INVESTMENT ADVISER

COMPLIANCE REVIEWS & TESTING

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Updated through
July 18, 2013

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SEC rules require investment advisers not only to <u>establish</u> and <u>implement</u> compliance policies and procedures, but to <u>review</u> them as well. This Q&A addresses some of the key issues pertaining to compliance program reviews.

1. ***<u>How Often Must an Adviser's Compliance Program be Reviewed</u>?***

Advisers are required to review their compliance program at least <u>annually</u>. (See Advisers Act Rule 206(4)-7(b).) Because a compliance review is required at least annually, it is often referred to as an "annual review" or an "annual compliance review." However, the SEC Staff has made it clear that advisers are also expected to conduct an <u>interim</u> review of their compliance programs, between annual reviews, when developments or changes warrant. The kinds of developments or changes that may warrant an interim review include those listed under Question 5 below, in cases where it would not be prudent to wait until the next annual review to ensure that the adviser's compliance program remains effective. In addition, certain aspects of an adviser's compliance "review" – such as monitoring and testing for compliance with specific requirements -- are best implemented on an <u>on-going</u> basis, as discussed more under Question 6 below.

2. ***<u>When During the Year Must the Annual Compliance Program Review be Completed</u>?***

SEC rules do not dictate a particular time of year for an adviser to conduct its compliance program review. In determining which time of year may be most suitable for them, advisers should ask questions such as:

- When does the adviser's fiscal year end? Are the adviser's financial statements audited at year-end? It might be more efficient to integrate an annual compliance program review into other review-type procedures the adviser would be undertaking at year-end anyway.
- What are the needs of the adviser's clients? For example, does the adviser manage an investment company where the fund board will be asking the adviser for compliance information as part of the fund's own compliance review, where it might therefore be important for the adviser's review to be relatively current?
- Is an "SSAE 16" or similar report going to be prepared or issued on the adviser's operations or are outside auditors or consultants going to be brought in to do any assessments?
- What are the availability and workload capacity of the adviser's personnel to conduct a complete compliance program review at various times during the year?
- What do the adviser's own policies and procedures say about a compliance review? Advisers should always adhere to their own program requirements, and many compliance policies and procedures are drafted with specific provisions stating how often and when they must be reviewed and updated.

3. ***<u>What is the Purpose of the Compliance Program Review</u>?***

The purpose of the compliance program review is twofold, to determine:

- the <u>adequacy</u> of the adviser's compliance policies and procedures, and
- the <u>effectiveness</u> of their implementation.

4. ***<u>What Basic Steps Should an Adviser Follow to Conduct a Compliance Program Review</u>?***

Because advisers and their businesses vary so widely, there is no “one size fits all” approach to conducting a compliance review. However, advisers would be wise to plan their approach in advance and incorporate at least the following basic steps:

> <u>STEP 1. Consider compliance developments</u>. Identify and consider the developments that have occurred since the date of the last review -- such as violations, deficiency letters, industry scandals and the other matters listed in Question 5 below -- which bear on whether the adviser’s program is adequate and effective or whether changes are warranted.
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> <u>STEP 2. Update the risk assessment</u>. A well-designed compliance program should focus resources on those areas where the adviser is at greater risk for having a compliance problem or having conflicts of interest arise. Accordingly, each adviser should define the appropriate contours of its compliance program by conducting a risk assessment that identifies those areas of risk pertinent to its particular business. That risk assessment should be updated at least annually to determine whether changes to its compliance program are warranted in light of any new or changed risks that may have come into play. Excellent materials are publicly available to help advisers conduct and update their risk assessment, including a Risk Assessment Guide, Questionnaire and Identification Chart put out by the Investment Adviser Association. (See the “Other Resources” section at the end of this paper.)
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> <u>STEP 3. Consider the results of compliance testing and monitoring</u>. Instead of gauging the effectiveness of their compliance programs by simply waiting for problems to arise, advisers should proactively test and monitor their programs. A robust compliance program will include testing and monitoring in various areas on an on-going basis throughout the year. On-going testing not only reduces the risk that compliance problems will go uncorrected for extended periods of time but also avoids the practical burden that would result from leaving all the testing to be accomplished at once as part of a compliance review. The results of testing and monitoring will be an important measure in assessing whether an adviser’s program is adequate and effective or whether changes are warranted. Testing and monitoring is discussed more fully under Question 6 below.
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> <u>STEP 4. Update existing policies and procedures</u>. Advisers should periodically re-read all of their existing policies and procedures, page by page, line by line, to determine whether they need to be changed or updated. The SEC Staff continues to identify advisers not following their own written procedures as one of the most common deficiencies they find upon inspection. If nothing else, the annual compliance review should include re-reading all existing policies and procedures to make sure they are consistent with the adviser’s actual practice.
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> <u>STEP 5. Memorialize the review</u>. In contrast to investment company CCOs who are <u>required</u> by SEC rules to prepare a written report of their annual compliance review, adviser CCOs are <u>not</u> <u>required</u> under the Advisers Act rules to produce a written report of their review. However, the Advisers Act books and records rules (see Rule 204-2(a)(17)(ii)) require advisers to preserve any records the adviser

does make documenting the annual review, even if the adviser chooses not to produce a written “report” of the review. Records documenting the annual review must be kept in an easily accessible place for a period of not less than 5 years from the end of the fiscal year during which the last entry was made on the record, the first 2 years in an appropriate office of the adviser.

Moreover, as a practical matter, the SEC Staff expects advisers to document the compliance review in some fashion, and they will request to see that documentation in an examination. Advisers unable to provide adequate written documentation of their compliance reviews risk being found deficient and subjected to closer Staff scrutiny or more frequent SEC inspections. Specific suggestions on memorializing a compliance review are included under Question 12 below.

5. ***What Issues Should be Considered When Assessing Whether a Compliance Program is Adequate and Effective?***

As a minimum, these issues should be considered as part of a compliance program review:

- Any compliance matters that arose since the last review.
  Examples might be:
    - Breaches, exceptions, deviations, failure, violations, glitches, confusion or close calls experienced in the adviser’s operations or with respect to a client account.
    - Results of any compliance monitoring and testing conducted by the adviser (see Question 6).
    - Deficiency letters received from the SEC or other regulatory body following inspection.
    - Employee warnings, sanctions or disciplinary actions.
    - Client complaints or lawsuits or enforcement actions implicating compliance.

