

## SPOTLIGHT ON

### Annual Compliance Reviews for Investment Advisers

*The contents of this Spotlight have been prepared for informational purposes only and should not be construed as legal or compliance advice.*

#### **Annual Review Requirement in the Investment Advisers Act**

Rule 206(4)-7 of the Investment Advisers Act of 1940 requires that investment advisers registered with the US Securities and Exchange Commission (“SEC” or “Commission”) meet the following requirements in order to provide investment advice:

- *Policies and Procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violations, by the firm and its supervised persons, of the Act and the rules that the Commission has adopted under the Act;
- **Annual Review. Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation;** and
- *Chief Compliance Officer.* Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under the first requirement above.<sup>1</sup>

Thus, in order to comply with Rule 206(4)-7, an investment adviser’s annual review is as important as having written policies and procedures and having a designated CCO. Firms must at least annually review their policies and procedures for adequacy and effectiveness in complying with applicable laws and regulations. Reviews should also look at the previous year to address any compliance problems that occurred, any substantive changes to the business model or activities, and any changes in laws or regulations that may affect the adviser’s business or compliance program. The SEC has provided an example of how an adviser that becomes affiliated with a broker-dealer within the previous year should review its compliance program to determine if there are adequate policies to address the potential conflict of interest.<sup>2</sup> The SEC has also provided that, although the rule only requires annual reviews, many registered investment advisers may want to conduct reviews more frequently to address significant compliance events. Additionally, many state-registered advisers are not required to comply with the annual review, but it is considered best practice to conduct the review, whether it is legally required or not.<sup>3</sup>

#### **Critical Areas of Review**

---

<sup>1</sup> *Guidance on Rule 206(4)-7 under the Investment Adviser Act*, Compliance Outsourcing Solutions, 1 (2011).

<sup>2</sup> *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, US Securities and Exchange Commission (2003), [https://www.sec.gov/rules/final/ia-2204.htm#P171\\_59189](https://www.sec.gov/rules/final/ia-2204.htm#P171_59189) (last visited September 24, 2020).

<sup>3</sup> *Annual Reviews: Suggestions for Compliance Best Practices*, Core Compliance & Legal Services, Inc. (2019), <https://www.corecls.com/blog/annual-reviews-suggestions-for-compliance-best-practices> (last visited September 24, 2020).

The SEC has outlined the “critical areas” of review, or the minimum areas of review, for investment advisers in their review process. The ten (10) areas of review are:

1. Portfolio management;
2. Trading practices;
3. Proprietary trading of the adviser and personal trading by employees;
4. Disclosures to clients;
5. Custody and safeguarding of client assets;
6. Accuracy and maintenance of books and records;
7. Marketing and solicitors;
8. Valuation and fees;
9. Client privacy protection; and
10. Business continuity.<sup>4</sup>

Advisers should focus their attention during the review on those areas most relevant to their actual business practices, but the above points should explicitly be addressed. Of course, this list is not exhaustive and specific issues can be more or less important from one firm to the next.

It is advisable for investment advisers to conduct risk assessments to identify areas that require more focus during their reviews, whether those be standard risks or new ones. In these risk assessments, advisers should keep track of the area evaluated, the specific policies associated, the potential risks, the severity of the risks, and any necessary action items. Identifying risks is crucial to successfully complete the annual review.<sup>5</sup>

To ensure that advisers comply with their annual review obligations, SEC examiners will review the firm’s policies about and documentation of its annual reviews. Specifically, the SEC is interested in who conducted the review, what was reviewed, the findings, any recommendations stemming from the review, how the review documented, and senior management’s involvement. These questions are about the procedures for conducting the annual review, which is important to consider in addition to the actual policies being reviewed.<sup>6</sup>

### **Suggestions for Conducting the Annual Review**

To be as comprehensive as possible, annual reviews should address the adequacy of every policy and procedure of the investment adviser. This review of each individual policy should make sure that the policies and procedures accurately reflect the business operations, potential weaknesses

---

<sup>4</sup> *Guidance on Rule 206(4)-7 under the Investment Adviser Act*, Compliance Outsourcing Solutions, 1 (2011).

<sup>5</sup> Kris Gruben, *The Importance of An Adviser’s Annual Review*, Marcum LLP (2013), <https://www.marcumllp.com/insights/the-importance-of-an-adviser-39-s-annual-review> (last visited September 24, 2020).

