

Administering Compliance and Annual Reviews - Outline

- I. Investment Advisers Act Rule 206(4)-7 compared with NASD Rule 3012 and FINRA Rule 3130
- II. Five Years of Compliance: Lessons Learned
 - a. Significant Compliance Events
 - b. Changes in Business Arrangements
 - c. Regulatory Developments

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Administering Compliance and Annual Reviews

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I. Differences and Similarities Between



Investment Advisers Act Compliance Rule 206(4)-7

and

NASD Rule 3012 - Supervisory Control System

**FINRA Rule 3130 - Annual Certification of
Compliance and Supervisory Processes**

Designation of Responsible Person

□ NASD Rule 3012

- Requires each member to designate a principal to establish, maintain, and enforce a system of supervisory control policies and procedures

FINRA Rule 3130

- Requires each member to designate a Chief Compliance Officer

□ Rule 206(4)-7

- Requires an investment adviser to designate a Chief Compliance Officer responsible for administering policies and procedures

Testing Requirements

NASD Rule 3012

- ❑ Each member must test and verify that the member's supervisory procedures are reasonably designed to achieve compliance with applicable rules and create additional procedures if warranted by such testing

Rule 206(4)-7

- ❑ Investment advisers must review, at least annually, the adequacy of the policies and procedures and the effectiveness of their implementation

Best Practices for Testing Compliance Procedures and Supervisory Control Procedures

1. Inventory the firm's businesses and the law, rules, and regulations relevant to those businesses
2. Analyze these activities for risk considering:
 - Major revenue areas
 - Any new products or changes in business
 - Changes in laws or rules that affect the firm
 - Prior history: Internal surveillance and audits, regulatory findings, complaints
 - Potential conflicts

Best Practices for Testing Compliance Procedures and Supervisory Control Procedures

3. Based on the analysis of risks, create a methodology for testing.
4. Implement the methodology for each area selected for testing.
5. Fully document the tests conducted and the results of those tests.

Reporting/Recordkeeping Requirements

- NASD Rule 3012:
A report must be submitted to senior management no less than annually detailing
 - the system of supervisory controls,
 - summary of test results and significant exceptions, and
 - procedures created in response to the results.
- FINRA Rule 3130: A report must be submitted to the CEO, CCO, board of directors and audit committee which
 - documents the processes for establishing , testing, and modifying policies and
 - includes the manner and frequency in which process are administered, and the identification of persons responsible for such administration.
- Rule 204(2)(a)(17):
Every investment adviser must make and keep any records documenting the investment adviser's annual review of the policies and procedures.

Required Procedures

NASD Rule 3010 requires that a member establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.

NASD Rule 3012 requires that a member establish procedures to:

- 1) Supervise a manager's customer account activity
- 2) Review and monitor
 - ❑ Customer fund transmittals
 - ❑ Customer changes of address
 - ❑ Customer changes of investment objectives

Rule 206(4)-7 requires investment advisers to adopt and implement procedures reasonably designed to prevent violations of the Advisers Act and the rules adopted under the Act. To the extent relevant, the procedures should include, among other things:

- 1) Safeguarding client assets from conversion or inappropriate use by advisory personnel
- 2) The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use

Best Practices for These Procedures

- Implementing strong supervisory controls over persons with access to customer accounts
 - Requiring independent reviews of money movements
 - Monitoring uses of post office box addresses
 - Calling a sample of customers to verify requested changes to the accounts

Certification of Compliance and Supervisory Processes

FINRA Rule 3130

A member's CEO must certify annually that

1. the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures and
2. the CEO has had one or more meetings with the CCO to discuss such processes.

Rule 206(4)-7

The rule does not require a certification.

II. Five Years of Compliance: Lessons Learned by CCOs

Although both compliance rules require annual reviews or certifications, registrants should consider the need for interim reviews in response to:

- ❑ significant compliance events,
- ❑ changes in business arrangements, and
- ❑ regulatory developments.