- Any changes in the business activities of the adviser or its affiliates.
  Examples might be:
    - Acquisitions, divestitures or restructurings that changed the scope or nature of the adviser’s business, the scope or nature of its clientele or the ownership or affiliations of the adviser.
    - Business lines, products or services added to or dropped from the adviser’s operations.
    - Changes in the adviser’s key personnel, offices or infrastructure (such as computer systems).

- Any changes in the law or regulatory developments that might suggest a need to revise the policies or procedures.
  Examples might be:
    - New guidance issued by the SEC on regulatory issues.
    - Public speeches and statements from the SEC Staff and Commissioners (available on the SEC’s website) addressing compliance-related issues.
    - Common areas of deficiency identified by the SEC Staff in a “ComplianceAlert,” “Risk Alert” or similar guidance (also available on the SEC’s website).
    - Tips or guidance made available by the SEC Staff at national and regional Compliance Outreach seminars.

- Recent SEC and state enforcement proceedings suggesting areas of particular compliance and enforcement concern, such as custody (including the Madoff debacle), insider trading, valuation of securities, privacy, books and records, etc.

6. ***How Can an Adviser Measure the "Adequacy" and "Effectiveness" of its Compliance Program?***

One of the most concrete ways for an adviser to measure whether a specific policy or procedure is effective is to proactively test or monitor whether the adviser and its personnel are in compliance with it. Every well designed compliance program aimed at preventing violations should include testing and monitoring designed to detect violations, in order to make sure that the program is working as intended.

What kind of testing and monitoring an adviser should do, and how often, depends on each adviser's compliance program. Examples of the methods an adviser might use to test for compliance are listed on Appendix A at the end of this paper. In some areas of operation, advisers might choose to test daily, others weekly, monthly, quarterly or annually, and still others, on an ad hoc basis. Adviser may also choose to do the testing themselves, or may choose to outsource some or all of their testing to third-party vendors. Indeed, industry surveys have shown that a significant percentage of the responding advisers indicated that they rely on an outside vendor to conduct some or all their compliance testing and reviews. (See the 2007 and 2013 Investment Management Compliance Testing Surveys referenced under "Other Resources" at the end of this paper.)

In any event, testing for compliance on an on-going basis avoids the work overload and practical risk that would result from testing only sporadically, or that would result from waiting until an annual compliance review to do all the specific testing of procedures at once. Indeed, having an on-going system for testing is a key element to having an efficient and robust compliance system in operation throughout the year. Fortunately, most advisers seem to have taken that point to heart. In an industry survey, over half of the advisers responding indicated that they conduct at least some testing on an on-going, "rolling" basis. (See the 2007 Investment Management Compliance Testing Survey referenced under "Other Resources" at the end of this paper.)

*7. **What is This "Forensic" Testing We Keep Hearing About?***

There are three main types of tests advisers use to assess their compliance programs – transactional, periodic and forensic 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. "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.

"Forensic" tests have caused the most confusion among advisers. Although the term "forensic test" is not defined in SEC rules or guidance, the Staff has used the term to mean a test with three characteristics:

- First, it provides a real test that does more than simply repeat things the adviser already does.
- Second, it helps answer the question: what am I missing? In other words, it covers new material to test and validate the material the adviser usually works with.

- Third, it adds current value, meaning it can be used as part of the everyday compliance program.

(Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, Remarks Before the National Society of Compliance Professionals National Membership Meeting, Washington, DC, October 25, 2005.)

Forensic testing will often involve looking beyond one individual transaction and instead looking at trends, patterns or statistics over time that may help to reveal hidden issues or violations that are not evident when one transaction is reviewed in isolation. For example, analyzing brokerage over a specified period by comparing the adviser's actual execution costs to the execution costs of a peer group benchmark is one type of "forensic test" an adviser might use to help assess compliance with its policy to seek best execution. Numerous other examples of forensic testing are included among the various tests listed on Appendix A at the end of this paper.

Just like transactional and periodic testing, forensic testing can be done on an on-going or rolling basis throughout the year. However, because forensic testing often involves looking at trends, patterns or statistics over a period of time, some forensic tests will be more effective if conducted at the end of a period at key points in time. For this reason, advisers might find themselves doing more forensic testing in conjunction with the annual compliance review than at other times during the year.

8. ***Are Adviser CCOs Legally Required to Do the Compliance Program Review Themselves?***

No. CCOs may delegate tasks to personnel inside their firm or to outside consultants or vendors to assist in a compliance review. However, since the adviser's CCO is responsible under SEC rules for "administering" the adviser's compliance program, it could easily be expected that the CCO would be held responsible for making sure the compliance review is conducted as well, as part of overall program administration. In practice, that means if other personnel or outsiders are tasked to complete certain steps in the review, the CCO should nonetheless remain apprised of and involved in the overall effort.

9. ***Should an Attorney or Law Firm Conduct the Compliance Review in Order to Protect the Results from Disclosure?***

Some speculate that having an attorney conduct an adviser's compliance program review would shield from disclosure to the SEC or anyone else any problems that might be discovered during the course of the review, due to protections afforded by the attorney-client privilege and/or work product doctrine. However, several factors suggest that the attorney-client privilege and work product protections might not be available even if the review were conducted by an attorney. Among them are assertions made by the SEC Staff to the effect that:

> "All reports required by [SEC] rules are meant to be made available to the Commission and the Commission staff and, thus, they are not subject to the attorney-client privilege, the work-product doctrine, or other similar protections." (Adopting Release No. IA-2204, n. 94)

Although this assertion was made in reference to compliance review reports required to be prepared by a fund CCO for a fund board under Rule 38a-1 (the fund compliance rule), it could be applied by analogy to the results of an adviser compliance review conducted under Rule 206(4)-7 (the adviser compliance rule) even if not required to be memorialized in "report" form. Although the Staff's position has not yet been tested in court, it seems to stake out their view of the matter and suggests that if an entire compliance review report were successfully shielded from disclosure to the Staff, the Staff might then take the position that the adviser failed to meet applicable regulatory requirements because the Staff could not verify by inspecting available documentation that the required review had indeed been adequately conducted. The Staff might also view the adviser as less than forthcoming and cooperative and therefore perceive it as a higher risk, potentially putting the adviser on a shorter cycle for SEC examination.

