FS Regulatory Brief

Broker-Dealer and Investment Adviser Compliance Programs: More Similar Than Different

Compliance programs are a requisite – and critical – part of every investment adviser, investment company, and broker-dealer firm. The required features of the compliance program are specified by the rules of the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA). These rules have certain common features – effectively creating "minimum elements" for broker-dealer and investment adviser compliance programs.

The separate regulatory requirements governing advisers' and broker-dealers' compliance programs are summarized here, as well as the common features – or "minimum elements." They share more than they differ.

In light of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the increase in the number of advisers that also operate as broker-dealers, and the current debate over establishing a common standard of care, being aware of the commonalities in legal requirements between the two regulatory frameworks may be valuable to chief compliance officers (CCOs) and others in the financial services industry.

I. Regulatory requirements governing the compliance programs of investment advisers and investment companies

Every investment adviser and investment company (fund) registered with the SEC is required to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. In addition, advisers and funds must review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a CCO to be responsible for administering the policies and procedures (under Rule 206(4)-7 of the Investment Advisers Act of 1940 (Advisers Act) and Rule 38a-1 under the Investment Company Act of 1940 (Investment Company Act), together called the "Compliance Rule").[1]

While advisers' compliance programs must be reasonably designed to prevent violations of the Advisers Act, funds' compliance programs must be broader in scope, and be reasonably designed to prevent violations of the Investment Company Act and the Advisers Act, as well as the Securities Act of 1933, the Securities Exchange Act of 1934 (Exchange Act), the Sarbanes-Oxley Act of 2002, Title V of the Gramm-Leach-Bliley Act (governing disclosure of nonpublic personal information), the Bank Secrecy Act (anti-money laundering requirements), and rules promulgated there under.

[1] References and quotations in this section are to the SEC's release adopting the Compliance Rule: "*Compliance Programs of Investment Companies and Investment Advisers*," (Release Nos. IA-2204 and IC-26299), December 17, 2003.

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Compliance policies and procedures should address the particular practices and risks present at each adviser. At a minimum, to the extent that they are relevant to the adviser, the policies and procedures must cover:

- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
- Processes to value client holdings and assess fees based on those valuations;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

There is no mandated set of policies and procedures, given the varied and individual nature of each adviser's different models, business relationships and affiliations. The SEC noted that each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks. Advisers and funds are required to conduct a review of their policies and procedures annually to determine their adequacy and the effectiveness of their implementation (funds are required to review the policies and procedures of service providers).

In addition, CCOs should be aware of the new regulatory requirements emanating from Dodd-Frank, namely the amendments to Form ADV and the Pay-to-Play Rule. CCOs also should continue to monitor the SEC for future developments concerning proposed Form PF, which would require certain registered advisers to provide additional information concerning the private funds they advise; and proposed rules that would require advisers to provide reports concerning their incentive compensation programs and to maintain policies and procedures regarding the use of such incentive-based compensation. These new proposals may require adjustments to an adviser's compliance program, including its policies and procedures.

II. Regulatory requirements governing the compliance programs of broker-dealers

Every broker-dealer that is a member of FINRA is required to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, Municipal Securities Rulemaking Board (MSRB) rules and federal securities laws and regulations.[2]

Broker-dealers must designate one or more CCOs. The CCO is to be "a primary advisor to the member on its overall compliance scheme and the particularized rules, policies and procedures that the member adopts."[3] The chief executive officer (CEO) of the broker-dealer firm must annually certify that the firm has such written compliance and supervisory procedures, and that the CEO has conducted

[2] References and quotations in this section are to FINRA's Rule 3130 "*Annual Certification of Compliance and Supervisory Processes*" and FINRA's Supplemental Material to the rule.
[3] See id.

one or more meetings with the CCO in the last 12 months to discuss such processes. These processes must be evidenced in a written report reviewed by the CEO, and provided to the broker-dealer firm's board of directors and audit committee (or equivalent bodies). A separate FINRA rule (Rule 3012) imposes certain supervisory obligations on broker-dealer firms, including the obligation to have written supervisory procedures, and to supervise specific aspects of the firm's and registered representatives' activities.

