

INVESTMENT ADVISER
ASSOCIATION



2012 Investment Management Compliance Testing Survey

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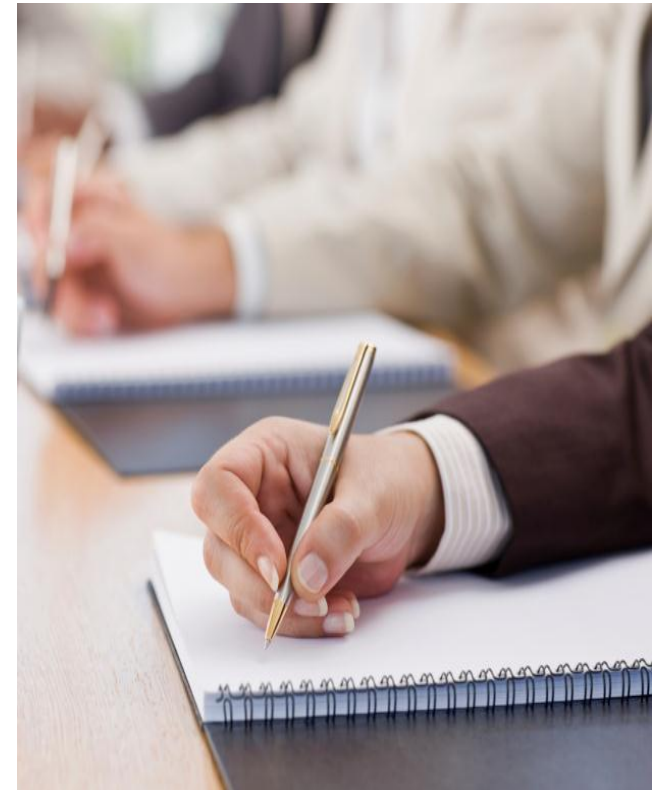
June 14, 2012

Survey Focus Areas

- ❖ Overall Compliance Program
- ❖ Performance Advertising
- ❖ Pay to Play
- ❖ Special Trading Issues
 - ❖ Best Execution Reviews
 - ❖ Cross Trades
- ❖ Oversight of Third-Party Service Providers
- ❖ TREND UPDATE – Social Media
- ❖ TREND UPDATE – Whistleblowing
- ❖ TREND UPDATE – Gifts & Entertainment
- ❖ TREND UPDATE – Insider Trading
- ❖ TREND UPDATE - “Hot” Compliance Topics

Survey Demographics

- The largest contingency responding were mid-size firms with **39%** of respondents between **\$1 billion and \$10 billion** in assets under management and **68%** of respondents reporting **50 employees or less**.
- Both small and large firms were well represented with **36%** of respondents managing **<\$1 billion** and **24%** of respondents managing **>\$10 billion**.
- **Established firms** (5-25 years in business) constituted **54%** with **long-timers** (more than 25 years) making up **29%** of respondents.
- The **services** provided by our respondents span the full range:
 - **56%** advise a private fund.
 - **47%** advise high net worth individuals (>\$1mm).
 - **39%** advise ERISA assets and/or are pension consultants.
 - **36%** advise a registered investment company.
 - **18%** advise retail individuals (<\$1mm).
 - **10%** advise a family office.



Notable Findings



- **37%** of the firms responding have only one person in a full time legal/compliance role.
- **7%** of firms reported detecting material compliance issues – and **22%** reported finding no compliance issues.
- **67%** of CCOs are wearing two or more hats.
- **54%** of firms use automated/electronic compliance systems.
- **80%** of firms have adopted formal written policies concerning social networking.
- Pay to play policies are on the increase.

