

INVESTMENT ADVISER
ASSOCIATION



2013 Investment Management Compliance Testing Survey

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Survey Focus Areas

- ❖ **Cost of Compliance**
- ❖ **Document Retention and Destruction Policies**
- ❖ **Impact of CFTC Registration and FATCA Regulations**
- ❖ **Fees and Expenses**
- ❖ **Directed Brokerage and Soft Dollars**
- ❖ **Conflicts of Interest**
- ❖ **TREND UPDATE – Social Media**
- ❖ **TREND UPDATE – Anti-Money Laundering**
- ❖ **TREND UPDATE – Business Continuity and Disaster Recovery Planning**
- ❖ **TREND UPDATE - “Hot” Compliance Topics**

Notable Findings



- **32%** of the firms responding have only one person in a full time legal/compliance role.
- **99%** of firms do not outsource the CCO role.
- **68%** of firms say the CCO is a senior executive in the firm.
- **8%** of firms reported detecting material compliance issues – and **22%** reported finding no compliance issues.
 - Most common material issues were advertising/marketing (**41%**), personal trading (**32%**), client guidelines (**24%**), and custody (**24%**).
- **63%** of CCOs are wearing two or more hats.

Survey Demographics

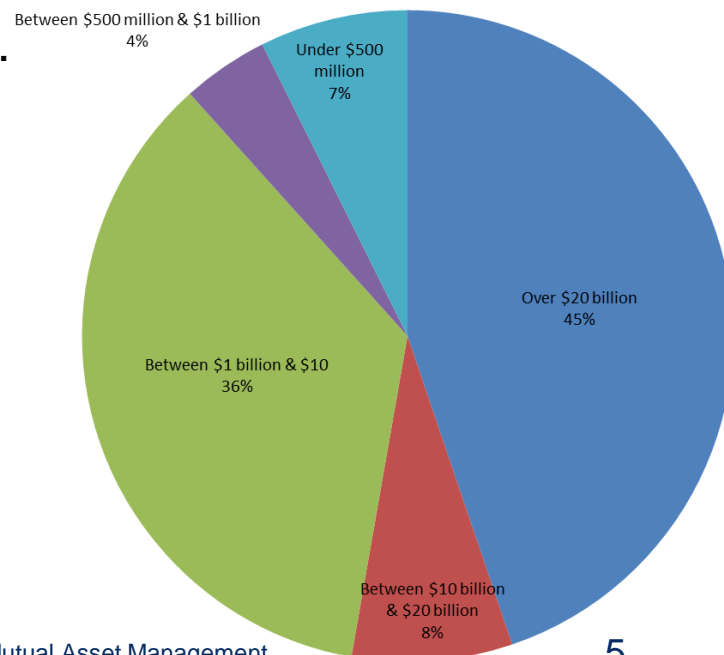
- The largest contingency responding were mid-size firms with **40%** of respondents between **\$1 billion and \$10 billion** in assets under management and **64%** of respondents reporting **50 employees or fewer**.
- Both small and large firms were well represented with **32%** of respondents managing **<\$1 billion** and **28%** of respondents managing **>\$10 billion**.
- **Established firms** (5-25 years in business) constituted **55%** with **long-timers** (more than 25 years) making up **30%** of respondents.
- The **services** provided by our respondents span the full range:
 - **56%** advise a private fund.
 - **47%** advise high net worth individuals (>\$1mm).
 - **40%** advise ERISA assets and/or are pension consultants.
 - **36%** advise a registered investment company.
 - **19%** advise retail individuals (<\$1mm).
 - **10%** advise a family office.



Compliance Program

- **93%** of the firms responding have at least one employee dedicated full-time to the legal/compliance role.
- **16%** of firms reported employing more than 6 full time compliance professionals.
- **63%** of CCOs wear more than one hat.

Over \$1 billion in AUM appears to be the level at which firms employ a dedicated CCO.



