Prevent, Detect, Correct

An Overview of Annual CCO Reports for RIAs

About AdvisorAssist

AdvisorAssist is a management consulting firm focused exclusively on serving investment advisory firms. Through consultative services and outsourcing, we provide expertise, resources and actionable solutions that enable investment advisors to achieve their full potential.

Our talented team of industry professionals provide actionable advice and execution to advisors to help build, grow, protect and optimize their practices. From concept through launch, we partner with advisors to assist in building world-class advisory practices. For established firms, we provide the ongoing business, strategy and risk management support that enables advisors to focus on growing their practice.

For more details, please view our website at **AdvisorAssist.com** or call us at **617-800-0388**.

Follow our blog at blog.AdvisorAssist.com

Join the AdvisorAssist LinkedIn Group

Follow @AdvisorAssist on Twitter

Introduction

As a registered investment advisor, you are required to adopt and implement written policies and procedures that are reasonably designed to prevent, detect, and correct violations of the Investment Advisers Act of 1940 and/or the various state regulations. Furthermore, these policies and procedures are expected to be *dynamic and evolving* based on changes in regulations and your business activities, as well as constantly *improving* as your firm matures.

In this paper, we provide an overview of an RIA's Annual CCO Report. This report is a formal document that is intended to memorialize your efforts to monitor activities related to regulatory compliance, test the efficacy of your procedures and controls, and seek opportunities for improvement.

The Annual CCO Review and CCO Report

Regulators require that RIAs perform a review (at least annually) of the adequacy of your firm's compliance policies and the effectiveness of their implementation. These requirements are detailed within the "Compliance Rule", or Rule 206(4)-7 of the Investment Advisers Act of 1940. The details and findings of this review must be captured and archived in the form of a written Annual CCO Report.

According to the SEC's Office of Compliance Inspections and Examinations (OCIE), your annual review should address the following questions with respect to your firm's compliance procedures:

- Are we detecting problematic conduct with this policy?
- Based on what we've detected, should we alter our policy?
- Is there a better way to detect problematic conduct?
- Are we preventing problematic conduct with this policy?
- Is there a better way to prevent problematic conduct?
- Were the actions we took, once problematic conduct was detected, adequate to deter problematic conduct by this individual or others?

Regulators can tell when firms are taking a "set it and forget it" approach to compliance.

They don't like it.

If they get this impression from your firm, they will be less lenient on violations and will likely place your firm in a higher risk category.

To evidence this review, regulators expect the CCO to issue an annual report that describes the effectiveness of the compliance program and activities that took place during the year.[1]

There is no rule with respect to when your annual review and report should be produced within the year. Rather, the rule simply states that it should be done at least annually. Most RIAs prepare this document towards the end of the calendar year because the original rule mandating the annual CCO review took effect in October 2004.

The Annual CCO Report requirement originated with the SEC and subsequently, states have adopted these requirements. So this practice is required of both large and small (state-regulated) RIAs. In fact, with the recent uptick in state-level examinations, this process and document is more important than ever for state-registered advisors.

While the CCO's review and monitoring of compliance procedures should be a continuous effort, an Annual CCO Report is an ideal way to codify these efforts in one formal document. Moreover, your RIA's Annual CCO Report will be a key focus when regulators perform examinations on your firm.

[1] The old adage applies here: when it comes to regulators, if it's not documented, it didn't happen!

Components of your Annual CCO Report

While the SEC lays out the principles behind the annual review process, the specifics on what should go into your Annual CCO Report are left open to the advisor's discretion.[2]

Below we provide an overview of the critical components of your Annual CCO Report. Specific focus areas may change from year to year or based your specific business model. Here are some broad categories to give you a sense of what regulators expect you to cover.

Firm Compliance Program
Your Annual CCO Report should include a simple overview of your compliance program, including references to each regulator to which your firm is accountable as well as each regulatory requirement your report is intended to satisfy. You should also clearly define the period of time each report covers.

Overall Control Environment
An important consideration in reviewing the effectiveness of your compliance program is an assessment of your firm's overall control environment.

Your Annual CCO Report should identify each of the documents that comprise your firm's compliance program, including: written policies and procedures (often referred to as your "Compliance Manual" or "Written Supervisory Procedures"), Code of Ethics and Business Continuity Plan. The specific location for the most recent versions of these documents may be included as well.

You should also reference any documents that you may use throughout the year to test and monitor the efficacy of your compliance program. For instance, our clients utilize our quarterly risk assessments to test their compliance procedures throughout the year.

If you rely on specific technologies or external consultants to help support your compliance obligations, references to these resources may be included in the description of your firm's control environment.

