Focus On: Adviser Compliance Testing

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Advisers are often told they should test their compliance procedures to make sure they are functioning effectively.[1] Rarely, however, are advisers told exactly what they might test and how. This article focuses on that question by first describing the types of tests advisers commonly use to assess their compliance procedures and then listing specific methods advisers can use to test in various operational areas. This is not offered as a one-size-fits-all testing solution, but as a useful resource for advisers as they build a testing regime tailored to meet their particular needs.

Types of Tests

Advisers commonly use three types of tests to assess their compliance procedures – "transactional," "periodic" and "forensic"[2] tests.

"Transactional" tests are conducted on a transaction-by-transaction basis contemporaneously with the transaction, such as a pre-purchase check against an account's investment guidelines to make sure the security is permissible for the account and that completing the purchase will not cause the account to exceed applicable restrictions. Transactional tests are particularly useful when they can be conducted quickly and with relative ease at the time of each transaction, and when the violations they aim to avoid can be costly.

"Periodic" tests are conducted at regular intervals on a look-back basis, such as reviewing employee emails at each quarter end for any violations of the adviser's email use policy or other inappropriate communications. Periodic tests are often suitable when transaction-by-transaction tests are not practical and when the risk of harm from potential violations is low enough to justify testing after the fact and less frequently.

"Forensic" tests analyze data over a period of time looking for any troubling trends, patterns or hidden issues that may not be obvious when the data are viewed in isolation. An example is analyzing year-long trading data for unusual spikes near quarter ends that might suggest a portfolio manager is "window dressing," that is, altering holdings near reporting period ends to make the portfolio appear different on account reports (for example, less risky) than it actually is for the bulk of the time. Because forensic tests involve analyzing data over longer periods, they are often conducted less frequently, sometimes only once a year in conjunction with the adviser's annual review of its compliance program.[3]

Note that the same basic test could be categorized as "transactional," "periodic" or "forensic," depending on when and how frequently it is run and, to some degree, what it aims to uncover.[4] For example, a review of brokerage placement could be conducted as a transactional test each time a trade is made, to ensure that only approved brokers are selected on the basis of factors consistent with the adviser's obligation to seek best execution, or as a periodic test at the end of each quarter, looking back over the entire period for similar issues. A review of brokerage placement could also be conducted as a forensic test at the end of the year, by comparing brokerage placements against logs identifying which brokers provided expensive gifts or business entertainment to the adviser's personnel, to see whether brokers might have been selected as a result of inappropriate influences rather than a desire to achieve best execution.

Aside from SEC statements that advisers should conduct testing – including some type of forensic testing[5] – the law does not dictate what types of tests advisers must run or how often. Instead, advisers are left to decide for themselves what tests they should run and when, as long as they satisfy the general rule requiring their compliance programs to be "reasonably designed" to prevent, detect and correct violations.[6] For that reason, testing needs can be expected to vary widely from adviser to adviser depending on their size, complexity and, perhaps most importantly, the risks posed by their operations. In any case, best practice would suggest testing on an on-going basis throughout the year using a mix of transactional, periodic and forensic tests.

Specific Testing Methods

Listed below are specific methods advisers might use to test compliance in various operational areas. None of the listed tests are specifically required by law, although some are mentioned in materials prepared by the SEC Staff[7] and some may be conducted by the Staff itself in an inspection.[8]

The list is neither comprehensive nor tailored for use by any particular type of firm. As such, it is likely both under-inclusive and over-inclusive for any given adviser. For that reason, the list should not be used as a checklist but rather as a reservoir of possible testing ideas.

Portfolio Management

- Review securities holdings in client accounts to make sure they reflect securities and techniques consistent with applicable restrictions, investment guidelines, client mandates, diversification and liquidity requirements, and the like.
- Analyze the performance of all client accounts managed with the same investment style to identify any outliers (i.e., performance significantly different than the others), which could be evidence of cherry-picking, unfair allocation of trading opportunities or other favoritism among clients or accounts. Accounts with performance two or more standard deviations away from the mean performance of all accounts managed under the same style[9] should be of particular concern.
- Compare the list of investment restrictions used by the portfolio manager (or the adviser's automated front-end compliance system) with that in the advisory contract or offering disclosure documents to ensure consistency.
- Review quarterly compliance checklists that portfolio managers have completed on the accounts they manage. Verify that securities holdings are within applicable restrictions, investment guidelines, client mandates, and so on.
- Review exception reports generated by the adviser's trade management or compliance software (which monitors trades proposed against account restrictions). Make sure any impermissible securities, concentrations, techniques or positions were avoided or promptly corrected.
- Monitor any manual overrides of automated trade management restrictions to make sure circumstances were appropriate to permit an override and documentation justifying the override is maintained.
- Calculate various risk metrics (e.g., alpha, beta, value-at-risk, various volatility measures) on cli-

ent accounts for relevant periods and compare them to appropriate benchmarks. Make sure they are consistent with client mandates, risk tolerances and suitability parameters.

- Verify that appropriate portfolio stress testing is being conducted to monitor foreseeable "what if" scenarios. Stress testing is important to maintaining appropriate risk exposures and hedges, particularly in portfolios using leverage or holding derivatives or other positions with unlimited or difficult to quantify exposures.
- Review creditworthiness research documentation and related due diligence reports supporting fixed-income trades and other credit-dependent portfolio decisions. Make sure credit decisions are consistent with applicable credit parameters and risk tolerances.
- Review credit analysis of any defaulted securities to make sure the security was appropriate when purchased and not retained unreasonably.
- Monitor cash holding reports for any unusually large cash balances to ensure appropriate deployment of assets.
- Review exposures to particular counterparties and debt issuers on an aggregate and client-by-client basis to make sure exposures are kept within reasonable and applicable limits.
- Calculate relevant percentages on holdings in accounts (how much in various market cap ranges, stocks/bonds/cash, sector and industry concentration, issuer diversification, foreign vs. domestic, etc.) at various points in time, including between reporting periods. Make sure they are consistent with investment guidelines, client mandates and risk disclosures, and that portfolio manager is not engaged in "window dressing" (altering holdings near reporting period ends to make the portfolio appear different on account reports than it actually is for the bulk of the time).
- Compare the number of profitable trades in each managed account over a defined period (for example, the last 12 months) to the average number of profitable trades for all accounts. Determine if there are any outliers and, if so, whether that may be due to unfair allocations or other inappropriate favoritism.
- Monitor inflows and outflows to and from client accounts for evidence of market timing (if a mutual fund) or suspicious or unexplained activity (e.g., insider trading, money laundering, embezzlement or unauthorized borrowing).
- Surveil communications of adviser personnel with clients to make sure client instructions are being carried out accurately and timely.