Compliance Program

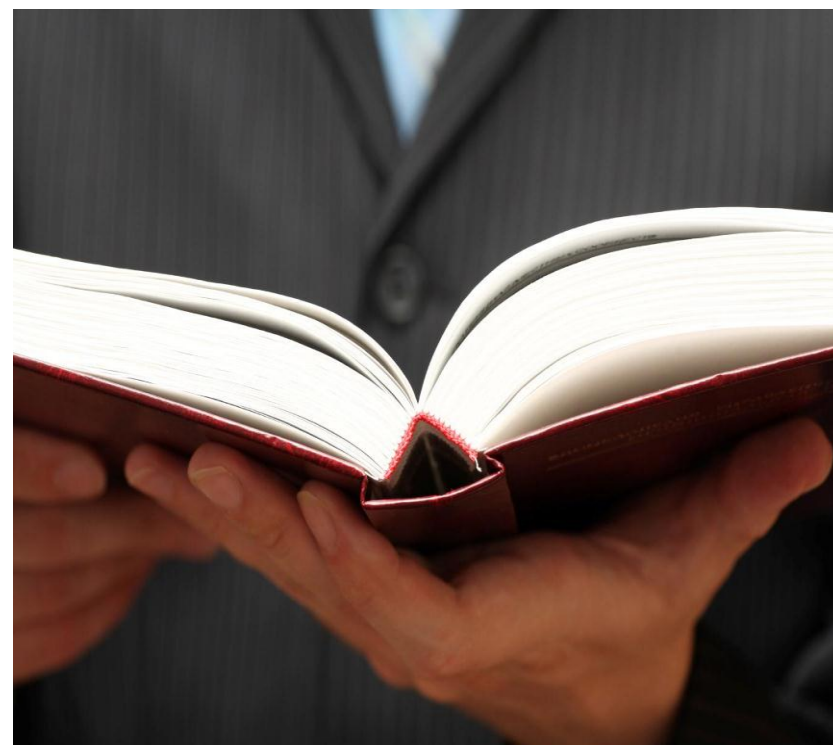
There are common threads **in best practices** regardless of the characteristics of the firm:

- **94%** of firms provide a copy of the annual compliance review to senior management.
- **85%** of firms conduct at least annual employee compliance training.
- **79%** of CCOs attend committee and other management meetings (e.g. valuation, best execution, investment/portfolio management etc.).
- **77%** of CCOs are mandated to immediately inform the CEO/President of any material compliance issues.
- **73%** of CCOs meet periodically with the CEO/President of the firm to discuss compliance issues and initiatives.

Compliance Program

- Firms reported **increasing the amount of testing** in the following areas:
 - Advertising/Marketing **(50%)**
 - Personal Trading **(36%)**
 - Disaster Recovery Planning **(33%)**
 - Pay to Play **(31%)**
 - Social Media **(27%)**

- When asked about areas of **decreased testing**, **79%** of firms indicated that they **have not decreased testing in any area.**