Another argument suggests that the attorney-client privilege might not apply in that context anyway. An attorney's engagement might be deemed to lack a necessary element for the privilege to apply, if it were not undertaken for the purpose of providing legal advice to the adviser but rather for the purpose of fulfilling the adviser's regulatory duty to conduct a compliance program review. This issue is even more acute if the adviser utilizes in-house counsel to conduct the review and it is unclear whether the individual is conducting the review in their role as counsel or in a business role as the CCO or another member of management. A similar problem could arise under the work product doctrine, which under classic interpretations would not apply if the engagement is not undertaken in connection with or in anticipation of litigation. Again, it remains to be seen whether any of these arguments would bear weight in any given case, but they suggest that using an attorney to conduct the regulatory review for the purpose of shielding the results from disclosure might not be as successful as expected.

As a separate matter, however, note that the objections to applying the attorney-client privilege or work product doctrine in the context of a regulatorily required compliance review would <u>not</u> exist if an attorney were instead engaged to conduct a compliance review in a different context, such as a "mock SEC audit" undertaken to assess whether an adviser's compliance program meets legal standards, completely aside from a compliance review called for by Rule 206(4)-7. There, the engagement would not be undertaken to fulfill a regulatory requirement but rather to obtain legal advice about whether the adviser's compliance program is legally sufficient, presumably disarming the potential objection to the attorney-client privilege applying in that case. Moreover, an engagement in that context might well be undertaken in anticipation of litigation – particularly if it is prompted by a problem having come to light – in that case disarming the potential objection to the work product doctrine applying as well. This suggests that using a lawyer to help assess a compliance program can still be a useful strategy for advisers, but with a greater chance of protection from disclosure when undertaken as a supplement to and not a substitute for the regulatorily required review.

Advisers looking for a more economical approach to conducting the regulatorily required review might well use their own compliance personnel rather than an attorney to spearhead the task. Indeed, this seems to be what most advisers do. In an industry survey, some 74% of adviser respondents indicated that they use their own internal compliance staff to conduct the annual review and only 1% indicated that they use outside counsel. (See the 2013 Investment Management Compliance Testing Survey referenced under "Other Resources" at the end of this paper.) If a specific issue were discovered in the course of the review, the adviser could at that point consider engaging an attorney to investigate and provide advice concerning <u>that specific issue</u>. This approach would allow the adviser to make a record of the overall review available for Staff inspection, but offer a better chance of shielding from disclosure those specific, narrow matters referred to counsel, using the attorney-client privilege or other applicable protection.

Looking beyond the traditional attorney-client privilege and work product doctrine, some advisers are considering the prospect of shielding their compliance reviews from disclosure using another privilege known as the "critical self-analysis privilege" (or "self-evaluation privilege"). This type of privilege has been recognized in other circumstances – perhaps most notably to shield medical "peer reviews" – on the theory that the benefits derived from frank and candid self-analysis outweigh the benefits of disclosing the analysis to an opposing or potentially opposing party. The "critical self-analysis privilege" has far from universal acceptance, however. Not all states or courts recognize the privilege or apply it in all circumstances. Some courts treat it as a common law privilege, while others treat it as a statutory privilege that does not exist absent legislative action. In certain cases, the privilege is applied only in private litigation and not to shield the results of an internal review from government regulators, particularly if the review is mandated by law. Moreover, even when applied, the privilege may be used only to shield from disclosure the <u>analysis</u> and <u>not</u> the underlying facts. Despite these limitations, a "critical self-analysis" privilege might be available in some cases.

Still other advisers seem willing to waive privileges and make their compliance reviews available to the SEC upon inspection, but are nonetheless concerned about the review getting into the hands of competitors, private plaintiffs or the media through other means, for example, through a request made to the SEC under FOIA (the Freedom of Information Act, the federal "open records" law). Concerned about relying on protections from disclosure under the federal securities laws or self-executing FOIA exceptions, these advisers are taking extra steps to request "confidential treatment" for any compliance reports or related materials that wind up in the SEC's records in the course of an inspection or otherwise. That way, if a FOIA request is made for those materials, at least the adviser will have the chance to argue why the materials (or portions of it) should not be disclosed on the basis of applicable exceptions under FOIA. Although it is not yet known how protected compliance reviews will be from FOIA disclosure, cautious advisers routinely take steps to request confidential treatment of sensitive materials provided to the Staff in an inspection. More information on seeking confidential treatment is available at the links listed under "Other Resources" at the end of this paper.

Lastly, wholly aside from the question of whether an adviser <u>can</u> shield a compliance review from disclosure using the attorney-client privilege or another available protection, there is a question of whether the adviser will <u>want</u> to assert those protections in any given case. More frequently in recent years, advisers and others have been waiving those types of protections either as a gesture of their "cooperation" with investigators or prosecutors (in the expectation or hope of getting less harsh treatment in return) or in order to fulfill a specific condition to settlement imposed by the SEC or another opposing party. Although the practice of pressuring targets to waive those protections in a federal investigation has attracted substantial criticism from the American Bar Association and other widely respected organizations, the practice of some regulatory agencies, including the SEC, has reportedly not substantially changed.

10. ***<u>What Should be Done if a Compliance Review Reveals a Weakness or Violation</u>?***

Advisers should be prepared in the event a compliance review reveals a weakness in their compliance controls or perhaps even reveals an actual compliance violation. At that point, a red flag is waving that an adviser must resolve with due speed. Because of the wide variety of problems that might be encountered, there is no uniform road map that should be followed in every case. However, whenever a weakness or violation is discovered, an adviser should formulate an action plan by considering all relevant issues, including the following:

- Should outside counsel be engaged to investigate specific issues or violations and provide legal advice, in an engagement intended to be protected by the attorney-client privilege?
- What can be done to enhance procedures and eliminate the discovered weakness?
- Has any client been harmed due to the weakness or violation and, if so, in what way, how much and for how long?

