



SEC to Home In on Compliance Rule Laggards in '07

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By Lisa Lacy

Chief compliance officers at fund shops better be on their toes, as many in the industry suspect the SEC will be much tougher on firms not in compliance with Rule 38a-1, also known as the compliance rule.

The rule was enacted to ensure that firms have set compliance programs and are testing those programs regularly. It also requires that a CCO be named to oversee the program and that an annual evaluation of the program be conducted. However, a study by the SEC in 2006 estimated that only 60% of firms conducted a “solid annual review.”

In previous years the SEC has been more understanding of CCOs and newly instated compliance programs. In many cases in 2006, the agency was fairly lenient and was more focused on the effort behind the compliance programs, according to Ted Eichenlaub, partner with Adviser Compliance Associates.

But now, according to experts, the honeymoon period may be over. The regulatory body is likely to be more vigilant in the second year of the testing requirement, they say.

That could spell trouble for the 40% of firms that were not deemed to have solid annual reviews. And their CCOs could be the ones to feel the squeeze.

“With its recent activity, the SEC is clearly sending a message that the compliance bar will be raised,” says Jim Volk, chief compliance officer and chief accounting officer of SEI’s Investment Manager Services unit. His firm recently released a white paper on the subject entitled “Raising the Bar: How Your Compliance Strategy Should Change in 2007.”

In the paper, SEI warns that the SEC’s flurry of outreach efforts, speeches and educational campaigns in recent months means that it is more important than ever for firms to implement more effective annual reviews and to make improvements in the use of risk assessments, among other things.

SEI points to numerous speeches by various members of the SEC staff over the last few months, which it says “have seemed unusually well coordinated.” Because they are on similar themes, SEI says, “the speeches may be part of a synchronized effort to ensure a clear message is delivered to the asset management industry.”

An SEC spokesman says the agency has made “great strides” in communicating with CCOs. However, he declined further comment.

With another year under its belt and more firms' programs in its sights, the SEC is likely to step up its action, observers say.

Carl Frischling, co-head of the financial services group at Kramer Levin Naftalis & Frankel, says that small and medium-size firms are more likely to be impacted. That's because most large firms likely have their compliance programs up to speed.

Eichenlaub says CCOs should "take a step back [and] see what worked and what didn't work in the initial review of the compliance program." He also says CCOs should be listening to public speeches made by commission staff and talking with other CCOs and compliance pros.

Volk says CCOs "need to do a much better job" on their reports and programs and also "prioritize their time and make sure all high-risk and some medium-risk areas are subject to some kind of testing."

The most important task for CCOs is internal risk assessment and tailoring risk to the firm, he adds. This means looking at how well the program addresses issues and performing gap analysis.

The SEI white paper itself outlines specific SEC expectations.

First and foremost, CCOs need to be asking tougher questions and looking harder at their programs, and senior management needs to be much more involved.

There should also be more effective annual reviews.

SEI recommends improvements in the use of risk assessments. Firms need to make sure their risk assessment ties results in with their policies and procedures, and they must determine how the results drive the design of compliance program testing and monitoring.

There should be stronger compliance program policies and well-defined policies for dealing with policy violations. This includes more rigorous testing, ongoing education for employees and clear evidence that not only have previously identified issues been fixed, but solutions have been applied to prevent similar occurrences, SEI says.

Adequate oversight of service providers is also necessary.

SEI also says fund shops should pay attention to the SEC's hot button issues. Compliance policies and procedures should address the SEC's priority concerns, which include insider trading and front-running, use of clients' money, trading issues and identity theft prevention.

Additional issues to watch in 2007 include facilitation of ETF introductions, potential action on Rule 12b-1 and revisions to recordkeeping rules.

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