

## Practice Management



# Operating an Effective Compliance Program in a Small Shop

The repeated disclosure of massive frauds by investment firms has sent the Securities and Exchange Commission into a frenzy of activity. In addition to considering a plethora of new regulation, the SEC is refocusing attention on some requirements where, until recently, it has been relatively lax.

Specifically, all investment companies and RIAs must have written policies designed to protect investors, and the firms must have a designated Chief Compliance Officer (embodied in CFR 270 & 275). The CCO must be “empowered with full responsibility and *authority* to develop and enforce... [and a] position of sufficient seniority and authority to compel.”

These requirements place a substantial burden on small financial advisors. With the SEC focusing much of its attention on small firms that formerly sailed below regulators’ radar, these firms now must take the requirement to have a CCO seriously, if they didn’t before.

The response of a significant number of firms has been a clumsy attempt to circumvent both the letter and the intention of the regulation by naming a CCO who has neither the skill nor the authority to effectively exercise the responsibilities of an actual CCO. A review of ADVs filed with FINRA reveals that in literally thousands of small firms, the CCO has the same last name as the owner. Naming your spouse as CCO does not mean that he or she has the training, the skill, or—most importantly—the authority to carry out the legal requirements of the job. The practice of calling your secretary the CCO has even less possibility of surviving an SEC or state audit.

Evasion is not the answer. Not only are these clumsy subterfuges dangerous, they are unnecessary. It is possible for the small shop to have a legitimate and effective compliance operation without hiring additional staff or consuming large amounts of time that should be directed toward managing client accounts. To have an effective compliance program, a firm needs only three things: 1) a real CCO; 2) two written documents; and 3) a process for assuring that the procedures in those documents are carried out.

### A Real CCO

The CCO position will require a commitment of time, and the person in the position must have the authority to enforce regulations. A firm’s owner can be its CCO. In fact, if your firm consists of you and your assistant or secretary, you *are* the CCO. And while looking over your own shoulder may be difficult, it can be done. (We’ll discuss how to do that in a moment.)

If you have a small staff, the task is easier. Choose a senior member for the job; this person is accustomed to being taken seriously. No matter how experienced he or she is, provide the CCO with some time to become and to stay familiar with compliance regulations. Then, give the CCO the time to establish procedures specific to your firm and time to review those procedures periodically. The demands on his or her time will diminish with experience, but they will never disappear.

The SEC actually does its very best to help new CCOs. Despite a contrary perception by some advisors, the SEC really would prefer that you do it right

in the first place. There are enough real crooks out there to keep them busy. The Commission publishes compliance guidelines, maintains a helpful website, and conducts training sessions tailored for new CCOs. When I contacted the SEC by phone with compliance questions, SEC attorneys responded within one day.

### Written Material

As noted above, two documents must be produced. Every firm must have an organization-specific policies and procedures manual and a code of ethics.

Many advisory firms have paid attorneys small fortunes to prepare documents, but, in my experience, this isn’t necessary. Standardized forms can be found on the web for around \$500, a fraction of what an attorney-written model will cost, and they are first-rate, if they are used properly. Of course, as other advisors have pointed out, the critical element is to modify the pre-written materials to fit your particular business procedures.

I agree that personalizing the generic form is a time-consuming task. But I believe that undertaking the process of modifying the standard form has benefits of its own because it’s invaluable training for your CCO.

While your CCO will be responsible for carrying out all of the 30 or so items in your new manual, there are three areas that will be of particular interest to SEC and/or state auditors and should receive immediate attention. They are:

- creation, retention, and protection of critical records;
- protection of client information; and

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- management of each client's account in a manner consistent with their best interests, not yours.

Let's examine each of these parts of the manual.

**Records.** SEC Rule 204-2 specifies in precise detail the records that a firm must create and retain. Retention of paper records is no longer required, but the ability to produce paper copies on demand is essential. Maintaining electronic records is a marvelous convenience and time saver, but it is perilous unless records are archived *at the time that they are created*. The archive should not be accessible for change or correction after it's been created, and there should be a second copy at a secure site outside your office.

**Protection of client data.** Identity theft is a growing problem for individuals and businesses of all types. When you consider the amount of data that you maintain about your clients, you can understand just how important it is to establish and constantly review protective measures.

Two areas are of primary concern: inappropriate employee curiosity and criminal access. The first is easily dealt with by limiting access and using password protection.

The second is a serious and ever-present danger. You can set up your own

secure data management and storage system, but it will require the ongoing services of a specialist and will be prohibitively expensive for a small shop. A more practical solution is to use a third-party service provider for handling all electronic data and internet access. A service provider will have technical expertise on-call, sophisticated malware protection, multiple and frequently changed passwords, and secure off-site duplicate data storage.

Even with all that, absolute security is not guaranteed. Frequent and random review of client accounts is still required to detect unauthorized activity. For CCOs, paranoia is a professional requirement.

**Appropriate account management.** Not only must accounts be managed in a way that reflects clients' age, financial condition, and account objectives, but the firm also should have proof that these standards are being upheld. The fact that a firm is doing what it should be doing is no longer sufficient; the firm should have available solid evidence that documents what it is doing, and why.

If your firm does not presently conduct an annual review of each client's financial condition and objectives, by all means start doing so. Keep written evidence of that activity. Make notes about phone conversations, and if any change occurs, confirm it via (archived) email. Then be

sure that trades on a client's behalf reflect your knowledge of their needs. The fact that your heart is pure is not enough for the SEC—it now demands evidence.

The critical point is to not only carry out the procedures noted above, but to record them. A one-person shop can do this through a simple note in the client's file or even in a calendar. "Today I reviewed the account of client X, and..." It must become an inviolate habit. This procedure will not only remind you to do it, but it will record the evidence that both regulation and your future security require.

If this seems like extra work and expense, bear in mind that most of the effort is involved in setting up the systems. Once these systems are in place, staff should notice very little difference from the daily routine.

A little work equals a lot of safety. Whether dealing with overly zealous regulators or with disgruntled clients, documentation is everything. An effective and fully documented compliance program is the only thing between an advisory firm and a cruel world. It is worth the effort to do it right. **NA**

*Chester Wright is chief compliance officer for Harmony Asset Management, a NAPFA corporate member.*

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