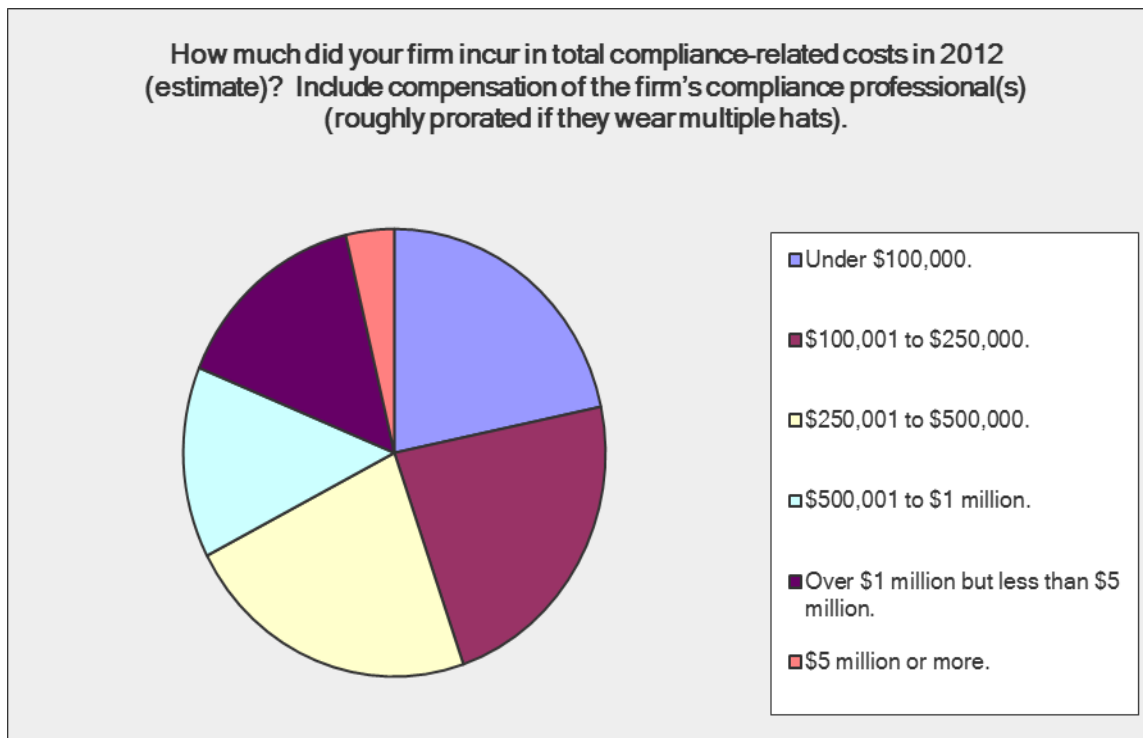
Automated/Electronic Compliance Systems

- **60%** of firms use automated/electronic compliance systems.
- These systems are most frequently used in the following areas:
 - Personal Trading **(77%)**
 - Client Guidelines **(38%)**
 - Gifts & Entertainment **(36%)**
 - Pay to Play **(35%)**
 - Portfolio Management **(28%)**



Cost of Compliance

- **30%** of firms have established a compliance budget.
- **64%** do not have a compliance budget but their requests are generally granted.
- **33%** of firms incurred over \$500,000 in compliance-related costs in 2012.



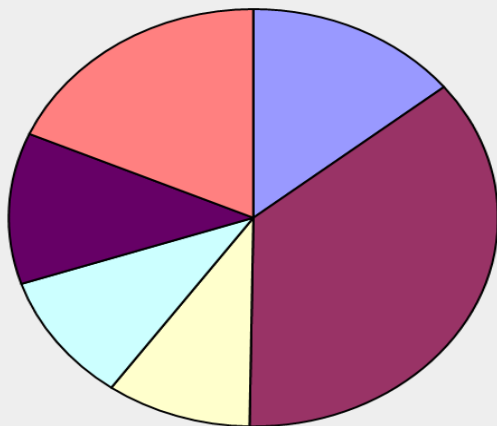
Cost of Compliance

- **53%** of firms said the compliance budget represents less than 5% of the firm's total revenue.
- Significant compliance costs:
 - Compliance personnel (**87%**)
 - Outside counsel (**45%**)
 - Technology (**38%**)
- **35%** spent less than \$10,000 on custody costs in 2012.
- **66%** spent less than \$25,000 on Form ADV Part 2 costs in 2012.
- About **1/3** bring in an outside consultant to do a mock SEC exam.

Document Retention/ Destruction Policies

- **58%** of firms have a policy addressing record destruction.
 - Half of those firms (**50%**) have a practice to destroy required records over time.
 - **50%** maintain records for periods longer than regulatory requirements.