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- Analyze the performance of accounts that consistently beat their benchmarks over time to find out what the performance is attributable to. Make sure it is attributable to securities, transactions and techniques that are appropriately disclosed and are within the investment guidelines for those accounts.
- Interview key personnel using a "what would you do if" line of questioning to make sure they recognize potential compliance violations and know what to do in response. For example, ask "What would you do if personnel at a corporate client asked you to facilitate an unusual transaction in the client's account?"
- Review trading in client and other accounts to make sure securities were not traded while appearing on any "restricted list" maintained by the adviser.
- Review trading and holdings in securities of companies with which the adviser has a material business relationship (lending, financing, ownership, lease, etc.). Make sure trades are made on the basis of objective investment criteria and that all conflicts of interest are appropriately disclosed.
- Monitor for contra-trades in a particular security on the same day in different accounts (such as one client account buying a security on the same day another account is selling that security) to avoid inadvertent cross-trading. Make sure there are appropriate justifications for each of the trades in light of each account's own investment parameters.

Trading Practices / Brokerage

- Review a list of what broker-dealers and market centers (exchanges, ECNs, dark pools, etc.) client trades are being directed to for execution and the commission dollars and commission rates being paid to each. Make sure only approved brokers/venues are being used and check for any issues with best execution, directed brokerage, undisclosed conflicts or the like.
- Compare average commission rates paid by particular clients to the average commission rate paid by all clients. Make sure variations are explained by appropriate differences and are not due to failure to seek best execution or other fiduciary issues.
- Compare brokerage placement against logs or reports of gifts/entertainment received from those brokers to see whether broker selections may be resulting from inappropriate influences rather than a desire to achieve best execution.
- Compare brokerage placement against lists of brokers with whom the adviser's portfolio management or trading personnel have familial or other relationships to make sure there are no undisclosed conflicts of interest or inappropriate favoritism toward those brokers.
- Analyze brokerage placement in light of client referrals received from brokers, for evidence of inappropriate or undisclosed commission or other brokerage placement arrangements in place in exchange for client referrals.
- Compare actual commission rates paid to approved or contractual rates to see whether they are consistent, paying particular attention to any commission overrides or rate increases.

This article tells advisers exactly what they might test and how, in order to assess the effectiveness of their compliance procedures.

- Compare commission rates on trades executed through any affiliated broker-dealer with commission rates on trades executed through non-affiliated brokers. Make sure that affiliated trades are fair and that commissions and other terms imposed by affiliated brokers are not less favorable to clients than what could be negotiated on an arm's-length basis with an unaffiliated broker.
- Obtain a post-trade report from outside consultants analyzing trade quality and execution costs (including market impact, opportunity cost, spreads and commissions) to help monitor for best execution.
- Compare the execution price of equity trades against the NBBO (national best bid and offer) for that security to help monitor for trade quality and best execution.
- Compare the adviser's equity trading costs against peer group costs using VWAP (volume weighted average price) as a benchmark to help monitor for best execution.
- Check documentation supporting any contemporaneous dealer quotations available for fixed-income securities trades (three or more where available) to help monitor for best execution.
- On a post-trade basis, check execution on comparable fixed-income securities traded by the adviser to help monitor for best execution on fixed-income trades.
- Monitor TRACE (Trade Reporting and Compliance Engine) System data from FINRA if trading in corporate bonds, or MSRB (Municipal Securities Rulemaking Board) data if trading in municipal bonds, to help monitor for best execution.
- Review any execution quality "score cards" or other evaluations of brokers and trading venues prepared by adviser's personnel internally. Make sure chronically low-scoring brokers/venues are being addressed or dropped. Make sure low-scoring brokers are not receiving soft dollar trades, which may indicate best execution is being compromised in an effort to generate soft dollar credits for the adviser.
- Analyze trading errors that occurred over a period of time to see if they reveal a pattern, for example, a higher than average number of errors for the same account/client, the same portfolio manager/trader or the same broker-dealer. Suspicious patterns may suggest an underlying problem, such as manipulation, fraud, incompetence or undisclosed conflicts, or shortcomings in procedures that need to be addressed.

