How to Pass the **Regulatory Exam**

6 Tips for Asset Management Operations

*by James Carney*

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Learn:

- Why compliance and operations should be viewed holistically
- The importance of having a culture of compliance
- How to link your compliance and operations manuals
- Common areas of exposure during regulatory exams
6 Tips For Asset Management Operations

Asset management firms know there is a compliance element to nearly every aspect of the business. From securities trading to account reconciliation, fund administration and more, operations teams need to be aware of regulations and ensure their day-to-day workflows reflect the requirements.

Failure to establish solid operational processes that show you embrace your firm's policies and procedures may lead to a poor regulatory review, and possibly encourage examiners to take an even closer look at your overall business.

In an effort to find out more about how operations teams can take steps to support regulatory requirements, I recently spoke with Gary Davis, Vice President of Practice Management, at MarketCounsel, about some of the major issues he sees across a variety of firms as he conducts compliance assessments.

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<th>Gary Davis Jr., Vice President, Practice Management, MarketCounsel</th>
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<td>Gary is responsible for assisting clients with raising the bar of their operations, including compliance, through the implementation of industry best practices. He has managed all aspects of operations including investment operations, back-office operations, compliance and staffing. He has coordinated operations functions supporting client service, marketing, financial planning, technology and the financial management of the firm.</td>
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<th>James Carney, President and CEO, ByAllAccounts</th>
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<td>James is a co-founder of ByAllAccounts. He and his teams have had a proven track record of effectively building, marketing and selling highly scalable, complex solutions on time and within budget.</td>
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Key Takeaways

1. Good compliance is good business. In today’s environment of heightened regulations, firms should create a “culture of compliance” and run their business like they are preparing for an SEC exam each and every day.

2. Operations teams should understand what’s in the compliance manual to minimize the risk of creating conflicting policies and procedures that can lead to miscommunication and inefficiency.

3. Compliance and operations manuals should complement each other—one describes what is required from a regulatory perspective, and the other describes best practices for working within the framework of the regulations.

4. On-going risk testing and adequate documentation is essential to show you are in control. Don’t leave any forms blank—if there is nothing to report, write that down.

5. Never leave the examiner guessing. Provide enough information that they feel you have taken appropriate steps. You want to demonstrate a proactive process that enables you to detect and correct problems.

6. Be aware of commons areas where information is missing, such as Order Memorandums for trading and explanations of best execution.
Gary, what are you trying to accomplish with your reviews?

The primary objective of any operational review is to make sure a firm can withstand a regulatory exam. To do that, we need to look at the compliance program as a whole—what are a firm’s policies and procedures, what systems and controls do they have in place, what technology is being used to run the business and what does all of this mean for their ability to meet compliance requirements. Ultimately, we are trying to determine if a firm can prove they do what they say they do in marketing materials, regulatory documents and other public materials an examiner can access—and help them make improvements to do so.

When you first go into a company, what is the number one thing you look for?

I want to know how integrated compliance is with the rest of the business. I often hear firms discuss compliance and operations as two separate departments, but I feel you need to look at things more holistically and have a culture of compliance—especially with today’s heightened regulations. After all, good compliance is good business so a firm’s policies and procedures should be integrated with the day-to-day operations. When I hear someone say, “We have to do this for SEC compliance”, that tells me there is no integration but it’s an afterthought. That’s when problems can arise.

What is the first thing you recommend to operations teams?

I recommend operations teams understand what’s in the compliance manual, which should contain all the regulatory requirements a firm needs to follow. If they do, they minimize the risk of creating conflicting policies and procedures that can lead to miscommunication and inefficiency. For anyone reviewing the firm, the compliance manual and the operations manual should align and tell a consistent story.

“A compliance manual should describe what is required from a regulatory perspective, and an operations manual should describe best practices for working within the requirements.”

Gary Davis Jr, Practice Management, Vice-President, MarketCounsel LLC

Let me make one point on compliance manuals—make sure they are customized for, and pertinent to, the business. Using off-the-shelf templates can often set off alarm bells with an examiner. While this may seems obvious, also make sure the manual given to the regulator is the latest one being used by employees and that it has been signed—I have seen instances where this is not the case.

Can you give an example of how the compliance and operations manuals should work together?

Regulators are going to want to see your investment research process, for example.

“Firms need to run their businesses like they are preparing for a regulatory exam every day to have a culture of compliance.”

Gary Davis Jr, Practice Management, Vice-President, MarketCounsel LLC
The compliance manual should outline what is required on this front. For instance, if you are using model portfolios you may be required to outline how often they are updated and rebalanced. To complement this, the operations manual would detail how and when this should be done, who will do it, how to report any issues that may arise and the documentation that is required to back things up.

**Where do you see issues with operational policies?**

One area is trading workflow. Every trade—whether it’s discretionary, non-discretionary or client-directed—must have an Order Memorandum associated with it. It doesn’t have to be a document that says Order Memorandum, but during the regulatory exam the SEC will look for certain pre-trade information to show proof of trade reconciliation. This typically includes all of the details about the trade: date, buy/sell, the custodian or trading partner, etc. I see a lot of firms that don’t have these Order Memorandums as they aren’t written into their operational policies—a gap that needs to be filled to pass a regulatory exam. For those that do have Order Memorandums, I consistently find three things missing: (1) who recommended the trade, (2) who placed the trade and (3) if the firm has discretion.

Are there other common areas where documentation is lacking?

