



# 2014 Investment Management Compliance Testing Survey

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# Survey Focus Areas

- ❖ **Cybersecurity**
- ❖ **Valuation**
- ❖ **Custody/Identity Theft/Red Flags**
- ❖ **International Regulatory Compliance, Including the Impact of AIFMD**
- ❖ **Proxy Voting Policies and Procedures**
- ❖ **TREND UPDATE – Whistleblowing**
- ❖ **TREND UPDATE – Directed Brokerage**
- ❖ **TREND UPDATE – “Hot” Compliance Topics**

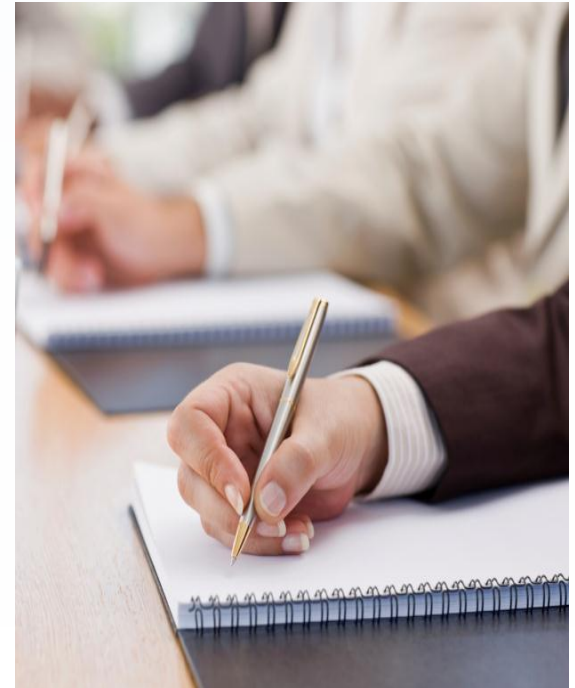
# Notable Findings



- **75%** of respondents consider cybersecurity/data security/privacy to be a hot compliance topic.
- Despite claims that advisers widely rely too heavily on third parties for recommendations on proxy voting decisions – only **33%** of advisers reported using third parties for this purpose at all.
- **75%** of firms indicated that their compliance testing has detected issues, none of which was deemed to be material.
- Of the firms responding that they detected material compliance issues, **33%** indicated that the issues were in the area of personal trading/code of ethics.

# Survey Demographics

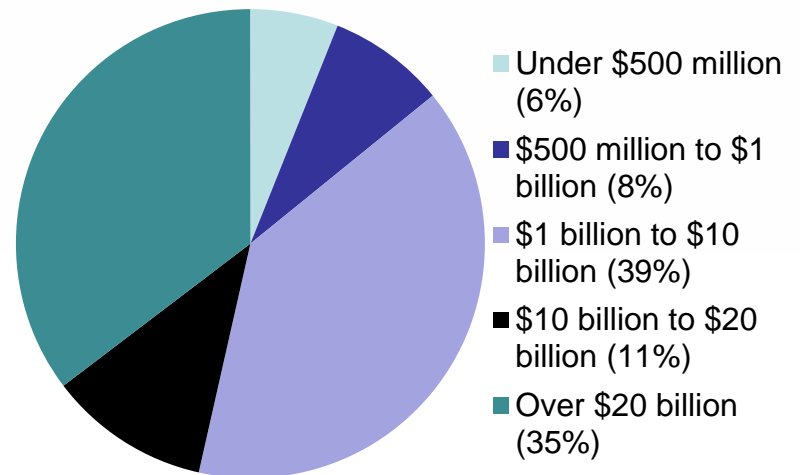
- **Established firms** (5-25 years in business) constituted **55%** with **long-timers** (more than 25 years) making up **32%** of respondents.
- Both small and large firms were well represented with **30%** of respondents managing **<\$1 billion** and **25%** of respondents managing **>\$10 billion**.
- The largest contingency responding were mid-size firms with **46%** of respondents between **\$1 billion and \$10 billion** in assets under management and **67%** of respondents reporting **50 employees or fewer**.
- The **services** provided by our respondents span the full range:
  - **53%** advise a private fund
  - **50%** advise high net worth individuals (>\$1mm)
  - **39%** advise ERISA assets and/or are pension consultants
  - **37%** advise a registered investment company
  - **22%** advise retail individuals (<\$1mm)
  - **15%** advise a family office



# Compliance Program: Personnel

- **93%** of the firms responding have at least one employee dedicated full-time to the legal/compliance role.
- **18%** of firms reported employing more than 6 full-time compliance professionals.
- **64%** of CCOs wear more than one hat.
- **64%** of firms reported that the CCO is a senior executive.
- In **70%** of the firms responding, the CCO has a direct reporting line to the Board of Directors and/or the CEO/President.