Compliance Program

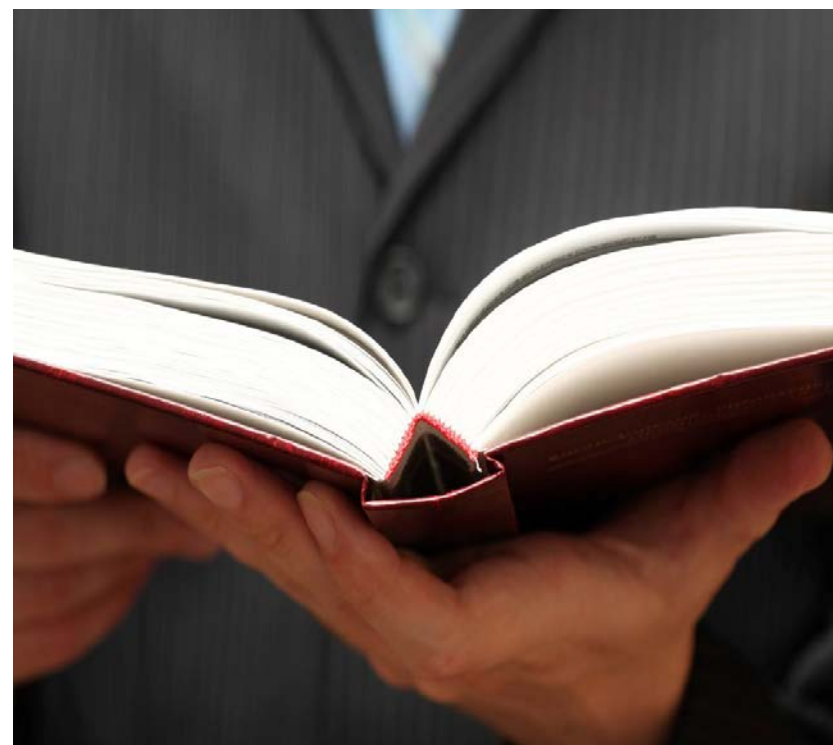
- **94%** of the firms responding have at least one employee dedicated full-time to the legal/compliance role.

- There are common threads **in best practices** regardless of the characteristics of the firm:
 - **92%** of firms provide a copy of the annual compliance review to senior management.
 - **83%** of firms conduct at least annual employee compliance training.
 - **77%** of CCOs attend committee and other management meetings (e.g. valuation, best execution, investment/portfolio management etc.).
 - **75%** of CCOs are mandated to immediately inform the CEO/President of any material compliance issues.
 - **75%** 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:
 - Pay to Play **(48%)**
 - Advertising/Marketing **(43%)**
 - Personal Trading **(39%)**
 - Social Media **(38%)**

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



Automated/Electronic Compliance Systems

- **54%** of firms use automated/electronic compliance systems.
- These systems are most frequently used in the following areas:
 - Personal Trading (**68%**)
 - Client Guidelines (**42%**)
 - Gifts & Entertainment (**33%**)
 - Pay to Play (**31%**)
 - Portfolio Management (**31%**)
- Only a few firms (**2%**) had discontinued use of automated/electronic compliance systems in **any** area.



Automated/Electronic Compliance Systems

➤ Firms that do not use automated/electronic compliance systems cited:

- Cost **(57%)**
- Lack of “fit” with business **(48%)**
- Systems limitations **(11%)**

➤ Comments:

“Not needed until we grow bigger”

“Very small firm – easily managed ‘manually’”



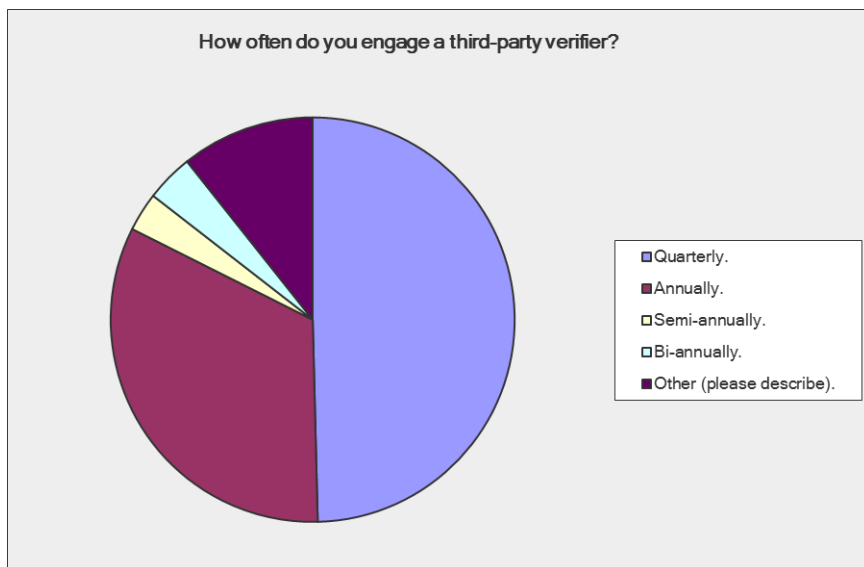
Performance Advertising

How do you test your performance calculations and presentations?

