

# How to Master the Annual Review and Promote a Culture of Compliance

## Part 2: Testing and Reviews

By Elizabeth Cope

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### Review of Part 1

In our previous article, we discussed the following:

- How you can use the annual review to:
  - promote a culture of compliance;
  - get your team on board and adhere, consistently, to your firm's compliance policies and procedures, and;
  - make your job as the CCO much easier!
- Why it is essential that you:
  - tailor your annual review to your firm's unique operations, and;
  - make your annual review as simple and practical as possible.
- How to develop and refine an effective risk assessment—which is the first stage in customizing the annual review to your firm.

If you haven't read [Part 1 of How to Master the Annual Review and Promote a Culture of Compliance](#) and completed your risk assessment, we recommend doing so before reading Part 2 because they build on each other. Part 2 requires that you have a completed risk assessment in order to move forward.

### Part 2: Testing & Reviews

As we mentioned in our previous article, the annual review is a big project and requires all elements of project management. (You didn't know you were a Project Manager, did you?!) This article will cover the planning and execution aspects of the annual review.

#### Step 1: Plan

The Advisers Act requires only an annual review, but that does NOT mean that the review needs to be conducted all at once, annually. We recommend breaking it up into a quarterly testing schedule to capture all elements throughout the year, as it is more manageable. It also serves as a benefit for identifying any issues before they have occurred for an extended period of time.

Planning your annual review requires a well-thought-out risk assessment to use as the basis of your planning. Once you know your risks, the level of severity of those risks, and the likelihood those risks will occur, you will use that information to determine what testing and reviews to conduct, how deep of a review to conduct, how often to conduct it, and when.

#### Define the Testing

- Your risks and policies should drive what kind of testing you complete.
- We have provided a list of possible testing items, the "Testing & Review Inventory." The list is not exhaustive, but it is robust and will be a great resource to refer to.
- We also recommend taking into consideration OCIE initiatives and focus areas when deciding what to test. For example, this year, one area OCIE is focusing on is fees and expenses being charged to clients, with even more emphasis placed on retail clients. If you are an adviser with retail clients, I would suggest a quarterly review of billing practices.
- Once you have identified everything that needs to be tested, you're ready to develop a testing schedule.

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#### About the Author

Elizabeth Cope is Managing Member, [SEC Compliance Solutions, LLC](#). She can be reached at [liz@secscsllc.com](mailto:liz@secscsllc.com).

## Develop the Testing Schedule

We suggest any risks rated as “high” to be tested frequently (e.g., quarterly). Any risks rated as “low” can be tested infrequently (e.g., annually or even every other year).

Create a [Compliance Calendar](#) document that maps out the areas to be reviewed and the timing of those reviews. The example provided places testing areas in general categories and breaks up the testing quarterly. You could use this model but change the time frame to monthly and provide more detail if that would work better for your operations. We encourage you to adjust this or use whatever method works for YOU.

## Step 2: Execution

### Conduct the Testing

Here is where you get to be creative. There is no defined, set way, nor guidance from the SEC on how to review or test specific areas. Since we can’t go through every possible test in this article, we’re going to give you some helpful tips for how to think through the process to develop testing and reviews that are practical for your firm’s business, using a couple of examples.

#### Example 1: Client Billing

Here is an example of how to conduct testing of fees and expenses being charged to clients:

Fee Invoice Review					
Account Code	Annual Fee Schedule per Contract	Annual Fee Per Invoice	Quarterly Fee Calculation	Quarter End Value Per Invoice or Custodial Stmt	Calculation of Quarterly Fee
Ex. 12345	Equity 0.75% 1% \$0-\$4MM 0.80% \$4MM - \$10MM	0.750%	0.188%	\$4,820,743.21	\$9,038.89
Ex. 54321	0.60% \$10MM+	0.800%	0.200%	\$6,294,587.00	\$12,589.17

1. Pull a sample of clients each quarter. It’s good to keep track of your samples so you do not pick the same accounts over again.
2. For each client in that sample, obtain and review the investment management agreement, invoice, and a third-party custodial statement.
3. Compare the rate used in the invoice to what the client agreed upon within the investment management agreement.
4. Compare the market value being used to calculate the fee to the third-party custodial statement.
5. Recalculate that fee, and make sure you get to the same number on the invoice.
6. Document your testing and add the documented testing to your annual review files.
7. Note any exceptions and discuss them with the appropriate personnel to prevent further errors.
8. Determine if the policies need to be re-written and/or if practices need to be changed as a result.