**Designated CCOs**



# Compliance Program: Best Practices

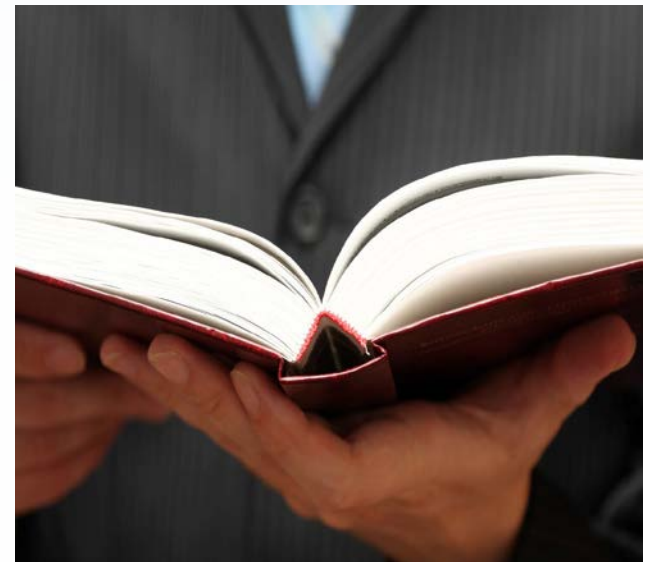
There are common threads **in best practices** regardless of the characteristics of the firm:

- **95%** of firms provide a copy of the annual compliance review to senior management.
- **91%** of firms conduct at least annual employee compliance training.
- **81%** of CCOs attend committee and other management meetings (e.g., valuation, best execution, investment/portfolio management, etc.).
- **84%** of CEOs/Presidents are informed immediately of any material compliance issues.
- **80%** of CCOs meet periodically with the CEO/President of the firm to discuss compliance issues and initiatives.

*“Our CCO is a member of various committees, including: management, enterprise risk management, compliance, best execution/brokerage, valuation, and audit.”*

# Compliance Program: Testing

- Firms reported **increasing the amount of testing** in the following areas (Top 5 responses):
  - Advertising/Marketing **(50%)**
  - Cybersecurity/Privacy/Identity Theft **(48%)**
  - Disaster Recovery Planning **(39%)**
  - Best Execution **(37%)**
  - Code of Ethics/Personal Trading **(33%)**
- When asked about areas of **decreased testing**, **78%** of firms indicated that they **have not decreased testing in any area**.
- Of those firms that reported decreased testing, the top areas were proxy voting **(5%)** and soft dollars **(5%)**.



*“Never decreasing, always adding.”*

# Cybersecurity

- **66%** of respondents do not have a standalone cybersecurity policy.
- **80%** of respondents outsource at least a portion of their IT services.
- **67%** of respondents communicate material risks to senior management.
- **52%** of respondents indicated that their policy has stayed the same or changed slightly since January 1, 2013, while **34%** reported that they are considering or are in the process of instituting a policy.
- **72%** of respondents have allocated the same, or an incremental increase in resources to this area, while **16%** reported no dedicated resources.
  - **To buy or not to buy cybersecurity insurance?**
    - **77%** do not have a cybersecurity insurance policy.
    - **20%** have purchased or are considering purchasing a cybersecurity insurance policy.
    - **3%** considered purchasing a cybersecurity insurance policy but opted not to.