Significant Compliance Events and Business Changes: Enforcement Cases

- ❑ *SEC v. Galleon Management, LP, et al., No. 09-8811 (S.D.N.Y. Oct. 16 and Nov. 5, 2009)*

- ❑ November 5, 2009: Complaint <http://www.sec.gov/litigation/complaints/2009/comp21284.pdf>, SEC Litigation Release No. 21284, <http://www.sec.gov/litigation/litreleases/2009/lr21284.htm>, SEC Charges 13 Additional Individuals and Entities in Galleon Insider Trading Case, SEC Press Release <http://www.sec.gov/news/press/2009/2009-235.htm>, October 16, 2009: Complaint for civil action for injunction <http://www.sec.gov/litigation/complaints/2009/comp21255.pdf>, SEC Litigation Release No. 21255 <http://www.sec.gov/litigation/litreleases/2009/lr21255.htm>, SEC Charges Billionaire Hedge Fund Manager Raj Rajaratnam with Insider Trading, SEC Press Release 2009-221 <http://www.sec.gov/news/press/2009/2009-221.htm>.

- ❑ *Spotlight on Insider Trading may help Investment Advisers develop techniques to detect and deter insider trading.*
- ❑ See SEC, *Spotlight on Insider Trading*, <http://www.sec.gov/spotlight/insidertrading.shtml>.

- ❑ ***In the Matter of E*Trade Clearing LLC and E*Trade Securities LLC, Admin. Proc. No. 34-58250, News Release 2008-156, July 30, 2008***
 - *FINRA fines E*Trade Units \$1 million for failing to comply with AML rule that requires broker-dealers to verify the identities of their customers and document their procedures for doing so.*

Recent Enforcement Cases to illustrate possible weaknesses

- *SEC v. Galleon Management, LP, et al.*
 - *The complaint alleges widespread and repeated insider trading concerning at least 12 different companies*
 - *Complaint details alleged elaborate network of corporate insiders*

Misuse of Material, Non-Public Information can be deterred and/or detected by compliance procedures and practices:

- *Compensation structure*
- *Forensic Testing*

Recent Enforcement Cases to illustrate possible weaknesses –cont-

- *FINRA fines E*Trade Units \$1 million for Inadequate Anti-Money Laundering Program*
 - *FINRA found that E*Trade Units failed to establish and implement AML policies and procedures that could reasonably be expected to detect and cause the reporting of suspicious securities transactions.*

Brokerage firms' AML programs must be tailored to their business models. FINRA instructed each broker/dealer that its AML program must be tailored to its business. Consider factors such as:

- *Size, location, business activities, types of accounts it maintains, types of transactions in which its customers engage, and the technological environment in which the firm operations.*

Managing Compliance after a Merger or Acquisition

- ❑ *Merger/Acquisition is Significant Event in Firm's business and operation model*
 - *Due Diligence for the transaction is the beginning of the assessment*
 - *Some things to consider in the internal controls assessment:*
 - ❑ *Regulatory Requirements*
 - *Change in ownership, control or business operations*
 - ❑ *Regulatory History of firm*
 - ❑ *Supervision in the resulting/surviving firm*
 - *Unified Policies, Procedures and WSPs*
 - *Branch and OSJ structure, supervisor designations and assignments*
 - *New Products, Activity – Training*

Managing Compliance after a Merger or Acquisition

- *Corporate Governance and Committees*
- *Operations*
 - *Changes in order routing, trade execution, clearing arrangements*
 - *Customer account transfers*
 - *Safeguard customer information*
 - *Technology systems*
 - *Financial reporting*
- *Communications with the public*
 - *Information sharing*
 - *Conflicting research reports/opinions*

□ Source: FINRA *Mergers, Acquisitions and Business Transfers*

Regulatory Developments

- Custody
- Legislation
- Other Regulatory Developments

Exams Verify Assets & Information

- ❑ Does custodian have the assets?
- ❑ Do accounts tie to independent records?
- ❑ Are audit reports reliable?
- ❑ Are assets verifiable?
- ❑ Is comprehensive asset verification and customer account verification required?

Questions?



Comments?