- What can be done to make any harmed client whole?
- Which personnel were involved in the situation and what were their role, responsibility and level of culpability?
- Should involved personnel be terminated, put on leave or reassigned pending resolution of the issue?
- What should the adviser's clients be told about the issue and when?
- Should the adviser "self-report" to the SEC or its primary regulators or otherwise contact authorities about the issue?
- Must or should the adviser or its clients disclose the matter publicly, in SEC filings or otherwise and, if so, when?
- Should the adviser's or client's fidelity bond carrier or E&O insurance carrier be notified of the problem, in order to preserve a possible claim under those policies? (Failure to notify a carrier of potential claims in a timely fashion may void otherwise available coverage.)
- Should the adviser engage the services of a public relations firm to assist with outside contacts and relations?
- Must or should a contingency be booked on the financial statements of the adviser and/or any affected clients?

Minor problems would typically be expected to engender a less full-scale response than larger or more serious problems. However, even minor problems should be viewed in context to see whether a pattern is developing that suggests a more serious problem may exist.

11. ***<u>Would a CCO Necessarily Be Personally Liable if a Compliance Violation Occurs on Their Watch</u>?***

Great concern has been expressed that simply by virtue of their position, CCOs could be held personally responsible for compliance violations committed by someone else in their organization on, for example, a "failure to supervise" or similar theory. For that theory to work, individuals within the organization would have to be viewed as under the CCO's "supervision" in some sense, at least as to compliance matters. Unfortunately, the SEC has raised the specter of exactly that, by defining a "supervisor" in past failure to supervise cases as <u>any person who</u> under the relevant facts and circumstances <u>has the requisite degree of responsibility, ability or authority to affect the conduct of the employee</u> whose behavior is at issue. See, e.g., *In the Matter of John H. Gutfreund, et al*., 51 S.E.C. 93, 113, Exchange Act Release No. 31554 (Dec. 3, 1992). That definition poses considerable concern when read alongside statements in the Adopting Release for the compliance rules, where the SEC says:

> "An adviser's [CCO] should be competent and knowledgeable…and… empowered with <u>full responsibility and authority to develop and enforce</u> appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of <u>sufficient seniority and authority within the organization to compel others to adhere</u> to the compliance policies and procedures." (Adopting Release No. IA-2204, at II.C.1., emphasis added)

Under the *Gutfreund* definition, then, would CCOs who have the requisite authority and influence that the Adopting Release says they should have be viewed as "supervising" individuals within the firm and therefore be potentially subject to a "failure to supervise" claim as a result of compliance violations committed in the firm?

Despite *Gutfreund*, the SEC Staff has said that the answer to that question is no. The Adopting Release says that the CCO designation does not <u>in and of itself</u> carry supervisory responsibilities and that, therefore, a CCO would not necessarily be subject to a sanction for failure to supervise other firm personnel. In public remarks, the SEC Staff has reiterated this view, calling it a "myth" that every CCO has accountability for all violations. (Bob Plaze, Associate Director of the SEC's Division of Investment Management at the CCOutreach National Seminar in Washington, DC, November 8, 2005.) Rather, according to the Staff, the cases where CCOs have been pursued by the SEC for compliance failures are where either:

- the CCO has some other role in the organization in addition to being CCO, and it is in that other role where the individual has gotten into trouble, or
- the CCO is held accountable for participating in, facilitating or covering up a fraud or compliance failure -- in other words, for being personally involved in the violation in some way.

Certain SEC cases seem to bear this out. For example, in In the Matter of CapitalWorks Investment Partners, LLC and Mark J. Correnti, Investment Advisers Act of 1940 Release No. 2520 (June 6, 2006) (settled), the SEC found that the adviser willfully violated the compliance rule by failing to adopt any procedures that could have prevented false statements from appearing in the adviser's RFP responses, which statements served as the basis for separately alleged fraud violations. In that case, the SEC also pursued personally the firm's head of compliance -- who had a dual role as the adviser's head of marketing -- asserting that he had willfully aided and abetted the firm's violations.

Another case tending to bear this out is SEC v. The Nutmeg Group LLC, Randall Goulding and David Goulding, et al., USDC ED IL (Case No. 09CV1775) (filed March 23, 2009), in which the SEC charged an adviser along with several officers personally, including the CCO, for various violations stemming from a scheme they allegedly conducted, in which they misappropriated client assets, made misrepresentations to clients, failed to comply with custodial obligations and violated books and records requirements.

Note, however, that CCOs can and have been held personally liable for an adviser's failure under Rule 206(4)-7 to merely establish and implement a compliance program reasonably designed to prevent violations, even in the absence of actual violations resulting from that failure. See, for example, In the Matter of Consulting Services Group, LLC, and Joe D. Meals, Release Nos. IA-2669 and 34-56612 (October 4, 2007) (settled), which sends the message that the CCO bears some measure of personal responsibility for ensuring that the adviser's compliance program meets the Rule 206(4)-7 standards, wholly aside from whether the program actually prevents violations in practice. See also In the Matter of Wunderlich Securities, Inc., Tracy L. Wiswall, and Gary K. Wunderlich, Jr., Investment Advisers Act Release No. 3211 (May 27, 2011) (settled), which included 206(4)-7 aiding and abetting claims brought against the CCO of an advisory business (among others) who allegedly failed to adopt adequate policies and procedures, failed to adopt and distribute an adequate Code of Ethics and failed to implement recommendations of a compliance consultant that had pointed out various requirements and made various recommendations for improvement.

Despite the SEC Staff's statements about failure to supervise, the industry was roiled over claims brought against Ted Urban, a General Counsel and executive officer of a broker-dealer firm for failure to reasonably supervise a rogue broker. It was unclear why Urban's actions in that case would – or should – have caused him to be viewed as the broker's "supervisor," as he was by an administrative law judge in 2010 even though the judge also found that Urban acted "reasonably" in his role as supervisor. (In the Matter of Theodore W. Urban, Initial Decision Release No. 402 (September 8, 2010).) On appeal, the Commission ordered the case dismissed without resolving whether Urban was a supervisor, or whether he acted "reasonably" in that case, leaving great uncertainty surrounding the law in this area. (Order Dismissing Proceeding, Investment Advisers Act of 1940 Release No. 3366 (January 26, 2012).) See also In the Matter of Charles L. Rizzo and Gina M. Hornbogen, Investment Advisers Act Release No. 3321 (November 28, 2011), in which a 37-year-old non-principal CCO is alleged to have had “supervisory responsibility” over the 51-year-old co-founder and principal of the firm whose misappropriation is at the heart of the case.

