

## HIGHLIGHTS OF A WEB SEMINAR FOR SEI CLIENTS

# Creating a Culture of Compliance

Mutual funds and investment advisors everywhere are grappling with new SEC requirements to develop, and begin implementing, an “overall compliance program” by October 5th. By that time firms must also appoint a Chief Compliance Officer (CCO) who is responsible for compliance efforts.

Legal and compliance experts agree that the new rules are “a lot to get your arms around”—especially the call for firms to create a “culture of compliance.” What does that mean? And how can it best be accomplished? An August 5th Web seminar held as part of SEI’s *ComplianceAdvantage* program offered informed advice from SEI management and legal counsel, summarized in the Q&A below.

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### GUEST PANELIST

**THOMAS LEMKE**, PARTNER, MORGAN, LEWIS & BOCKIUS LLP

### SEI PANELISTS

**SEI KNOWLEDGE PARTNERSHIP**

#### What if we don’t have a CCO yet?

Don’t panic, because there is a great deal of work that can be done by your existing personnel. What you should be working on is the written policies and procedures that the CCO is going to implement. Remember, much of the job will entail codifying what your firm presumably is already doing. It’s a lot of work, but it won’t all be breaking new ground.

If you don’t have a CCO in place, you should be building as much of the system as possible so that when finally hired, the CCO can hit the ground running and work on tailoring aspects of the program. One thing, though—you’ll need to make sure the CCO you hire is comfortable with the approach you’ve taken, so you’ll have to educate them as

you’re interviewing. You don’t want to have someone come on board a month before the compliance program deadline and say they have basic disagreements with your approach.

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#### Where do we begin?

Although it sounds simplistic, the best place to start is by reading the SEC rule and adopting release. They are well written and outline 16 specific areas that, at a minimum,



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every fund compliance program should address. Clearly, your plan cannot consist solely of those 16 elements, but as they represent the minimum, it makes sense to begin with those.

As the SEC has publicly confirmed since re-leasing this rule in December, there is a straightforward process the SEC wants firms to follow in developing compliance programs:

- Inventory the compliance efforts you have, comparing them to the federal securities laws as they relate to the specific areas outlined in the rule.
- Match those areas with your current compliance efforts.
- Finally, come up with a plan to test the effectiveness of your program over time. The rule allows a year to complete this last step.

If anything ever begged for a project plan, it's implementing this particular rule, and that would be the approach we'd recommend you take.

## How extensively must the compliance plan be customized?

There has been considerable debate concerning “cookie-cutter” programs, and the SEC has made it crystal-clear that off-the-shelf programs will not be satisfactory. But that doesn't negate the likelihood that the majority of program components—perhaps as much as eighty or ninety percent—will be similar among advisors and funds.

The critical thing will be to analyze and address the conflicts of interest specific to your firm—that will be a key to particularizing your compliance program. This will require sitting down not just with your legal people, but with your business people, to think through the issues. For example, if you have an affiliated broker dealer, what are the implications of that? If you have an affiliate that engages in investment banking, are your information barriers strong enough? Are you making sure that you don't know what they're doing? To meet the SEC's expectations that you address the particular conflicts within your organization, you will need to walk through the issues step by step and then document what you've done to deal with them

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## Who needs to be involved in developing the plan?

Your legal and compliance people are certainly key, but they can't write these rules in a vacuum. You will also need to involve:

**Senior management.** Those at the top need to embrace what you're trying to accomplish as well as specific policies and procedures, so it's vital to get their involvement and viewpoints early on. Otherwise, you could just have policies and procedures in a binder—and that's not consistent with a culture of compliance.

**Your fund board.** Though your fund board members are smart people who probably understand their obligations under this rule, you cannot afford to assume that. If you haven't yet had at least a phone call to brief your board and set some expectations, you should do that immediately. You should also be planning a September board meeting focusing on the compliance program, as board approval of the program is required by the SEC rule. Obviously, you should work backward from the date of your board meeting to set your interim deadlines.