- We confirm that disclosures required by the Investment Advisers Act and relevant no action relief are included in appropriate font, location and prominence **(55%)**
- We confirm that performance presentations are presented net of fees unless in one-on-one presentations and then we confirm that the one-on-one presentation is in compliance with relevant no action relief **(55%)**
- We confirm that required back-up documentation is retained **(52%)**
- We confirm that consistent periods and benchmarks are included in marketing materials overtime to detect cherry picking **(50%)**
- We review compliance with our firm's policies and procedures (e.g., GIPS policies) **(46%)**
- We sample marketing materials periodically to confirm that accurate performance figures are being used and that all necessary disclosures are included **(46%)**

Performance Advertising

- Only **36%** of firms test for performance dispersion among similarly managed accounts – a valuable test to find potential conflicts of interest and violations of the firm’s trade allocation policies AND one frequently performed by SEC examiners.
- **31%** of respondents who do not claim GIPS compliance indicated that they engage a third party to verify their firm’s performance presentations, with **50%** of those firms receiving quarterly verifications and **33%** receiving annual verifications.



“All promotional materials containing performance information must be reviewed and certified in writing as to their accuracy by relevant management and control personnel.”

Performance Advertising

Of the firms reporting that they have **significantly increased testing** of performance advertising in the past year, most reported that it was due to preparation for registration as an Investment Adviser as a result of the Dodd-Frank Act.



Interestingly, despite the SEC's increased focus on performance advertising, **3%** of firms indicated that they **do not conduct any testing of performance** advertising.

Performance Advertising

GIPS Update

- Less than half of respondents claim compliance with GIPS (**43%**)
- Even though the CFA Institute determined not to mandate GIPS verifications, the majority of GIPS compliant respondents engage a verifier (**85%**) and **67%** also obtain a performance review of certain composites.
- The majority (**90%**) of firms who engage a verifier receive quarterly updates (**47%**) or annual updates (**43%**) despite the CFA Institute's implication that bi-annual verifications (only done by **3.2%** of respondents) is acceptable.
- Frequently cited under reasons for significant increases in performance testing was the adoption of GIPS: *"Obtained GIPS audit. Significantly increased compliance to meet GIPS standards in addition to SEC standards."*

Pay to Play

- **Pay to play policies are on the increase.**
- **15%** of firms report that the rule is **not applicable** to them (compared with **20%** in 2011).
- **43%** of firms reported that they have adopted policies to address the rule as **part of other compliance policies**.
- **38%** of firms have adopted a **stand alone policy** to address the rule.
 - **76%** of firms apply their policy to **all employees**, as compared with last year's survey percentage of **68%**. Only **12%** limit their policy to Covered Associates.
 - **23%** of firms apply their policy to the **spouses, household members and/or dependent children of Covered Associates**.
 - **13%** of firms apply their policy to the **spouses, household members and/or dependent children of other employees** covered by the policy.

Pay to Play



- **7%** of firms **prohibit all political contributions.**
- **60%** of firms responding **require pre-clearance** of political contributions by **Covered Associates.** This is the most common approach, followed by reporting (**32%**), prohibition above a de minimis amount (**21%**), and pre-clearance above a de minimis amount (**14%**).
- **De minimis amounts** ranged from \$100 to \$350 and were defined by additional controls such as:
 - the eligibility of the employee to vote for the candidate
 - whether it was a state or federal election.
- **60%** of firms **require periodic certifications** by employees as to their compliance with the policy.
- **35%** of firms **request a list of all contributions** as part of the employee hiring process.

Best Execution

- **82%** of firms conduct best execution reviews. Of those 82%,
 - **29%** are Advisers to private funds
 - **26%** are Advisers to High Net Worth Individuals
 - **23%** are Advisers to ERISA assets/pension consultant
 - **21%** are Adviser to RICs

- Surprisingly, given the issues which have arisen with regard to FX best execution, only **17%** of respondents include FX transactions in their review.

- **88%** of firms indicated that they do not report the results of best execution evaluations to their broker dealers.

