InteractiveBrokers

SPOTLIGHT ON

The Compliance Systems and Documentation Advisors Must Maintain

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When regulators examine firms, they often look for shortcomings in the firms' policies and procedures and supporting documents, as much as tangible rule violations. Regulators may penalize advisors for having deficient compliance policies and procedures even if the advisors did not break any substantive rules. For instance, a firm's failure to follow certain policies and procedures the firm chose to adopt may be used to demonstrate lack of supervision, even if the firm was not required to adopt the procedures in the first place.

Registered advisors are expected to implement written policies and procedures reasonably designed to ensure compliance with applicable regulations. Firms must also adopt a written Code of Ethics setting forth a standard of business conduct for all employees that reinforces the advisory firm's fiduciary obligations and requires compliance with securities laws. Advisors must also generate and maintain certain reports and documents in connection with these policies and procedures.

Advisors' Compliance Program.

Procedures advisors must adopt.

The Investment Advisers Act (the "Act") requires SEC-registered advisors to:

- **Adopt and implement written compliance policies and procedures reasonably designed to prevent, detect, and promptly correct violations of the Act and its rules by advisory firms and the firms' supervised persons.**
    - This compliance program must be comprehensive and cover the scope of the advisor's business and compliance responsibilities.
    - Advisors' compliance program must have a component that tests and analyzes information and trends on a regular basis so that the firm can demonstrate its procedures are reasonably designed to catch violations.

Advisors' Compliance Program (cont.)

- **Review those policies and procedures annually for adequacy, thoroughness, and effectiveness in light of changes in the advisor's (or its affiliates') business activity, changes in applicable laws and regulations, and any significant compliance events that occurred during the year.**
    - Firms may need to conduct interim reviews during the year if material changes occur.
    - Some advisors may choose to prepare a written report memorializing findings from their annual compliance review.
    - If advisors choose to create a report in connection with the annual review, that report or documentation should demonstrate that the following areas were addressed:
        - Any issues raised during recent regulatory exams and actions the firm took to correct those issues;
        - Findings from any interim reviews or other audits and follow-up or corrective actions that resulted;
        - Any serious compliance issues at the firm and/or in the industry generally during the past year;
        - Any violations reported pursuant to the advisor's Code of Ethics;
        - Analysis of the compliance implications of new or discontinued businesses or changes in the firm's operations during the past year;
        - Impact of new statutory or regulatory requirements;
        - Issues SEC staff identified as areas on which the SEC is focusing;
        - Procedures to identify firm risk, i.e., formal risk assessments and personnel interviews; and
        - Testing to assess the effectiveness of critical controls.
    - Any written report findings the advisor chose to create should address whether:
        - The firm believes that compliance policies and procedures are still reasonably designed to prevent and detect violations of applicable rules and laws;
        - The advisor implemented any new policies and procedures to address any gaps identified;
        - Advisory personnel adequately carry out compliance policies and procedures and whether any discipline, training, or heightened supervision is required; and
        - Any clients were harmed by any significant compliance deficiencies uncovered during the annual review.

- **Designate a Chief Compliance Officer who is competent and knowledgeable regarding the Act, empowered with full responsibility and authority to develop and enforce appropriate compliance policies and procedures and who has sufficient seniority and authority within the firm to compel others to adhere to the firm's compliance policies and procedures.**
    - The Chief Compliance Officer can be any appropriate employee of the firm and may also have other roles or positions at the firm. For instance, the Chief Compliance Officer at small advisory firms is typically one of the principals.

Advisors' Compliance Program (cont.)

- **Maintain certain records related to the firm's compliance policies and procedures, including.**
    - Copies of the policies and procedures in effect for the past five years; and
    - Documentation of the advisor's annual review of those policies and procedures.

Scope of advisors' compliance policies and procedures.

To be reasonably designed to prevent any violations of the Act by the advisors and their supervised persons, SEC-registered advisors' compliance program must be comprehensive and cover the scope of the advisor's business and compliance responsibilities. At the least, these procedures are expected to cover the following areas:

- **Portfolio management processes.** This includes the allocation of investment opportunities among clients, the consistency of portfolios with clients' investment objectives, disclosures by the advisor, and applicable regulatory restrictions;

- **Trading practices.** This includes procedures the advisor uses to satisfy its best execution obligations, any soft-dollar arrangements (i.e., the extent to which the advisor uses client payments to obtain research and other services from the broker), and how the advisor allocates aggregated trades among clients;

- **Proprietary trading** by the advisor and **personal trades** by the firm's supervised persons;

- **Accuracy of disclosures** to investors, clients, and regulators, including account statements and advertisements;

- **Safeguarding of client assets** against theft or inappropriate use by advisory personnel;

- **Creating accurate records and maintaining them** in a manner that protects them against unauthorized use or alteration and untimely destruction;

- **Marketing advisory services,** including the use of third-party solicitors;

- **Processes for valuing client assets and assessing fees** based on those valuations;

- **Protecting the privacy of client records and information;** and

- **Business continuity plans,** including disaster recovery planning.

Advisors' Compliance Program (cont.)

What the Act does not require.

Compliance policies and procedures are expected to describe a mechanism to meet the firm's obligations, but do not need to memorialize every action to be taken to remain in compliance with the Act. It is enough if the firm's compliance policies and procedures designate the people or groups within the firm responsible for addressing each compliance subject, e.g., identify who must file and update required forms.

The Act does not require all compliance policies and procedures to be consolidated in one document.