- Check records supporting trading error corrections or adjustments to make sure they are consistent with the adviser's procedures on trade error correction and applicable SEC guidance (for example, that no brokers are absorbing the cost of adviser trading errors in exchange for soft dollars).
- Check whether the adviser's trade order management system is (or is capable of) stopping trades that are "clearly erroneous" or that have a high probability of "intent to defraud" before they are communicated for execution. This will help to prevent trading violations before they occur.
- Inspect adviser's cash journals for any non-recurring or special payments to or from broker-dealers, which (among other things) may indicate inappropriate, unapproved or undisclosed cash adjustments for trading errors.
- Check trading and portfolio turnover in client accounts in the period immediately before and after a reporting period end (for example, 5 days before and after a quarter end), as compared to longer periods. Trading spikes near period ends may indicate the portfolio manager is engaged in "window dressing" (altering holdings near reporting period ends to make the portfolio appear different on account reports than it actually is for the bulk of the time) or "portfolio pumping" (manipulating trading to boost performance at the end of a period). Spikes may also evidence inappropriate attempts to fulfill soft dollar commitments at the last minute, at the expense of best execution.
- Review trading activity, turnover and break-even rates in client accounts by account and portfolio manager. Look for inconsistencies with account objectives/restrictions and any unusual increases, which may be evidence of improper churning to generate commissions or soft dollar credits, or other inappropriate trading activity.
- Review any principal trades to make sure any necessary consents were obtained consistent with the requirements of Advisers Act Section 206(3).
- Review cross-trades and agency cross-trades made between client accounts. Make sure that they were conducted in accordance with applicable restrictions, that any necessary consents were obtained in a timely fashion, that all appropriate disclosures were made and that prices used were reasonable in relation to available market prices. Abusive cross-trading can be used to "dump" securities from a favored account to another account.
- Review trading across account types (long only, long-short, etc.) for inconsistent trading decisions, prohibited short selling or other issues arising from side-by-side management of different account types (unfair allocations, inadvertent cross-trading, and so on).
- Compare performance of accounts with performance-based fees versus those with non-performance-based fees, for disparities that may indicate cherry-picking or other favoritism in allocations.
- Check for any trades with affiliated broker-dealers that might be viewed as principal trades to avoid violating the Section 206(3) restrictions on principal trading.
- Check client files for clients with directed brokerage arrangements. Make sure those clients have received appropriate disclosures explaining how directed brokerage might impact the adviser's ability to achieve best execution (so-called "Bailey" disclosures).
- Compare commissions, commission rates and other services provided to accounts that have client-directed brokerage arrangements versus those that do not to help monitor for best execution and the need for particular directed brokerage disclosures.
- Check accounts with client-directed brokerage arrangements to see if trades for those accounts were placed with other brokers or step-out trades were used in order to seek best execution where appropriate.
- Check brokerage placements on client-directed accounts to make sure client's instructions on percentage of trades to be placed with the directed broker were met.
- Monitor the sequencing of trade execution for same-day trades that are not aggregated together to make sure sequencing is fair and consistent with disclosures.
- Check allocations of investment opportunities – in particular of IPOs and other limited investment opportunities – among client accounts eligible for those investments to make sure no accounts were inappropriately left out.

- Check allocations of partially filled orders among client accounts versus proprietary/personal accounts over the same period to make sure they were allocated in a fair and equitable manner and in accordance with firm's procedures and any relevant disclosures. Pay particular attention to any after-the-fact reallocations and any allocations made by overriding automated systems. Aberrant allocations may be evidence of cherry-picking or inappropriate favoritism.
- Check allocations of securities purchased in IPOs and any purchased in the immediate aftermarket for the same security to make sure they were allocated in accordance with firm's procedures and in a fashion that is fair to all clients.
- Check for significant disparities in performance among accounts that are eligible to participate in IPOs. Make sure the disparities are not due to accounts being unfairly favored in the allocation of IPOs.
- Review trades that are the most profitable over a specified period, as measured by parameters defined and consistently applied by the adviser (such as Top 10 or Top 5% based on annualized return). Look for any suspicious patterns of accounts, clients, managers, brokers or other parties consistently involved in these trades.
- For advisers trading on behalf of registered funds, analyze whether any of the fund's selling brokers are getting a disproportionate share of the fund's portfolio brokerage. This may be evidence that fund share sales are being taken into consideration in placing brokerage, in violation of the SEC's ban on directing brokerage in exchange for distribution (Rule 12b-1(h)).
- Compare the adviser's trading records against the Advisers Act books and records rules addressing trades and trade orders (for example Rule 204-2(a)(3)) to make sure all required records are being created and preserved as required.
- Check trade tickets (if paper) for any signs of inaccuracy, incompleteness, missing time-stamps, unexplained duplication, alterations, unauthorized signatures or other problems that may indicate fraud or other inappropriate or illegal manipulation of records.
- Check trade blotter and other trade documentation for trades cancelled, altered, modified or reallocated after-the-fact. Make sure there is supporting rationale for all changes, a fully documented audit trail and no patterns indicating fraud or other impropriety.

Soft Dollars

- Check soft dollar arrangements to make sure they have been approved (evidenced by initials, approval memo or similar means) by appropriate personnel (such as the head of trading and/or CCO).
- Check products and services received from soft dollar broker-dealers. Make sure they are either "research" or "brokerage" as defined by Section 28(e), if adviser intends to operate within 28(e), or otherwise permissible and fully disclosed.
- Check 28(e) soft dollar transactions to make sure soft dollars are being paid only on commissioned agency trades (equity trades and/or riskless principal fixed-income trades to the extent permitted by SEC guidance) and not on principal trades (such as regular fixed-income transactions).
- Review the logistics of 28(e) soft dollar payments to make sure that products and services are being "provided by" the broker as required under 28(e). This is of particular concern for advisers involved in CCAs (client commission arrangements) or CSAs (commission sharing arrangements).
- Check commission rates charged in soft dollar arrangements to make sure they are "reasonable" and that documentation evidencing determination of reasonableness is being created and maintained where required.
- Comparison shop soft dollar commission rates and ratios to make sure adviser is getting reasonable terms for soft dollar arrangements.
- Check soft dollar allocations to make sure they are going to soft dollar brokers and arrangements that appear on a list of all approved soft dollar arrangements.
- Compare budgeted soft dollar allocations against actual broker-dealer allocations to make sure products and services provided by soft dollar brokers are being received and paid for as expected.
- Check soft dollar statements and reconciliations received from soft dollar brokers against adviser's records to make sure they agree.

- Check adviser's records on soft dollar/hard dollar "mixed use" allocations to make sure they are being maintained and to verify that allocations are justified, accurate and consistent based on actual use of mixed use items.
- Check adviser expense journals to verify that "hard dollars" are actually being paid for mixed use items to the extent not covered by soft dollars.
- Check with broker-dealers as to whether any soft dollar, reallowance, rebate, commission-sharing or other arrangements are in place with regard to commissions, trade executions or custody, between the broker-dealer and the adviser, its clients or other related parties. Assess the consistency of information provided by brokers with adviser's own records, disclosures and policies.