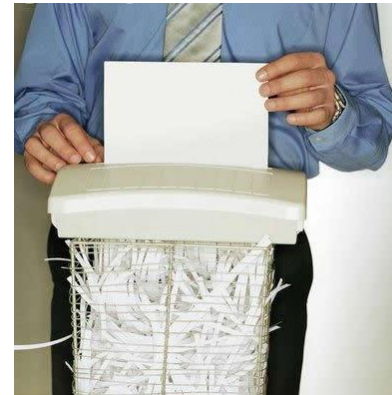
You indicated that your firm has a record destruction policy; please answer the following additional question with respect to your firm's destruction policy:



- Our policy is to not destroy any records.
- Our policy is to identify records not required to be maintained and to only destroy non-required records.
- Our policy is to automatically destroy records after a specific period with a destroy date provided to a record archiving vendor.
- Our policy is to automatically destroy records after a specific period internally.
- Our policy is to automatically destroy certain records after a specific period and to inquire with a responsible party for other records prior to destroying.
- Our policy is to inquire with a responsible party prior to destroying any record.

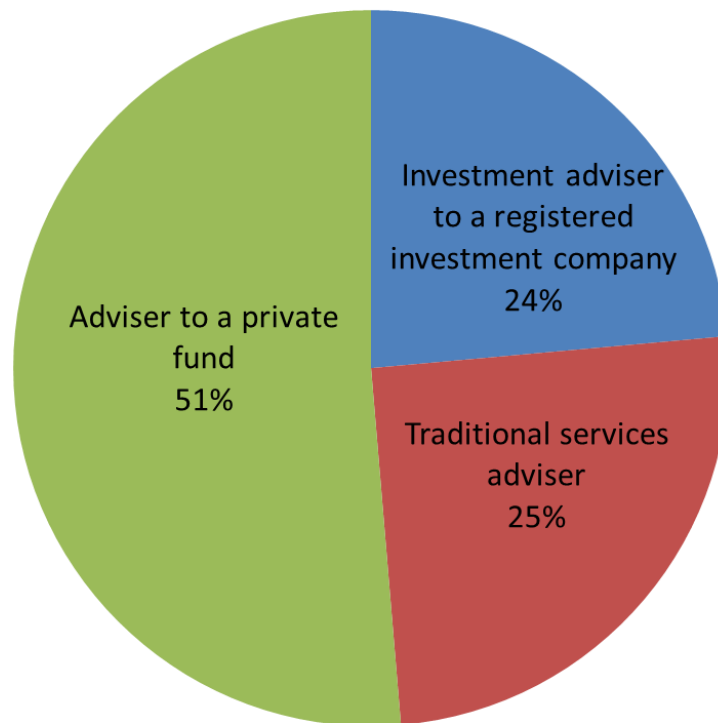
Document Retention/Destruction Policies

- **76%** of firms have a partially or fully paperless environment or are moving towards paperless.
- **38%** of firms provide all requested records to regulators electronically.
- **87%** of firms test books and records compliance but less than **1/3** check to see that records to back up performance statistics are maintained.
- **61%** of firms test books and records compliance annually.