<sup>6</sup> Gene Gohlke, *Examiner Oversight of “Annual” Reviews Conducted by Advisers and Funds*, US Securities and Exchange Commission (2006), [https://www.sec.gov/info/cco/ann\\_review\\_oversight.htm](https://www.sec.gov/info/cco/ann_review_oversight.htm) (last visited September 24, 2020).

in the given policy or procedure, and any events recorded during the year that are related to the given policy or procedure. Once the policies and procedures are reviewed individually, the annual review should focus on testing, specifically the three forms of compliance testing that the SEC advocates:

1. *Transactional testing.* This type of testing should be occurring throughout the year around the time an activity happens. For example, a transaction test may occur when an employee submits personal trading reports, and those reports are evaluated according to the firm's personal trading policy to ensure compliance.
2. *Periodic testing.* This type of testing occurs at certain intervals throughout the year, as opposed to an individual transaction or an overall yearly basis. Reviewing broker-dealer commissions and soft-dollar benefits on a quarterly basis to ensure a conflict of interest is not being exploited is an example of a periodic test.<sup>7</sup>
3. *Forensic testing.* These tests occur over longer periods of time to detect any emerging patterns that might reveal a violation of firm policies or federal securities laws. While forensic tests mainly draw suspicion to an area or a policy, the trends detected may help predict future violations. A forensic test may, for example, be created to track portfolio performance for separate portfolios to detect if the adviser gives preference to a certain portfolio that would violate fiduciary duty.<sup>8</sup>

The review of the individual policies and the compliance testing constitute a good basis for identifying and understanding which policies need to be evaluated and adjusted. While the granular-level analysis is useful in sorting out the annual review details, advisers should also pay attention to the compliance program as a whole. The annual review may accurately and effectively detect and compile the firm's risks but is also important to understand how effective the compliance program was at identifying and addressing compliance issues throughout the year.<sup>9</sup>

### **Suggestions for Documenting the Annual Review**

Rule 206(4)-7 requires an annual review of the SEC registered investment advisers but provides little guidance on how the results of the review should be documented. The documentation is not sent to the regulators, and no specific documentation is required for an adviser's books and records.<sup>10</sup> It would, however, be generally best practice to summarize the annual review in

---

<sup>7</sup> Kris Gruben, *The Importance of An Adviser's Annual Review*, Marcum LLP (2013), <https://www.marcumllp.com/insights/the-importance-of-an-adviser-39-s-annual-review> (last visited September 24, 2020)

<sup>8</sup> *Guidance on Rule 206(4)-7 under the Investment Adviser Act*, Compliance Outsourcing Solutions, 2 (2011)

<sup>9</sup> *Ibid.*, 3.

<sup>10</sup> Bryan Hill, *Conducting an Annual Review of a Registered Investment Adviser*, RIA Compliance Consultants, Inc. (2012), <https://www.ria-compliance-consultants.com/2012/11/conducting-an-annual-review-of-a-registered-investment-adviser/> (last visited September 24, 2020)

writing and potentially a spreadsheet laying out the specific tests used. The Office of Compliance Inspections and Examinations of the SEC has recommended that Chief Compliance Officers record each policy and procedure reviewed, a summary of the findings for each policy and procedure, a summary of any violations for each policy and procedure, conclusions regarding the effectiveness of any policy or procedure, and any changes made any policy or procedure during the review. Additionally, the findings should be communicated to the rest of the senior management. This communication allows management to actively address any compliance issues that they come across and to set a tone of compliance from the top down. In addition to summarizing the compliance program during the last year, advisers may want to convey some compliance strategies for the firm and any potential changes they predict to occur in the compliance program going forward.<sup>11</sup>

### SEC Enforcement Actions

The SEC has charged multiple investment advisers with violations of Rule 206(4)-7, specifically citing annual review violations in many cases.

Most recently, in September 2018, the SEC settled with the New York-based advisory firm Hudson Housing Capital LLC (“HHC”) on charges that the adviser failed to conduct annual reviews of its compliance policies and procedures and to comply with the custody rule. In this case, the adviser adopted a set of policies and procedures when it registered with the SEC in 2012.<sup>12</sup> The SEC investigation found that, after adopting its policies and procedures, the adviser had not met its annual review obligations from 2012 through 2017 by not conducting the annual reviews at all. Then, in 2018, HHC performed a review of the compliance policies and procedures with the assistance of outside counsel and consultants, which led to revisions directed towards the custody rule and changes in the business model. The adviser was required to pay a civil money penalty to cover their violations of both Rule 206(4)-2 (the Custody Rule) and Rule 206(4)-7, although the amount attributable to each violation was not disclosed.<sup>13</sup> One important fact to note from this enforcement action is that scienter was not required and that negligence on behalf of the firm or Chief Compliance Officer was sufficient to bring charges.<sup>14</sup>