Proprietary and Personal Trading / Code of Ethics

- Review list of firm access persons to make sure it is accurate and being updated as necessary.
- Review documents, verifications, acknowledgements and other materials provided to and obtained from employees upon hiring to make sure they are aware of, acknowledge in writing and adhere to their personal trading restrictions and reporting requirements.
- Monitor transactions reports (or duplicate statements and confirms) received from access persons to make sure they are received in a timely fashion and do not reveal any improper trading activity (i.e., lack of compliance with Code of Ethics requirements, such as black-out periods, short-swing transaction restrictions, IPO and limited offering pre-approvals, trading in securities while on "restricted list" or "watch list," front running, and so on).
- Monitor reports received from covered personnel quarterly and annually as to their accounts and securities holdings to make sure reports are received in a timely fashion and that any accounts in which personnel have an interest are treated as "personal" or "proprietary" accounts when appropriate.
- Compare the performance of client accounts with the performance of employees' personal accounts and proprietary accounts. Look for questionable discrepancies indicating improper favoritism in allocations, cherry-picking, front running, or the like.
- Compare the number (or percentage) of profitable trades in each personal and proprietary account over a defined period (for example, the last 12 months) to the average number (or percentage) of profitable trades for client accounts over the same period. As to any outliers, determine whether those accounts are receiving unfair allocations or other inappropriate favoritism.
- Compare information on employees' confirms and account statements with the holdings and transactions reports submitted to check for discrepancies or concerns.
- Compare employees' trading pre-approval forms with their account statements and confirms to make sure they traded as expected and only on the terms and in the time frame approved.
- Compare employees' personal trades with client trades to see if any patterns or concerns emerge, such as front running, improper principal trading, scalping (telling clients to buy when secretly selling personally), or the like.
- Review employee trades to see whether any securities, trades or investment opportunities taken by employees should have been offered to clients.
- Review employee tax returns for any brokerage, bank or other accounts subject to reporting under the adviser's Code of Ethics that were not reported to adviser and to detect any unexplained sources of income.
- Compare new securities holdings reported by employees against publicly available reports of new IPOs to make sure that no employees bought shares in an IPO inconsistent with the firm's policies or procedures.
- Review the gifts/entertainment log to see if a particular person or firm has been the sender or recipient of an unusual number of gifts or entertainment of unusual value, which might indicate inappropriate influence, undisclosed conflicts or other impropriety.
- Review employee expense reports for any unusual expenditures or patterns involving gifts or entertainment that might indicate personnel are involved in bribes, "pay-offs" for personal perks or illegal or inappropriate influence or favors.
- Send an anonymous gift to a firm employee to see whether the gift is declined or reported consistent with the adviser's policies and procedures.

- Obtain from the adviser's most commonly used broker-dealers a log of any gifts/entertainment the broker-dealer or its personnel have received from the adviser or its personnel. Make sure that gifts and entertainment are being treated and reported consistent with the adviser's policies and procedures.
- Monitor certifications/acknowledgments requested from all personnel annually (acknowledging receipt of and adherence to Code of Ethics and/or Compliance Manual) to make sure they are all signed and received in a timely fashion.
- Check any waivers or exceptions granted under the adviser's Code of Ethics to make sure that (i) appropriate documentation exists justifying the waiver/exception and memorializing the process by which the waiver or exception was granted and (ii) waivers and exceptions have not been granted authorizing conduct that is inconsistent with the law (including specific Code requirements under Advisers Act Rule 204A-1).
- Interview employees about the Code of Ethics to confirm their understanding of the applicable restrictions and reporting requirements.
- Check training session sign-in sheets or attendance certifications to confirm that all relevant personnel attended as expected or required.

Insider Trading

- Track trading patterns in client accounts and employees' personal accounts against news stories about relevant issuers. Suspicious patterns may suggest individuals traded on the basis of inside information. (Software systems are available today that can help to automate this process.)
- Compare the firm's Top 10 (or Top 5%) most profitable or best performing trades to news events about the issuer and/or meetings that adviser personnel had with the issuer's management. This can help to detect whether individuals may have had access to inside information near the time of the trades.
- Review circumstances surrounding any unusually profitable trades in client accounts and employees' personal accounts to verify that there was no access to inside information.
- Surveil communications (including emails, phone calls, instant messages, and so on) between employees and other employees, key clients and outside contacts who may be privy to inside information, such as broker-dealers, investment bankers, research analysts, lawyers, consultants, lobbyists, other investment advisers, insiders at public companies, and so on. Look for any evidence of insider trading or tipping. Surveillance can be undertaken by random sampling or by key-word screening aimed at identifying more sensitive communications.
- Check trades in securities of companies to which any firm personnel are known to have connections (for example, a spouse or other relative is employed there, firm personnel sit on creditors committee, client serves as executive there, etc.). Look for any patterns suggesting insider trading may have occurred.
- Surveil communications among employees for any sensitive client or inside information that may have leaked through information barriers or is being used inappropriately for trading purposes.

Safeguarding Client Assets (Custody)

- Verify with independent sources that custodian is in fact a "qualified custodian" per SEC rules.
- Obtain written confirmation from custodian that it is sending account statements directly to clients at least quarterly, if required to satisfy the adviser custody rule (Rule 206(4)-2).
- Conduct background checks and/or credit checks on employees with access to client assets to avoid providing access to employees who may have greater incentive or propensity for misappropriation or other wrongdoing.
- Review documentation granting or changing signatory authority, withdrawal/transfer authority or trading authority over accounts to detect any unapproved or fraudulent authorizations.
- Obtain from custodians duplicate account statements and trade confirms sent to clients for their accounts. Make sure amounts reconcile with adviser's own records for holdings/transactions and with the adviser's own statements and reports sent to clients for the same periods.
- For advisers that self-custody or use a related person as custodian, check holdings information obtained from higher up the custody chain, such as with prime brokers,

depositories, OTC counterparties or other independent sources. This may require sorting out advisory client holdings from other client or proprietary holdings held for the adviser in an omnibus account.