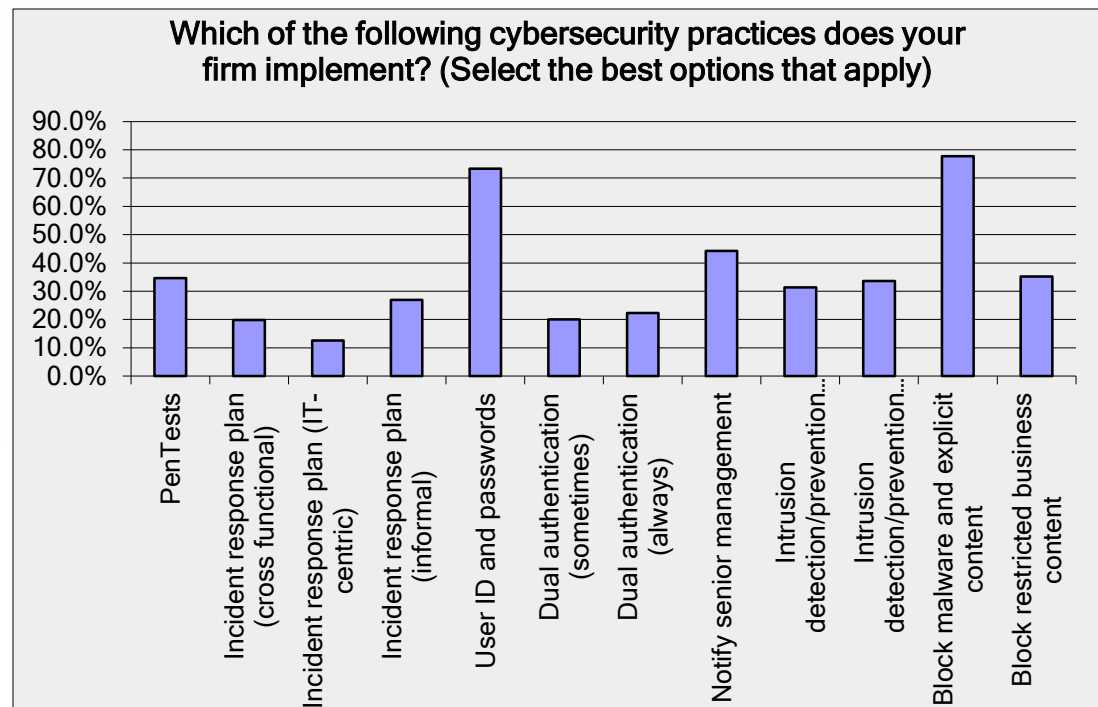




# Cybersecurity (continued)

## What are the potential gaps in cybersecurity programs?

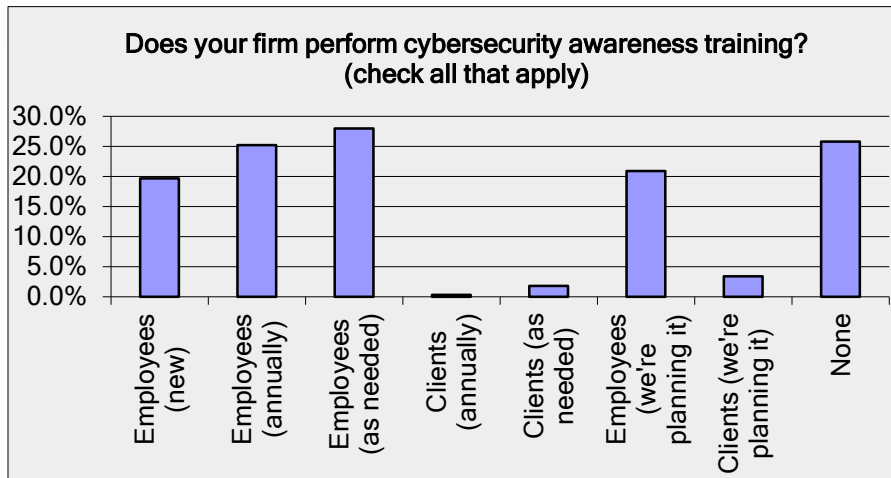
- **78%** of firms do not benchmark to a specific industry IT security/control framework.
- **42%** of firms do not have a formal policy to conduct due diligence on how key vendors manage cybersecurity.
- **80-87%** of firms have not adopted a formally documented incident response plan.
- **80%** of firms do not protect remote access with a second form of authentication.
- **66-69%** of firms do not have a formal intrusion detection program (managed internally or externally).



# Cybersecurity (continued)

## Internal Threats

### ➤ Cybersecurity awareness training



### ➤ Allow BYOD mobile devices?

- **22%** require employees' devices to be encrypted.
- **40%** require employees to have complex passwords on the device.
- **23%** require software on the device to allow the firm to monitor/manage company content on the devices.
- **19%** restrict the type of devices that employees may use.
- **29%** do not place any restrictions on employees' use of personal devices.
- **12%** do not permit employees to use their own devices for business purposes.

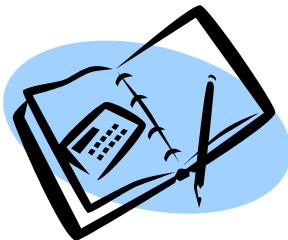


*“Actual risk of harm is low, but more concerned about reputational risks than actual risk of harm.”*

# Valuation

## Marketable Securities

- **87%** of firms invest in marketable securities.
- **50%** of those firms rely entirely on independent third parties to value those securities.
- **69%** of those firms purchase at least one data feed from a pricing vendor.
- **81%** of those firms maintain fair valuation policies and procedures.



## Hard to Value Securities

- **51%** of firms invest in hard to value securities.
- **26%** of those firms rely entirely on independent third parties to value those securities.
- **40%** of those firms rely on dealer quotes provided by the counterparty originally involved in the sale.
- **82%** of those firms maintain fair valuation policies and procedures.

# Valuation (continued)

## Fair Valuation

**You indicated that you maintain fair valuation policies and procedures. Which policies and procedures does your firm use? (check all that apply)**

- |  |              |
|--|--------------|
| • We price everything at cost until we dispose of the investment.  | <b>9.4%</b>  |
| • We use valuation models to price illiquid or hard-to-price investments.  | <b>37.3%</b> |
| • We rely on dealer quotes provided by the counterparty that originally sold us the security.  | <b>20.9%</b> |
| • We rely on dealer quotes provided by various broker-dealers with which we do business.   | <b>39.8%</b> |
| • We use an independent valuation agent.   | <b>35.2%</b> |
| • We permit our investment professionals to challenge prices only with oversight and approval from the legal and/or compliance department(s).                    | <b>28.7%</b> |
| • We permit our investment professionals to override prices without prior approval, but they must subsequently notify the legal and/or compliance department(s). | <b>4.9%</b>  |

