2018 Investment Management Compliance Testing Survey

Cybersecurity Continues to Top Compliance Concerns

Survey also finds that the use of technology is on the rise

The IAA is pleased to present this Executive Summary of the results of the ***2018 Investment Management Compliance Testing Survey***, a joint project of the **Investment Adviser Association**, and IAA Associate Member **ACA Compliance Group.** Now in its 13th year, the *Survey* is the most comprehensive resource available for identifying the top concerns of investment management compliance professionals, as well as the types of compliance testing practices and strategies investment adviser firms are using to address core compliance topics such as conducting annual reviews, identifying and disclosing conflicts of interest, overseeing service providers, cybersecurity, social media, and more.

SEC-registered investment advisers operate in a rapidly changing, ever-evolving regulatory environment. The *Survey* is designed to be a useful resource for compliance professionals to:

- ✔ ***Benchmark*** their compliance testing practices against those of other firms;
- ✔ ***Collect ideas*** for new testing techniques that can be used by firms in future testing efforts;
- ✔ ***Assess compliance testing trends*** over time within a variety of specific areas;
- ✔ ***Identify practices*** that appear to have become (or may become) prevalent industry practices; and
- ✔ ***Assess the impact*** of current and potential regulatory requirements and market developments on advisers' businesses.

This year's survey addressed compliance testing in the areas of **fees and expenses**, adhering to **investment mandates**, **custody**, **best execution**, **soft dollars**, **individual clients**, and **advertising**. The *Survey* also addressed **social media**, and other emerging technologies such as the use of **automated compliance tools, data analytics**, and **cryptocurrency**. In addition, the *Survey* provided trend updates regarding **cybersecurity**, **pay-to-play**, recent amendments to **Form ADV**, and other compliance hot topics.

Primary type of clients

Firms with AUM under $1 Billion

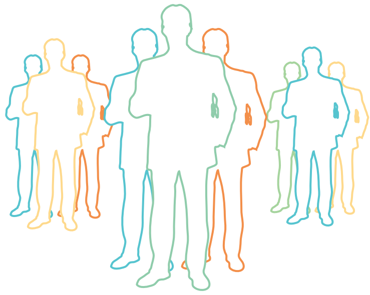
Retail	16%
High net worth ($1mm or more)	37%
Family office	0%
Institutional	19%
ERISA assets/pension consultant	2%
RICs	6%
Private funds	20%

Firms with AUM between $1 Billion and $20 Billion

Retail	11%
High net worth ($1mm or more)	27%
Family office	1%
Institutional	28%
ERISA assets/pension consultant	3%
RICs	9%
Private funds	18%

Firms with AUM over $20 Billion

Retail	5%
High net worth ($1mm or more)	8%
Family office	3%
Institutional	45%
ERISA assets/pension consultant	3%
RICs	29%
Private funds	8%



About the Survey Respondents

Compliance professionals at **454** investment adviser firms participated in the *Survey*. Established firms made up the vast majority of the respondents. Firms with five to 25 years in business constituted 52 percent of the respondents. Another 38 percent were firms with more than 25 years in business.

And all firm sizes were represented – with 30 percent of respondents managing less than $1 billion, 45 percent managing $1 billion to $10 billion, and 25 percent managing more than $10 billion. Two-thirds (64 percent) of responding firms reported having 50 or fewer employees, which is consistent with industry data showing that the vast majority of investment advisers are small businesses.

Services provided by responding firms spanned the full range of client types, including non-high net worth (retail) individuals (39 percent of respondents), private funds (47 percent), ERISA assets/pension consultants (55 percent), institutional clients (66 percent), and high net worth individuals (70 percent).

Do you use automated electronic compliance systems?

Firms with AUM under $1 Billion

Yes	41%
No	59%

Firms with AUM between $1 Billion and $20 Billion

Yes	76%
No	24%

Firms with AUM over $20 Billion

Yes	92%
No	8%

Key Findings

Cybersecurity: Still the Top Concern

There were several interesting takeaways from this year's survey. Not surprisingly, first and foremost is the continued heightened focus by advisers on addressing cybersecurity risks – an area identified by regulators as a top priority as well. For the fifth year in a row, cybersecurity continues to be the biggest compliance concern at registered investment adviser firms – with 81 percent of survey respondents identifying cybersecurity as the "hottest" compliance topic and nearly two-thirds indicating that their firms increased compliance testing in this area over the past year.