CCOs should be aware of recent regulatory proposals that may affect broker-dealers' reporting requirements. In June 2011, the SEC proposed significant changes to the broker-dealer financial reporting rule, Rule 17a-5 under the Exchange Act, to revise existing reporting requirements and create new reporting requirements, such as an annual "Compliance Report" which would contain a statement and assertions concerning compliance, and internal control over compliance, with the certain rules such as the net capital and customer protection rules. The proposal also would enhance the SEC's and other regulatory authorities' oversight of broker-dealers' custody practices by requiring broker-dealers to provide information regarding their custodial activities on new Form Custody.

In addition, as required by Dodd-Frank, the SEC released its *Study on Investment Advisers and Broker-Dealers,* which concluded that retail investors generally are not aware of the different regulatory requirements and standards of care governing broker-dealers and investment advisers, and recommended a "uniform fiduciary standard" for investment advisers and broker-dealers. The SEC has indicated that it intends to propose rules outlining a uniform fiduciary duty, as appropriate, sometime before the end of the year.

III. Common minimum (required) elements of both adviser and broker-dealer compliance programs

The rules governing investment adviser and fund compliance programs and the rules governing broker-dealer compliance programs have certain features in common.[4] These common features effectively create "minimum elements" for broker-dealer and investment adviser compliance programs. These "minimum elements" are:

1. A designated CCO

- Advisers and funds must have a single CCO.
- Broker-dealers may have more than one CCO (with defined areas of responsibility).

2. A knowledgeable CCO

- Broker-dealer CCOs should have "expertise in the process of compliance."
- Adviser and fund CCOs should be "competent and knowledgeable" regarding the Advisers Act, and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.
- A fund's CCO and should be knowledgeable regarding the federal securities laws and must report directly to the fund's board of directors.

3. The CCO must have authority within the organization

- Adviser CCOs "must have sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures."

[4] There are also some significant differences, such as the required annual certification and the specific reference to "testing" in FINRA rules, which have no corollary in the Compliance Rule for advisers and funds (though testing is a best practice and urged by the SEC staff). In addition, the Compliance Rule does not mandate that advisers create a written annual report of the compliance review, as is required for funds and broker-dealers, though the creation of a written record is desirable to document that the review was performed.

- Fund CCOs must report to the fund's board of directors.
- Broker-dealer CCOs must be principals, and are "primary advisors" to the firm on its overall compliance scheme and the particularized rules, policies and procedures of the firm.

4. The compliance program must be effectively designed to achieve compliance with certain securities laws and regulations applicable to the firm

- Advisers' compliance programs must be designed to prevent, detect and correct promptly any violations of applicable provisions of the Advisers Act.
- Fund compliance programs must be designed to prevent, detect and correct promptly any violations of applicable provisions of the federal securities laws and any rules adopted under these statutes.
- Broker-dealers' compliance and supervisory programs must be reasonably designed to achieve compliance with applicable provisions of the federal securities laws and rules, FINRA rules, and MSRB rules.

5. The effectiveness of the compliance program must be reviewed regularly, at least annually

- This review should include "tests" of the effectiveness of the compliance program. Specific tests performed depend on the particular activities and risks at the firm.
- Although advisers are only required to perform annual reviews, the SEC has urged advisers to consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.

6. The compliance program must be dynamic

- Advisers "should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments."
- Broker-dealers must modify policies and procedures "as business, regulatory and legislative changes and events dictate."

7. The compliance program must "report up" on the effectiveness of compliance policies and procedures

- Advisers must perform an annual review of their compliance programs. To allow the firm to fulfill this obligation, the CCO will need to "report up" on the operation of the compliance program.
- Fund CCOs must deliver a written report describing material compliance issues to the fund's board of directors, and must meet with fund board independent directors at least once each year to "speak freely about any sensitive compliance issues of concern to any of them."
- Broker-dealer CCOs and CEOs must meet at least once a year to discuss and review the compliance certification, the firm's compliance efforts, and identify and address significant compliance problems and plans for emerging business areas. A written report on the firm's process to establish, maintain, review and test its procedures must be provided to the Board and audit committee.

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The regulatory requirements governing investment advisers' and broker dealers' compliance programs share certain a number of common required "minimum elements." Given the increase in number of dually registered advisers and the current debate over establishing a common fiduciary duty of care, CCOs and others in the financial industry can benefit from being aware of the commonalities in legal requirements and the new regulatory environment mandated by Dodd-Frank.

Additional information

If you would like additional information about the topic discussed in this FS Regulatory Brief, please contact:

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