

Building a Better Compliance System: Using SEC methodology to develop and fine tune your system of internal controls

Presented by

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Today's Goals

Show you the basics of how to build a compliance system including:

- Some Rules
- Discussion of internal controls
- What is a risk analysis and how to conduct one
- What goes into a manual
- How to integrate a compliance matrix to analyze and track your system

Why have a compliance system?

- You need compliance policies and procedures to address the demands of external parties and internal management.
- External
 - Regulators
 - Opposing Counsel
- Internal Risk Management

Why have a compliance system?

- Internal management
 - Reduce the risks associated with your business
 - Increased accuracy of your product
 - Improved investment performance
 - And in some cases the review of your process will increase efficiency within your office.

SEC Rule 206(4)-7

- Written policies and procedures
 - Reasonably designed to prevent violations...
- Annual review
 - The adequacy of the policies and procedures
- Chief Compliance Officer

Internal Controls = Compliance

- Compliance is a process, not an event
- Objectives of compliance / internal controls
 - Effectiveness and efficiency of operations
 - Reliability of reporting
 - Compliance with laws and regulations

Internal Controls

- Internal control is effected by people. It is not merely policy manuals and forms, but people at every level of an organization.
- An internal control is not just what is in your manual , its what you and your people do everyday.

Reasonable Assurance

- Internal control can be expected to provide only reasonable assurance, not absolute assurance to an entity's management.

Parts of a compliance system

Theoretical	Your World
Control Environment	What part of your business do you want to control? Example: Your company, your people and securities rules
Risk Assessment	What potential risks to your company and clients are out there?
Control Activities	The procedures your firm actually does to review and document business.
Information and communication	Actions that let information flow to other parts of the company
Monitoring	Procedures that require and document the CCO's oversight.

Theoretical vs. Reality

You are already in business

- You might already have a manual
- You already have policies, “how you want to do things”
- You already have procedures, “how you do things”
- Defining and making an inventory of your risks may seem like a silly waste of time, but it is critical.

Why do a risk analysis?

- Take an inventory of the your potential dangers or pit falls.
- The analysis quantifies, ranks and maps your inventory of risks to your written policies and procedures.
- Its just good business.
- Its required by the SEC and many states.

Risk Analysis

- Many methods to accomplish the goals
 - Memos
 - Checklists
 - Tables
 - **Matrices**

Matrix Risk Analysis

1. Document each risk.
2. Rank as to potential impact to you or your clients – Before and after your internal control.
3. Map Control to your policies and procedures.
4. Cost Benefit analysis – is it worth doing?

Matrix Risk Analysis

Risk	L	I	W R	Control	L	I	WR
Failure to Renew registration	3	3	9				

1. Gather “risks” from everyone in your firm.
2. Assign each risk a:
 - Likelihood of it occurring (1-5 scale)
 - 1 = not likely to 5 = very likely
 - Impact to the firm if it did happen (1-5 scale)
 - 1 = small impact (not a big deal)
 - 5 = big impact (could end the firm)

Matrix Risk Analysis

Risk	L	I	W R	Control	L	I	WR
Failure to Renew registration	3	3	9	The CCO shall renew the company's advisor registration each year in December. (2.6)	1	3	3

3. Add the control for that risk.
4. Using the same scale, assess the likelihood and impact the control has on reducing the risk.
5. Assess the benefit.
6. Prioritize.

Compliance Manual

- Most manuals I review are:
 - Incredibly dull
 - Painfully long
 - Excruciating complicated
- Most manuals don't have a clear message
 - What do I have to do?
 - What do I get for doing it?

Compliance Manual

- Reality vs. Theory
 - You already have policies
 - What you want to do
 - You already have procedures
 - What you do on a day-to-day basis.
- Are you doing the right things?
- Can you prove it?

Compliance Manual

Are you doing the right things?

- Use your Risk Matrix
- Review the rules
- Existing manual or template

Compliance Manual

- Templates
 - Good
 - Starting place
 - Outline
 - Background
 - Bad
 - Most don't have policies or procedures
 - Or they are not what you do

Compliance Manual

Policies should be:

- Clear
- Short
- Attainable

Sample:

“The company shall renew its investment advisor registration in all states and jurisdictions where required annually.”

Compliance Manual

Procedures should:

- Describe what you actually do.
- Be detailed enough to be helpful.
- Create evidence of their completion.

Compliance Manual

Procedures should

- Describe who is supposed to do it.
- Describe when should it be done.
- Describe what records its completion.

Compliance Manual

Who?

- Manual should use titles
- Define titles in a table in the manual

Title	Individual
Chief Compliance Officer	Tom Rausch
Portfolio Manager	Warren Buffett
Reception	Heidi Klum
Client Service Manager	Tony Robbins

Compliance Manual

When?

- Some actions are required to be done at a certain time by rule.
- Some actions are just convenient to do at a certain time of the year.

Compliance Manual

What denotes records completion?

- Sometimes it will be a piece of paper
- Sometimes it will be a signature and date
- Sometimes it will be an electronic file with an electronic signature and date

Compliance Manual

For my last example:

- Policy : “The company shall renew its investment advisor registration in all states and jurisdictions where required annually.”
- Procedures might include:
 - Sort client list by state
 - Count clients
 - Check state de minimis
 - Check branch office addresses

Compliance Matrix

Section	Page	Action	Document	Responsible Person	Frequency
2 Registration	6	Assure all IARs are registered in proper states	Forms U-4 CRD reports IARD reports	CCO	Quarterly
2 Registration	8	The firm registration shall be renewed annually.	ADV 1A IARD	CCO	Annually

Compliance Manual

Each November the firm's [Client Service Manager] shall :

- Create a list of all advisory clients of the firm
- Sort the list by state of residence
- Count clients in each state
- Determine if any clients are in zero de minimis states
- Provide completed list to CCO by November 10

What Should the Manual Address?

- The SEC said that it expects to see:
 - Portfolio management processes
 - Accuracy of disclosures
 - Proprietary trading
 - Safeguarding of client assets
 - Books and records
 - Safeguarding of client information

What Should the Manual Address?

- SEC expects to see (*continued*):
 - Trading practices
 - Marketing
 - Valuation of client holdings, and
 - Business continuity plans – PLUS
- All the significant items from your Risk Matrix

Internal Audit

- At least annually you should
- Use your Risk Matrix to assure
 - There are no new risks
 - All risks are addressed in the manual

Internal Audit

- Is the compliance system working?
- The manual should contain the requirement that each internal control:
 - Creates evidence of its completion
 - The CCO to review it on no less than an annual basis
- Use your Compliance Matrix
 - Checklist
 - To-do list and Schedule or calendar

Conducting an audit

Another whole topic!

Questions?

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