There are sound reasons why CCOs should not be “automatically” liable – under any theory -- simply because a compliance violation has occurred somewhere in the organization. Without doubt, the CCO would be among those who come under scrutiny in the wake of a violation when tough questions are being asked about how and why the violation occurred. But saddling CCOs with strict liability for violations would be counterproductive to recruiting good, qualified individuals to serve as CCOs and thereby weaken the overall regulatory aim of protecting clients. In short, CCOs should not risk liability for violations in which they were not personally involved and which were committed by a person for which they do not clearly bear responsibility. Instead, individuals should be encouraged to step up and step in to rectify problems in their firms without the fear that doing so would cause them to become a “supervisor” and potentially liable for others’ failures.

Of course, a compliance violation by itself is not evidence that the CCO failed to meet a regulatory responsibility. Human frailty being what it is, slip-ups will occasionally occur in any organization, including one with a reasonably designed, implemented and administered compliance program. The SEC Staff has even acknowledged that in compliance “everyone hits bumps in the road” and that the compliance rules call for “reasonable” policies and procedures, not “perfect” policies and procedures. (Lori Richards, Director of the SEC’s Office of Compliance Inspections and Examinations, Remarks Before the National Society of Compliance Professionals National Membership Meeting, Washington, DC, October 25, 2005.) Moreover, all too often violations are committed by individuals bent on working the system to their advantage no matter what, who may do everything possible to hide their wrongdoing. CCOs diligently fulfilling their responsibilities would become nothing more than insurers if held responsible for violations in those cases.

At least one SEC Commissioner seems to agree with this general sentiment and has made public remarks about the SEC’s approach to “failure to supervise” in the wake of the Urban case discussed above. Commenting on the ‘disturbingly murky’ question of when compliance and legal personnel may be deemed to be supervisors and therefore potentially liable for failure to supervise, he noted that robust participation by legal and compliance in resolving issues is in everyone’s interest, although the more robust the participation, the greater the risk that ‘supervisory’ status will be found. He noted: “We must strive to ensure, however, that the fear of failure-to-supervise liability never deters legal and compliance personnel from carrying out their own critical responsibilities. Such a result could only be described as perverse.” (Remarks of SEC Commissioner Daniel M. Gallagher at “The SEC Speaks in 2012” (February 24, 2012).) It remains to be seen how this will bear out in future SEC enforcement actions.

Regardless, even an adviser CCO who does have supervisory responsibilities over other individuals in their firm may have an affirmative defense to a “failure to supervise” claim stemming from a violation committed by someone under their supervision, so long as the adviser had an adequate compliance program in place. This is because Section 203(e)(6) of the Advisers Act says that a person will not be deemed to have failed to reasonably supervise another person if:

- procedures were established that would reasonably be expected to prevent and detect, insofar as practicable, any such violation by the other person;
- a system was in place for applying the procedures; and

- the supervising person had reasonably discharged their supervisory responsibilities in accordance with the procedures and had no reasonable cause to believe the procedures and system were not being complied with.

12. ***What Documentation Should be Maintained of a Compliance Program Review?***

As previously mentioned, adviser CCOs are not required by SEC rules to produce a written report memorializing their compliance review, in contrast to fund CCOs who must prepare a written report for the fund board. Nonetheless, the SEC Staff expects advisers to document the compliance review and can be expected to request that documentation in an examination. Fortunately, the vast majority of advisers seem to understand this point. According to an industry survey, only 3.1% of the responding advisers indicated that they did not document their annual review. Among the ways that surveyed advisers documented their annual review were:

- a lengthy written report (45.6%)
- a short memorandum (37.4%)
- informal notes (summarizing tests) (30.4%)
- workpapers (evidencing tests) (48.7%) and/or
- other (13.9%).

(See the 2007 Investment Management Compliance Testing Survey referenced under “Other Resources” at the end of this paper. Note that more than one response could be checked.)

Prudence would suggest that advisers create written documentation to memorialize, at a minimum:

- what period was covered by the review,
- what steps were taken in the process,
- who undertook those steps,
- what was found generally in each of the various areas or operations reviewed, for example, whether issues or problems were found and the general nature of those matters,
- what follow-up was taken thereafter on specific items found or changes recommended.

Some have described the review process as “iterative” or “cyclical,” meaning that by following the documentation, one can understand what reviews were done, what was found, and what was done in response, period after period, over and over in an iterative or cyclical way.

Documentation might take many different forms, including:

- copies or lists of the specific policies and procedures that were reviewed (the adviser’s Compliance Manual would be a logical place to start);
- documents reflecting the risk assessment or inventory of risks considered or updated in the course of the review (the SEC is likely to ask for this specifically when they come to inspect);
- data, surveys, analyses or other information gathered to assess the adviser’s policies and procedures (these might be materials commissioned by the adviser or publicly available information gathered by or for the adviser);
- results of compliance testing and monitoring conducted during the course of the year (good recordkeeping to keep track of prior testing will be helpful here);
- results of additional transactional or forensic testing conducted in the course of the review (now is the time to catch up in any area when testing or monitoring remains to be completed);

- notes from or summaries of interviews conducted with employees or others in the course of the review (interviews with personnel using a "show me" line of questioning can be a valuable source of information on how the firm's policies and procedures are actually being implemented in practice; similarly, interviews using a "what would you do if" line of questioning may help to identify personnel who may not completely understand what their compliance responsibilities are and where additional training would be beneficial);
- copies or summaries of reports from auditors, consultants, service providers or others that may be used as part of the review (audit reports from accountants, SSAE 16 reports, legal compliance review reports, etc.);
- copies of compliance attestations or certifications that were gathered and relied on as part of the review (from service providers, sub-advisers or the adviser's own personnel);
- summaries or copies of regulatory updates or developments that were considered in conjunction with the annual review (SEC enforcement cases, legal or compliance newsletters or articles, etc.);
- compliance summaries or reports prepared for the adviser's management or others at the conclusion of the review (this might include a more formal written report the adviser's CCO would produce for management).

