



# Compliance Program Assessment

## *Phase 1 – Strategic Analysis – Investment Management Compliance Program Review*

January 15, 2009

Deloitte & Touche LLP



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## Executive Summary

### Background and Scope of Services

The State Board of Administration of Florida (the "SBA") engaged Deloitte & Touche LLP ("Deloitte & Touche") to undertake an assessment of the SBA's compliance program and related compliance control, monitoring, and oversight activities associated with its investment management activities, middle- and back-office operations, and certain other processes. As stated in the August 21, 2008 engagement letter (the "Engagement Letter"), the SBA identified the following five objectives related to this initiative:

- Assessment of current state investment processes, including compliance activities;
- Identification of key compliance program gaps relative to leading industry practices and/or regulatory standards of registered investment advisers;
- Prioritization (with the SBA) of compliance program improvement efforts and resources based upon a risk-based analysis of needs;
- Evaluation of alternative methods for sourcing pre- and post-trade investment compliance systems; and
- Development of recommendations for enhancing the overall compliance program.

As part of the Phase I assessment, Deloitte & Touche identified and assessed certain compliance and compliance-related activities, and benchmarked them against our understanding of industry leading compliance practices. In addition, Deloitte & Touche developed tactical recommendations for the SBA to consider as it continues to evaluate its investment operations and strengthen its compliance program, including certain middle- and back-office support functions. All decisions made in connection with these recommendations are the responsibility of, and are to be made by, the SBA.

Deloitte & Touche performed services in accordance with the Statement on Standards for Consulting Services that is issued by the American Institute of Certified Public Accountants. We provided to the SBA our observations, advice, and recommendations. However, our services did not constitute an engagement to provide audit, compilation, review, or attestation services as described in the pronouncements on professional standards issued by the American Institute of Certified Public Accountants, and, therefore, we did not express an opinion or other form of assurance with respect to our services.

In addition, we did not provide any legal advice regarding our services nor did we provide any assurance regarding the outcome of any future audit or regulatory examination or other regulatory action. The responsibility for all legal issues with respect to these matters, such as reviewing all deliverables and work product for any legal implications to the SBA, is the SBA's. The management of the SBA has responsibility for, among other things, identifying and ensuring compliance with laws and regulations applicable to the SBA's activities and for establishing and maintaining effective internal control to assure such compliance. In addition, the SBA has responsibility for approving any reports and/or deliverables.



## Executive Summary Cont'd

Deloitte & Touche does not engage in the practice of law. All recommendations made by Deloitte & Touche during the course of this engagement were subject to review and concurrence by the management of the SBA and, at the SBA's option, its legal counsel. Deloitte & Touche cannot give legal advice or opine on specific legal aspects of the federal securities laws or any other applicable statutory requirements. Accordingly, Deloitte & Touche relied upon the SBA's legal counsel's interpretations of statutory and other legal authority for purposes of this engagement.

### Our Approach

Although we based our assessment on a holistic view of the SBA's investment activities and operations (i.e., front-, middle-, and back-office), the risks inherent to those activities, and their potential consequences and impact on the SBA's strategic objectives, our frame of reference and area of focus was the compliance program and associated compliance activities across each of the below-noted functional areas. The table below depicts, as discussed with and agreed to by the SBA, the risk-based framework/approach used to identify potential "gaps" and potential opportunities for improvement in light of our understanding of industry leading compliance practices.

		Risk Categories		
		People	Process / Technology	Information / Data
Functional Areas	Portfolio Management	<ul style="list-style-type: none"> <li>Average industry experience of the principals</li> </ul>	<ul style="list-style-type: none"> <li>Governance structure and "tone at the top"</li> </ul>	<ul style="list-style-type: none"> <li>Documented policies and procedures</li> </ul>
	Trading Operations	<ul style="list-style-type: none"> <li>Tenure of key professionals (management team)</li> </ul>	<ul style="list-style-type: none"> <li>Senior management oversight and supervision of compliance activities</li> </ul>	<ul style="list-style-type: none"> <li>Standard operating procedures</li> </ul>
	Operations & Administration	<ul style="list-style-type: none"> <li>Back-up provisions for key professionals</li> </ul>	<ul style="list-style-type: none"> <li>Compliance culture and internal controls</li> </ul>	<ul style="list-style-type: none"> <li>Supporting compliance documentation</li> </ul>
	Compliance Environment	<ul style="list-style-type: none"> <li>Turnover - changes in key management positions</li> </ul>	<ul style="list-style-type: none"> <li>Identification of risks and risk assessments</li> </ul>	<ul style="list-style-type: none"> <li>Processes to check the integrity of data sources</li> </ul>
	Technology Administration	<ul style="list-style-type: none"> <li>Segregation of duties and responsibilities</li> </ul>	<ul style="list-style-type: none"> <li>Physical and access controls</li> </ul>	<ul style="list-style-type: none"> <li>Document management and record retention</li> </ul>



## Executive Summary Cont'd

### Our Approach (cont'd)

In performing the assessment, we undertook the following steps:

- Obtained and read certain policies and procedures related to the SBA's investment operations and compliance program (see Appendix II for list of documents read) ;
- Conducted interviews with key members of senior management and process owners in certain business units (see Appendix III for list of professionals interviewed);
- Walked through certain compliance and operational control activities with the SBA to confirm our understanding of compliance processes;
- Considered certain SBA policies, procedures, and practices in light of our understanding of industry leading practices; and
- Developed recommendations in light of our understanding of the information provided by the SBA (and our understanding of the current regulatory environment).

In connection with the assessment and subsequent strategic analysis, we worked with the SBA to develop a desired future state, including strategic objectives, governance structure, and model compliance framework (i.e., the compliance program). We also worked with the SBA to identify core compliance activities and functional challenges that may present an obstacle in achieving this vision (e.g., misaligned or inadequate resources, missing policies and procedures, weaknesses in internal control design or implementation). Based on the information gathered through the above-mentioned activities, we developed tactical recommendations for the SBA's consideration regarding implementing a compliance program, including , among other things, considerations with regard to organizational structure, policy matters, resource and deployment requirements, and due diligence framework for overseeing external investment managers.

### Summary of Tactical Recommendations and Functional Challenges

Based on our experience, the SBA's investment operations and compliance program generally appear to be in line with our understanding of other similar organizations that are responsible for administering and managing retirement and/or other state assets. Based on our assessment and our understanding of leading industry practices of registered investment advisers, we identified a number of potential opportunities to improve upon or enhance existing processes, create new processes to increase operational efficiencies, and strengthen the SBA's overall governance structure. These potential opportunities for further development and improvement include, but are not limited to, the following:

- Instituting a governance structure that separates, to the extent practicable, oversight functions from management functions (and in instances where a clear separation of duties is not feasible, developing well-defined roles and responsibilities and implementing compensating controls to reduce the risk of potential control weaknesses);
- Establishing an independent and dedicated compliance function, including a Chief Compliance Officer ("CCO") position, to oversee the investment activities and operations of the SBA;
- Enhancing pre- and post-trade monitoring of investment guidelines, including oversight of external investment managers responsible for managing assets entrusted to the SBA;



## Executive Summary Cont'd

### Summary of Tactical Recommendations and Functional Challenges (cont'd)

- Enhancing the current culture of compliance to facilitate monitoring and surveillance activities through awareness and communication of internal policies designed to detect and prevent potential conflicts of interest;
- Enhancing compliance-risk management functions in an effort to allow for more integrated and transparent analysis and monitoring of internal as well as external risks (e.g., external investment managers responsible for managing assets on behalf of the SBA);
- Conducting periodic assessments of the compliance program, including tests of the control activities, to identify new developments and emerging risks and their impact on the organization; and
- Developing a training and education program to keep personnel apprised of new policies, procedures, or regulatory developments.

As the SBA looks to restructure its governance model and compliance framework, it should consider the following functional challenges and their potential impact on the organization. The SBA faces certain resource management questions (e.g., key person risk, segregation of duties, leadership and knowledge management, etc.) that may potentially affect the SBA's ability to achieve its strategic objectives. Other potential challenges include developing and maintaining policies and procedures aligned with the SBA's business practices; enhancing the current communications plan to encourage vertical and horizontal communication; and considering resource allocation across the organization.

### Prospective Phase 2 Considerations

As originally contemplated in the Engagement Letter, Phase 2 of the project involved evaluating "alternative sourcing methodologies for pre- and post-trade compliance solutions." However, given our observations and the proposed tactical recommendations discussed in further detail below, we would recommend that the SBA consider shifting the focus of Phase 2 from evaluating technology solutions to enhancing its governance structure and compliance framework, including the SBA's program and/or procedures to oversee its external investment managers. While automated systems may offer many advantages for monitoring investment guidelines, these benefits may be costly and may require additional resources to maintain the systems (e.g., technology resources to build and maintain the rules within the system, and compliance resources to monitor, report, and resolve potential investment guideline breaches).

In light of these costs and the SBA's available resources, it may be more cost effective to take a process-oriented approach for Phase 2 and evaluate options for developing, enhancing, or redesigning workflows, processes, or control structures related to the proposed new governance structure and compliance framework. Key areas considered should include the governance structure, external manager oversight program, compliance activities, monitoring of investment guidelines for internally managed portfolios, compliance testing, and training.