- Review names and addresses on duplicate client account statements and confirms received from custodian. Make sure they match the names and addresses maintained by the adviser in its records and used by the adviser for sending its own statements and reports to clients.
- Check that client addresses on custodian statements do not reveal troubling patterns or anomalies that may indicate statements are being diverted, such as frequent use of P.O. boxes, use of the same P.O. box number or street address by seemingly unrelated clients or use of addresses in geographical areas not served by the adviser.
- Review documentation of reconciliations performed between custodian statements and adviser's records to make sure reconciliations are being performed by the adviser on a timely basis, preferably by personnel who are separate from any personnel with authorization to access or transfer client assets. Look for any indication that reconciliations are being manipulated, such as unexplained "plug" numbers, stale items or patterns or anomalies that are not explained. Pay particular attention to corrections or adjustments that appear chronically period after period.
- Review any withdrawals or transfers from client accounts within the control of adviser personnel to make sure they are appropriate and that documentation of compliance with internal approval and control procedures exists.
- Request from custodian(s) SAS-70 or similar report assessing custodial and related controls. Review the report to make sure adequate controls are in place and routinely tested.
- Check any client funds or securities inadvertently received by the adviser to make sure they were returned to the sender promptly (in any case within 3 business days after receipt), if required by the adviser custody rule (Rule 206(4)-2).
- Arrange for and review results of an independent "surprise examination" of client accounts conducted pursuant to Advisers Act Rule 206(4)-2, for any account subject to the "surprise examination" requirement.
- Arrange for and review results of any financial statement audit of any pooled vehicle clients relying on audited financial statements to avoid account statement or other requirements under the adviser custody rule (Rule 206(4)-2).
- Check that a Form ADV-E was filed with the SEC by the independent auditor for any accounts subject to the "surprise examination" requirement.
- Check the list of PCAOB-registered accounting firms maintained on the PCAOB's website to make sure any independent auditors conducting surprise exams, internal control assessments or financial statement audits for the adviser's client accounts are PCAOB-registered if required to be by Rule 206(4)-2.
- Obtain from the PCAOB's website the accountant's last PCAOB inspection report for any auditor used for the adviser's client accounts that is required by Rule 206(4)-2 to be PCAOB-inspected. Review it for potential issues and to ensure that the auditor meets the requirement to be "subject to regular inspection" by the PCAOB as of the dates specified in the custody rule.
- Verify that documentation exists explaining why the adviser and its related person custodian are "operationally independent," if the adviser is avoiding a "surprise examination" requirement under the adviser custody rule (Rule 206(4)-2) by overcoming the otherwise applicable presumption that the adviser and its related person are not "operationally independent." Verify that the factors used to establish operational independence are still valid.
- Check with clients' custodians as to whether the adviser or its personnel have any business or personal relationships with the custodians (loans, banking relationships, or the like) or if the adviser receives anything of value from the custodians (software, compliance, back office or administrative support, access to research or other databases, or the like) to make sure that any conflicts of interest are known, monitored and properly disclosed.
- Verify with custodians that the only adviser personnel interacting with the custodian are those with proper authorization to give instructions to the custodian.
- Verify with clients that (i) they are receiving account statements directly from their custodian

as expected, (ii) they are informed they should be checking their own account statements and confirms routinely and comparing information received from their custodian to any information received from the adviser, and (iii) they know who to contact at the adviser (preferably the CCO or other "independent" personnel) if questions or discrepancies arise.

- Verify that complaints and concerns received (from clients and elsewhere) about client accounts are reviewed and resolved by individuals who have no access to the clients' assets and who are in a position to effectively act on the information.
- Interview adviser employees to make sure they have not taken on any roles or duties (such as become the trustee of a client's trust account) that might cause the adviser to be deemed to have "custody" of client assets where the adviser does not desire to have "custody" under SEC rules.

Books and Records

- Compare a list of SEC-required books and records to a list of the types of books and records kept by the adviser (on-site or through storage service companies). Verify that appropriate records are being created, maintained and preserved in all required areas.
- Randomly request from IT/records department or storage service company retrieval of specified historical records from among those required or expected to be retained, including email. Verify that the records still exist and can be retrieved in a timely and accurate fashion. Make sure that legacy equipment is maintained for required periods if necessary to read archived records in their native format or that archived records can be converted to a new format accurately.
- Review documentation on new and existing client accounts to make sure that appropriate client-intake documentation has been filled out, received, signed, delivered, kept up-to-date, and so on (such as an advisory agreement, risk tolerance or financial circumstances questionnaire, privacy notice, Part II of ADV, other disclosures, tax forms, AML documentation, and the like).
- Check emails "deleted" by firm personnel but retained on the firm's servers to make sure personnel are not inappropriately deleting emails that constitute required books and records.
- Surveil incoming and outgoing email of adviser personnel for potential violations, inappropriate communications, unauthorized use of email system or undisclosed/unreported gifts or entertainment. (Email surveillance software is available to assist in this process using keyword searches.)
- Check client files or firm records of any client to whom regulatory documents are being delivered electronically to make sure they have provided informed consent to electronic delivery and that evidence exists of their ability to receive electronic deliveries.

Privacy / Data Security

- Surveil communications of personnel with access to portfolio information (for example, postal mail, email and/or recorded phone conversations) to make sure they are not divulging private client or portfolio information in any unauthorized manner.
- Test accessibility of client files/records from various computers using authorized and unauthorized methods to make sure that unauthorized persons cannot access such information. (Advisers can conduct these tests internally or hire a computer security consultant to conduct them.)
- Check file drawers, cabinets and rooms that are supposed to be locked to make sure unauthorized persons do not have access.
- Monitor desk areas of adviser personnel to see whether confidential client information or computer passwords are readily visible or accessible to unauthorized persons or whether sensitive information has leaked across any information barriers.
- Check client files to make sure documentation has been retained showing that a copy of adviser's Privacy Notice has been provided to clients initially and at least annually.
- Check any "returned mail" or undeliverable email messages that contain Privacy Notices to make sure notices were actually received and that addresses on record are current.
- Check client files to make sure that client privacy and marketing "opt-outs" are requested, maintained and adhered to faithfully.

- Check disclosures or transfers of client information made outside the firm (such as in account transfers) to make sure they were made consistent with the adviser's privacy policy and client "opt-outs."
- Re-read the adviser's Privacy Notice to make sure that actual practices are consistent with representations on how information is handled.
- Review any complaints received from clients about information gathered and used by the adviser. Verify that the adviser's information handling is consistent with all applicable rules, disclosures and "opt-outs."
- Check shredders and other receptacles for disposal of data/documents to make sure they are locked and papers destroyed in such a fashion that information cannot be reconstituted.
- Check computers used to access firm and client sensitive data and accounts (including laptops, home computers and mobile devices). Make sure they have appropriate firewalls, virus protection, anti-hacking and anti-spyware protection and other relevant protections.
- Check documents slated for destruction under the adviser's document retention policy to make sure they are destroyed in a timely and effective fashion.
- On a test basis, issue firm-wide instructions calling for suspension of document destruction. Make sure that all discretionary and automatic document destruction can be suspended should the adviser need to call for it (such as in the event of an inspection, investigation or litigation).
- Check client communication records to make sure that any data security breach notifications have been sent to clients and governmental authorities whenever required by any applicable federal or state notification requirements.