As previously noted, under the SEC's adviser books and records rules, any records that are created to document the adviser's compliance program review must be maintained and preserved in an easily accessible place for not less than 5 years from the end of the fiscal year during which the last entry was made on the record. During the first 2 years, the record must be maintained in an appropriate office of the adviser.

Adequate documentation is a prudent course in today's environment where some regulators take the view that "if it isn't in writing, it didn't happen." At the same time, there will be an unavoidable tension inherent in creating documentation that is sufficient to meet regulatory expectations but which nonetheless avoids creating a "roadmap" for subsequent claims or litigation. As a result, documentation should be prepared with appropriate care understanding that it might well become subject to SEC inspection and/or public disclosure in connection with a lawsuit or otherwise. Of course, any documentation intended to be protected by the attorney-client privilege, work product doctrine or confidential treatment rules should be conspicuously marked as such and appropriately limited in distribution.

* * *

Other Resources:

Compliance Programs of Investment Companies and Investment Advisers (the compliance rule "Adopting Release"), SEC Release Nos. IC-26299, IA-2204 (December 17, 2003): http://www.sec.gov/rules/final/ia-2204.htm

Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedures, Investment Company Institute whitepaper (December 2005): http://www.ici.org/pdf/rpt_05_comp.pdf

Remarks of Gene Gohlke (OCIE) and Bob Plaze (Division of Investment Management) at the CCOutreach National Seminar for CCOs (November 8, 2005), concerning CCO accountability for compliance violations (archived webcast): http://www.connectlive.com/events/ccoutreach/

Remarks of Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, Before the National Society of Compliance Professionals National Membership Meeting (October 25, 2005): http://www.sec.gov/news/speech/spch102605lr.htm

Risk Assessment Guide, Questionnaire and Identification Chart, prepared by the Investment Adviser Association:
http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PubDoc-RiskAssesment

Securities and Exchange Commission Confidential Treatment Procedure Under Rule 83 (17 CFR 200.83) at http://www.sec.gov/foia/conftreat.htm, concerning seeking confidential treatment under FOIA.

ComplianceAlert Letters, Risk Alerts and other guidance from the SEC Staff of the OCIE National Exam Program to all Adviser/Fund CCOs, at http://www.sec.gov/about/offices/ocie.shtml

SEC Compliance Outreach program and materials (advisers and funds):
http://www.sec.gov/info/complianceoutreach_ia-funds.htm

Investment Management Compliance Testing Survey, Summary Reports (2007 and later), prepared by ACA Compliance Group, Investment Adviser Association, IM Insight and Old Mutual (US) Holdings Inc.:
http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB

Speech by SEC Staff: Strengthening Examination Oversight: Changes to Regulatory Examinations, by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, at the SIFMA Compliance and Legal Division St. Louis Regional Seminar, The New World of Compliance and Legal (June 17, 2009):
http://www.sec.gov/news/speech/2009/spch061709lar.htm

Speech by SEC Staff: The Role of Compliance and Ethics in Risk Management by Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, NSCP National Meeting (October 17, 2011): http://www.sec.gov/news/speech/2011/spch101711cvd.htm

APPENDIX A
METHODS FOR TESTING AND MONITORING ADVISER COMPLIANCE

Caveat: *Following is a list of methods that an investment adviser might use to monitor or test for compliance in various operational areas. The list does not constitute a comprehensive or complete adviser compliance program or compliance review, nor does it include every method available to monitor or test in the operational areas noted. Moreover, some of the methods listed may not apply to or be appropriate for some advisers since advisers and their businesses vary significantly from firm to firm. Therefore, the list should not be used as a checklist, but rather only as a resource or discussion tool to provide ideas for possible testing methods.*

Note that this list includes methods for testing or monitoring compliance, not steps for "doing" compliance. In other words, it is not a list of compliance procedures but rather a list of methods that might be used to test whether procedures already in place at an advisory firm are adequate and effective to achieve compliance.

In most cases, this list does not attempt to address the question of when or how frequently these tests should be run. Those questions must be answered by each adviser based on its own compliance program and needs. Note also that these tests are often undertaken by using spot checking or statistical sampling techniques rather than attempting to test every single case.

Portfolio Management

--Review holdings in client accounts at key points in time, to make sure they reflect securities and techniques consistent with applicable restrictions, investment guidelines, client mandates, etc.

--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, other favoritism among clients or accounts or errors. Accounts with performance two or more standard deviations away from the mean performance of all accounts managed under the same style 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, to make sure all securities in relevant portfolios are within applicable restrictions, investment guidelines, client mandates, etc.

--Review all exceptions generated by firm's trade management/compliance software (which monitors trades proposed in relevant accounts relative to account restrictions), to make sure any impermissible securities, concentration, techniques or positions were avoided or corrected.

--Monitor manual overrides of automated trade management restrictions to make sure circumstances were appropriate to permit an override.

--Calculate various risk metrics (e.g., alpha, beta, various volatility measures) on client accounts for relevant periods and compare them to known benchmarks, to make sure they are consistent with client mandates and suitability issues.

--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 (looking at financial condition, reputation, ratings, etc.) 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, to make sure they are consistent with investment guidelines, client mandates, risk disclosures, etc., and that portfolio manager is not engaged in “window dressing.”

--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, to see 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 relevant accounts, for evidence of market timing (if a mutual fund) or suspicious or unexplained activity (e.g., anti-money laundering issues).

--Surveil communications of personnel with access to portfolio information (e.g., postal mail, email and/or recorded phone conversations) to make sure (among other things) that client instructions are being carried out accurately and timely.

--Analyze the performance of accounts that consistently beat their benchmarks over time to find out what the performance is attributable to, to make sure that it is attributable to securities, transactions and techniques that are appropriately disclosed and are within the investment guidelines for those accounts.

--Review account performance changes from period to period to detect anomalies or errors.

--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, what would you do if an employee at a client asked you to facilitate an unusual trade in the client’s account, etc.?

--Compare the performance of client accounts with the performance of employees' personal accounts to see if there are questionable discrepancies.

--Review trading to make sure no securities were 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 the same security), to 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, ATSs, ECNs, dark pools, etc.) client trades are being directed to for execution and the commission dollars and commission rates being paid to each, to see whether there are 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, to make sure variations are explained by appropriate differences and are not due to failure to seek best execution or other fiduciary issues.