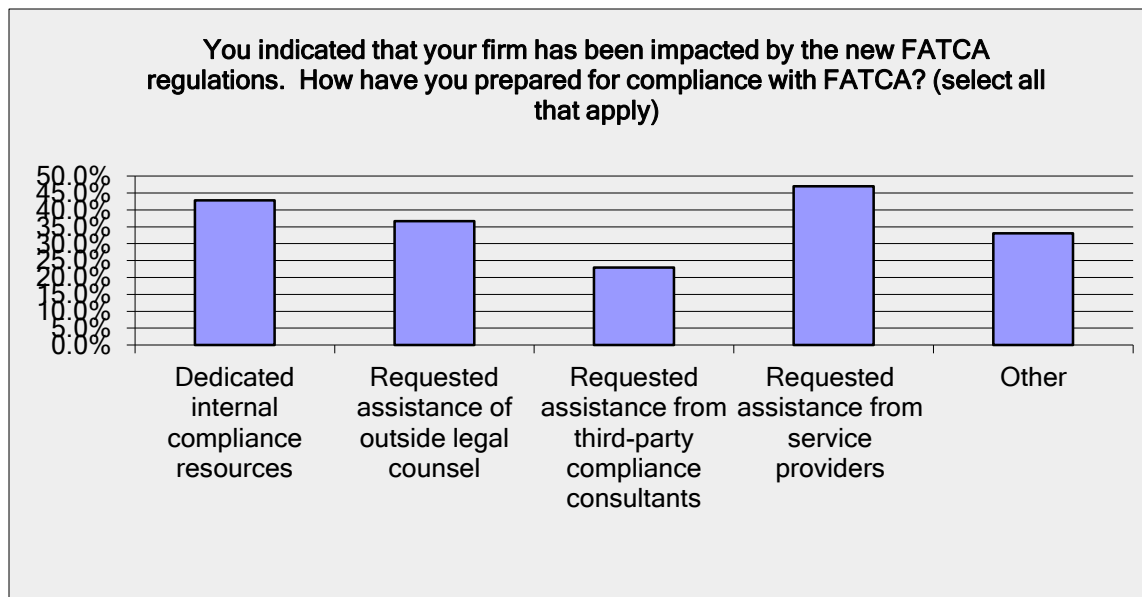
Beyond the SEC: FATCA

40% of firms responding have been impacted by the new FATCA regulations.



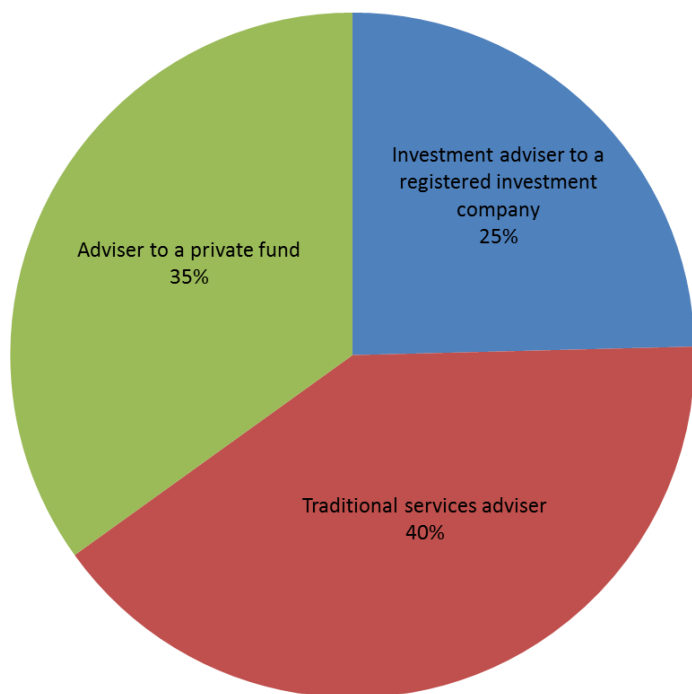
Beyond the SEC: FATCA

- Of those firms, **68%** say that complying with FATCA has *somewhat* increased time and costs devoted to compliance and an additional **12%** say that it has *significantly* increased time and costs devoted to compliance.
- Many firms expect their administrators, custodians and/or accounting firms to assist.



Beyond the SEC: CFTC

20% of respondents indicated that they were required to register with the CFTC/NFA as a result of changes by the Dodd Frank Act.