In other cases, the SEC has brought charges against investment advisory firms that conducted annual reviews that were found to be inadequate to satisfy Rule 206(4)-7. For example, the adviser Feltl & Company, Inc. conducted what the SEC considered its first annual review in 2010, a few years after being registered. In the annual review, the adviser discovered the need to revise

---

<sup>11</sup> John Gentile, *Roadmap to Conducting Annual Compliance Reviews*, Compliance Solutions Strategies (2019), <https://www.compliancesolutionsstrategies.com/roadmap-to-conducting-annual-compliance-reviews/> (last visited September 24, 2020).

<sup>12</sup> *Investment Adviser Settles Charges for Custody Rule and Compliance Rule Violations*, US Securities and Exchange Commission (2018), <https://www.sec.gov/enforce/ia-5047-s> (last visited September 28, 2020).

<sup>13</sup> *Administrative Proceeding: Hudson Housing Capital LLC*, US Securities and Exchange Commission (2018), <https://www.sec.gov/litigation/admin/2018/ia-5047.pdf> (last visited September 28, 2020).

<sup>14</sup> Mary Hansent, James Lundy, and Kaitlin Klamann, *How to Manage the Risky Role of the Investment Adviser CCO in the 21<sup>st</sup> Century*, vol.24 *The Investment Lawyer*, 2 (2017).

many of the firm's compliance policies and procedures. The SEC noted that this adviser was using a checklist to conduct annual reviews prior to 2010 that did not look at specific business practices or individual compliance policies, which is why the SEC disregarded any review prior to 2010.<sup>15</sup> In another case, the investment advisory firm Asset Advisers, LLC was found to be conducting its annual review in some years and completely forgoing the annual review in other years. In 2009, a year in which the firm did conduct an annual review, the SEC found the review to be inadequate. SEC staff claimed that the review only summarized the firm's policies and procedures and listed the types of risk testing possible in a risk management matrix. This annual review was not tailored to firm-specific business risks or its compliance documents. There was no description of policies reviewed or changed, types of analysis performed or any findings from the review.<sup>16</sup> As proven by these charges brought by the SEC in the past, simply conducting an undetailed and nonspecific annual review does not meet the annual review requirements set forth by Rule 206(4)-7.

### **SEC Examination Expectations**

During an SEC examination, the examiners will focus on certain areas and ask specific questions in regard to the firm's annual review and compliance with Rule 206(4)-7. To determine if a firm has complied with its review obligations, the SEC examiners will collect information from documentation and from conversations with the personnel involved in the annual review. Given that the compliance rules do not provide detailed guidance on conducting annual reviews, the SEC will analyze a firm's policies and information based on how the annual review addresses the firm's specific business practices. Nonetheless, every annual review's goal is to assess if the firm's compliance program continues to reasonably and effectively prevent compliance issues.

While the examiners will take each firm's situation individually when determining its annual reviews' adequacy, the SEC has provided a set of baseline of questions that investment advisers should expect. The SEC will ask who conducted the review, what was reviewed when it was conducted, what findings and recommendations stemmed from the review, how the review documented, and the extent to which senior management was involved. The answers to these questions and the information provided are expected to vary greatly. In the end, the SEC will determine if the adviser's annual reviews result in the adviser having effective compliance policies and procedures, the ability to detect any compliance issue, and the framework to promptly address those issues.<sup>17</sup>

---

<sup>15</sup> *Administrative Proceeding: Felt & Company, Inc.*, US Securities and Exchange Commission (2011), <https://www.sec.gov/litigation/admin/2011/34-65838.pdf> (last visited September 28, 2020).

<sup>16</sup> *Administrative Proceeding: Asset Advisers, LLC*, US Securities and Exchange Commission (2011), <https://www.sec.gov/litigation/admin/2011/ia-3324.pdf> (last visited September 28, 2020).

<sup>17</sup> Gene Gohlke, *Examiner Oversight of "Annual" Reviews Conducted by Advisers and Funds*, US Securities and Exchange Commission (2006), [https://www.sec.gov/info/cco/ann\\_review\\_oversight.htm](https://www.sec.gov/info/cco/ann_review_oversight.htm) (last visited September 30, 2020).