--Compare any patterns of brokerage placement against logs or reports of gifts/entertainment received from those brokers.

--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, to see whether there are inappropriate or undisclosed commission or other trade arrangements in exchange for client referrals.

--Compare actual commission rates to approved or contractual rates, paying particular attention to any commission overrides or rate increases.

--Compare commission rates on trades executed through any affiliated broker-dealer with commission rates on trades executed through non-affiliated brokers.

--Obtain a post-trade report from outside consultants analyzing adviser's trade quality and execution costs, to help monitor best execution.

--Compare execution price of each equity trade against the NBBO (national best bid and offer) for that security, to help monitor trade quality.

--Compare adviser's equity trading costs against peer group costs using VWAP (volume weighted average price) as a benchmark, to help monitor best execution.

--Check documentation supporting any contemporaneous dealer quotations available for fixed-income securities (3 or more where available), to help monitor best execution for those trades.

--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 similar MSRB 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 all trading errors that occurred over a period of time, to see if they reveal a pattern suggesting an underlying problem needs to be addressed or that procedures need to be changed, etc.

--Check records supporting trading error corrections or adjustments, to make sure they are consistent with firm’s procedures on trade error correction and applicable SEC guidance.

--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.

--Inspect adviser (or fund) cash journals for any non-recurring or special payments to or from broker-dealers, which among other things may indicate cash adjustments for trading errors.

--Review trading activity and portfolio turnover in client accounts in the period immediately leading up to a reporting period end (for example, quarter end), to see if the portfolio manager is engaged in window dressing or portfolio pumping or is inappropriately attempting to fulfill soft dollar commitments.

--Review trading activity, turnover and break-even rates in client accounts by account and portfolio manager, for any inconsistencies with account objectives/restrictions and any unusual increases, which may be evidence of improper churning 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).

--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.

--Review cross-trades and agency cross-trades made between client accounts conducted over a specified period, to 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, that prices received were reasonable in relation to available market prices, etc. Make sure documentation supporting rationale for cross-trades is maintained.

--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 client files for clients with directed brokerage arrangements to 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) and that signed instructions from client appear in file.

--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 placement reports on client-directed accounts to make sure client's instructions on target percentage of trades to be placed with the directed broker were met.

--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.

--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.

<u>Soft Dollars</u>

--Check soft dollar arrangements, to make sure that they have been approved (evidenced by initials or approval memo) by 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.
> --Make sure that firm's soft dollar policies and procedures were followed.

--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 all going to arrangements that appear on a "master" approved soft dollar arrangements list.

--Compare soft dollar research and execution budgets (targets) against actual broker-dealer allocations.

--Check soft dollar statements received from participating soft dollar brokers against firm's records, to make sure that they agree.

--Check firm's records on soft dollar/hard dollar "mixed use" allocations, to make sure they are being maintained properly and that allocations appear justified, accurate and consistent.

--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/funds, or other related parties, to make sure this is consistent with information in adviser's own records, disclosure and policies.

--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 soft dollar broker quality of execution against quantity of brokerage allocation to that broker.

--Review soft dollar placements in the period immediately leading up to a reporting period end (for example, quarter end), to see if the portfolio manager is inappropriately attempting to fulfill soft dollar commitments.

--Review soft dollar products and services for reasonableness of cost and value to firm.

--Review the total amount of soft dollar commissions against total commissions generated.

Proprietary and Personal Trading / Code of Ethics

--Review list of firm access persons, to make sure that it is 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 all initial, quarterly and annual transactions reports (or duplicate statements and confirms) received from access persons, to make sure they are all received in a timely fashion and do not reveal any improper trading activity (including compliance with all Code of Ethics requirements, such as black-out periods, short-swing transaction restrictions, IPO and limited offering pre-approvals, no trading in securities while on "restricted list" or "watch list," etc.).

--Monitor reports received from covered personnel quarterly and annually as to their accounts and securities holdings, to make sure all reports are received in a timely fashion and that any accounts in which they have an interest are treated as "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 accounts statements and confirms to ensure that they traded 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 (front running, improper principal trading, etc.).

--Review employee trades to see whether any securities, trades or 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.

--Look at the gifts/entertainment log over time, to see if a particular person or firm has been the sender or recipient of an unusual number of gifts from any advisory firm personnel.

--Review employee expense reports to identify any unusual expenditures or patterns involving gifts or entertainment.

--Send an anonymous gift to a firm employee to see whether the gift is declined or reported consistent with firm policies and procedures.

--Obtain from the adviser's most commonly used broker-dealers a log of any gifts the broker-dealer or its personnel have received from the adviser or its personnel, to make sure that gift giving is being done and reported consistent with firm's policies and procedures.

--Check gift and entertainment records of key clients against those of the firm to make sure they are consistent and in accordance with applicable rules and 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 received and are signed.

--Check any waivers or exceptions permitted 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.

--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.

<u>Insider Trading</u>

--Track trading patterns in client accounts and employee's personal accounts around news stories, to see if any suspicious patterns suggest access to 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 employee communications with (emails, phone calls, IMs) key clients and contacts who are more likely to be privy to inside information, such as broker-dealers, investment bankers, research analysts, consultants, lobbyists, other investment advisers, insiders at public companies, etc.

--Surveil employee communications with parties involved in known insider trading cases.

--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.

--Institute and monitor “fire walls” (information barriers) to ensure that advisory personnel do not get access to material, non-public information that may exist elsewhere in the firm.

--Maintain and monitor an inventory of potential sources for material, non-public information coming to firm or its personnel.

--Require pre-clearance of any personnel contact with “expert networks” or contacts made through expert networks. Monitor, record or chaperone expert network communications.

Safeguarding Client Assets / Asset Verification / 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.

--Review names and addresses on duplicate client account statements and confirms received from custodian, to 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) SSAE 16 (formerly 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 (or include certification of same in annual questionnaire) 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, in accordance with applicable rules and firm’s own policies and procedures.

--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.

--Use a sample SEC examination request list to periodically request retrieval of listed documents to verify that they exist and can be retrieved in an appropriate format.

--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 2 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.

--Do a “deep dive” into the records backing performance track record to make sure all records to support the calculations are being maintained for required periods.