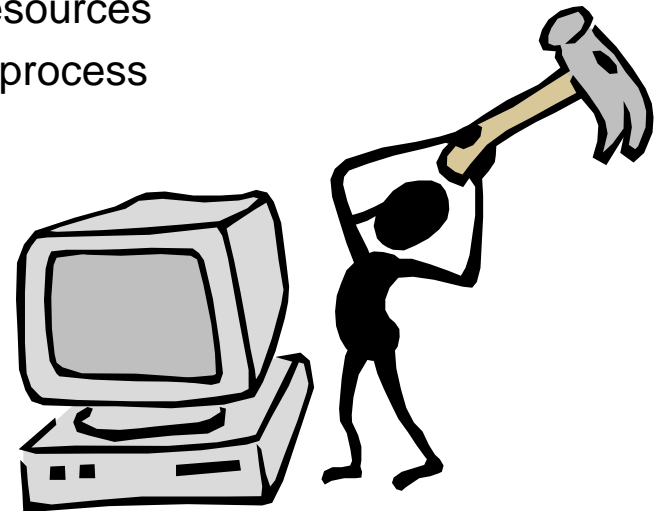
Yes, as a commodity pool operator (CPO)	16.7%
Yes, as a commodity trading advisor (CTA)	9.6%
Yes, as a major swap participant (MSP)	0.2%
Yes, as other (please describe)	2.7%

Of those that answered “Yes, as other” the primary response was that they were required to file for an exemption.

Beyond the SEC: CFTC

- Of the firms that were required to register, only 22.5% indicated that their compliance programs were “significantly impacted”.

- The most common impacts mentioned:
 - Development of additional policies and procedures
 - Increase in use of outside legal counsel
 - Increase in dedication of compliance resources
 - Significant time devoted to registration process



Fees and Expenses

- Firms reported **testing relating to fee arrangements and expenses** in the following areas:
 - Whether clients are billed advisory fees in accordance with the terms of their advisory contracts **(71%)**
 - To ensure that the amount of AUM on which the advisory fee is billed is accurate **(66%)**
 - Whether the description of fee arrangements in Form ADV is accurate, current and consistent with the compensation arrangements in advisory contracts **(66%)**
 - Whether expenses billed to clients are correct and appropriately allocated **(33%)**
 - To ensure compliance with most favored nations provisions periodically during the term of the advisory contract **(19%)**

- Firms use the following **controls** to ensure that the amount of AUM on which the advisory fee is billed is **accurate**:
 - More than one person must sign off on bills and invoices **(44%)**
 - Periodic testing on a sample basis **(43%)**
 - Test all calculations **(26%)**

Referral/Solicitation Fees

- Firms reported testing the following relating to referral/solicitation fees:
 - Whether disclosure in your firm's Form ADV is consistent with your firm's solicitation arrangements. **(57%)**
 - Whether referral/solicitation fees are paid in accordance with the terms of the solicitation agreement. **(42%)**
 - Whether referral/solicitation fee arrangements with third parties are in accordance with the solicitation rule. **(35%)**
 - Whether solicitors are properly registered, if required. **(28%)**
 - Background checks using FINRA's BrokerCheck to ensure that solicitors are not "bad boys/bad actors" under the solicitation rule. **(20%)**
 - Certifications to ensure that solicitors are complying with the requirements of the solicitation arrangement and solicitation rule. **(15%)**
 - To ensure that referral/solicitation fees are not paid to solicitors after the period required by the solicitation agreements. **(15%)**

Directed Brokerage

- About **1/3** of firms limit or seek to limit the amount of brokerage a client may direct (limit varies but generally **25%** or **30%**).
- Where clients request that brokerage be fully directed, **59%** of firms reported that they rely on **disclosure** that they do not have the responsibility to seek best execution and do not trade away from the directed broker.
- **21%** of firms will not direct brokerage unless they seek best execution.
- About 1/3 (**32%**) of firms will inform the client when they believe the direction arrangement is not in the client's best interest.
- About **16%** of firms will trade away from the directed broker on occasion to seek best execution and about **6%** will do so frequently.