## Executive Summary Cont'd

### Prospective Phase 2 Considerations (cont'd)

For each of the areas noted below, we would consider assisting the SBA, as requested and pursuant to execution of an addendum to our engagement letter dated August 21, 2008, with the enhancement of the following documents, tools (e.g. project plan), and/or materials:

#### *Governance Structure*

- Committee charters, including purpose, scope of responsibilities, meeting procedures
- Reporting package for committee meetings
- Project plan for defining steps to accomplish the identified objectives, performance measures, and scheduling of meetings

#### *External Manager Oversight Program*

- Due diligence materials and tools (e.g., meeting agenda, document request list, questionnaires, and checklists, manager certifications)
- Sample reporting templates
- Data repository framework

#### *Compliance Activities*

- Operational procedures for performing the various compliance activities
- Reports, files, and tools (e.g., checklists, exception reports) used in connection with monitoring and surveillance activities
- Compliance checklists and supporting documents

#### *Monitoring of Investment Guidelines for Internally Managed Portfolios*

- Document management protocol, including identification of universe of existing trust or other investment agreements, investment guidelines, and amendments (collectively, the "Guidelines")
- Analysis of a sample of Guidelines to identify contractual provisions and investment restrictions
- Procedures/tools (e.g., templates, checklists) to monitor investment restrictions, including outsourcing solutions

#### *Compliance Testing/Assessments*

- Periodic testing of the overall compliance program, including periodic testing plan, control objectives, and test scripts
- Data and information sources
- Reports used in connection with conducting the periodic tests (e.g., management reports, special purpose reports, exception reports, certifications, internal audit reports, etc.)

#### *Training and Education*

- Compliance training program for new hires as well as existing staff, including compliance professionals
- Continuing education in connection with policy and/or program changes



# Strategic Analysis





## Tactical Recommendations Road Map

The observations and recommendations noted below and in Appendix I highlight gaps between the SBA's current compliance activities and leading practices adopted by federally registered investment advisers. Should the SBA wish to modify its compliance practices, it should undertake an initiative to evaluate which of the noted gaps and related recommendations the SBA desires to adopt and implement.

All recommendations provided herein are suggestions for the SBA to consider as it continues to build-out and enhance its compliance program.

The following outlines our strategic analysis and tactical recommendations for the SBA to consider:

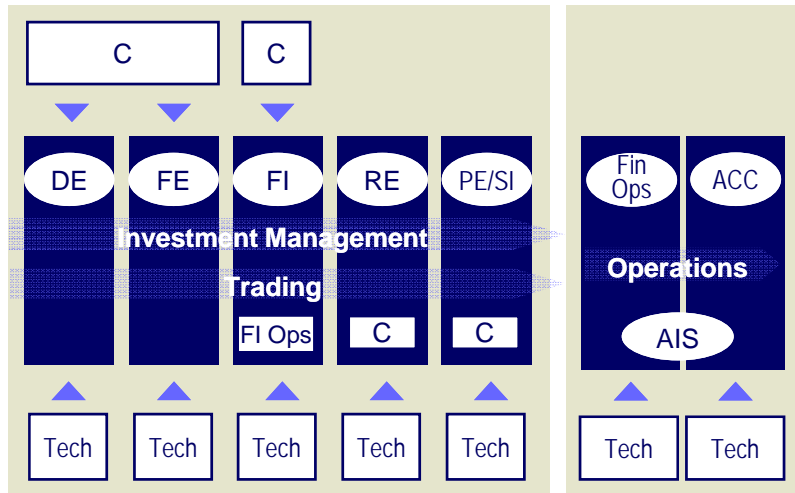




## Current State vs. Future State



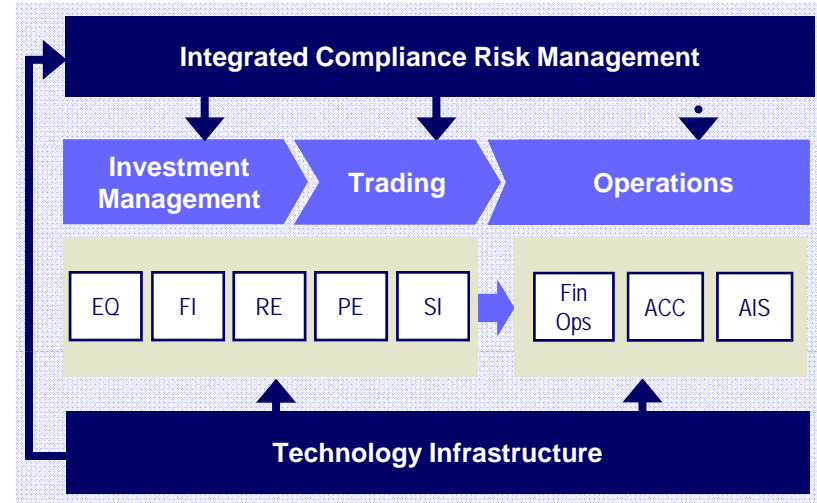
### Current State



C – Compliance  
FE – Foreign Equities  
RE – Real Estate

Fin Ops – Financial Operations  
FI Ops – Fixed Income Operations  
Tech – Technology

### Stylized Future State\*



**Key:**  
DE – Domestic Equities  
FI – Fixed Income  
PE/SI – Private Equity/Strategic Investments  
ACC - Accounting  
AIS – Accounting Information Systems

#### Current State:

As highlighted by the above illustration, certain functional units currently exist and operate in silos. For example:

- Asset classes are structured in silos with independent compliance functions and technology tools
- Disparate organization of compliance and oversight function throughout the organization
- Fragmented technology framework

As a “silo-ed” organization, the SBA might be exposed to inefficiencies, including, but not limited to, duplication of efforts, inconsistent methodologies, unidentified organizational risks, or misaligned risk strategies.

#### Future State Considerations and Goals:

As documented within the recommendations in Appendix I, the SBA should consider streamlining its organizational structure to include, among other things, the following:

- A centralized and dedicated compliance function responsible for overseeing compliance and compliance-related matters throughout the organization
- A streamlined technology framework and infrastructure, leveraging existing technologies to support current investment operations efficiently and effectively

Considerations for streamlining the compliance function are presented on the following pages.

\* The stylized future state chart is presented as a heuristic device, not a recommended structure



## What is “Future State”?



As discussed, some of the benefits of a centralized compliance function include a coordinated approach to compliance risk monitoring, consistent oversight, and rationalization of resources. Prior to considering how the SBA could approach the implementation of the recommendations discussed in Appendix I, the SBA should define the role of compliance and establish a culture of compliance within the organization. Described below are some steps for the SBA to consider.

It is our understanding that the SBA has undertaken significant measures (e.g., implementing an internal audit function, creating an inspector general role) in an effort to demonstrate its commitment to compliance and set the proper “tone at the top.” The Executive Director, in his leadership role, should continue with these initiatives to set the tone for compliance within the SBA as well as define the strategic vision for compliance in light of the SBA’s overall strategic objectives and institute a governance structure to support and implement that vision.

### **Tone at the Top**

As part of his efforts, the Executive Director should obtain buy-in from key stakeholders within the organization on the desired changes for developing a more robust compliance framework. This should entail agreement on the current state as well as consensus building for establishing the desired future state (see previous slide). Without acceptance from stakeholders that change is necessary, change implementation might be difficult and ineffective. However, establishing the ‘tone at the top’ also requires on-going commitment from the Executive Director and senior management to promote the ‘culture of compliance’ at the SBA.

*“Cultivating a culture of compliance requires a sustainable effort. A one-time push is not enough. Employees will see such an effort for what it is and won’t believe it represents a true commitment to an ethical culture. You have to make sure, on a regular basis, that your code of conduct and your policies and procedures are being followed. That means giving your internal audit and compliance functions the resources and tools they need to do their jobs.”<sup>1</sup>*

The SEC has long emphasized that compliance begins at the top. While there is no simple solution to shift an organization’s perspective from viewing compliance as a cost center to embracing it as an integral part of sound business practices, it is our experience that some institutions develop awareness campaigns to communicate executive and senior management’s support and endorsement of compliance efforts clearly and continuously throughout the entire organization.

Such efforts have included ‘town hall’ style meetings to address questions or concerns, formalized training sessions to raise awareness of what compliance is and why it is important, emails or newsletters addressing frequently asked questions, periodic updates around the compliance efforts and its benefits, distribution of relevant news articles around compliance or failure of compliance at other organizations, etc. An awareness campaign should, in part, be designed to educate employees that compliance performs a risk management function that protects the SBA from certain regulatory and compliance risks, which in turn may have a direct impact on the bottom line. An awareness campaign should also illustrate why compliance should be embraced as part of day-to-day decision making and on-going strategic planning. Another way to signal the SBA’s commitment to compliance might be to implement an incentive structure designed to reinforce compliance or incorporate compliance as part of the annual performance reviews (i.e., in addition to the relationship between the Incentive Compensation Plan and Risk Budget Compliance).

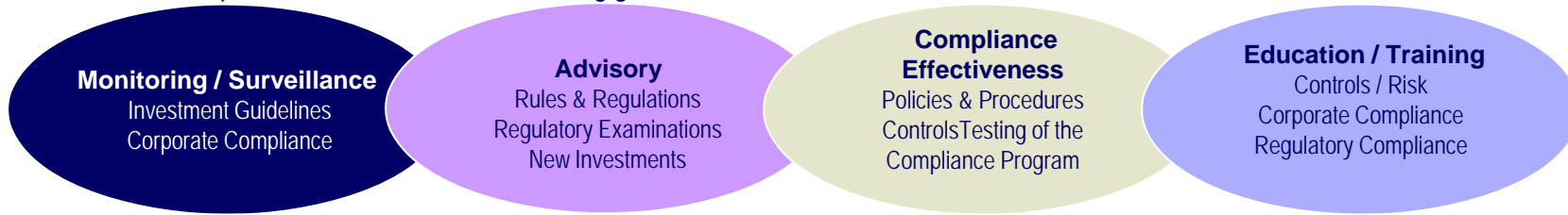
<sup>1</sup> Speech by SEC Staff: Tone at the Top: Getting it Right , Stephen M. Cutler, Director, Division of Enforcement SEC, December 3, 2004.