One is with best execution. I often see a lack of documentation around a review of a firm’s best execution policies and monitoring procedures. There are two sides to the execution review. First is the quality of your execution; second is the quality of the relationship your trading partners provide you and your clients. Many times when I ask a firm for their execution review documents, they show me a form that says they are using a certain custodian, have reviewed their reports and they continue to be a good custodian. This doesn’t tell the examiner anything. They need to know what was discussed, if any actions took place as a result and the quality of your trade execution.

“Provide regulators with enough information so they feel you have taken appropriate steps—don’t leave them wondering what you did.”

**Gary Davis Jr, Practice Management, Vice-President, MarketCounsel LLC**

Another is with complaint logs. I never like to give an examiner a blank form as it doesn’t explain things well enough. For example, if your complaint log is blank, does it mean you didn’t have any complaints or you didn’t document them? I highly recommend firms test their complaint logs semi-annually to see what is there and question staff if nothing is written down. If you haven’t had complaints, that should be noted. If you have had complaints, show how they have been handled. The same should be done for trade errors. If you haven’t had any trade errors,

A ByAllAccounts paper entitled *Fast, Efficient Reconciliation—In the Wake of Big Data and the Regulatory Tsunami*, discussed the importance of introducing technology tools to better leverage staff and ensure you are compliant. Another advantage of using proven technology is that it goes a long way to showing regulators you’ve engaged outside support to incorporate automatic checks and balances to reduce the chance of missing something.

confirm it with the trader and write down the essence of your conversation. It shows a system and control that proactively monitors problems.

**What comments do you have about the annual compliance review?**

Every SEC-registered firm is required to conduct an annual compliance review of their policies and procedures. I’m finding that a lot of firms are doing this inefficiently and they aren’t providing a lot of documentation. For example, we recommend you discuss how you have been testing your fee calculations as part of this review, making sure they are correct and you haven’t over-billed or under-billed any clients. I frequently see comments regarding this that are very simplistic, such as “reviewed fees and found no problems”. That doesn’t tell an examiner anything. You need to be more explicit about what you reviewed, if you did a sampling and, if so, how you did it.

“**You want to show you have a very proactive review process in place and good controls.”**

*Gary Davis Jr, Practice Management, Vice-President, MarketCounsel LLC*

It is important not to leave the examiner guessing. It would be better to say something like: “After every fee billing, we sample using our standard sampling methodology. The results of that sampling over the past four quarters resulted in our finding five inaccurate billings; they were caused by these issues, and this is what we’ve done to resolve things going forward”. We recommend every firm have a standard sampling methodology accompanied by documentation. We also recommend that firms right their wrongs. If you only write down what you did wrong and not how you corrected things, you are giving the examiners an opportunity to investigate further.

**Are there other areas you would point out?**

Code of ethics is another area that is often lacking. Aside from describing a set of practices and behaviors expected of all employees, the code of ethics details how personal investment accounts are to be handled and reviewed vis-à-vis the firm and its trading activities. When a new person comes on board, the compliance officer should collect the holdings report for each personal trading account of that individual, and document it for ongoing surveillance. Quarterly, the compliance officer should receive a copy of the reportable securities transactions for all access persons and then, at least annually, collect the holdings reports again to see if there are any restricted securities that are included or securities that are traded for client accounts. Most firms are collecting the transactions reports, but sometimes they forget to collect the initial or annual holdings reports. It is often hit or miss, and there aren’t well-documented processes a firm can point to.

While monitoring personal trading is necessary, our clients tell us paper-based or outdated systems can make tracking an onerous task.

In a ByAllAccounts paper, *Personal Trade Monitoring—Compliance Officers Implement Leading Practices to Better Manage Risk*, we saw that data aggregation technology could help remove the time-consuming and error-prone steps of manually reviewing and entering data in order to effectively review employee activities.

**Download the paper:**
Conclusion

To help your firm stay on the right side of compliance and withstand a regulatory exam, a proactive training program will help ensure the operations team is aware of all of the requirements in the compliance manual and has aligned their policies and procedures accordingly. Ongoing risk-assessment testing of the firm’s policies, procedures, systems and controls can also be very helpful. The main focus is to pinpoint what’s not working and identify solutions to tighten up systems and controls. This link between compliance and operations will help create and reinforce the ever-important culture of compliance.

“ByAllAccounts helps firms meet their regulatory requirements by eliminating manual tasks and showing they have a third-party helping to improve processes.”

James Carney, President and CEO
About MarketCounsel

MarketCounsel is a leading business and regulatory compliance consulting firm to the country’s preeminent entrepreneurial investment advisors. The firm delivers comprehensive and sound, yet business-savvy, regulatory compliance solutions. At MarketCounsel, you will discover an impressive roster of seasoned compliance professionals paired with state-of-the-art technology to meet, anticipate, and exceed the exacting needs of clients. MarketCounsel’s service platform consistently delivers on the promise of trusted counsel within the wrapper of extraordinary service. For more information, visit www.marketcounsel.com or call 877-658-2675.

About ByAllAccounts

ByAllAccounts is the only provider of intelligent data aggregation for financial services companies and the platforms on which their businesses depend. Their patented, intelligent data aggregation system implements a knowledge-based process that uses artificial intelligence to gather and transform financial account data and deliver it to portfolio management, reconciliation, compliance, trust accounting and performance systems. The financial industry’s most reputable advisory firms, financial institutions, and financial technology vendors rely on ByAllAccounts as their primary connector to structured and unstructured financial account data, enabling them to streamline their third-party relationships and to empower their applications and services. For more information, visit www.byallaccounts.com.

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