**Third-party service providers.** The rule names four types of service providers whose compliance efforts must be reflected in your plan: your advisor, administrator, transfer agent, and principal underwriter. If your funds use any of these third-party agents and you haven't already contacted them to set expectations for the documentation they will provide, you should do so immediately.

A note on custodians: the SEC makes it clear that a custodian is not a service provider. If, however, the advisor delegates some of its functions to the custodian, or if the custodian acts as a de facto administrator, then you must oversee those activities relating to the compliance program (though not all their custodial activities).

In cases where SEI acts as your third-party administrator and principal underwriter, which we do for many clients, you



will be receiving (if you haven't already) a summary of our compliance program to present to your fund board. That will be based on an independent review of our compliance program and procedures conducted by our legal counsel, Morgan, Lewis & Bockius.

**An important caveat:** *Compliance programs for third-party service providers for funds must be adopted as a component of your overall program. It is not enough to simply forward to your fund board the recommendations of your service providers. There must be some due diligence process that tells your board how the funds' compliance program includes oversight of service providers.*

*Note, too, that service providers may vary considerably in their responsiveness and thoroughness. With the October 5th deadline closing in, it is vital to set aggressive deadlines for service providers and make sure they follow through. In the best case, the service provider will provide an independent, third-party review. Otherwise, your program will need to assess the adequacy of your service providers' policies and procedures.*

*A culture of compliance emanates from the top. Senior management needs to embrace what you're trying to accomplish as well as specific policies and procedures.*

## What about documentation?

Documenting the entire process will be critical. Think ahead to a year or two from now when the SEC comes in to review your program and testing. They have made it clear they will be seeking to make an example of firms that are disregarding this rule, because it is at the heart of their regulatory program. You will want to have a thick, complete file demonstrating that you have made a serious effort to comply from day one and that your process is as objective as possible. So be sure to track and document everything that went into your process.

That includes e-mails, which the SEC reserves the right to request and has been inspecting aggressively. Although neither the Advisor's Act nor the Investment Company rules have specific requirements for e-mail retention, the SEC has applied the same requirement throughout the securities industry—that is, the SEC expects that you will keep all

e-mails or else have an orderly, understandable system for determining which e-mails are kept and how that relates to the required records. As a practical matter, it is so costly and complex to develop a system for identifying and segregating required records that almost all firms are implementing systems to save all e-mails.

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## What are “best practices” in building a culture of compliance?

What constitutes a best practice will undoubtedly evolve over time, but as we talk with a wide range of firms and study the many speeches given by SEC officials, an early view of best practices is beginning to emerge. Here are some general guidelines:

### **Resist the temptation to outsource the CCO function.**

We believe it will be difficult for a third-party provider to effectively create a compliance culture that permeates every level of your firm. Potential conflicts of interest are another problem.

**Involve senior management from the outset.** The people at the top must embrace the compliance program and agree with its process and procedures.

### **Allow for enough lead time to implement procedures.**

If your goal is to complete your program on October 4th, you will be left with no time to educate your staff, conduct training, and make sure procedures are implemented. In short, you will be omitting a vital step.

### **Take time to educate those implementing the program.**

For example, if you have rewritten procedures to fill compliance gaps, don't assume that employees will start following a new directive as a result of simply reading an e-mail. An orientation session is a better idea.

**Help employees understand the big picture.** It aids the compliance effort if employees understand the intent of federal securities laws, rather than simply being told chapter and verse. Explain, in laymen's terms, the problems these laws are trying to prevent and how important it is for everyone to take this matter seriously.



**Conduct special training for senior management.** Not only does this set the tone for the firm's efforts, it will help you prepare for SEC inspections, which increasingly involve senior management interviews. The SEC wants to know that top managers have a general understanding of compliance requirements and the firm's compliance culture. Some firms hold periodic compliance sessions for their management team, plus occasional refreshers to help managers be prepared in case of a surprise examination (which is increasingly the SEC's mode of operation). Managers should generally know how the firm's compliance works and be able to articulate that understanding to the SEC.