# Why Compliance?



Prior to discussing the compliance framework, the Executive Director should address another important foundational element – setting the strategic vision for compliance in line with SBA’s overall objectives. While compliance may serve in many roles, it is our experience that some firms concentrate their compliance efforts around the following general areas:



The SBA should consider tailoring the role of its compliance function to its business objectives and regulatory requirements as well as its size and resources. Typically, the compliance function is established to manage, mitigate, control and oversee certain risks, in particular legal and regulatory. Setting the vision for compliance is expected to facilitate and guide the development of the overall compliance framework.

## Compliance Value Proposition

### Potential Costs of Failure

Potential Measurable Costs:

- Correction and Recovery – In general, investment fiduciaries are potentially responsible for the reimbursement of lost client revenue resulting from trade errors and investment guideline breaches.

Potential Collateral Damage:

- Reputation – Negative publicity resulting from inadequate compliance efforts or oversight activities performed by the investment fiduciary may lead to loss of investor confidence and potential loss of revenue.
- Lost Opportunity – Reacting to the recovery and correction of compliance related issues could result in a less proactive business strategy. Lack of a forward focus could lead to a lost opportunity (e.g., missed investment opportunity).

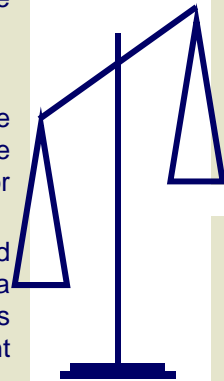
### Potential Cost of Compliance

Potential Measurable Costs:

- Compliance Resources (e.g., salaries for additional resources)
- Awareness/Training (e.g., cost of conferences admissions, periodic compliance publications, external training vendors)
- Systems & Technology (e.g., implementation of a pre and post trade compliance system)
- Internal/External Assurance (e.g., allocating internal resources or hiring external firms to test compliance program and controls)

### Potential Compliance Cost Savings:

- Early risk detection – identifying and correcting risks and errors on a real time basis
- Risk prevention – controls to prevent recurring trade error and guideline breach costs
- Reputational – may result in additional recruitment and retention of investors





# Governance Structure



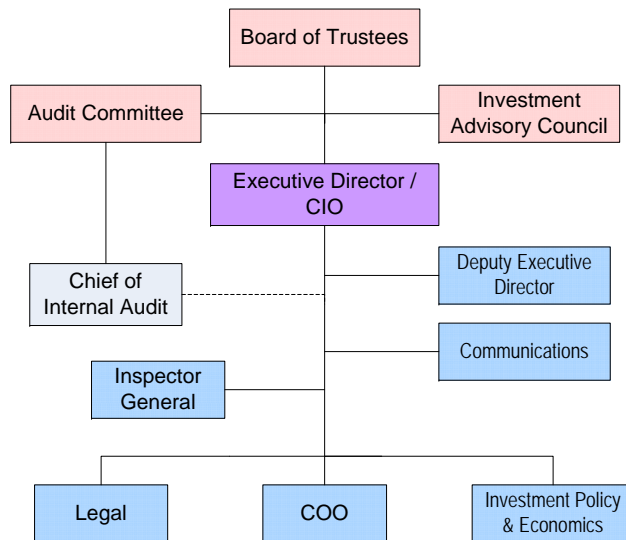
One of the next steps for the SBA to consider in developing or enhancing the compliance framework is the SBA's governance structure. The following outlines some suggestions for the Executive Director and the SBA to consider as they evaluate the current governance structure.

The SBA should determine if the current governance structure supports the aforementioned strategic objectives of the SBA and specifically, the strategic vision for, and role of, compliance. The governance structure should be designed to facilitate the implementation of the compliance program as well as enhance the efficacy of the compliance activities. We propose the following considerations for the SBA to evaluate as it reviews its governance structure.

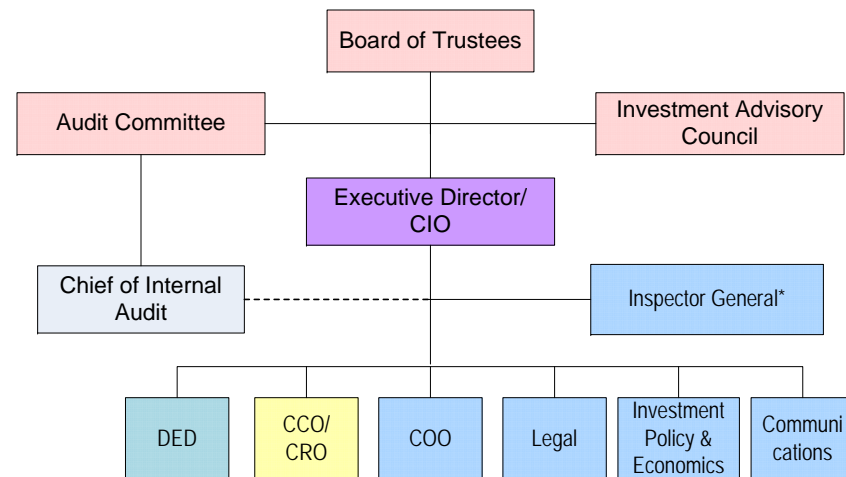
## Independence

- Compliance is considered a control function. Accordingly, control functions (i.e., compliance) and revenue generating functions are typically segregated to avoid the appearance of conflicts of interest. To maintain its independence, the compliance function typically reports via a Chief Compliance Officer ("CCO") to a senior-level (e.g., CEO) position. While we understand that combining the Executive Director and Chief Investment Officer ("CIO") positions is by design, separating the two positions is expected to strengthen the SBA's overall governance structure and compliance program. Because segregating the two positions may not be feasible, the SBA should consider the following to enhance its current governance structure:
  - Creating a CCO position that would directly report to the Executive Director. Considerations for filling the position are discussed on the next pages. Other controls to mitigate the lack of segregation should also be considered.
  - Elevating Enterprise Risk Management ("ERM") within the organization to provide more visibility and authority as well as enhance the control environment at the SBA.

Understanding of Current State



Proposed Future State



\* Certain Inspector General responsibilities may overlap with the CCO/CRO role. The role of the Inspector General will be considered in further detail in Phase 2.



## Committee Overview



The committee structure is an important aspect of any governance framework. Formal committees provide an opportunity to integrate business units by providing individuals from a cross-section of disciplines with a forum to address pertinent issues together. Generally, committees are designed to oversee an organization's control environment in light of its business activities, supplement and enhance executive decision-making, and provide a perspective on future initiatives.

Current SBA committees:

- **Senior Investment Group (“SIG”)**: Sets direction of investment strategy, including investment policy, asset allocation and cash flows, portfolio diversification in line with risk appetite, counterparty risk exposure, investment research initiatives, broker/dealer activity and derivative usage.
- **Senior Operations Group (“SOG”)**: Sets direction of operations and administrative needs for the SBA, strategic decisions, and new initiatives.
- **Enterprise Risk Management Steering Group (“ERM SG”)**: Cross-functional forum to oversee Enterprise Risk Management and Compliance (“ERMC”), including review of compliance exceptions and new or existing risk issues, evaluation of relevant monitoring, and education of senior management on risk matters.
- **Investment Oversight Group (“IOG”)**: Specifically developed to review, document and formally escalate compliance exceptions and events pertaining to the 2a-7 funds. Rather than acting in a broad oversight capacity, the IOG has a specialized compliance function. Therefore, it will be excluded from the discussion below.
- **Information Technology Steering Committee (“ITSC”)**: Oversees and counsels on matters of technology innovation and the role of technology and its use throughout the SBA (we understand that the ITSC meets infrequently on an as-needed basis).

The next few pages highlight types of committees that the SBA may wish to consider as it reviews its current committee structure. The considerations present a few suggestions for the SBA to leverage its current committee structure while addressing some of the oversight responsibilities typically addressed by the committees listed below.

### Common Oversight Committee Descriptions

#### Investment Committee

**Responsibilities:** Sets investment direction and reviews performance. Additional responsibilities may include overseeing individual asset class' consistency with investment strategy, approving and periodically reviewing investment guidelines, approving new investments and/or strategies, overseeing proxy voting, overseeing external investment managers (as applicable), etc.

**Composition:** CEO, CIO(s), COO, Head of Trading, Head of Research (as relevant), Compliance, and other key personnel

**Frequency:** bi-weekly / monthly

### Considerations for the SBA

SBA's SIG performs some of the duties of an Investment Committee.

The SBA could expand the composition and charter of the SIG to closer align it with typical practices of an Investment Committee.



# Committee Overview Cont'd



## Common Oversight Committee Descriptions

**Operations Committee**

**Responsibilities:** Sets operational initiatives for the organization by providing a forum for review and guidance. Serves as a forum for escalation for any operational items to approve corrective actions as well as determine control enhancements. Additional responsibilities include review and approval of any Operational policies and procedures and oversight of any relevant sub-committees (e.g., Information Technology)

**Composition:** CEO, COO, Head of Trading, representatives from IT, Compliance, Risk, and other key personnel

**Frequency:** bi-weekly / monthly

**Compliance Committee**

**Responsibilities:** Assess impacts of corporate-wide compliance initiatives and any relevant industry events on the organization, in particular regulatory or legal exposures. Reviews investment compliance violations, trading, or operations errors; evaluates proposed corrective actions and control enhancements; administers code of ethics; and oversees external investment managers (as applicable).