Other Concerns in the Top Four

Compliance professionals rank issues relating to the SEC's ***Advertising Rule*** as the second hottest compliance topic (29 percent) after cybersecurity – not surprising, given the SEC's recent focus in this area. This includes concerns raised by the SEC staff in a published Risk Alert regarding the most commonly cited Advertising Rule deficiencies in examinations, several settled enforcement actions relating to advertising, and the agency's consideration of potential amendments to the Advertising Rule. Other areas of concern identified by respondents were issues relating to the ***Custody Rule***, with 28 percent of survey respondents identifying it as a top issue – making it the third hottest topic – and many expressing concerns with custody-related disclosures in Form ADV. Issues relating to ***privacy*** rounded out the top four compliance concerns.

Other Notable Findings

- **Role of CCOs:** This year's survey also revealed that the majority of CCOs (66 percent) continue to wear more than one hat (with 20 percent also serving in some legal capacity). The *Survey* shows that the job of a CCO is becoming more complex and varied, as demonstrated by the wide range of legal and compliance areas for which CCOs are responsible, with new ones being added every year.

Most Common Automated Tasks Among Those Using Automated Systems

Personal trading/code of ethics	78%
Gifts and entertainment	49%
Political contributions/pay-to-play	42%
Client guidelines	41%
Cybersecurity	23%

Most Common Automated Task by AUM

Firms with AUM under $1 Billion

Personal trading/code of ethics	55%
Gifts and entertainment	49%
Books and records	32%
Portfolio management	26%
Advertising/marketing	26%

Firms with AUM between $1 Billion and $20 Billion

Personal trading/code of ethics	81%
Gifts and entertainment	48%
Client guidelines	41%
Political contributions/pay-to-play	40%
Cybersecurity	27%

Firms with AUM over $20 Billion

Personal trading/code of ethics	89%
Client guidelines	67%
Gifts and entertainment	51%
Political contributions/pay-to-play	47%
Cybersecurity	47%

Have not purchased a cybersecurity insurance policy

Firms with AUM under $1 Billion

55%

Firms with AUM between $1 Billion and $20 Billion

48%

Firms with AUM over $20 Billion

24%

- **Role of Technology:** The survey results also reflect the impact that ***technology*** is having on firms more broadly, including the use of social media, tools to fight cybersecurity, and the role of automated compliance systems.

  — ***Use of automation:*** Close to 70 percent of overall respondents use some form of technology in their compliance program, with the most common usage involving personal trading/code of ethics, gifts and entertainment, political contributions, and client guidelines. Over half of survey respondents anticipate increasing their use of technology.

  — ***Data Analytics:*** A majority of firms (67 percent) said that they do not use trading data analytics to monitor trading activity. Of the survey respondents that do, about half use third-party software and the other half use internal trading data surveillance. Survey respondents were also asked about the use of technology to mine or survey data. Most firms (70 percent) do not currently use alternative data research, but of the firms that do, 18 percent have dedicated policies and procedures regarding its use.

  — ***Cryptocurrency:*** Despite the SEC's recent focus on issues relating to cryptocurrency, virtually all survey respondents reported that their firms do not trade in cryptocurrency on behalf of clients. A majority of survey respondents reported that their codes of ethics relating to employee trading do not contemplate cryptocurrencies; only 10 percent require pre-clearance for initial coin offerings.

  — ***Cybersecurity:*** 83 percent of firms reported conducting cybersecurity assessments, including software patches (76 percent), network penetration tests (73 percent), and vulnerability assessments (72 percent). Nearly two-thirds of respondents increased the type, scope, and/or frequency of compliance testing in the area of cybersecurity. 47 percent of respondents have not purchased cybersecurity insurance. A common response to how firms have enhanced their cybersecurity program is that they now conduct phishing tests of employees.

- **Fees and expenses:** The vast majority of survey respondents test fee calculations (88 percent), with most testing on a periodic sample basis (55 percent). With respect to expenses, the top three tests are making sure expenses are consistent with advisory contracts (47 percent) or fund offering documents (41 percent), and that the expenses billed to clients are explicitly disclosed in the firm brochure (45 percent).

- **Investment Mandates:** Nearly half (46 percent) of firms consider environmental, social, and governance (ESG) factors in managing client portfolios, with 62 percent of these indicating that their investment teams analyze ESG factors. With respect to investment mandates more generally, most firms (93 percent) have policies and procedures to ensure that client objectives and restrictions are being met with 42 percent using front-end automated compliance systems for surveillance.

- **Custody:** The top three controls relating to safeguarding client assets are conducting background and credit checks on access employees (55 percent), providing custodians with a list of authorized employees (52 percent), and limiting employees who are authorized to transmit trade orders (51 percent). With respect to the SEC staff's February 2017 guidance on inadvertent custody, survey respondents cited complying with the standing letter of authorization (SLOA) no-action letter and conducting due diligence regarding inadvertent custody as steps they have taken to avoid or limit having custody since the guidance was issued.