Compliance training (both formal and informal) is an important element of a CCO's duties. Document any specific training that may have been conducted throughout the year so that regulators can be confident that your staff understands the regulatory regime within which they operate.

Staffing
CCO's often delegate certain compliance activities to other staff members. This is often the case in circumstances where dedicated compliance resources are limited and other members of your team (based on their primary responsibilities) are in a better position to perform certain activities

---

[2] This is often the case since the SEC follows a "principles-based" approach to advisor regulation and oversight. This can be contrasted with FINRA's "rules-based" approach for broker-dealers and registered representatives.

Include in your Annual CCO Report a list of each member of your team that contributes to the implementation of your compliance program. By doing so, you demonstrate a recognition that improved monitoring may be accomplished by those that work closer to relevant data or business processes (e.g. trading, client on-boarding)

In addition, note any changes in staffing or delegation that may have occurred throughout the review period and describe how you expect these staffing changes to impact compliance.

Scope of Annual Review

The scope of your annual review should be highlighted in your Annual CCO Report. The SEC has identified baseline topics that they expect to be included:[3]

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the advisor, and applicable regulatory restrictions;
- Trading practices, including procedures by which the advisor 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 advisor and personal trading activities of supervised persons[4];
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- 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
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

---

[3] *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, Securities and Exchange Commission 17 CFR Parts 270 and 275

[4] For additional guidance on "supervised persons" as well as other defined roles within your firm, see our blog post "Who's Who in the Eyes of RIA Regulators".

We would also include a thorough review of the Form U4 for each of your Investment Adviser Representatives (IARs) as well your firm's Form ADV to ensure that both your RIA and IARs are registered or notice filed in each applicable state.

One of the focuses of your annual review is to identify key risk areas within your firm and determine which areas may require additional scrutiny or testing. Risk areas will differ among RIAs based on their business model, advisory activities and external relationships. Each RIA should be sure to identify which aspects of their specific compliance program represent a higher level of regulatory risk. An example of this would be areas where there are (disclosed) conflicts of interest.

Oversight of Service Providers

In almost all cases, registered investment advisors delegate certain business activities to unaffiliated third parties like custodians, TAMPS or technology vendors. With this delegation comes additional responsibility to confirm that these partners are adequately supporting your compliance obligations. An example of this would be the security and integrity of client information.

While you are allowed to outsource certain elements of your business model and compliance program, you cannot outsource your accountability.

For this reason, your annual CCO review should also include a review of the business practices of these service providers. This due diligence may be conducted in a variety of ways but we have included some examples below:

- Review of SAS 70 reports on internal controls
- Review of your service provider's annual compliance review (if they are also a registered investment advisor)
- Written certifications that your vendors are complying with federal securities laws and will disclose any material compliance matters or material changes to their compliance procedures.

Changes to Procedures

Document any changes in your compliance program that either occurred during the year or arose as a result of your annual review process.

Along with changes that come out of each year's annual review, your procedures may also change as a result of:

- Changes in your business model
- Regulatory changes
- Implementation of new technologies to further enhance internal controls
- Addition of external resources like compliance consultants

Compliance Issues

Your report should include a list of any compliance issues that occurred during the year. This inventory should include material as well as non-material issues. For each compliance issue, provide details on:

- How each issue was discovered
- How each issue was resolved
- What actions were taken to prevent recurrence

Focus for the Coming Year
A key objective of your annual review is to identify opportunities to enhance both your compliance program as well as your compliance oversight model. Include in your Annual CCO Report a forward-looking plan for the next twelve months. This section may be used to demonstrate how your firm makes improvements to your processes. It may also be used to reinforce to your staff that certain topics remain an issue and require additional attention.

Conclusions and Recommendations
After conducting your review, provide a set of conclusions and recommendations with respect to the efficacy of your compliance procedures. This synopsis should include a statement regarding the adequacy of existing procedures, any material changes, and any material compliance matters that have occurred during the review period.

Best Practices

We recommend that all advisors (even one-person firms) take the time to reflect on compliance activities that took place during the year and prepare an Annual CCO Report summarizing their process and findings.

Below we list a few best practices to help you implement this:

1. Perform quarterly risk assessments and document findings in what will eventually become the first draft of your Annual CCO Report.

2. Maintain a log of compliance issues that come up throughout the year. (If you wait until December, it will be challenging to recall each and every compliance issue that came up ten or eleven months ago.)

3. Maintain a copy of each Annual CCO Report. These reports are included in your RIA's books and records obligations and will undoubtedly be included in each document request that you receive prior to regulatory examinations.

4. Use your annual review process and Annual CCO Report to communicate a "culture of compliance" within your firm.