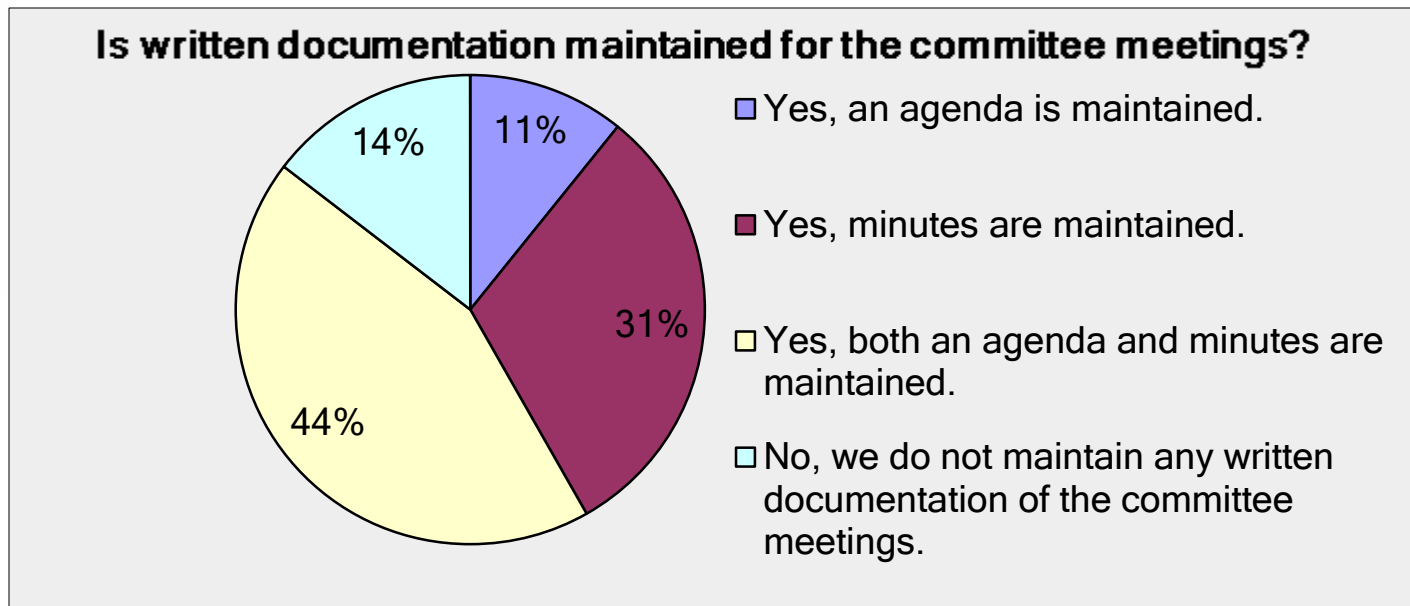
*“Our investment professionals speak to the company and conduct their own analysis to determine a fair price of the illiquid holding and use arms length transactions where available.”*

*“Investment professionals may provide input, but Valuation Committee (which consists of President, CCO, CFO and the relevant fund's portfolio manager) is required to sign off on pricing related to all illiquid positions (i.e., those other than Level 1).”*

*“We've developed our policies based on guidelines established by the Private Equity Industry Guidelines Group and the National Venture Capital Association.”*

# Valuation (continued)

- **52%** of respondents have a Valuation Committee.
- The Committee most commonly meets Quarterly (**37%**) or Monthly (**24%**).
- **82%** of firms with a Valuation Committee have the CCO as a member, whether voting (**48%**) or non-voting (**34%**).
- **85%** of firms maintain written documentation of the Valuation Committee meetings:



# Valuation (continued)

## What types of forensic tests related to valuation of marketable securities does your firm conduct?

- We review the inputs used in model-based pricing and in particular those to which the model's price exhibits significant sensitivity. **17.4%**
- We review internal valuation of assets with valuations provided to clients on custodial statements. **45.6%**
- We compare the methods actually used for valuation with our written policies and procedures and client disclosures. **38.2%**
- We review a periodic price change tolerance report to determine the reason(s) for any significant pricing movements in any securities during the period (for example, if we see that the price of Security X has moved more than a certain percentage in the past month, we examine further). **31.5%**
- We review the process for valuation challenges and overrides whereby an investment professional (e.g., portfolio manager, trader, analyst, etc.) is provided the opportunity to challenge or override a price or valuation provided by an independent third-party (e.g., pricing service or broker-dealer). **30.7%**
- We compare multiple pricing services to ensure that the values being provided are reasonable. **45.6%**

*"We use IDC and until now didn't realize we should be doing any sort of verification, as we have relied on it exclusively for years."*

*"For fixed income securities, managers review a quarterly bond yield report and we research anything that looks out-of-sync. we also sample test fixed income prices as part of our trade execution testing. When looking at sales, we compare to our prior day pricing and for purchases, we compare to our subsequent days' pricing. We also sample test fixed income prices by comparing to bond trade activity available through MSRB and FINRA."*

# Valuation (continued)

**What types of forensic tests related to the valuation of illiquid/hard to price securities does your firm conduct?**

- We obtain and review documentation for each investment to determine whether sufficient documentary support is maintained for each valuation. **(62%)**
- We compare the methods actually used for valuation with our written policies and procedures and client disclosures. **(44%)**
- We compare current valuations with recent sales prices for the same securities. **(39%)**
- We conduct an analysis of securities whose price has not changed for a certain period of time (*i.e.*, “stale price report”). **(36%)**
- We conduct initial and on-going due diligence on third-parties that are involved in our valuation process. **(32%)**