- **55%** of firms report that they conduct reviews quarterly, while the rest are split, with 20% reporting annual reviews, 15% reporting semi-annual reviews, and only 10% conducting monthly reviews.

Best Execution



- **87%** of firms reported that **compliance personnel** are involved in the best execution reviews, while only **71%** of firms reported that **traders** are involved.
- In the “Other” category, firms reported participation by technology personnel, senior management, legal staff, operations staff, accounting personnel.

- **92%** of firms reported including equity assets in their best execution reviews, followed by fixed income assets (**52%**), and derivatives (**21%**).
- Mutual Funds and ETFs dominated the “Other” category.

Best Execution

➤ Common **Forensic Tests** for best execution:

1. Review of trade errors **(53%)**
2. Review of best execution policies and procedures **(53%)**
3. Review of an approved broker-dealers list **(52%)**
4. Comparisons to benchmarks such as VWAP **(45%)**
5. Soft dollars and/or commission sharing arrangements **(41%)**

➤ Common **Focus Areas** for best execution reviews:

1. Timeliness of Execution and Settlement **(76%)**
2. Intermediary Compensation **(69%)**
3. Order Flow Sent to Brokers **(60%)**
4. Products and research services provided **(52%)**
5. Timeliness and accuracy of trade confirmations **(52%)**

Best Execution

- **92%** of firms maintain written documentation evidencing their best execution reviews:
- *“Brokerage committee minutes, third party trade cost analyses, internal analyses”*
 - *“Best execution memorandum, soft dollar reports, vwap analysis, trade error reports approved broker list.”*
 - *“Meeting materials consisting of agenda, commission reports, excerpts of policies and procedures, broker evaluations, trade error documentation.”*
 - *“Best Execution Committee minutes and corresponding memorandum, results of broker surveys, Compliance test plan and corresponding exhibits (Bloomberg VWAP screens, trade tickets).”*
 - *“Agenda, Trade Cost Analysis reports, gift and entertainment logs, commission budget (includes soft dollar budget), broker review matrix, approved broker list.”*

Cross Trades

- Only **23%** of firms reported that they engage in cross trading. Of those:
 - **29%** are Advisers to Private Funds.
 - **23%** are Advisers to a Registered Investment Company.
 - **21%** are Advisers to ERISA/pension assets.

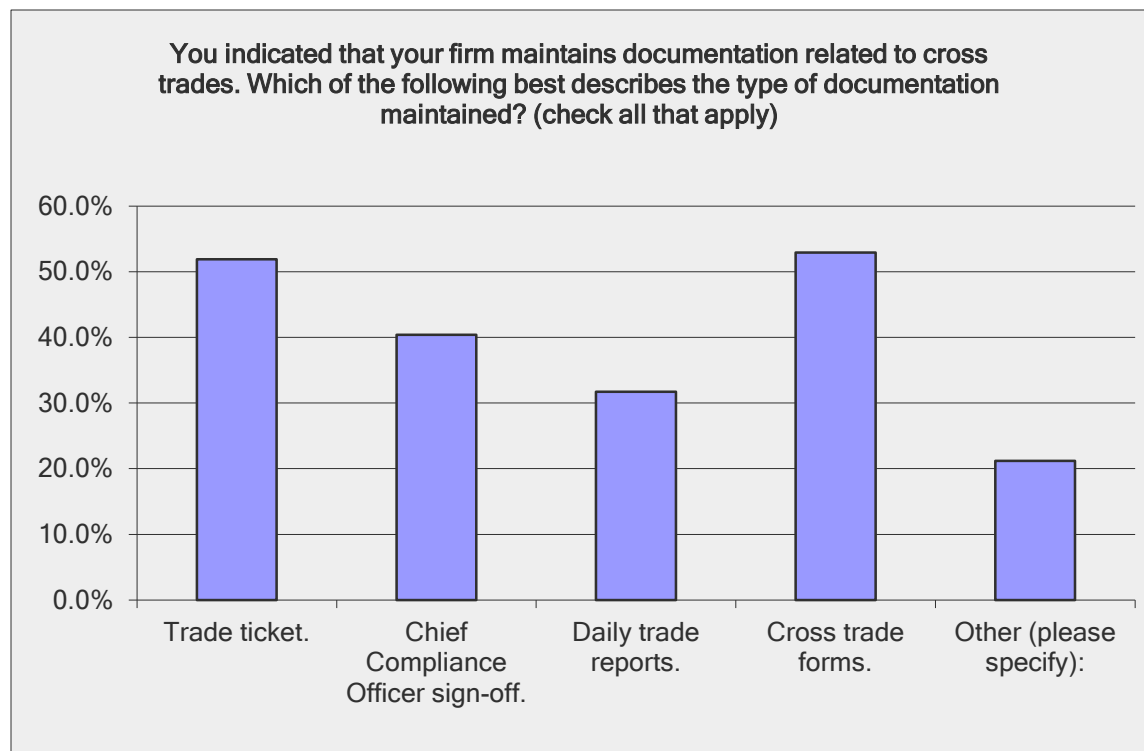
- **50%** of firms engaged in cross trading conduct cross trades in the market through non-affiliated broker-dealers, while **44%** reported that they cross trades internally.