Marketing / Advertising

- Review documents, websites, files and RFP responses containing any marketing materials, sales literature, advertisements or other promotional-type materials. Make sure that the materials are accurate, balanced, consistent with internal policies and applicable legal requirements, and reflect any required approvals (initials, etc.).
- Check for consistency between the firm's economic outlook as described in client communications and the firm's internal assessment of economic matters and internal actions.
- Surveil communications of personnel with clients and prospective clients (for example, postal mail, email and/or recorded phone conversations) to make sure personnel are not making false or misleading statements and that they are using only approved marketing materials.
- Send a "mystery shopper" (undercover prospective client) to sales seminars or meetings conducted by firm marketing personnel or third-party solicitors. Have them report back to the adviser as to what materials were handed out, what statements were made, and so on, to make sure all laws and procedures were adhered to as required.
- Recalculate account or composite performance for specified periods to confirm the accuracy of any performance claims used in marketing or client materials or provided to third-party databases.
- Check holdings in client accounts included within a composite to make sure they are appropriate for that composite, including sector and security concentrations and minimum asset levels.
- Review accounts excluded from composites to make sure exclusion is appropriate and that adequate documentation explaining exclusion is maintained. Excluding accounts inappropriately could skew performance results.
- Check marketing materials and advertisements for any express or implied claims of compliance with GIPS (Global Investment Performance Standards). Claiming GIPS compliance in the absence of actual compliance can constitute fraud.
- Analyze performance on model portfolios or key accounts to determine what performance is attributable to (for example, to IPOs or other limited investment opportunities that may not be available in the future). Make sure that any appropriate disclosures about how performance was achieved are being made, that the appropriate index is being used as a benchmark and that any material differences between the account and the index are being disclosed.
- Check back-up records supporting performance claims to ensure that appropriate documentation supporting the entire period covered by the performance is being retained.

- Check communications sent to adviser through its website or to a "general info" email address to make sure they are being routed to the correct individuals and handled appropriately.
- Review expenses of marketing personnel/ department for expenditures directed to the benefit of prospective clients or their consultants. These expenses may indicate attempts to exert inappropriate influence over hiring decision makers, violation of "pay to play" rules, kickbacks, bribes or other illegal or inappropriate payments.
- Conduct a general Internet search on adviser and its key personnel to see whether unapproved "advertising" has been posted on the Internet or whether personnel (or solicitors) are making unapproved or unsubstantiated statements in blogs, forums or the like.
- Check any pre-clearances or after-the-fact reports of communications between adviser personnel and the media to make sure procedures were followed and no unauthorized statements were made.

Solicitors

- Check files relating to solicitors acting on behalf of the adviser. Make sure proper signed agreements are in place between the adviser and the solicitor containing all appropriate provisions under the "cash solicitation rule" (Advisers Act Rule 206(4)-3). This should be done whether the solicitor is an employee or an independent third party.
- Contact clients referred to the adviser by a solicitor to make sure the solicitor provided only approved materials to the client, delivered any required disclosures in a timely fashion, obtained client's consent to or acknowledgement of any required deliveries and otherwise adhered to adviser's procedures.
- Obtain a compliance certification from third-party solicitors certifying that (i) they have adhered to adviser's procedures and all applicable legal requirements, (ii) they have obtained all required client acknowledgements, and (iii) they are not disqualified from continuing to act as a solicitor.
- Check third-party solicitor registrations and disciplinary records on available databases (IARD, BrokerCheck, state securities commissions, etc.) for anything that might disqualify them from acting as a solicitor or otherwise cause concern.
- Check that third-party solicitors who refer clients to the adviser for investment in a pooled vehicle are registered as broker-dealers or exempt.
- Check adviser's financial records to confirm that any fees paid to solicitors were in accordance with the written agreement with solicitor and relevant disclosures.

Valuation / Assessing Advisory Fee

- Verify that due diligence was conducted on any service providers used to provide securities prices to ensure they have been appropriately vetted for capability, availability, reasonableness and so on.
- Review any models used for pricing purposes to make sure they are sound, consistent with any required disclosures and generating reasonable results.
- Compare valuations of client assets as shown on statements sent by adviser to clients against an independent source for valuations to make sure they agree.
- Compare values assigned to securities in all accounts holding a position in those securities (long, borrowed, segregated as collateral, etc.). Make sure that valuations across accounts are consistent or that variations are supportable.
- Check pricing or valuation exception reports for stale pricing (prices that have remained static for an unusually long period), unusual price fluctuations or other potential pricing problems.
- Review pricing overrides made by portfolio managers, sub-advisers, Boards of Directors or others, to make sure they are reasonable and that documentation is maintained supporting the rationale for the override.
- Review "fair value" assigned to any client assets where market prices are not readily available. Make sure valuation was done in accordance with disclosed methodology and back-up documentation for valuation has been preserved.
- Compare valuations on any portfolio securities that were "fair valued" for any purpose against the next available sale price of those securities to monitor the accuracy of the fair valuation used.

Check for circumstances suggesting that the fair valuation methodology needs refinement, for example, if the methodology is consistently producing overvaluations. (Software is available today to assist with fair valuation of securities.)

- Check the description of the adviser's fee schedule, fee calculation methodology and billing practices in Form ADV to make sure they are consistent with actual practice.
- Recalculate the advisory fees charged on client accounts. Make sure that the calculation was done correctly and consistently with the advisory contract and disclosures, and that any breakpoints were applied correctly.
- Check the aggregate amount of advisory fees invoiced to clients for a specified period for reasonableness relative to the amount of assets the adviser had under management for that period.
- Check client account statements to make sure any advisory fees debited against the account are consistent with the fees owed, when fees are paid by automatic invoicing to the custodian.
- Confirm that any clients charged a performance fee meet the net worth or other applicable requirements set out in Rule 205-3 of the Advisers Act.
- Check accounts terminated mid-billing period to make sure any unearned advisory fees paid in advance were reimbursed as required.
- Check account statements to make sure the adviser's (or pricing agent's) procedures for identifying and recording corporate actions (such as dividends and stock splits) capture and integrate those actions into accounts in a timely and accurate manner.