**Composition:** CEO, CIO, COO, General Counsel, CCO, CRO, Head of Trading, Head of Research, and other key personnel

**Frequency:** monthly and ad hoc

**Risk Committee**

**Responsibility:** Sets risk appetite by managing expected returns and selecting risks the organization is willing to assume based on these returns.

**Composition:** CEO, CIO, COO, General Counsel, CCO, CRO, Head of Trading, Head of Research, and other key personnel

**Frequency:** monthly and ad hoc

## Considerations for the SBA

SBA's SOG performs some of the duties of an Operations Committee.

The SBA should revisit the current composition of the SOG as well as its charter to determine if enhancement opportunities exist.

SBA's ERM SG carries out some responsibilities often assigned to a Compliance Committee as well as a Risk Committee. Based on our experience, organizations will combine their Risk and Compliance committees as both compliance and risk span the entire organization and the committees' focus as well as membership tend to be similar. As such, the SBA could enhance its current ERM SG, to formally incorporate Compliance as part of the committee (e.g., ERM & Compliance SG) and review the ERM SG's composition to determine if all relevant representatives are currently included (e.g., Head of Technology).



## Committee Overview Cont'd



Common Oversight Committee Descriptions	Considerations for the SBA
<p><b>Brokerage / Trading Oversight Committee</b></p> <p><b>Responsibilities:</b> Oversees trading related activities such as best execution, trade allocation, counterparty use and exposures using a consistent approach across all asset classes. Some of their oversight typically entails reviewing trading activity reports across asset classes to evaluate the organization's trade completion rates, market impact and other pertinent indicator; reviewing and approving the counterparty list used for trading on a periodic basis, reviewing transaction cost reports, etc.</p> <p><b>Composition:</b> CEO, CIO, COO, CCO, CRO, Head of Trading, Head of Research, and other key personnel</p> <p><b>Frequency:</b> quarterly (or monthly)</p>	<p>SIG performs oversight of some of these areas, but its role could be enhanced. The individual asset classes could retain the responsibility for performing on-going due diligence and review but would present relevant reports to the committee for periodic independent, cross-asset class oversight, particularly of best execution and trade allocation.</p>
<p><b>Valuation Committee</b></p> <p><b>Responsibility:</b> Establishes and approves valuation policies and procedures. Reviews fair valuation activity, as applicable, for adequacy and consistency with approved methodologies. Acts as a forum to escalate valuation issues and approves proposed approach/methodology.</p> <p><b>Composition:</b> CEO, CIO(s), COO, Head of Trading, Head of Research (as relevant), Compliance, Risk and other key personnel</p> <p><b>Frequency:</b> monthly</p>	<p>SBA does not appear to currently have a formalized process in place for valuation oversight.</p> <p>The SBA could extend the responsibilities of the SOG to include oversight over the current valuation activities at the SBA. The SBA would need to ensure that all relevant individuals participate in the SOG.</p>
<p><b>Technology Committee</b></p> <p><b>Responsibility:</b> Assess and sets the technical architecture as well as system security, reviews IT initiatives for alignment with organization's priorities and strategies.</p> <p><b>Composition:</b> Head of Technology, IT Group representative personnel, Compliance or Risk representatives and other key personnel, as necessary</p> <p><b>Frequency:</b> bi-weekly, monthly</p>	<p>It appears that the TSG addresses some typical areas of responsibility. However, the SBA should consider formalizing the process and increase meeting frequency as well as scope of oversight to facilitate that IT initiatives are current, relevant and in line with SBA's strategic objectives.</p>

The above discussion provides illustrative examples of typical committees that asset management firms have put in place, based on our experience. Organizations should tailor their committee structure to accommodate their size, governance structure as well as business objectives.



## Proposed Committee Structure



This table outlines how SBA might maintain its current committee structure but adapt their composition to include the responsibilities of the committees discussed above.

	Risk & Compliance Committee	SIG	SOG
Executive Director/CIO	✓	✓	✓
Deputy Executive Director	✓	✓	✓
Sr. Investment Officer – Domestic Equities		✓	
Sr. Investment Officer – Foreign Equities		✓	
Sr. Investment Officer – Fixed Income		✓	
Sr. Investment Officer – Real Estate		✓	
Sr. Investment Officer – Alternative Investments		✓	
Senior Investment Policy Officer	✓	✓	✓
General Counsel	✓		
Chief Compliance Officer /Chief Risk Officer (suggested position)	✓	✓	✓
Equities Compliance Manager	OPT		
Fixed Income Compliance Manager	OPT		
Private Market Compliance Manager	OPT		
Inspector General	✓		
Chief Operating Officer	✓		✓
SOO – Planning, Policy and Admin. Services	✓		✓
Director of Information Technology			✓
Technology Staff			OPT
SOO – Accounting and Financial Operations			✓
Director of Financial Operations			OPT
Director of Accounting			OPT

**Legend:**

- ✓ – Current Member of Similar Committee
- ✓ – Suggested New Member
- OPT – Previous permanent member, consider making optional
- OPT – New Optional Committee Member



## Roles & Responsibilities



Along with defining a governance structure, the SBA should consider defining the roles and responsibilities between management, business units, and compliance as they relate to overall compliance efforts. The clear communications of such defined roles and responsibilities should position compliance as an integrated component of everyday business decisions rather than a silo-ed and isolated activity.

Executive management generally bears the responsibility for compliance with relevant regulations, while compliance with firm policies typically rests with senior management and individual employees. Compliance usually advises the organization on how to comply with applicable regulatory requirements. The illustration below shows typical segregation of responsibilities related to business and compliance activities based on our industry knowledge.

### Typical Business Responsibilities

- Portfolio Management:
  - Carry out investment strategy in line with investment guidelines
  - Manage conflicts of interests
- Trading
  - Implement investment decisions in line with investment guidelines
  - Seek best execution
  - Treat portfolios in a fair and equitable manner (trade allocation)
  - Review counterparty list
- Risk Management
  - Performance related to external manager oversight and internally managed portfolios
- Operations & Administration
  - Trade settlement and confirmations
  - Portfolio accounting, recordkeeping, corporate actions, valuation
- Corporate:
  - Comply with Code of Ethics and internal policies
  - Disclose and manage conflicts of interest
  - Disclosures/outside communications

### Typical Compliance Responsibilities

- **Monitoring and Surveillance:**
  - Portfolio Management and Trading:
    - Investment guideline monitoring
    - Review trade activity for best execution
    - Trade allocation and aggregation
    - Counterparties
  - Operations & Administration:
    - Trade settlement / trade errors
    - Pricing and fair valuation
- **Compliance Risk Management:**
  - External investment manager oversight and due diligence
  - Legal matters and guideline compliance
- **Corporate Compliance:**
  - Monitor Code of Ethics/other requirements
  - Review disclosure documents
  - Address any regulatory disclosure requirements
  - Perform an annual review of policies and procedures
  - Develop adequate business unit compliance training
  - Perform regulatory Inquiries, Inspections and Examinations
  - Comply with books and records requirements



# Chief Compliance Officer



Rule 206(4)-7 under the Investment Advisers Act of 1940 (“Advisers Act”) requires investment advisers to appoint an individual to administer the compliance program and perform an annual review of the compliance program. The following highlights thoughts and ideas around the CCO position for the SBA to consider.

## CCO

### Typical Areas of Responsibility:

#### Administer the Compliance Program:

- Develop and implement compliance policies and procedures
- Establish roles and responsibilities of compliance resources
- Oversee execution of the compliance activities
- Resolve compliance matters as they arise
- Act in an advisory capacity with regard to regulatory and compliance matters
- Report compliance-related issues on a periodic and as-needed basis to senior management

#### Identify Compliance Risks and Mitigating Controls

- Review the effectiveness of adopted compliance program on an annual basis

## Considerations for the SBA

### Organizational – does the CCO:

- have sufficient influence and authority over compliance related matters to administer the compliance program?
- have sufficient resources, support and infrastructure to pursue compliance matters effectively?
- have access to, and support from, senior management to administer compliance program effectively?
- have any apparent or potential conflict of interests in administering the compliance program and performing her other duties, if any?

### Competency – does the CCO possess adequate qualifications, knowledge and experience to perform her duties, such as:

- An understanding of relevant regulatory requirements and leading industry practices of registered investment advisers
- An understanding of compliance matters and environment as well as SBA’s business structure and internal policies
- Experience in implementing / “operationalizing” applicable requirements and policies into procedures and control activities.

### Potential Functional Challenges – appointing the CCO:

- External Hire:
  - Finding a resource to satisfy competency considerations above
  - Compensation: Given budgetary limitations, the SBA may be constrained in attracting the qualified resource it would be seeking.
  - Geography: The location of the SBA may also limit the pool of qualified applicants with the requisite compliance experience.
- Internal Promotion:
  - Identifying an individual capable to acquire and learn the requisite information, be able to bring fresh perspective despite previous integration in the business. Providing this individual with proper authority and support from senior management to effectively administer the compliance program.

### Functional Challenge – establishing the CCO within the organization:

- The CCO is expected to be integrated with senior management and within the organization. Part of this process is a culture/attitude shift within the organization that is directly linked with “tone at the top” and is expected to take time to implement (see ‘Tone at the Top’ discussion on previous slides).