- Most common testing of cross trades reported:

• Review cross trades for compliance with firm policies.	76%
• Review each transaction for fiduciary principles. (i.e., mutually beneficial to both clients.)	72%
• Review pricing process and results for cross trades.	64%
• Review participating client accounts to ensure eligibility to cross trade.	58%
• Review documented rationale for each transaction.	57%
• Review Form ADV and other disclosures regarding cross trades for consistency with actual practices.	56%
• Review transactions in light of Investment Company Act regulations.	51%

Cross Trades

- **95%** of respondents indicated that they maintain documentation related to the firm's cross trading activities:



Oversight of TSPs

- Unsurprisingly, **91%** of respondents indicated that they engage a third-party service provider:
 1. Attorneys (**85%**)
 2. Email Archival Vendors (**81%**)
 3. Auditors (**75%**)
 4. Independent Qualified Custodians (**71%**)
 5. Information Technology Companies (**65%**)

- Also mentioned frequently:
 - Proxy Voting Vendors
 - Sub-Advisers
 - Personal Trade Compliance Vendors

- Interestingly, in a post-Galleon world, only **22%** of firms indicated that they engage third-party Investment Research Consultants.

Oversight of TSPs

How does your firm conduct oversight of its third-party service providers?

• We conduct an initial due diligence.	83%
• We oversee through regular interaction but do not conduct a focused review.	51%
• We designate employees responsible for managing each relationship.	39%
• We conduct onsite visits on a periodic basis.	34%
• We conduct periodic testing (e.g., business continuity, compliance with contractual representations, etc.)	29%
• We conduct teleconferences on a periodic basis.	25%
• We review all contracts annually.	21%
• We require periodic reporting/questionnaires (please explain below).	19%
• We engage a third-party to conduct due diligence.	3%

“Not all of the items checked above apply to all service providers. Oversight is determined based on the services – what is warranted by the services.”

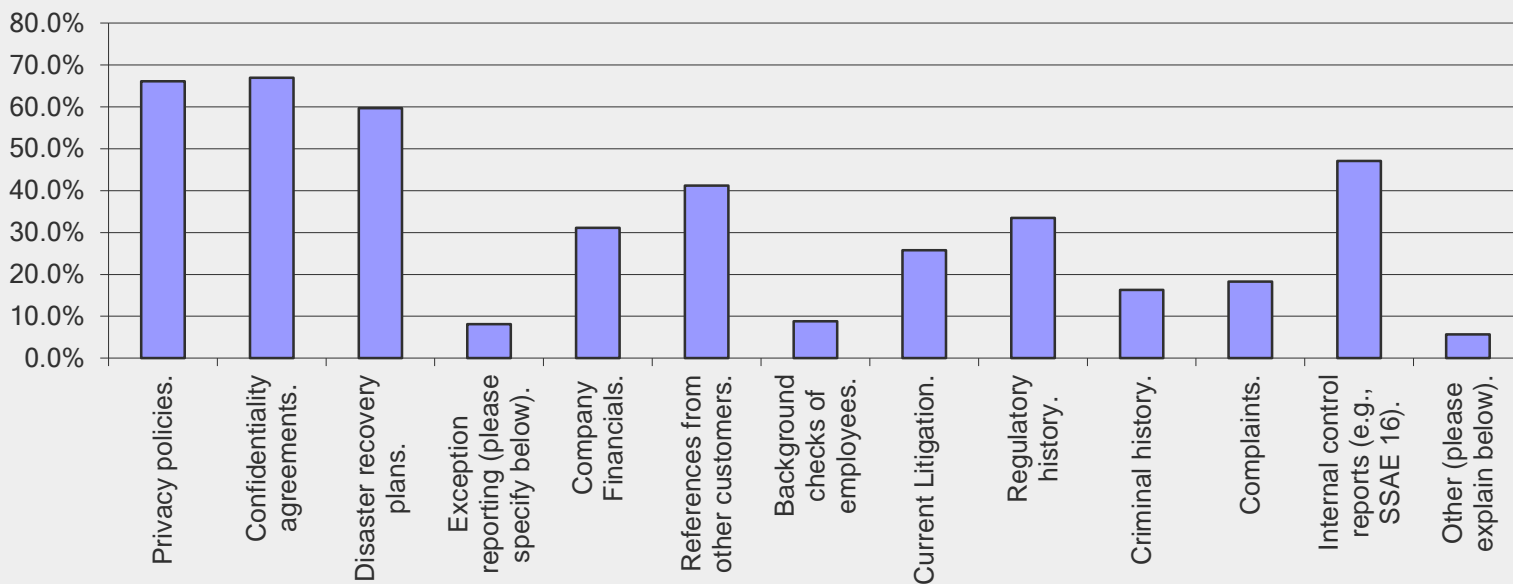
“We ask for members of the office cleaning crew to sign in when they clean so we may track them.”

