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Practice note: lessons learned from mock RIA audit

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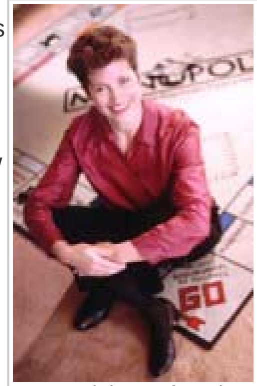

Nancy Lininger, founder of The Consortium

Show your best side during a regulatory audit by heeding these lessons learned from a recent mock audit. Auditors may show up on your doorstep one morning unannounced. It is likely, however, that you will be provided with a few days notice and be furnished with a documents request.

If you have been diligent in watching compliance prior to the audit, things should go relatively smoothly. If you have not prepared in advance for the inevitable exam, then a few days notice will not be of much help.

Here are some audit findings that I noted during a recent registered investment adviser mock audit. If some of these deficiencies sound familiar to you, then you may have some fixes to do.

- Under the Privacy Rule (Regulation S-P), the RIA had a privacy policy that included obtaining confidentiality agreements from employees. The RIA did not maintain these records in accordance with the firm's own procedures.

- The firm was lacking in best execution reviews of trade tickets (for time and price) and broker-dealer due diligence (comparison shopping). Many RIAs are aware they need to perform best execution reviews but seem to be at a loss as to how to go about it — and to document it.

- While maybe only one or two clients over the course of many years may actually take you up on your Form ADV annual offer, each RIA should maintain a log of when the request was made and when the request was filled. Until a request is made, a blank log should be maintained as evidence that the procedure is in place.

- RIAs need to produce a daily blotter of cash and certificates received and delivered. Cash receipts include checks payable to your firm for advisory fees and checks payable to the custodial broker-dealer that you forward. If a check for the benefit of a third party (e.g., the custodial broker-dealer) is inadvertently made payable to the RIA, the RIA cannot forward the check and must return the check to the client within three days (all of which should be documented in and out on the daily blotter). Only registered representatives are able to forward stock certificates to their broker-dealer of record. Any inadvertent receipt of a stock certificate by an RIA must be returned to the client within three days (and must be documented).

- While some RIAs with discretion have disclaimed proxy-voting authority, if the RIA retains the obligation to vote, the RIA cannot simply always vote with the management recommendation. RIAs must show evidence that they have voted in the best interest of the client. It may help in the decision-making process for an RIA to develop proxy voting guidelines. For example:

  - Generally the advisor will support management initiatives and shareholder resolutions that are socially responsible and reduce a company's negative impact on the environment.
  - Generally the advisor will oppose an executive compensation proposal if it believes the compensation does not reflect the economic and social circumstances of the company (i.e. at times of layoff, wage freezes, etc.)

- If you utilize an investment policy statement as most advisors do nowadays, make sure that each IPS is complete, and show evidence that the clients' dictates are being followed. If the IPS is completed and then filed away never to be reviewed when changing client investments, then there may not be much value in obtaining the IPS to begin with. It is difficult to remember in your head the investment objectives of hundreds of clients. Information from the IPS should be input into the computer so that the information is accessible for review as needed.

- Don't assume that if you have an outside bookkeeper or accountant that he or she is properly maintaining all the required financial records. Whether you do the accounting yourself or outsource it, there are so many easy and wonderful accounting software packages (e.g. QuickBooks) that there should be no excuse for not being able to create journals, ledgers and other basic financial reports.

- If you outsource to an IT person for your computer needs, don't assume that they are archiving your e-mail and other computer records properly. You need to get involved in a discussion with your IT person and your compliance person to ensure that it is being done correctly.

- In addition to the quarterly transaction reports that you should all be getting from your access persons, make sure that you get a complete holdings report for all new employees and annually for all existing employees.

Consider performing a mock audit of your operations. If you have the time and inclination, it is something you can attempt on your own. This can also be outsourced to compliance consultants with expertise in this field.

Nancy Lininger (liftburden.com) is founder/consultant of The Consortium, a Camarillo, California-based consulting company providing compliance and marketing consulting to investment advisers and broker-dealers, and publisher of the CompliancE-News. The Consortium provides compliance resources, including a Self-Audit Kit. Ms. Lininger is often quoted in the trade journals and speaks at industry conventions on Success Strategies, Marketing and Compliance.

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