- **Best Execution:** The vast majority of survey respondents (88 percent) evaluate best execution with respect to the following types of transactions: equities (81 percent), fixed income (44 percent), derivatives (18 percent), and foreign currency transactions (17 percent). A majority of respondents (53 percent) never accept client-directed brokerage whereas less than one-third (24 percent) almost always do so without imposing limits.

- **Soft Dollars:** While 29 percent of respondents reported that their firms do not engage full service broker-dealers and also do not receive proprietary research, 39 percent reported receiving proprietary research from brokers and 29 percent reported receiving outside research from independent providers. Fully 79 percent of respondents indicated that they were not affected at all by the new European Union MiFID II requirements that firms unbundle research from execution costs.

- **Advertising/Social Media:** The most common controls relating to advertising are requiring formal pre-approvals by CCOs (67 percent) and requiring pre-clearance of interactions with the media (54 percent). The vast majority of firms reported having written policies and procedures related to advertising and social media (86 percent), and common testing of marketing activities include reviewing the firm website (70 percent) and conducting focused reviews of newly-created documents (64 percent). The use of social media is on the rise, but slightly, with 32 percent of firms reporting that they prohibit use of social media. According to the *Survey*, firms that do use social media do so mostly on a very limited "business card" basis.

- **Individual Clients:** The majority of survey respondents provide advisory services to individual clients and most (59 percent) meet with their clients at least yearly; about one-third are meeting on a quarterly basis. With respect to dealing with issues relating to aging clients, such as diminished capacity, 45 percent of firms have documentation regarding beneficiaries and contingent beneficiaries; 35 percent of respondents indicated that they conduct employee training, have specific policies and procedures, and/or require authorized persons to notify them of changing circumstances.

- **Form ADV Amendments**: When asked about the most onerous part of preparing the new Form ADV, disclosures relating to separately managed accounts (SMAs) came in first – specifically, increased SMA reporting of derivatives and borrowing (37 percent of respondents), determining the classification of investment types held in SMAs (21 percent), determining what is an SMA for purposes of Form ADV (13 percent), and disclosures relating to SMA custodians (7 percent of respondents).

- **Pay-to-Play:** 80 percent of firms responding have adopted pay-to-play policies and 79 percent of these respondents did not make any changes to their policies and procedures.

Prohibit use of social media for business purposes

Firms with AUM under $1 Billion
38%

Firms with AUM between $1 Billion and $20 Billion
31%

Firms with AUM over $20 Billion
20%

Get the Complete Survey Results

Full results of this year's *Survey* – and previous years – are available at www.investmentadviser.org *(Publications>>Investment Management Compliance Testing Survey).*

For questions regarding the Survey, please contact:

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About the IAA – and its Compliance Resources

The Investment Adviser Association (IAA) is the leading trade association representing the interests of SEC-registered investment adviser firms. The IAA's more than 640 member firms collectively manage approximately $20 trillion in assets for a wide variety of institutional and individual investors. In addition to serving as the voice of the advisory profession on Capitol Hill and before the SEC, DOL, CFTC and other U.S. and international regulators, the IAA provides extensive compliance and educational services to its membership. For more information, visit www.investmentadviser.org or follow us on LinkedIn, Twitter and YouTube.

The IAA's Members-Only Legal, Regulatory and Compliance Library

The IAA's online resource library receives thousands of visits from members seeking information on a wide range of issues. It also features a series of issue-specific Compliance Guides with practical information for building a successful compliance program and preparing for SEC exams.

The IAA Investment Adviser Compliance Conference

Each spring, the IAA holds what has become the industry's premier compliance conference, a two-day program that provides legal and compliance officers with the most current information available on the changing regulatory landscape. Participants return to their firms with practical insights and knowledge of best practices to help them maintain a successful compliance program. In addition to meetings and interacting with peers, attendees hear from a distinguished roster of speakers that includes SEC staff, investment adviser industry professionals, and legal experts.

The IAA Fall Compliance Workshop Series

Every fall, the IAA's legal team leads one-day Compliance Workshops in cities across the country. IAA attorneys, representatives from nationally recognized law firms, compliance consultants, and SEC Senior Regional Staff address new compliance challenges, along with current regulatory and examination priorities.

IAA INVESTMENT ADVISER ASSOCIATION

For more information about the IAA Compliance Conference and Workshops, visit www.investmentadviser.org and click on **Events**.