*“Valuation committee reviews pricing of each illiquid position and signs off on a monthly basis.”*

# Custody/Identity Theft/Red Flags

## Custody – Safeguard client assets and prevent misappropriation

- Provide custodians with a list of employees authorized to provide instructions. **(65%)**
- Limit the employees who are authorized to transmit trade orders for client accounts. **(62%)**
- Limit the number of employees who are permitted to interact with custodians with respect to client assets. **(54%)**
- Test reconciliation of account statements prepared by our firm with account statements prepared by the custodians. **(54%)**
- Require the authorization of more than one employee before the movement of assets within, and withdrawals or transfers from, a client's account. **(44%)**



*“All client account activity and address change requests are monitored by multiple employees.”*



# Custody/Identity Theft/Red Flags (cont'd)

## Custody – Avoid inappropriate fee deductions

- Ensure the clients' AUM on which their advisory fee is billed is accurate and has been reconciled with the AUM reflected on the clients' custodial statement. **(54%)**
- Review client contracts to determine that we bill in accordance with the terms of client contracts. **(49%)**
- Conduct periodic testing on a sample basis of fee calculations for client accounts to determine their accuracy. **(43%)**
- Reconcile invoices with deposits made by custodian(s) into our proprietary bank account to confirm that accurate fee amounts are being deducted. **(27%)**
- Review our fee calculations in conjunction with our valuation policies and procedures for accounts holding hard-to-price or illiquid securities. **(25%)**



*“We do not debit fees from institutional assets. Only have power to debit, have custody over 2 pooled hedge funds where we act as the Adviser and the related person is the GP. We have a 3rd party administrator who calculates the management fee. We have the GP and administrative person at the Adviser Sign off on Letters of Authorization to move money (redeem investors, pay bills or pay management fees) then the 3rd party Administrator receives copies of supporting documents (invoices) signs off and forwards the request to 3rd party prime broker/custodian for processing.”*

# Custody/Identity Theft/Red Flags (cont'd)

## Custody – Account Statements

- **33%** rely on the custodian to mail or email the firm a duplicate copy of the account statement at the same time it mails or emails the statement to the client.
- For **24%**, the custodian makes custodial account statements sent to the firm's clients available on the custodian's website, and the firm accesses and reviews the account statements on the custodian's website in addition to taking additional steps to determine whether account statements were sent to clients, or that clients obtained statements through the website.
- **18%** rely on the custodian to sign an attestation, letter, notice, or other statement indicating that it sends account statements to clients on a quarterly basis, in addition to other measures.

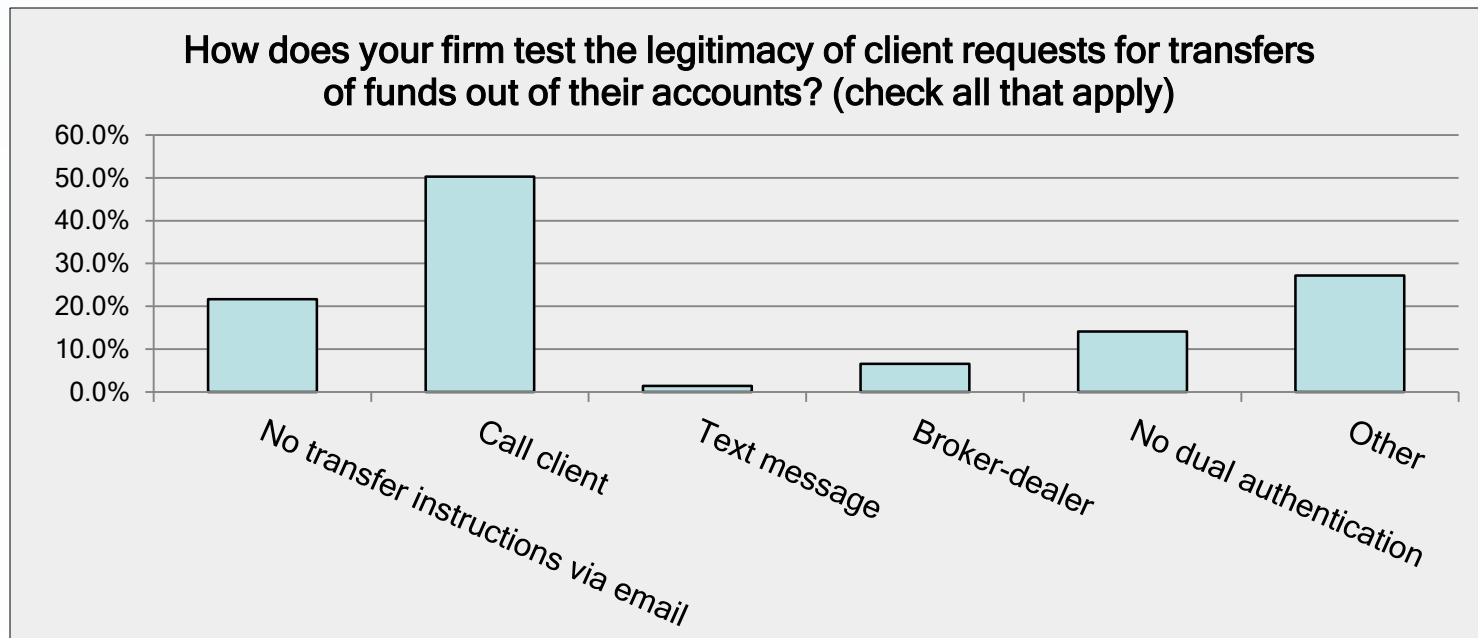
*“We send account statements with a notice to contact us if they are not receiving a custodial statement.”*