Soft Dollars



- About half (**49%**) of firms do not actively seek to participate in soft dollar arrangements, including receipt of proprietary research.
- **34%** of firms responding do not test soft dollars.
- **40%** of firms review their soft dollar disclosures against their actual practices. This is the most common approach, followed by reviewing each soft dollar product and service to confirm that it is “brokerage or research” covered by Section 28(e) (**34%**), requiring written approval for all soft dollar requisitions and reviewing those approvals against actual expenditures (**34%**), and reviewing soft dollar commission reports that firms prepare in-house (**32%**).

Conflicts of Interest

- Firms reported that the following are involved in detecting conflicts of interest:
 - Legal and/or compliance department (**79%**)
 - Business heads (**59%**)
 - Employees (**53%**)
 - An internal committee (**15%**)

- Only **10%** of respondents include fund board members.

“Everyone from top to bottom.”

“The principals of the firm.”

“Fiduciary committee.”

Conflicts of Interest

- Firms identify conflicts of interest as follows:
 - Employee certifications (71%)
 - Track gifts and entertainment (64%)
 - Employee questionnaires (57%)
 - Employee interviews (40%)

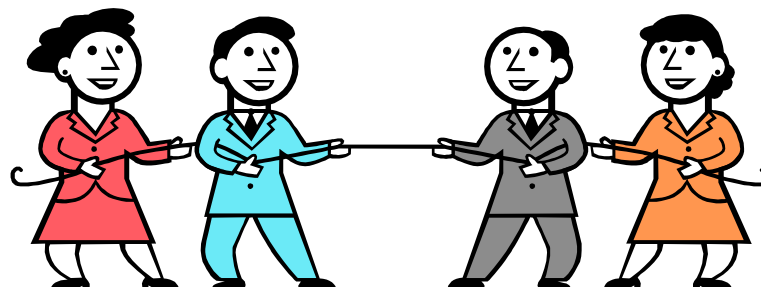


“When conducting email surveillance this is something we look for.”

“Whenever an employee or the CCO perceives that there is a conflict it is discussed and acted upon.”

Conflicts of Interest

- **48%** of firms report that they test for conflicts of interest annually, with **30%** reporting quarterly reviews.
- Many commenters noted that it is an ongoing/constant/daily process.
- Only **10%** of firms compare reported conflicts of interest against those disclosed in Form ADV Part 2A.



Conflicts of Interest

Most common testing of conflicts of interest reported:

- Personal and proprietary trading (**88%**)
- Gifts and entertainment (**77%**)
- Political contributions (**68%**)
- Employees' outside financial interests (**66%**)
- Directors/control persons/governing board members/advisory board members' outside financial interests (**45%**)
- Allocation of brokerage (**44%**)

“We don't allow any personal trading that is not preapproved, all employees are restricted from trading any securities on our restricted list, we don't vote proxies, we don't use soft dollars, we don't use affiliated entities, we don't use referrals, we don't accept compensation from third parties, we require all employees to preclear gifts and entertainment as well as political contributions. All employees who want to engage in any outside activity must get it precleared.”

TREND UPDATE: Social Media and Networking

- **83%** of firms have adopted **formal written policies and procedures** to govern the use of social networking by employees, compared to **80%** in 2012. Another **6%** have informal policies.
- **49%** **prohibit** the use of personal social networking websites for **business purposes**, compared to **54%** in 2012.
- **63%** test compliance with the firm's social media policy (compared to **54%** in 2012).
- Social media testing is most commonly done annually (**25%**).
- **43%** report that the firm's social media testing has increased over the past year.



TREND UPDATE: Social Media and Networking

Most Common Testing Approaches:

- Ensure that employee LinkedIn accounts are linked to the Firm's and the CCO's accounts
- Use Google alerts for firm, fund and employees' names to detect unauthorized social media use
- Use software or third party vendors to monitor posts
- Require employees to "friend"/connect with CCO

"All social media posts are pre-approved by Compliance. Corporate Communications searches public social media sites daily for references to certain key words and escalates issues, as necessary."