# Compliance Program



## Compliance Program Considerations

Once the SBA has given thought to the considerations and challenges presented in the previous slides, it should begin to formulate its compliance program. Generally, the CCO would lead the development and drafting of compliance policies and procedures. The broad objective that an investment adviser typically assigns its compliance program is the identification of regulatory and compliance risks and development of mitigating controls, which include processes undertaken directly by a compliance function as well as oversight over processes executed by business units who own the underlying responsibility for the control activity. If compliance resources were unlimited and cost was not a factor, compliance would ideally be able to consistently undertake all relevant activities and maintain a strictly controlled environment. However, due to inherent resource and cost constraints as well as an understanding that some risk is a necessary part of business objectives, compliance generally allocates its efforts based on the organization's risk appetite through an internal risk assessment.

Based on our industry experience, compliance programs of registered investment advisers generally consist of the following components:

- "Mission Statement" for the compliance function. The SBA should formalize the role of compliance for the organization by developing a mission statement.
- Policies designed to support the mission of compliance. These typically cover the principles that an investment adviser is expected to follow to address relevant regulatory and compliance risks integrated with the overall business objectives.
- Compliance procedures that implement the compliance policies and describe the control activities and oversight for compliance personnel to perform.

As part of the initial process, the SBA (preferably the CCO) should perform a risk assessment to compile the list of potential compliance and regulatory risks, any current mitigating controls, and residual risks. This process should enable the CCO to document policies in a complete manner and provide an opportunity to review current procedures for enhancement opportunities. Using the risk assessment, the CCO could then begin to develop detailed procedures for the compliance department as well as relevant business units. The risk assessment should consider risk levels as well as likelihood of impact, which in turn would drive the allocation of compliance resources (e.g., frequency of monitoring). To prevent silo mentality, the CCO should leverage resources from other functions when identifying compliance and regulatory risks and developing control activities to determine if the risk appetite is appropriate for the SBA and its overall objective.

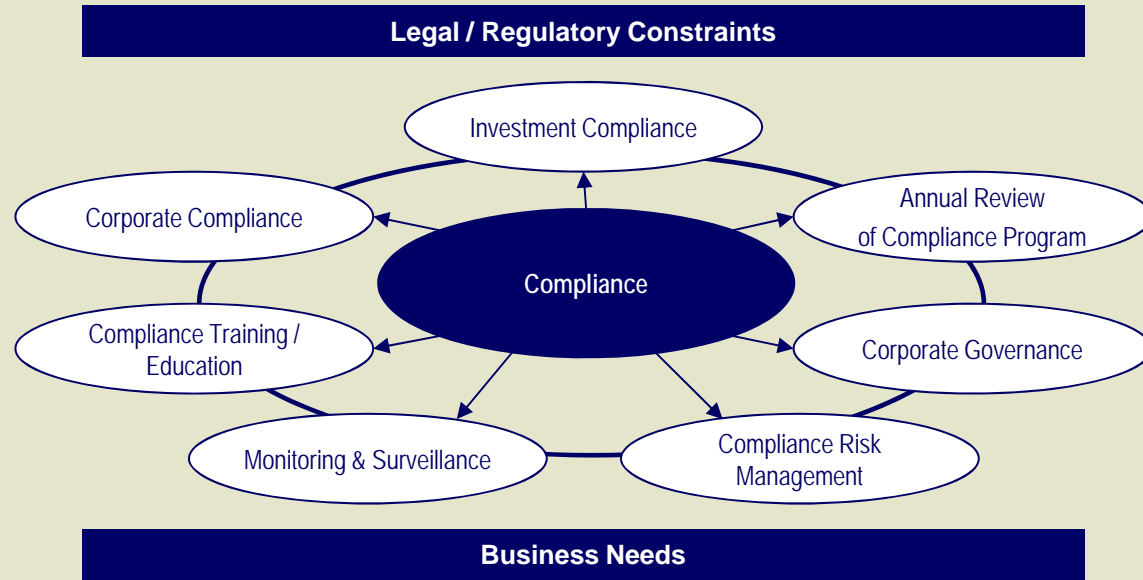
The compliance program should also document the structure of the compliance department and its means for oversight. Finally, one important aspect of any compliance program is the periodic review of the compliance policies and procedures for their effectiveness, adequacy and appropriateness.



# Compliance Program Cont'd

## Compliance Program Considerations

The SBA's Compliance group should document the activities of its compliance personnel (whether direct execution or monitoring/oversight) while aligning these activities with the regulatory environment and SBA's overall business objectives.



The above provides some suggested activities for the SBA to consider. The SBA's compliance resource requirements will derive from its compliance activities as well as the frequency of their execution. Additionally, the SBA could evaluate whether opportunities exist to streamline processes across functions and implement automated tools to augment the compliance efforts. The next slides cover the steps compliance could take to address the compliance activities noted above in greater detail.



# Compliance Activities



The following outlines the functional considerations and tactical recommendations, including typical core compliance activities related to the proposed governance structure and compliance framework, that the SBA should evaluate as it looks to reshape its compliance function and the interaction and coordination compliance currently has with the other business units. It is anticipated that as the SBA reshapes its compliance function, compliance is expected to increasingly play a larger role in proactively identifying and responding to potential problem areas.

<b>Functional Considerations</b>	<ul style="list-style-type: none"><li>• Competencies: subject matter knowledge, experience, and ability to implement and execute compliance activities</li><li>• Resources: available resources, including capacity considerations, necessary to administer the compliance program</li><li>• Identified Gaps: formal compliance program, including compliance policies and procedures; pre- and post-trade investment compliance monitoring; external manager oversight framework; compliance education and training</li></ul>
<b>Tactical Recommendations</b>	<ul style="list-style-type: none"><li>• Independent and centralized compliance function responsible for developing compliance policies, including procedures to implement the policies</li><li>• Core compliance areas of focus and activities:<ul style="list-style-type: none"><li>– Investment compliance monitoring</li><li>– Monitoring and surveillance activities</li><li>– Compliance risk management, including oversight of external managers</li><li>– Corporate compliance</li></ul></li><li>• Daily pre- and post-trade investment compliance monitoring</li><li>• Expanded external manager oversight with respect to legal and guideline compliance and operations due diligence, including standardized approach, tools (e.g., templates, checklists, exception reports), and reporting</li><li>• Periodic assessment of the compliance program and, including efficacy of the compliance control activities</li><li>• Formal compliance training and education</li></ul>



## Core Compliance Functions, Responsibilities and Practices



### Investment Compliance Monitoring

Monitoring compliance with investment guidelines is one of the core activities typically performed by the compliance function within an asset management firm. The provisions of the investment management agreements (“IMAs”) along with the associated investment guidelines form the basis for managing the asset manager’s various portfolios and/or accounts. To the extent that the asset manager has delegated investment management responsibilities to other investment fiduciaries (i.e., external investment managers) to manage all or portions of the investment portfolios entrusted to the asset manager, it is usually incumbent upon the asset manager to manage and oversee the investment compliance monitoring activities of the external manager. To address their fiduciary and/or contractual obligations with regard to investment compliance, leading asset management firms have typically opted to implement automated systems to monitor investment compliance while others have looked to enhance their compliance monitoring capabilities. Whether the asset manager uses automated systems or manual procedures to monitor investment guideline compliance, compliance (and/or business) activities typically associated with pre- and/or post-trade compliance monitoring include:

- Development and implementation of procedures in connection with document management and retention (e.g., scanning of IMAs, investment guidelines, and amendments; physical and/or electronic document repository; protocol for document routing, reviews, and approvals, etc.);
- Analysis—primary and secondary reviews—of IMAs and related documents such as amendments, side letters, and attachments to identify investment guidelines and contractual provisions (e.g., most favored nations clauses, periodic reports, change notification, etc.);
- Identification and resolution of interpretive issues involving ambiguous terms and provisions, including development of tools (e.g., templates, open issues report) to track the resolution thereof, to establish consistent internal policies and practices;
- Development and testing of automated rules within the compliance engine (as applicable); and
- Analysis of data requirements, including maintenance of a rules library and/or data models (as applicable).

The types of securities (e.g., equity, fixed income, or alternative investments such as credit default swaps) used in connection with the investment strategies pursued by the asset manager will usually determine whether compliance checking will take place on a pre- or post-trade basis. For equity and equity-type instruments, it is our experience that pre-trade monitoring of security-level restrictions (e.g., prohibited issues) during the portfolio construction phase or at the time of trade order entry is typically the norm. In addition to the pre-trade checks, it is our experience that monitoring of other investment restrictions (i.e., non-security specific investment restrictions such as concentration limits) typically takes place on a post-trade basis through either exception reports or overnight batch processes.



## Core Compliance Functions, Responsibilities and Practices Cont'd



### Investment Compliance Monitoring (cont'd)

For those asset managers that have delegated responsibility for managing their portfolios to external managers, the complexity of the mandates and investment guidelines largely dictate the manner and mode by which the asset managers should monitor the external managers' compliance with the investment guidelines. The asset manager should take the necessary steps to understand thoroughly the compliance monitoring capabilities of the external manager. This includes, among other things, the experience of the resources responsible for monitoring compliance with the investment guidelines, the workflows for monitoring, detecting, and reporting potential investment guideline breaches, and the technology infrastructure associated with the investment compliance tools and systems. The asset manager should also determine the compliance history of the external manager. Some considerations include: Has the external manager ever breached the investment guidelines of the asset manager and/or the investment guidelines of other accounts that it manages? Were the breaches isolated events or suggestive of systemic problems? Under what circumstances would the external manager notify the asset manager of any potential breaches?