*“We verify the duplicate statement our office receives has the same mailing address as our system.”*

*“We include a notice on all of our quarterly reports to clients and in our email blast to clients when we post their quarterly performance reports.”*

# Custody/Identity Theft/Red Flags (cont'd)

## ➤ Identity Theft/Red Flags – Legitimacy of client requests for fund transfers

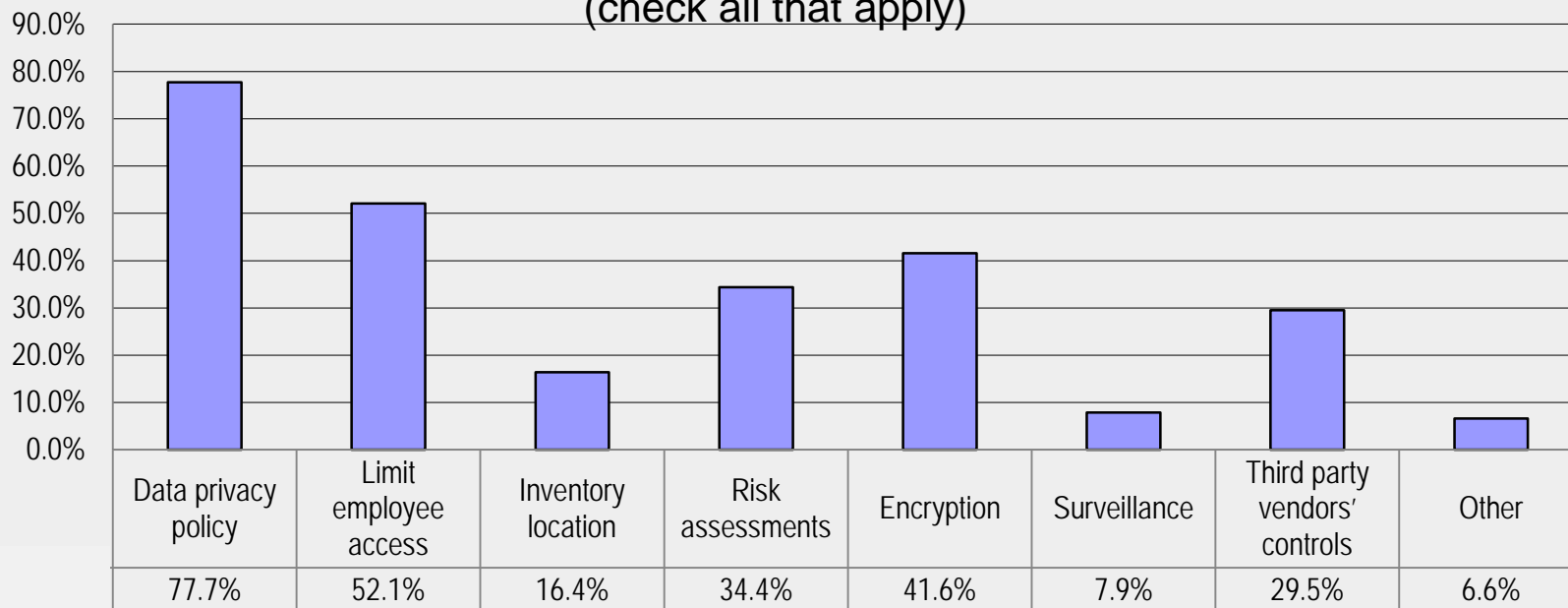


- We call and speak with clients to verify:
  - All third party requests for funds
  - Transfer requests over \$50,000
  - Transfer requests over \$25,000
  - Foreign wires

# Custody/Identity Theft/Red Flags (cont'd)

➤ **Identity Theft/Red Flags – Prevent internal threats to clients’ personal identifiable information**

How does your firm prevent internal threats to clients’ personal identifiable information (PII) (i.e., an employee intentionally or inadvertently reveals clients’ personally identifiable information)?  
(check all that apply)



# International Regulatory Compliance

- **30%** of respondents operate internationally.
- **11.5%** of respondents have a US office either registered or exempt from registration in a foreign jurisdiction.
- **23%** of respondents have a branch/affiliate registered in a foreign region.
- **13%** of respondents market in a foreign jurisdiction.
- **1.5%** are currently in the process of setting up operations abroad.
- **36%** CCOs visit foreign offices at least annually with **11%** never visiting.