"Semi-annual formal testing. CCO is also linked to employee LinkedIn pages for regular, informal monitoring."

"Google alerts are set up for all employees. Firm pages are tested periodically."

TREND UPDATE: Anti-Money Laundering

- Although not yet required, over **80%** have adopted an anti-money laundering policy or are subject to an affiliate's policy.
- **70%** reported that they conduct some anti-money laundering screening, testing and/or oversight.

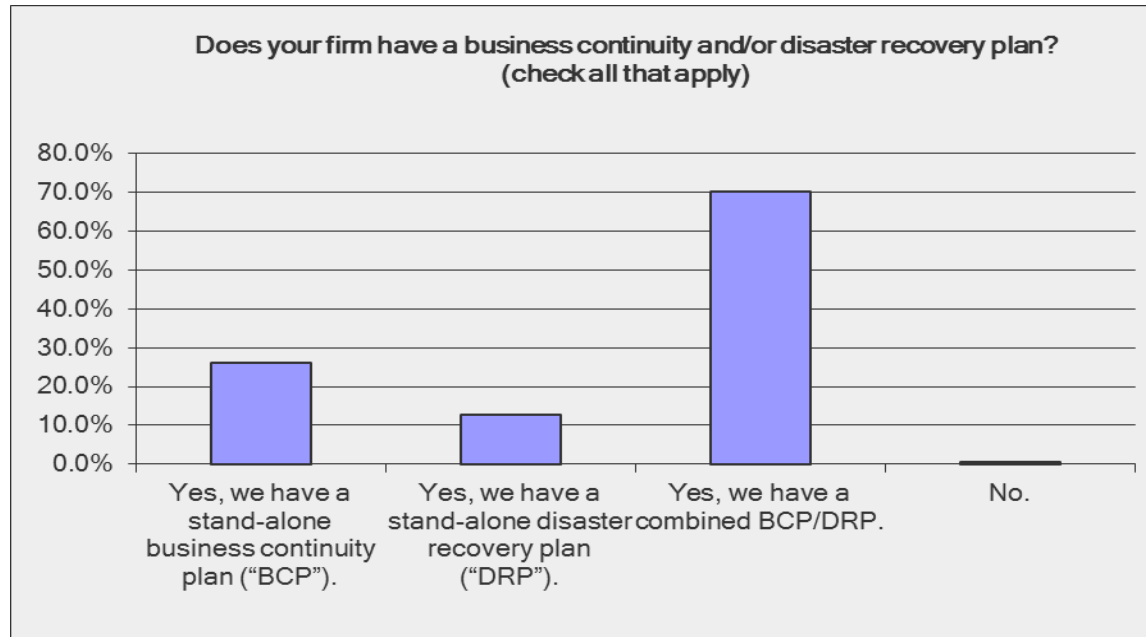


“Enhanced due diligence.”

“Purchased third party AML software.”

TREND UPDATE: Business Continuity and Disaster Recovery Planning

- Virtually all firms (**99%**) have a business continuity and/or disaster recovery plan.



TREND UPDATE: Business Continuity and Disaster Recovery Planning

48% of firms report that they updated their policies in 2012.

“We upgraded to the cloud.”

“Enhancing remote access.”

“A significant increase in the firm’s budget for this area.”

“Required key personnel to test their laptop from home.”

“Simulations have increased.”

“No critical infrastructure on site, allowing near complete productivity from any alternative environment.”



TREND UPDATE: Hot Compliance Topics

Topics	2010	2011	2012	2013
Custody	56%	35%	12%	20%
Data Security/Privacy	41%	33%	15%	14%
Advertising/Marketing	27%	29%	26%	34%
Valuation	20%	27%	25%	26%
Fraud Prevention	20%	20%	11%	12%
Regulatory reporting	X	44%	31%	18%
Insider Trading	X	42%	32%	22%
Social Media	X	X	43%	25%

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