Depending on the state of the external manager's compliance monitoring capabilities, the asset manager should, at a minimum, request a certificate of compliance from the external manager. In addition, the asset manager may wish to request the results of third-party reports such as SAS 70s, internal audit reports, or agreed upon procedures (to the extent they are available). Alternatively, the asset manager may wish to conduct remote inspections through questionnaires and requests for information. If the risk profile (e.g., assets under management, complexity of the mandate, compliance capabilities) or compliance history of the external manager warrants, the asset manager may wish to conduct in-person site visits in connection with a broader external manager oversight program (see below for additional further discussions).

Automated systems may offer many advantages for monitoring investment guidelines. They allow for real-time pre-trade, post-execution, and end-of-day compliance monitoring capabilities. The decision to implement an automated system, however, should align with the organization's business strategies and investment activities. Investment constraints, guidelines, and restrictions typically associated with private equity, real estate, and other alternative investment strategies generally do not lend themselves to automated monitoring. In addition, to the extent that management of the underlying assets has been outsourced to external investment managers, it may not be cost effective to implement an automated system to monitor investment compliance of external managers. Under such circumstances, a comprehensive oversight and due diligence framework may provide a more cost effective solution.



## Core Compliance Functions, Responsibilities and Practices Cont'd



### Monitoring and Surveillance

Given the breadth, depth, and complexity of an asset management firm's investment operations, monitoring and surveillance of investment activities are other critical compliance functions for the SBA to consider. This role often involves, among other things, a detailed review of business standards and conduct, investment transactions, and internal and external communications to identify potential problem areas and/or systemic control weaknesses throughout the organization. Ongoing monitoring and surveillance may not only serve to deter improper conduct, it may also serve to facilitate compliance with internal policies and regulatory requirements.

Principles of sound management and effective internal controls (i.e., separation of duties and functions to establish a system of checks and balances) should be considered as drivers of the monitoring and surveillance program. The program should clearly define and assign responsibilities and control points to individuals within the Compliance group as well as the business units. The range of areas for monitoring, in general, includes:

- Activities associated with investment management processes such as style drift, allocation of investment opportunities, portfolio turnover, and volatility;
- Trading and brokerage practices, including trade allocation, trade error management, best execution, and commission sharing arrangements;
- Code of Ethics and personal trading; and
- Middle- and back-office operations, including safeguarding of assets vis-à-vis business continuity and disaster recovery planning.

Creating an effective monitoring and surveillance program typically requires communicating and publicizing the policies and procedures designed to identify and prevent potential conflicts of interest that are an inherent part of an asset manager's business.

Compliance should consider providing guidance to employees consistently throughout the organization on how to handle potential situations arising from transactions, situations, and arrangements that might violate the firm's policies and/or applicable regulations. The monitoring and surveillance program should also include the methods by which a compliance function will identify breaches (e.g., exception reports, testing of transactions, whistle blower line, etc.) due to mistakes, misinterpretations, or intentional actions to circumvent the policies. Upon detection of potential violations or "red flags," the monitoring and surveillance program should provide for escalation and timely resolution of the issue at the appropriate levels of the firm. Ultimately, achieving an effective monitoring and surveillance program normally requires active participation and support throughout the entire organization — compliance, senior management, and line personnel.



## Core Compliance Functions, Responsibilities and Practices Cont'd



### Compliance Risk- Management and External Manager Oversight

Risk is inherent in various activities associated with an asset manager's investment operations. Compliance risk, among other risks, can arise when organizations fail to comply with laws, regulations, or standards or conduct. Identifying these risks and developing a plan to manage these risks are responsibilities that typically lie with compliance as well as other business units throughout the organization. A common trend in the asset management industry has been to install comprehensive, enterprise-level compliance-risk management functions where compliance is integrated into the overall risk management function (see "Alignment with ERM" section pg. 32-36). Many firms are striving to enhance their compliance-risk management functions by implementing compliance management information systems, which are designed to allow for more integrated and transparent analysis and monitoring. In addition, these firms are largely moving away from task-oriented compliance programs to process-oriented compliance programs.

Process-oriented compliance programs, which usually require testing and validation of compliance on an ongoing basis, typically allow for a better understanding of compliance across the organization and the elimination of fragmented and duplicative compliance activities. In addition, process-oriented programs typically promote consistency in expectations, documentation, assessments, and reporting. Furthermore, a process-oriented compliance program is typically designed to be responsive to change and adaptable, allowing for easy modifications to fit an asset management firm's business strategies, investment activities, and external environment (which includes external investment managers that are managing assets on behalf of the asset manager).

Even though investment fiduciaries (i.e., asset managers) may have delegated their investment management responsibilities to external investment managers to manage their investment portfolios, the fiduciary responsibility is ongoing. To satisfy their fiduciary responsibilities, asset managers should ensure—on an initial and ongoing basis—that the appointed external investment managers clearly understand their fiduciary obligations and that the managers have appropriate tools to manage the assets. In addition, the asset managers should ensure that the external investment managers have appropriate operational and compliance controls in place to measure, monitor, and manage risks that are inherent to the external managers' investment activities. Lastly, asset managers need to identify and address potential operational and/or compliance gaps and control weaknesses associated with their external investment manager.



# Core Compliance Functions, Responsibilities and Practices Cont'd

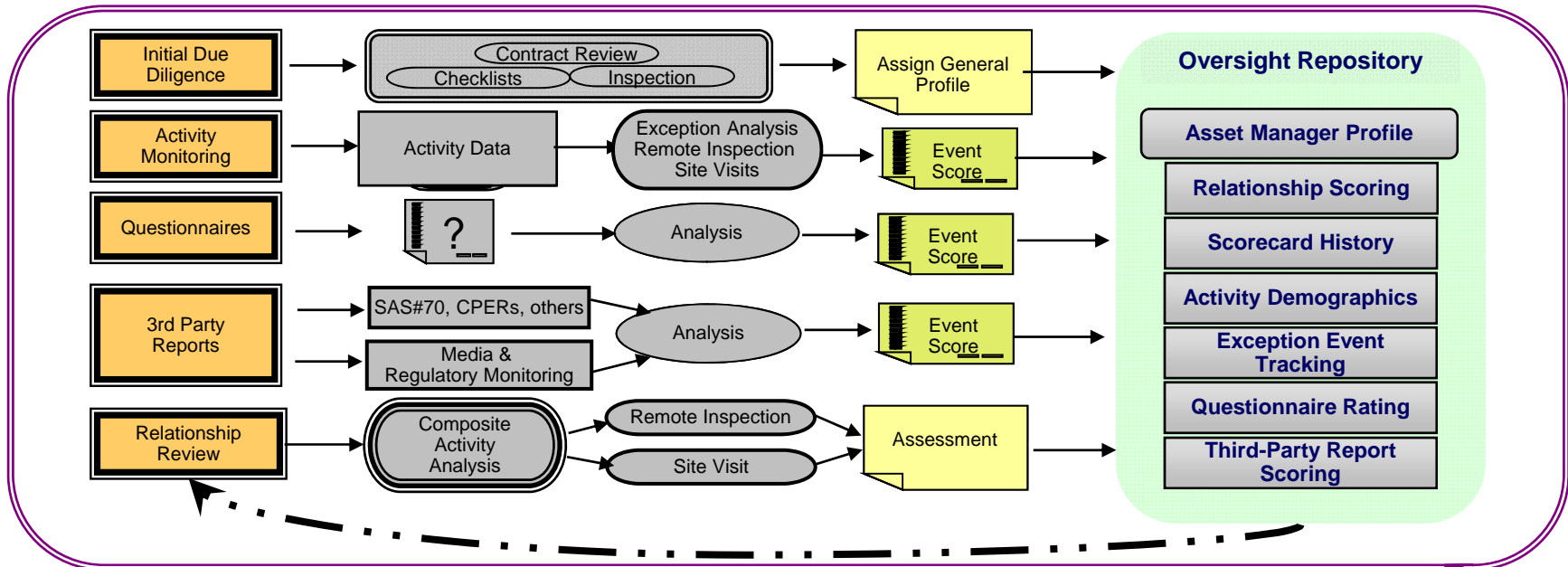


## Compliance Risk-Management and External Manager Oversight (cont'd)

Although the scope and approach of an oversight framework may vary from asset manager-to-asset manager, there are certain core concepts and elements that are generally considered germane to due diligence and/or site visit (i.e., oversight) programs. As depicted in the illustration below, most programs include a data repository to store the information collected from the assessments, system for scoring the results of the assessment, and standard toolset such as meeting agenda, questionnaires, and document request lists used in connection with the due diligence/site visit. In addition to evaluating the investment compliance monitoring capabilities of the external manager as mentioned above, the oversight program typically includes the evaluation of the overarching operational and compliance controls (i.e., compliance program) that the external manager has put in place to manage risks associated with its investment operations. In addition, the program typically includes the evaluation of the quality and experience of the resources responsible for performing the various activities from making investment decisions to performing account reconciliations; the efficacy of the workflows and processes for implementing and executing the external manager's investment strategies; and the technology infrastructure designed to support the investment activities.

### Illustrative External Manager Oversight Framework

The below illustrative model presents various components that may be included in an oversight framework.





## Core Compliance Functions, Responsibilities and Practices Cont'd



### Compliance Program Assessment

Effective compliance programs typically require continuous review and updating in light of emerging risks resulting from new business activities, operational practices, technologies, and/or regulations (Note: Rule 206(4)-7 under the Advisers Act requires federally registered investment advisers to conduct an assessment of their compliance policies and procedures on an annual basis). Compliance must keep apprised of these developments to assess how they affect firm policies and procedures, business activities, operations, and the compliance program. In addition, the compliance function is typically responsible for designing the testing plan to evaluate the adequacy of the compliance policies and procedures and the effectiveness of their implementation.