**Make sure the advisor and fund sides work in tandem.** If your firm has separate CCOs for those two sides of the business, they ought to be working together from the start. Given the significant overlap in requirements, the program can only work if the two sides are in sync—consistent, of course, with the fund CCO's special independent status. If the same CCO handles both sides, that person should be spending significant amounts of time on both areas of the business, not just one or the other.

**Effective problem-solving is key.** Conducting an inventory process and identifying gaps and conflicts is well and good. What the SEC will want to see what you did to fix those problems and how you tested your solutions. That's what's will separate a run-of-the-mill compliance program from one that actually works.

**Treat compliance as an ongoing, dynamic effort.** It's not just a set of steps toward periodic deadlines, but a mindset of continually seeking ways to improve how we do business.

## How much do we need to think about annual reviews right now?

Clearly, the SEC doesn't expect to see results of extensive testing by this October 6th. But they will want to see your plans for monitoring and testing of compliance procedures over the next 12 months. A year from now, the standard is sure to be much higher, and in advance of the SEC review you will need to show your board evidence that your process works.

**A note on mutual fund vs. investment advisor rules:** The mutual fund rules require that the CCO annually report to the fund board on the need for updates and changes in the program. While there is no comparable requirement for CCOs of investment advisors, the same standard should be assumed. Internally, at least once a year advisor CCOs should report up to management and implement the changes deemed necessary.

## What risks are posed by firms that don't fully meet the spirit and the letter of the SEC's expectations?

This rule is clearly here to stay, and it's one to take very seriously. Any firm planning to meet the October 5th deadline and then go back to business as usual is likely to be on dangerous ground. Consider that:

**The risk/reward quotient compliance has changed dramatically.** The SEC is increasingly referring matters to enforcement, rather than relying on inspections and deficiency letters. That means you have less chance to make your case if they find anything significant—and they are now considering things to be significant that weren't deemed so in the past.

**Inspections are more frequent.** The SEC's inspection staffing has gone from about 150 to something like 500 people. And where some firms used to be inspected once a decade, that will now be far more frequent—especially if the SEC has already tagged you for some compliance problem. In recent speeches, the SEC staff has even raised the idea of assigning to the largest fund groups a permanent examiner who would stop by monthly.

**The business repercussions of an SEC investigation or private litigation are enormous.** Business operations are disrupted because people are nervous about any process relating to an investigation. Senior managers spend enormous time preparing for depositions. If the matter is serious, each entity and person involved may get its own set of lawyers, which is an enormous expense and drag on the business. Worst of all is the uncertainty—not knowing what will happen or when.



# SEI Knowledge Partnership

Insights for Investment Managers

## If the SEC inspects our firm soon after the October 5th deadline, what will it expect to see?

Our list is based on the rule itself plus our reading of what SEC officials have signaled:

- The actual compliance program—the board-approved, overall document that the CCO has put together.
- The compliance summaries or third-party reports from your service providers, along with approvals from your board, if you're adopting those recommendations as part of your own program. That means they will have to be thorough and detailed enough for your board to have acted on them.
- "Briefing materials"—meaning anything you give your board to help them with their decision. That may include things that are not in the board books, though everything you produce should be made part of the official record.
- Board minutes relating to the deliberation process are important. The SEC will likely be interested in what questions and concerns the board raised. Since there is a tendency to keep minutes brief and at a high level, it may be advisable to tell the attorneys to keep more detailed minutes for the meetings where compliance programs are discussed and approved.
- Any evidence you can provide to show that your program is being followed, such as training materials, minutes from staff orientations, etc.
- As noted above, documentation of the process that was followed to develop the program.
- Finally, your plans for monitoring and testing..

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