# International Regulatory Compliance (cont'd)

- Of those reporting foreign offices, **67%** have a centralized compliance program with a global CCO.
- **57%** of those respondents require all employees to report personal securities transactions.
- There's an even split when it comes to compliance manuals between firms reporting that they have one manual for all offices and each office having its own manual (**43% each**).
- **95%** of respondents indicated that foreign domiciled SEC registered advisers apply their US compliance program to all clients, not just US clients.
- **73%** of respondents indicated that their foreign offices have distinct compliance budgets.
- **57%** of respondents include all offices in the annual compliance program review.



# International Regulatory Compliance (cont'd)

## AIFMD

- **11%** of respondents manage an EU domiciled fund (other than a UCITS) fund or any fund actively marketed into the EU.
- Of those respondents, **8%** have given no consideration to the implications of AIFMD.
- Of those that have considered the implications of AIFMD on their business, **61%** consider the remuneration requirements to be the most concerning, followed by the risk management component (**42%**).
- **15%** of respondents have indicated that they are considering altering the structure of the group to avoid registration as an AIFM.
- Of the **66%** of respondents who intend to actively market a fund into the EU, **91%** have received legal advice on the private placement rules for each jurisdiction where they intend to market.



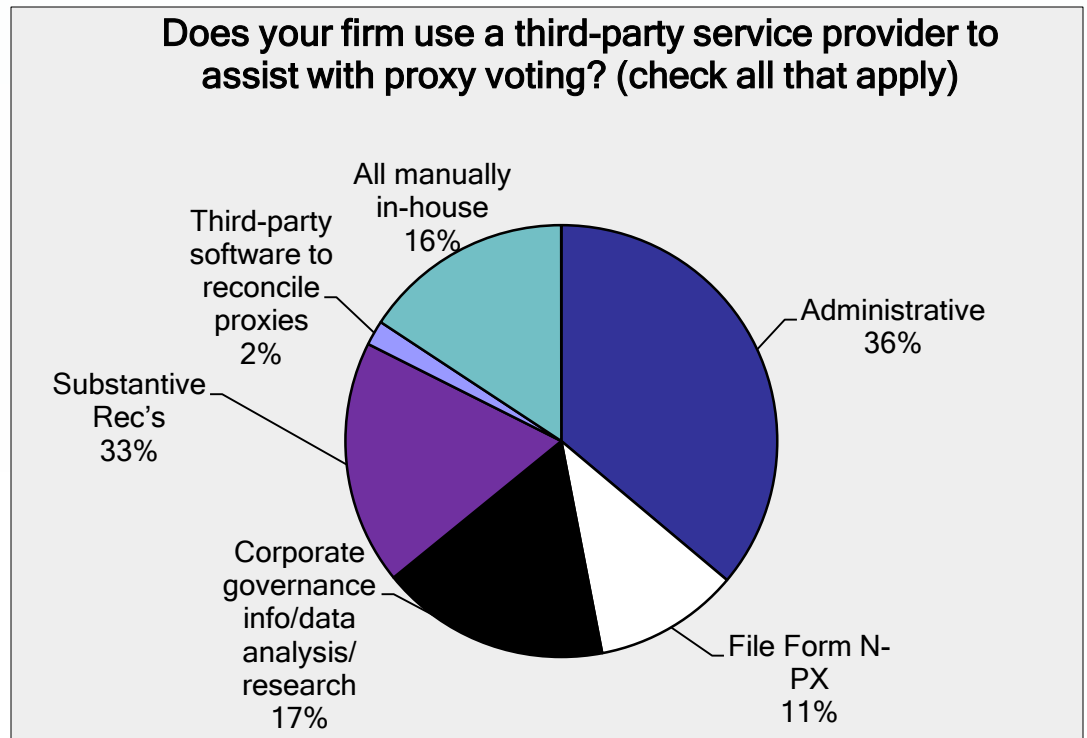
# Proxy Voting Policies and Procedures

- 77% of firms vote proxies on behalf of at least some of their clients.
- Vast majority (82%) of these firms do not address ESG in policies.
- 29% of these firms handle proxy voting entirely manually in-house.

➤ 66% of respondents use a third-party service provider to assist with administrative functions (e.g., mechanics of voting proxies, voting logistics, record management).

➤ Only 33% of advisers have retained third parties to assist with recommendations or substantive voting decisions.