Regulatory Filings and Matters

- Check Form ADV disclosures against SEC form requirements, item by item, to make sure disclosures are up-to-date and accurate in general and in light of actual practices at the adviser.
- Check client files to make sure ADV Part II was offered to each client in writing at least annually and that any requests for Part II were fulfilled in a timely fashion.
- Check personnel records of adviser employees who are "Investment Adviser Representatives" to make sure that they have proper state registrations/notice filings, proper exams (e.g., FINRA/NASAA administered exams) or qualifications (e.g., CFA, CFP, ChFC, if used as a substitute), proper forms on record (e.g., Form U-4), and so on.
- Check client address lists to make sure no clients reside in jurisdictions where the adviser has not met all applicable adviser/IAR registration or notice filing requirements (or where exemptions are not otherwise available).
- Check disclosures in Part 1 of Form ADV against similar disclosures in Part II of Form ADV to make sure they are complete and consistent.
- Check disclosures in Part 1 and Part II of Form ADV against related disclosures appearing elsewhere (any firm brochure the adviser may use, any client-specific materials or RFPs, the SAI of any mutual fund clients, etc.) to make sure they are complete and consistent.
- Check EDGAR database to make sure that any Form 13F required from adviser was filed in a timely fashion. If adviser is a discretionary manager but does not yet exceed the $100 million reporting threshold for Form 13F, check the adviser's AUM to monitor for first required filing date.
- Check account holdings across accounts managed by adviser for positions exceeding SEC or other reporting thresholds or changes to positions that triggering follow-on reporting, such as Schedules 13D/13G or Hart-Scott-Rodino filings. Make sure timely filings and amended filings were made as required.
- Check adviser's filing fee account balances on the EDGAR and IARD filing systems to make sure they are kept sufficient to cover foreseeable future filings.
- Check prior SEC deficiency letters and responses to ensure that adviser has kept any commitments made and adhered to any restrictions or conditions imposed.
- Check any SEC orders and no-action letters on which adviser is relying to make sure adviser is complying with any applicable conditions or restrictions.
- Review list of events that trigger client disclosure obligations under Rule 206(4)-4 to make sure no adverse financial condition or material disciplinary events have occurred without necessary disclosures having been made.

Business Continuity / Disaster Recovery Planning

- Without prior notice, request access to licensed seats/stations at any off-site recovery center that adviser has contracted for to make sure that all services expected are indeed available when requested.
- Test connectivity and operations capabilities from key alternative locations, such as homes of key employees, mobile capabilities and so on, to make sure they can be utilized as expected in the event of a real emergency.
- Randomly request retrieval of specified computer files or records from any back-up or "mirrored" computer system maintained by the adviser to make sure records actually exist and would be accessible in case of emergency.
- Do a full "post-mortem" assessment of the performance of any back-up systems or contingency plans whenever activated, such as following a loss of power, weather event, absence of key personnel, or the like.
- Practice a premises evacuation drill or continuity plan simulation to make sure employees know what to do and that key personnel know how to stay in contact if a real evacuation emergency were to arise.
- Conduct a "table-top" exercise simulating a business disruption or disaster to make sure key personnel have talked through what to do.
- On a test basis, trigger the adviser's "calling tree" or other emergency communications system to make sure employees know how to implement it and that it is up-to-date and working smoothly.
- Interview key personnel about the adviser's business continuity/disaster recovery plan to make sure that they would know what to do if various foreseeable circumstances were to arise, including a widespread disaster, pandemic or similar event in the adviser's area.
- Confirm that key vendors and service providers have functional and effective business continuity plans in place.
- Participate in an industry-wide emergency preparedness drill coordinated by the Financial Services Sector Coordinating Council or other similar organization aimed at ensuring preparedness.

Proxy Voting /Class Action Settlements

- Review client files to make sure client has signed appropriate documents (for example, advisory agreement or separate document) acknowledging whether or not adviser will be (i) voting proxies on securities in client's account, (ii) handling proofs of claims in class action lawsuits pertaining to securities in client's account, or (iii) acting on client's behalf in corporate actions, bankruptcies, etc., affecting securities held in client's account.
- Check each incoming proxy against firm's records to make sure holdings information agrees.
- Check proxy records to make sure incoming proxies were voted and were voted consistently with firm's proxy voting policy. If not, make sure that an acceptable explanation was created and maintained in the files.
- Check any report of proxies voted by an adviser on behalf of its client (for example, on Form N-PX for mutual fund clients) to make sure the proxies were in fact voted as indicated in the report.
- Check any changes made in the proxy voting policies to be applied to any client accounts. Make sure there is an appropriate explanation for the change and that related disclosures were updated where necessary.
- Check that the proxy voting guidelines selected for a particular client account are consistent with the best interest of that client. For example, selecting proxy voting guidelines that automatically vote in favor of management's recommendations may not be in the best interest of Taft-Hartley (labor union related) clients, particularly when other sets of guidelines could be selected (for example, from a proxy voting service).
- Check client holdings during relevant class periods when class action settlements are announced to make sure that client interests were represented and that any settlement proceeds paid out were in fact received.

Anti-Money Laundering

- Review client files for all account-opening documentation called for by adviser's anti-money laundering procedures (for example, copies of IDs for individual clients).

- Check names of new and existing clients against the OFAC (Office of Foreign Assets Control) SDN (Specially Designated Nationals and Blocked Persons) List and any other pertinent lists made available by OFAC to avoid opening accounts for persons where it would be illegal to do so.
- Check for transactions, accounts and dealings involving offshore locations to make sure adviser is not conducting business or facilitating the conduct of business in countries subject to government sanctions.
- Check any AML risk-ratings assigned to clients under adviser's procedures based on identity, location, account characteristics and other pertinent factors. Make sure ratings are being assigned consistently and higher-risk accounts are handled accordingly.
- Monitor transaction flow in client accounts for suspicious activity (multiple transactions "structured" to avoid the $10,000 reporting triggers, inflow or outflow of amounts or at times inconsistent with account history or purported use, transactions involving offshore tax-haven or secrecy jurisdictions, etc.) to identify accounts or transactions that may be subject to AML concerns.
- Check any Suspicious Activity Reports (SARs), reports for cash transactions over $10,000 or similar reports as filed to make sure they are being filed when appropriate and maintained for required time periods.
- Request written confirmation from any custodians or other service providers on which adviser is relying to implement portions of its own AML program that they have discharged their AML responsibilities as required.
- Obtain an independent audit of client accounts to test compliance with AML procedures.

