared under the legal department's direction, and the final report should be distributed internally only to responsible persons with a need to know.

2. Disclosures and consents

The adviser will want to update any disclosures that are found to be inaccurate or incomplete, including the adviser's Form ADV, marketing materials, and disclosures of conflicts of interest, fees, or soft dollar practices. Consideration should be given if any client consents are required.

3. Policies and procedures

The adviser's compliance policies and procedures should be updated if they are determined to be outdated, incomplete, inaccurate, or insufficient. Prior to discarding any outdated policies and procedures, however, registered advisers should consider that Advisers Act Rule 204-2 requires advisers to make and keep copies of all policies and procedures that are in effect or were in effect at any time during the last five years.

4. Training

As part of the adviser's regular compliance protocol, personnel should routinely receive training in the event of material changes in business, procedures, or operations. If the adviser's procedures are updated as a result of review findings, or if compliance issues are discovered, compliance training should be provided to relevant personnel.

5. Mitigation and self-reporting

If any deficiencies are uncovered during the review, prompt remedial action should be taken and documented. If the deficiency is material, the adviser, in consultation with counsel, should determine whether to self-report the issue to the SEC.

** K. Susan Grafton, an Of Counsel at Gibson, Dunn & Crutcher LLP in Washington, DC, focuses her practice on representing broker-dealers and investment advisers. She may be reached at (202) 887-3554 or SGrafton@gibsondunn.com.* *This article is intended to provide general information on the subject matters discussed and should not be relied upon for legal advice on any matter.* ■