“We request SAS-70 reports annually.”

“We conduct an annual review of all service providers.”

Oversight of TSPs

What types of information do you request from the third-party service provider as part of your due diligence? (check all that apply)



- Only **26%** of respondents indicate that they require periodic certifications from service providers.
- The most frequently reported certifications requested by respondents include compliance certifications, data privacy and security, and disaster recovery planning.

TREND UPDATE: Social Media and Networking

- **80%** of firms have adopted **formal written policies and procedures** to govern the use of social networking by employees, compared to **64%** in 2011. Another **10%** have informal policies.
- **54% prohibit** the use of personal social networking websites for **business purposes**.
- **54%** test compliance with the firm's social media policy.
- Social media testing is most commonly done annually (**31%**), but **24%** test quarterly.
- **52%** report that the firm's social media testing has increased over the past year.



TREND UPDATE: Social Media and Networking

➤ Testing approaches:

- Use Google alerts for firm, fund and employees' names to detect unauthorized social media use.
- Subscribe to service that screens social media sites for key words and reports results daily
- Require employees to "friend"/connect with CCO

TREND UPDATE: Whistleblowing

- The majority of respondents have some form of whistleblowing policy (**67%**).
- **24%** reported that they have or are implementing a hotline for anonymous reporting.
- **33%** reported that their whistleblowing policies have changed since 2011.
- Comments:
 - “We indicate in our Code of Ethics that we support the SEC Whistleblowing Policy whereby all allegations are taken seriously and no employee will be ostracized for reporting a potential violation.”
 - “A Reporting Procedure was added to our Code of Ethics creating a responsibility to every employee to report violations of the Firm’s policies.”



TREND UPDATE: Gifts and Entertainment

- The vast majority of firms (**over 95%**) have a gifts and entertainment policy.
- Testing has increased in less than 15% of firms, with common testing approaches including:
 - Interviews
 - Review of corporate credit card charges
 - Email reviews
 - Use of tracking software summary of client policies
- Only **25%** of those responding obtain and review gifts and entertainment policies of clients, but over half of those conduct testing of compliance with client policies.

TREND UPDATE: Insider Trading

- **98%** of firms report that their testing in the area of insider trading has increased or remained the same since 2011.

Common tests used for the detection of insider trading:

- Reviewing trading patterns around news stories for client trading
- Reviewing news stories around personal trading
- Reviewing for unusually profitable trades in client accounts and personal accounts
- Email surveillance



TREND UPDATE: Hot Compliance Topics

Topics	2009	2010	2011	2012
Custody	26%	56%	35%	12%
Data Security/Privacy	22%	41%	33%	15%
Advertising/Marketing	27%	27%	29%	26%
Valuation	33%	20%	27%	25%
Fraud Prevention	22%	20%	20%	11%
Regulatory reporting	X	X	44%	31%
Insider Trading	X	X	42%	32%
Pay to Play	X	X	X	19%
Social Media	X	X	X	43%

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