--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.

--Check key records – such as trade tickets – to make sure they contain all required information (such as that called for by Rule 204-2(a)(3)).

--Check to ensure that documents slated for destruction are being destroyed in a timely way, in accordance with applicable rules and the firm’s own policies and procedures.

--Conduct similar testing on any records maintenance system maintained by a third-party vendor for the adviser.

<u>Privacy / Data Security / ID Theft</u>

--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) to 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.

--Monitor client accounts for "red flags" indicating risk of ID theft or other inappropriate or illegal activity, as spelled out in the Adopting Release for the ID Theft "Red Flags" Rules, including:

> --Alerts, Notifications or Warnings from a Consumer Reporting Agency
> --Suspicious Documents
> --Suspicious Personal Identifying Information
> --Unusual Use of, or Suspicious Activity Related to, the Covered Account
> --Notice from Customers, Victims of Identity Theft, Law Enforcement Authorities, or Other Persons Regarding Possible Identity Theft in Connection With Covered Accounts Held by the Adviser

<u>Marketing / Advertising</u>

--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.).

--Confirm that any use of related performance information of the firm or its personnel (performance earned by predecessor or at another firm or earned by other individuals) conforms to SEC regulatory requirements.

--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.

--Have second individual within the firm, other than the preparer of performance, review the accuracy of the performance figures.

--Hire a third-party firm to prepare or review the firm's performance calculations.

--Check marketing materials and advertisements for any express or implied claims of compliance with GIPS (Global Investment Performance Standards).

--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.

--Surveil social networks and any prohibited channels of communication for inappropriate communications, solicitations or advertising by firm employees, solicitors or others.

--Require personnel to pre-clear any social network or electronic systems use to conduct firm business and to report similar personal use so surveillance can be conducted.

--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.

--Check that "accredited investor" standard has been met by every investor in a Rule 506 private fund offering where general solicitation or general advertising has been used and that adequate documentation indicating reasonable verification has been gathered and maintained.

--Confirm that performance presentations are presented net of fees unless in one-on-one presentations in conformity with applicable SEC guidance.

--Review composites and composite performance for:

--inclusion of all required, similarly managed, fee paying, discretionary accounts;--inclusion/exclusion of new/terminated accounts in compliance with guidance and policies and procedures;

--account holdings within composite to make sure they are appropriate for that composite, including sector and security concentrations and minimum asset levels;

--compliance with GIPS requirements (if GIPS compliance claimed).

<u>Solicitors and "Pay-to-Play"</u>

--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, (iii) they are not disqualified from continuing to act as a solicitor, and (iv) they are properly registered, if required.

--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.

--Require pre-clearance of all political contributions by firm, firm personnel (and related persons, such as spouses) and solicitors acting on behalf of firm to monitor for compliance with "pay-to-play" rules.

--Monitor publicly available databases for unauthorized political contributions.

--Obtain periodic certifications from firm personnel and solicitors that all political contributions have been reported/pre-cleared as required.

--Monitor expense reports from relevant personnel for potential “pay-to-play” or similar concerns.

--Get certifications from government clients that no officials received contributions from firm solicitors or placement agents.

--Get list of political contributions from prospective new hires to ensure no “pay-to-play” issues upon hiring.

--Look for patterns between political contributions or gifts/entertainment and government or related entities from which firm wins business.

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.) to 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 to 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 to 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 eligibility criteria 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.

--Check expenses billed to clients to make sure they are appropriately and correctly allocated between the adviser and clients and among clients.

--Check fee rates charged to relevant clients to ensure that any "most favored nations" provision in a new client contract are adhered to from inception and periodically throughout the duration of the relationship.

--Require that client bills be signed off on by more than one individual in the firm.

--Segregate employees who are responsible for creating and processing invoices with those responsible for reconciling invoices with deposits of advisory fees by custodians into the adviser's proprietary bank account.

Regulatory Filings, Deliveries and Related 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 2 was delivered to each client at the inception of relationship and at least annually (if material changes) and that any requests for Part 2 were fulfilled in a timely fashion.

--Check client files to make sure any ADV Part 2B Brochure Supplements (disclosures about relevant "supervised persons") were delivered to each client at the appropriate time.

--Check personnel records of adviser employees 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.

--Perform background check on key personnel for items required to be disclosed or otherwise causing concern.

--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 2 of Form ADV to make sure they are complete and consistent.

--Check disclosures in Part 1 and Part 2 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 EDGAR database to make sure that any Form 13H required from adviser was filed in a timely fashion. If adviser trades securities but does not yet exceed the 13H reporting thresholds, check the adviser's trading volumes 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.

--Check that supporting documentation is being maintained of AUM calculation that varies from RAUM calculation in Form ADV.

--Check that supporting documentation is being maintained of any disciplinary disclosures adviser treats as "immaterial" and therefore does not disclose on Form ADV as otherwise required.

--Maintain and periodically review list of Exemptive Orders, undertakings, no-action letters and other regulatory items applicable to adviser to make sure that relevant terms and conditions are being met.

<u>Conflicts of Interest</u>

--Obtain questionnaires/certifications from employees, affiliates and relevant third parties to identify potential conflicts of interest.

--Interview employees, affiliates and relevant third parties for same.

--Track firm revenue streams and look for a financial interest in the outcome (“follow the money”) to help identify conflicts.

--Track financial incentives of firm and employees to help identify conflicts.

--Track firm and personal trading to monitor for conflicts.

--Track brokerage placement and soft dollars to monitor for conflicts.

--Track gifts and entertainment to monitor for conflicts. Review reports on gifts and entertainment from counterparties to make sure they reconcile with the firm’s records.

--Check investments made in affiliated funds and products for initial and on-going suitability.

--Monitor any payments or other consideration provided for referrals to monitor for conflicts.

--Track employees’ outside business activities, financial interests and sources of compensation for potential conflicts.

--Monitor allocation of investment opportunities to conflicted accounts (personal, proprietary, higher fee rate, performance fee) versus other accounts to ensure fair treatment.

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 to 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, are being maintained for required time periods and are being kept confidential as required.

--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

--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, SSAE 16 (formerly SAS-70) 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 SSAE 16 reports (formerly SAS-70) 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.