Also, dually registered advisors do not need to segregate their advisor and broker-dealer policies and procedures.

State rules on compliance policies and procedures.

State laws vary, but a majority of state securities regulators require state-registered advisors to develop written compliance and supervisory procedures much like the SEC does. Advisors should research the law of the state(s) where they operate to ensure compliance with the applicable requirements.

Advisors' Code of Ethics.

The SEC and many states require advisors to adopt a formal Code of Ethics document setting forth a standard of business conduct for their supervised persons reflecting their and their supervised persons' fiduciary obligations.

Registered advisors must describe their Code of Ethics in Part 2A of the Form ADV and must offer to provide, upon request, a complete copy of the Code of Ethics to advisory clients.

Advisors’ Code of Ethics (cont.)

What advisors’ Code of Ethics must address.

SEC-registered advisors’ Code of Ethics must at least:

- Require compliance with applicable Federal securities laws;
- Require supervised persons with access to nonpublic information (“access persons”) to report personal securities transactions and holdings on an ongoing basis to the firm so that the firm can review these reports;
- Require access persons to obtain firm approval before directly or indirectly buying a security in an IPO or limited offering;
- Require all supervised persons to promptly report Code of Ethics violations to the firm’s Chief Compliance Officer or other appropriate personnel; and
- Require that the Code of Ethics (and any amendments) be provided to all supervised persons and that supervised persons acknowledge receipt in writing.

Personal holdings and trade reporting for access persons.

SEC-registered advisors must require that all access persons submit a report of their current securities holdings and transactions in reportable securities. These reports must be submitted to the firm’s Chief Compliance Officer or his designee.

The Act defines an “access person” as a supervised person who:

- Has access to nonpublic information regarding any client’s purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, i.e., any fund for which the advisory firm serves as an investment advisor or any fund whose investment advisor or principal underwriter controls, is controlled by, or is under common control with the advisory firm;

- Is involved in making securities recommendations to clients or has access to these nonpublic recommendations; or

- Is a partner, officer, or director of an advisor whose primary business is providing investment advice.

Advisors’ Code of Ethics (cont.)

Access persons must submit initial and annual holdings reports and quarterly transaction reports. They may submit duplicate copies of trade confirmations or brokerage statements that contain the required information in lieu of the reporting forms if the confirmations or statements are current and the advisor receives them a certain number of days after the end of the quarter.

The following are not considered “reportable securities,” and access persons do not have to report holdings or transactions in these instruments:

- U.S. government bonds or debt obligations;
- Bankers’ acceptances, bank certificates of deposit, commercial paper and high quality short-term debt instruments, including repurchase agreements;
- Shares issued by money market funds;
- Shares issued by open-end funds other than reportable funds; and
- Shares issued by unit investment trusts that are invested exclusively in one or more open-end funds, none of which are reportable funds.

Although not required by the rule, advisors may choose to require access persons to report that they do not have any transactions or holdings to report to ensure that all access persons remain consistently aware of the personal securities holding and transaction reporting requirements.

Advisors’ review of access persons’ personal holding and transaction reporting.

The Act requires advisors to maintain and enforce their Code of Ethics. The SEC expects the enforcement of the Code of Ethics to include a review of the access persons’ personal holding and transaction reports.

Specifically, the SEC expects advisors’ review of personal securities holding and transaction reports to:

- Assess whether the access person followed required internal procedures, such as pre-clearance;

- Compare personal trading to any restricted lists;

- Assess whether the access person is trading for his own account in the same securities he is trading for clients, and, if so, whether the clients are receiving terms as favorable as the access person gets for himself;

- Periodically analyze the access person’s trading for patterns that may indicate abuse, including market timing;

- Investigate any substantial disparities between the quality of performance the access person achieves for his own account and what he achieves for clients; and

- Investigate any substantial disparities between the percentage of trades that are profitable when the access person trades for his own account and the percentage that are profitable when he places trades for clients.

The SEC does not require advisors to retain records of these reports in an electronic database but appears to expect that firms will store and review these materials electronically. The Commission has expressed serious doubt about whether a larger investment advisory firm can adequately review these reports manually and/or on paper.

Code of Ethics-related records advisors must keep.

The Act requires advisors to keep certain records related to the Code of Ethics including:

- Copies of the Code;
- Records of violations of the Code and of any actions taken against those who violated it;
- Copies of each supervised person's acknowledgment of receipt of a copy of the Code;
- A list of all access persons at the firm;
- Personal securities holding and transaction reports of the access persons; and
- Records regarding prior firm approval of access persons' acquisitions of securities in IPOs and private placements.

State law and other requirements.

The states also generally require state-registered advisory firms to adopt a Code of Ethics. Advisors should consult the rules and regulations of their state(s) to determine whether they require a Code of Ethics.

In addition, Section 204A of the Act requires both SEC- and state-registered investment advisors to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the advisor and its supervised persons. Advisors often include this prohibition on insider trading in their Code of Ethics.

Other Procedures Advisors Must Adopt.

SEC-registered advisors must also adopt a number of other procedural documents.

Among others, advisors must have written privacy policies and procedures outlining the advisor's administrative, technical, and physical safeguards to protect customer records and information, which are reasonably designed to protect against unauthorized access or misuse of customers' personal information.

Firms must also have written proxy voting policies and procedures reasonably designed to ensure that advisors will cast votes in their clients' best interests. These procedures are expected to describe how advisors will resolve material conflicts of interest between the advisor's and clients' interests, and disclose how clients can learn how their proxies were voted and obtain more information about proxy voting procedures.