Designing a testing plan usually begins with developing an understanding of the organization's strategic (i.e., business, operation, and compliance) objectives; identifying the policies and procedures adopted and implemented to meet those objectives; and mapping the policies and procedures to regulatory requirements (as applicable). The next phase usually involves examining the extended enterprise to identify events (i.e., risks) that might potentially prevent the organization from achieving its strategic objectives. A comprehensive risk identification exercise using a well-structured and systematic process is typically considered critical because missing or not including a potential risk at this stage would exclude that risk from further analysis. The next step is usually to define the control objectives and identify the control activities put in place to achieve the control objectives. The characteristic elements of a control activity usually include:

- The frequency or timing of the activity;
- The party responsible for conducting the activity;
- The specific risk mitigating activity (e.g., reconciliation of the custodian's cash positions to the cash positions from the accounting system);
- The sources of information (if applicable), and
- The action taken with the results of the activity (e.g., generating a Cash Discrepancy Report and researching the discrepancies).

Control testing typically seeks to determine and provide evidence of the existence, effectiveness, and efficiency of the control activity. Combining traditional transaction-based testing with "forensic" testing is becoming increasingly more common. As noted in the SEC's release adopting Rule 206(4)-7, forensic testing involves analyzing information over time to identify unusual patterns and evaluating whether the outcomes are consistent with expectations. Forensic testing can span across the extended enterprise, including internal operations as well as outsourced services (e.g., investment management services provided by external investment managers).

# Core Compliance Functions, Responsibilities and Practices Cont'd



## Training and Education

Compliance is typically responsible for providing regulatory and compliance advice to business personnel on an ongoing basis. These efforts may involve responding to questions and issues as they arise or they may involve proactively keeping the business units apprised of new policies or procedures or regulatory events. In addition, the compliance function is often responsible for developing training materials and conducting training and education programs to keep business personnel apprised of new developments. Training should involve regularly scheduled updates as well as additional sessions on an as-needed basis for business unit managers and/or new hires.

In order to train the business units, compliance professionals should be well versed in the internal policies, laws, regulations, and standards of conduct that are applicable to their particular organization. They should be aware of new regulatory developments that may affect their organization and be able to identify areas of their organization that could potentially be impacted by these changes. In order to facilitate the efforts of compliance personnel to stay abreast of regulatory and industry developments, many organizations have invested in industry publications to provide their compliance professionals with resources to stay up-to-date on new industry developments. Based on our experience, it is a common industry practice to send their compliance personnel to periodic (e.g., annual) conferences and/or external training seminars that provide the opportunity to learn about leading industry compliance practices and objectively assess the current compliance efforts undertaken by the organization. Employees who attend conferences are typically required to educate their colleagues on information learned to facilitate timely dissemination of information as well as periodic discussions relating to current compliance efforts.

When developing training plans for compliance professionals, it is important to consider the key person risk that is inherent in many smaller organizations. New regulatory updates should be properly documented and presented to the organization's compliance professionals and management to ensure that specialized knowledge does not reside with just one person. Dissemination of information and periodic internal trainings/seminars could facilitate the development of regulatory knowledge and relevant skills not only within the compliance personnel but also within the larger organization as compliance is a responsibility borne by all.



## Functional Challenges



Should the SBA decide to adopt and implement some or all of the above-discussed tactical recommendations related to the proposed compliance transformation strategy, the SBA should consider and evaluate the following functional challenges (e.g., structural, organizational, and resource issues) and their potential impact on the compliance function as well as the organization as a whole.

### Resource (Human Capital) Management vis-à-vis Key Person Risk

The SBA faces resource management (e.g., key person risk, ability to recruit and retain qualified resources, compensation) issues that may potentially affect the SBA's ability to achieve its overall strategic objectives. Succession planning (i.e., leadership and knowledge management) is a tool used by many organizations to manage their current and prospective resource needs. Some basics to succession planning typically include:

- Conducting an enterprise-wide assessment to identify mission critical positions, which require continuous coverage and/or specialized knowledge;
- Defining criteria for core leadership and technical competencies and using these criteria as measures for selection and development of internal candidates;
- Identifying junior staff that fulfills core competency criteria (i.e., building candidate profiles) and assessing readiness;
- Developing a training-based development program that establishes common goals and provides incentives to achieving those goals (e.g., leadership curriculum, external training, self-directed study); and
- Aligning succession/leadership management to overall business strategies and objectives.

The ability to recruit and retain qualified resources is expected to be a critical success factor to establishing a succession plan and resource management program. The main challenges include the availability of qualified resources with compliance experience and the ability to recruit and retain these resources in light of geographic location considerations, including compensation practices relative to other financial centers.

Another challenge that small to medium size organizations come across is often times the ability to segregate responsibilities. The proposed governance structure attempts to delineate and separate oversight responsibilities from management activities. In addition, the proposed governance structure looks to establish an independent compliance program with a CCO to administer the program. Identifying a qualified CCO with the requisite experience and knowledge and providing the CCO with adequate compliance resources is expected to be central to establishing an independent compliance program within the proposed governance structure.



## Functional Challenges Cont'd



### Policies and Procedures

The foundation of an infrastructure with sound internal controls is often times its documented policies and procedures that set forth the principles underlying the organization's strategic objectives and the measures put in place to achieve those objectives. Policies and procedures also typically serve as a useful training tool, provide future reference, establish standards for performing the organization's unique operating practices, and may serve to help the organization meet regulatory requirements. While many organizations might very well do a good job in performing the procedural and/or control activities across the functional areas, the inherent weakness is likely to be in the documentation of these activities.

To launch and maintain policies and procedures, an organization should have a policies and procedures development process in place. Many times, organizations invest and develop policies and procedures without regard for future maintenance. Information that is out-dated and not maintained may lose integrity and effectiveness. The development process should identify the roles and responsibilities for initiating, owning, communicating, revising, approving, and executing the policies and procedures. Considerations for developing effective policies and procedures include, but are not limited to, the following:

- Developing and implementing policies and procedures aligned with the organization's business practices (e.g., as the SBA reshapes its governance structure and compliance program, the SBA should amend its policies and procedures to reflect these changes; in addition, the SBA should consider the relationship between various policies and procedures and the up- and down-stream consequences that policy changes in one area may have in another area);
- Assigning responsibility for the development of the policies and procedures to each business unit head to ensure their relevance and applicability;
- Standardizing the process for developing the policies and procedures to facilitate their maintenance;
- Maximizing the efficiency and usability of policies and procedures by developing a consistent format in terms of content, level of detail, and readability; and
- Reviewing the policies and procedures on an ongoing basis by personnel with the authority and knowledge to make necessary changes.

A primary purpose of documented policies and procedures is to provide a curriculum for organizational training. The development process should serve as an opportunity to "learn the business" and improve performance of the employees and the organization. The architecture (i.e., format and presentation) of the policies and procedures should be task-oriented according to business processes rather than subject-oriented according to business functions, which leaves users to assemble the information as to how to perform their jobs. The presentation of the information should be in the form of lists, tables, scripts, and flow diagrams to pre-interpret the information and facilitate processing of the information by the users. Pre-interpreted information reduces the amount of reading, increase comprehension, and reduces the chance for errors.

Communicating with and obtaining input from the business units and functional areas is expected to be critical to developing the content and form (e.g., purpose, scope, responsibility, policy, procedure, forms, and references) of the documented policies and procedures.



## Functional Challenges Cont'd



### Communications

In our experience, a key feature common to many organizations is an effective communications plan. That is, to operate effectively and efficiently, an organization must have high degrees of communications—upward and downward communication between management and staff as well as communication between and among business units. Considerations for developing an effective communications plan include:

- Establishing a strong and deliberate “tone at the top” that encourages vertical and horizontal communication that starts with senior management and filters throughout the organization; Developing and disseminating clearly defined policy that establishes and articulates the organization’s strategic plan, including mission, vision, value statement, goals, and strategies for achieving those goals;
- Developing a basic set of procedures, including standard operating procedures (i.e., desk procedures) for performing and completing routine tasks;
- Holding regularly scheduled meetings—committee, management, one-on-one—to discuss, among other things, emerging issues, potential problem areas, and/or general announcements regarding the organization’s performance, including accomplishments to provide a sense of direction and fulfillment;
- Establishing an open floor plan (e.g., placing related business units in close proximity to one another, embedding senior management with the staff, etc.) to allow for the natural flow of information across the organization and encourage communications within and between business units; and
- Providing a mechanism/forum to solicit and provide feedback, share information, and leverage work performed by others to minimize potential duplication of effort.

Effective communication between and among the business units is expected to be instrumental under the proposed governance structure and compliance program. The sharing of information is expected to allow a compliance function to be proactive and identify potential issues before they materialize into problems.

### Integration with Enterprise Risk Management

ERM is commonly defined as an integrated risk management framework that places consideration of risk as a focal point in business activities, including compliance functions. A key objective of ERM is to aid organizations make intelligent risk-based decisions and manage its expected returns by selecting the risks it is willing to assume. Determining the appropriate structure and governance model of an ERM program is intended to provide the necessary foundation for an organization’s ERM strategy. To be effective, the design of the ERM program should be consistent with the organization’s overall strategic objectives.