- Procedures to retain third parties:
  - Due diligence on provider
  - Periodically assess providers' conflict procedures
  - Require disclosure of conflicts
  - Periodically review competency of providers' administrative functions





# Proxy Voting Policies and Procedures (cont'd)

## Testing Compliance with Proxy Voting Policies and Procedures:

- Review client files to ensure correct id of accounts for which to vote proxies **(48%)**
- Compare firm policy to actual votes **(53%)**
- Review disclosures in light of practices **(53%)**
- Review guidelines to ensure consistency with best interests of client **(45%)**
- Review whether votes cast for all clients holding subject security **(39%)**
- Compare incoming proxy information against firm holding records **(36%)**

## Handling Conflicts:

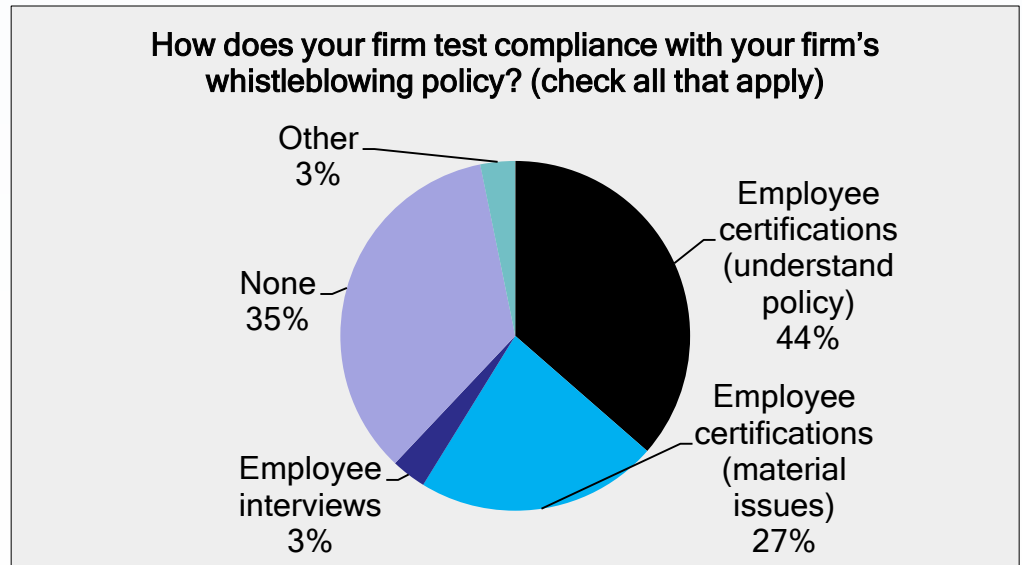
- Disclose conflict and obtain consent **(24%)**
- Vote in accordance with firm's pre-determined policies **(42%)**
- Vote in accordance with pre-determined policy based on 3<sup>rd</sup> party recommendation **(31%)**
- Firms wrote in:
  - Use of Proxy Voting Committee
  - Recusals
  - Refraining from vote



# TREND UPDATE: Whistleblowing

- **70%** of firms have either a written or oral policy.
- Similar to 2012 trend update of **67%** and original survey questions on whistleblowing in 2011 (**69%**).
- Slight rise in firms developing/having a whistleblowing hotline **24%** (2012) and **17%** (2011) vs. almost **30%** (2014).
- Close to a **quarter** of respondents require employees to **certify** that they have reported material compliance matters and **71%** of respondents require some form of **certification**.

*“More anonymous mechanisms for reporting.”*



*“New hires are trained in how to report anonymously and are required to provide a sample anonymous email. Training is included in our annual compliance training and by signing the annual Code of Ethics acknowledgement; the employee also certifies their knowledge of an adherence to the policy.”*

# TREND UPDATE: Directed Brokerage

- About **half** of respondents have a directed brokerage policy.
- Of those with a policy, about **half** of respondents confirm that the client has provided a written brokerage direction letter.
- Fewer than **30%** compare actual allocations to targets and about **half** of respondents review directed brokerage commission reports prepared internally or by a broker.
- About **41%** review the execution quality of directed brokers.



- Fewer than **18%** review direction arrangements to notify clients if the arrangement is not in their best interest.
- Just under **12%** review wrap arrangements to determine if the firm traded away from the arrangement.

*“Traders affirm quarterly that they are not directing brokerage for favors or sale of mutual fund shares (or anything other than best execution).”*

# TREND UPDATE: Hot Compliance Topics

<b>Topics</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>Custody</b>	<b>35%</b>	<b>12%</b>	<b>20%</b>	<b>23%</b>
<b>Cybersecurity/Privacy/Identity Theft</b>	<b>33%</b>	<b>15%</b>	<b>14%</b>	<b>75%</b>
<b>Advertising/Marketing</b>	<b>29%</b>	<b>26%</b>	<b>34%</b>	<b>27%</b>
<b>Valuation</b>	<b>27%</b>	<b>25%</b>	<b>26%</b>	<b>18%</b>
<b>Fraud Prevention</b>	<b>20%</b>	<b>11%</b>	<b>12%</b>	<b>13%</b>
<b>Regulatory reporting</b>	<b>44%</b>	<b>31%</b>	<b>18%</b>	<b>6%</b>
<b>Insider Trading</b>	<b>42%</b>	<b>32%</b>	<b>22%</b>	<b>13%</b>
<b>International</b>	<b>X</b>	<b>X</b>	<b>17%</b>	<b>14%</b>
<b>Social Media</b>	<b>X</b>	<b>43%</b>	<b>25%</b>	<b>28%</b>
<b>Disaster Recovery</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>16%</b>
<b>FATCA</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>16%</b>

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