We have provided an [example worksheet](#) for fee testing.

#### Example 2: Investment Guidelines & Restrictions

Here is an example of how to review adherence with client guidelines and restrictions:

Client Guidelines & Restrictions Review		
Account Code	Guidelines/Restrictions per Agreement	Guidelines/Restrictions per S
Ex. 1234	Max 5% in one security	Coded
	Max 15% in one sector	Coded
	Max Cash 10%	Coded

1. Pull a sample of clients each quarter. It’s good to keep track of your samples so you do not pick the same accounts over again.
2. For each client in that sample, obtain and review the investment policy statement, internal appraisal report, report for any coded restrictions (if applicable), any document from the client for guideline and/or restriction changes, and a third-party custodial statement.
3. Identify and document the client’s stipulated guidelines and restrictions per their investment policy statement.
4. Compare the internal appraisal report and/or third party custodial statement, confirming the securities invested in, allocations, etc. are in line with stipulated guidelines and restrictions. For example, if the client has a restriction of no IBM, confirm the account does not hold IBM. Another common example is a client may require that their account holds no more than 5% in any one security. You can compare this against the portfolio appraisal report to see if in line with the client’s requirements.

5. If restrictions are coded within a system, compare them against the client’s investment policy statement to confirm they are properly recorded.
6. If any restrictions cannot be coded and are, instead, manually monitored, interview the person(s) responsible for monitoring and trading to confirm the process is consistent with your written policies and procedures, and use the opportunity to see if there is a better way to keep track and monitor.
7. Document your testing and add the documented testing to your annual review files.
8. Note any exceptions and discuss them with the appropriate personnel to prevent further errors.
9. Determine if the policies need to be re-written as a result.

We have provided an [example worksheet](#) for testing adherence to client guidelines and restrictions.

Please note: These are only meant to be examples. The method and process will need to reflect your Firm’s business and should be adjusted accordingly.

MONITORING SCHEDULE					
Tasks	Item Reference	Quarter in which the review was performed/completed			
		1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
<b>Compliance Oversight</b>					
Current CCO Profile	<a href="#">Item 1</a>	x			
Compliance Support	<a href="#">Item 2</a>				x
Oversight of Employee and Firm Activities	<a href="#">Item 3</a>	x			
Training	<a href="#">Item 4</a>				x
Due Diligence of remote offices, affiliates, service providers and sub-advisers.	<a href="#">Item 5</a>			x	
Policies & Procedures	<a href="#">Item 6</a>				x
Private Fund Expense Allocations	<a href="#">Item 7</a>	x	x	x	x

### Document the Results

As mentioned in the previous two examples, it is good to document the results of all the testing. This should include a summary of the testing conducted, references to any supporting records, and the results. If you find any exceptions, you should also note the remedy (i.e. provided additional training to staff, enhanced or changed existing procedures, etc.)

It is actually not a requirement to have a written report that memorializes your annual review (except for Mutual Funds,

which must provide a written report to the Board of Directors). However, it is in your best interest to document your annual review, as the SEC does expect it.

You need to be able to substantiate to an SEC examiner and leadership that the reviews have been completed along with the results of those reviews. It is also VERY important when you note exceptions that you provide the remedy or follow up. If you are not able to address them at the time of the review, you can create a log of exceptions that you re-visit to confirm the violations and/or exceptions have been followed up on. You do not want those coming back to haunt you.

In addition to supporting the testing, as discussed above and provided in the templates, I suggest a letter or memo, which we will discuss in detail in Part 3, to summarize the results of that period’s review.

### Summary

Conducting the testing and reviews throughout the year can serve in managing your workflow and in putting out any fires before they get out of hand. As the CCO, you can also delegate tasks to others within the firm or even a third party. Using the risk assessment as your guide, will help make sure the reviews and testing are adding value to your firm and not just serving as busy work. It is essential you customize the testing to address your firm’s uniqueness and make the process as simple and practical as you can.

Please use the [Testing & Review Inventory](#) as your guide, as you work through Part 2, defining the testing and reviews. Also, remember to use the risk assessment, developed in Part 1, as your compass.

Stay tuned for our third and final issue of How to Master the Annual Review and Promote a Culture of Compliance which will focus on how to tie it all together, document the results in a formal letter, how to communicate the results internally and with the regulators, as well as how to debrief and plan for the next year.