Oversight of Sub-Advisers [10]

- Meet with sub-adviser and its compliance personnel, either in person or via teleconference, to evaluate whether sub-adviser is in compliance, is likely to remain in compliance and has a reasonably designed compliance program.
- Review quarterly compliance checklists that sub-adviser has completed to make sure all securities in portfolios managed by sub-adviser are within applicable restrictions, investment guidelines, client mandates, and so on.
- Conduct a site visit at sub-adviser's offices to evaluate capability, sophistication and professionalism of sub-adviser and its compliance personnel and strength of compliance program.
- Request and review any reports sub-adviser prepares on compliance matters or compliance reviews relating its own firm, such as annual compliance review reports, compliance program updates, reports investigating potential compliance violations, SAS-70 or SOP 07-2 reports assessing sub-adviser's controls, Code of Ethics exception reports, and so on. Assess the substance of the report and evaluate sub-adviser's vigilance, compliance capability, promptness in responding, and other relevant matters.
- Obtain from sub-adviser and test the same types of data/reports that would be available from adviser's own firm on key portfolio management, trading and other compliance matters, such as reports on trade errors, soft dollars, brokerage placement, portfolio characteristics (liquidity, diversification, etc.), Form ADV updates and the like.
- On matters not tested directly by adviser, obtain from sub-adviser reports on its own testing of those matters.
- Request and review quarterly compliance certification from sub-adviser.
- Request and review any deficiency letters or similar assessments or summaries of findings received by sub-adviser from SEC or other regulators.
- Conduct a general Internet search on sub-adviser and its key personnel to see whether events have occurred that were not disclosed to adviser or whether other information of concern appears.
- Look up sub-adviser on IARD website (if sub-adviser is registered) to see whether information reported, including disciplinary information, is already known to adviser or otherwise of concern.

Compliance Attestations / Certifications

- Review compliance attestations/certifications received from adviser's personnel to make sure they have read and understand compliance procedures and to identify any potentially relevant issues or concerns.

- Review compliance attestations/certifications received from sub-advisers and other key service providers to identify any potentially relevant issues or concerns regarding their compliance for adviser or adviser's client accounts.
- Review any independent consultant reports (such as SAS-70 reports or reports issued under SOP 07-2 by an auditing firm) describing and/or testing the compliance controls in place at adviser or other service providers.
- Review any compliance attestations/certifications received from third-party solicitors for consistency with applicable requirements.

Testing Follow-Up

Advisers should be prepared to follow up quickly if testing reveals deficiencies, such as weaknesses in procedures or actual violations. At that point, red flags are waving that must be addressed with due speed. As a regulatory matter, leaving a deficiency unresolved can lead to consequences as serious – if not more serious – than the deficiency itself.[11] Finding deficiencies may also trigger the need for additional testing, in the same or other areas.

Conclusion

This article tells advisers exactly what they might test and how, in order to assess the effectiveness of their compliance procedures. Since advisers and their testing needs vary so widely, this is not offered a one-size-fits-all testing solution, but rather as a resource for ideas about various types of tests and specific testing methods advisers might find useful in building a testing regime tailored to their particular needs.

ENDNOTES

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1 See, for example, Compliance Programs of Investment Companies and Investment Advisers; Final Rule, Release Nos. IA-2204 and IC-26299 (Dec. 17, 2003) (Adopting Release) at fn. 15 ("Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns…."); and the SEC Staff-prepared CCOutreach handout entitled "Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs" (May 2006), in particular the questions under the "Quality control and forensic testing" heading ("Do you regularly conduct transactional or quality control tests to determine whether your activities are consistent with your compliance policies and procedures?" and "Do you conduct periodic tests to detect instances in which your policies and procedures may be circumvented or where there may have been attempts to take advantage of the gaps in your policies and procedures?").

2 Different sources use different terminology for these tests, as discussed in Arthur B. Laby, "Detecting Insider Trading Through Forensic Testing," *Practical Compliance & Risk Management for the Securities Industry,* Vol. 2, No. 3 (May–June 2009) at pp. 8-9.

3 An annual review of procedures is called for by Rule 206(4)-7(b) under the Investment Advisers Act of 1940 (Advisers Act).

4 For that reason, the tests listed under the "Specific Testing Methods" heading of this article are not categorized as "transactional," "periodic" or "forensic."

5 See, for example, the sources cited in note 1 above and note 7 below.

6 Advisers Act Rule 206(4)-7 generally requires an adviser to adopt procedures "reasonably designed to prevent violation, by [the adviser] and [its] supervised persons, of the [Advisers] Act and the rules that the Commission has adopted under the Act." In this context, "prevent" includes "prevent," "detect" and "correct." See the Adopting Release cited in note 1 above, at fn. 16.

7 See, for example, the 2007 CCOutreach national seminar handout entitled "Forensic Measures for Funds and Advisers" (November 14, 2007) (Forensic Measures). See also the 2009 CCOutreach regional seminar handout entitled "Safeguarding Clients' Assets Under Management Through Asset Verification and Reconciliation" (April 2009).

8 See Forensic Measures, cited in note 7 above, at p. 1: "Many of these forensic measures are used by examination staff during inspections…."

9 See Forensic Measures, cited in note 7 above, at p. 2, which references the 'two deviations away from the mean' standard.

10 Similar tests can be conducted to oversee compliance of other service providers as well.

11 For example, see In the Matter of Equity Services, Inc., Release Nos. 34-61181, IA-2964 (December 16, 2009) (settled) (adviser became the target of an enforcement action when deficiencies were not corrected after they had been brought to the adviser's attention several times, including by SEC Staff on at least one prior inspection).