While ERM practices may vary from organization to organization, there are four fundamental and critical components to most ERM programs—culture, roles and responsibilities, integration into the business, and communication. The next section discusses how compliance at the SBA should consider aligning with ERM. As a smaller resource-constrained organization, the SBA should consider the formal integration of ERM and Compliance.



## Alignment with ERM



Based on our interviews and reading of documents provided by the SBA, it is our understanding that the SBA's Enterprise Risk Management, Compliance and Internal Audit functions each play a distinct and separate role in the organization's overall risk management effort. There are potential benefits to integrating and coordinating the risk assessment initiatives across these functions areas/units (e.g., alignment of strategic objectives, allocation of resources, enhanced transparency and open communications, operational efficiencies, and cost improvements).

Enterprise Risk Management	Compliance	Internal Audit*
<p><b>Mission / Objective</b></p> <ul style="list-style-type: none"> <li>• Identification and management of <u>residual risks</u> in light of strategic objectives of the organization</li> </ul> <p><b>Main Areas of Focus</b></p> <ul style="list-style-type: none"> <li>• Strategic planning, including developing a risk profile and risk appetite</li> <li>• Organizational processes for identifying and managing key business risks, required mitigation actions, and monitoring and reporting responsibilities</li> <li>• Operations management, including informed, proactive, and timely management of risks (e.g., investment risk, strategic risk, financial risk, risk to reputation, etc.)</li> <li>• Internal and external risk factors and events</li> <li>• Business relationships, including service providers, vendors, and external investment managers</li> </ul> <p><b>General Roles and Responsibilities</b></p> <ul style="list-style-type: none"> <li>• Risk identification and prioritization</li> <li>• Risk assessment and analysis</li> <li>• Risk response strategies</li> <li>• Risk measurement, monitoring, and reporting</li> </ul>	<p><b>Mission / Objective</b></p> <ul style="list-style-type: none"> <li>• Establish culture of compliance in an effort to comply with applicable laws, rules, regulations or guidelines governing the organization</li> </ul> <p><b>Main Areas of Focus</b></p> <ul style="list-style-type: none"> <li>• Compliance strategies and processes, including monitoring and surveillance procedures</li> <li>• Conduct policies, including Code of Ethics, conflicts of interest, business conduct, and gifts and entertainment</li> <li>• Investment guideline compliance related to internally and externally managed portfolios</li> <li>• Enabling technologies, systems, tools (e.g., templates, checklists), and applications</li> </ul> <p><b>General Roles and Responsibilities</b></p> <ul style="list-style-type: none"> <li>• Developing and maintaining compliance policies, procedures, and practices in connection with overall risk management strategy</li> <li>• Managing organizational and compliance risk in connection with investment activities</li> <li>• Advising, training, and educating firm personnel on compliance matters</li> </ul>	<p><b>Mission / Objective</b></p> <ul style="list-style-type: none"> <li>• Independent assessment of <u>inherent risks</u> associated with business, management, and operational activities</li> </ul> <p><b>Main Areas of Focus</b></p> <ul style="list-style-type: none"> <li>• Overall governance structure, including investment management activities, operations, compliance, and technology</li> <li>• Internal control environment, including adequacy of design and operating effectiveness of controls</li> <li>• Key risk indicators (KRIs) to detect operational and/or compliance trends and issues</li> <li>• Compliance with laws, rules, and regulations</li> </ul> <p><b>General Roles and Responsibilities</b></p> <ul style="list-style-type: none"> <li>• Systematic and disciplined approach to evaluate effectiveness of risk management, control, and governance processes</li> <li>• Coordinate with senior management to identify key business strategies, risks, and priorities</li> <li>• Risk-based testing and ranking</li> </ul>

\*At the request of the SBA, Internal Audit was not included in the scope of the observations, recommendations or strategic analysis in this report



## Alignment with ERM Cont'd



### Culture

One of the keys to implementing a successful ERM program is embedding risk management within the organization's culture. The tone at the top, organizational structures, strength of the reporting lines, and communication channels all play an important role in developing this culture. The ERM program should align with the organization's strategic objectives, business activities, and compliance initiatives. Similar to the compliance function, senior management should create a culture of risk management by establishing a clear mandate for an independent ERM function within the organization and communicating this mandate throughout the organization. Additionally, senior management should clearly convey the organization's commitment to effective ERM to business unit leads and staff through well documented policies and training to raise risk-awareness.

### Roles & Responsibilities

Depending on the size of the organization, the risk management function may range from a single risk champion to a full-scale risk management department. Senior management should clearly define and document the roles and responsibilities of an organization's ERM function. Typical responsibilities include:

- Setting policies and strategies for risk management;
- Building a risk culture within the organization, including appropriate education;
- Establishing internal risk policies, procedures and communication protocols (e.g., escalation and documentation) for business units;
- Designing and reviewing processes for risk management;
- Coordinating the various functional activities that advise on risk management issues within the organization as well as other risk and control evaluation initiatives;
- Developing risk response processes, including business contingency and disaster recovery programs; and
- Preparing reports on risk for senior management and key stakeholders.

Senior management should establish the resources required to implement the organization's risk management policy within each business unit. In addition to other operational functions, those involved in risk management (e.g., compliance, internal audit) should have their roles in coordinating risk management policy/strategy clearly defined. The same clear definition is also important for those involved in the audit and review of internal controls and facilitating the risk management process. Risk management should be embedded within the organization and highlighted through periodic training and development.



## Alignment with ERM Cont'd



### Integration into the Business

To be effective, the ERM program should align with and support an organization's overall objectives and strategic direction, complexity of its business activities, operating practices, and internal culture. It is important that management provides a clear statement of its commitment to risk management and determines the most effective way to implement risk management into its organization. This typically includes communicating internal parameters, priorities, and practices for the implementation of risk management. Clear communication of the organization's strategic direction, supported by documented policies and procedures, is expected to help foster the creation and promotion of a risk management culture. The policy should guide employees by describing the risk management process, establishing roles and responsibilities, providing methods for managing risk, as well as providing for the evaluation of both the objectives and results of risk management practices.

### Communication

The establishment and communication of the organization's risk management vision, objectives, and operating principles are important to providing overall direction and integration of the risk management function into the organization. Establishing an integrated risk management function typically involves setting up an infrastructure for risk management that enhances understanding and communication of risk issues, provides direction, and demonstrates management support. To ensure successful integration of risk management into the organization, management should seek to achieve, among other things, the following objectives:

- Management's direction (i.e., vision, policy, and operating principles) on risk management is communicated and understood by the business unit leads and staff.
- Decision-making structures—governance, defined roles and responsibilities, and reporting—are in place to “operationalize” risk management.
- Capacity is built throughout the organization through learning plans and tools.



## Appendix I

# Recommendations & Supporting Observations





## Organizational – Recommendations & Observations

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>The SBA should consider developing a succession plan tailored to address key person risks associated with the unique characteristics of its organization. This should include, among other things, considerations for SBA's size, location, compensation structure, and ability to retain and attract skilled professionals necessary to achieve its business and investment objectives. As part of the succession planning, the SBA should document procedures to facilitate on-going investment operations in case of business disruptions.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b></p> <p>In the release adopting Rule 206(4)-7 (the "Compliance Program Rule") under Advisers Act, the SEC states, "an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster, or in the case of <i>smaller firms</i> [emphasis added], the death of the owner or key personnel."</p> <p>In our experience, maintaining a succession plan for key individuals as well as documented procedures to resume operations in the event of a business disruption are emerging leading industry practices that advisers are adopting to help evidence compliance with the expectations of the SEC and allow them continue their investment operations in the event of a business disruption.</p>
<p><b>Supporting Observation – Resource Management</b></p> <p>Given the size and inherent limitations of its organization, the SBA is exposed to key person risk. Certain key individuals are responsible for performing selected mission critical tasks for which the SBA has not documented procedures or cross-trained its personnel. Personnel departures may create gaps in coverage within the asset class. Key person risks include, but are not limited to, the following areas:</p> <ul style="list-style-type: none"><li>– The Fixed Income Manager of Credit &amp; Research is solely responsible for coordinating the gathering of credit information and approving the presentation of Fixed Income Research Analysts' credit reviews. The credit reviews are used as one of several factors in the investment decision-making process.</li><li>– The Senior Acquisitions Manager is the primary point-person for all real estate acquisitions and makes all recommendations related thereto. While the Real Estate Senior Investment Officer ("SIO") is aware of acquisition opportunities and involved in the decision-making process, serving as the head of the Real Estate group as well as functioning as the Senior Acquisitions Manager is likely to present time management challenges.</li><li>– The SIO of Private Equity is the primary point-person for establishing and maintaining a material number of fund relationships.</li><li>– The Deputy Executive Director, in addition to serving in an executive oversight capacity, performs certain management functions. There is no designated and trained resource to back-up the Deputy Executive Director in the event his services were no longer available.</li><li>– Two Accounting Information Specialists specialize in the SBA's back-end systems and are respectively responsible for maintaining Eagle STAR and PeopleSoft.</li></ul> <p>The SBA does not currently have an overall succession plan in place to address key person risk.</p>	



## Organizational – Recommendations & Observations Cont’d

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>The SBA should revisit its current organizational structure to ensure that it has clearly delineated, defined, and communicated roles and responsibilities for governance, oversight, and management throughout the organization, including the separation of management responsibilities from oversight responsibilities. To the extent that the SBA adopts the proposed compliance framework with an independent CCO, the SBA may wish to consider reassigning the Deputy Executive Director’s compliance and compliance-related responsibilities to the CCO.</p>	<p><b>Leading Industry Practice</b></p> <p>The Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) describes segregation of duties as a control activity that “helps ensure that necessary actions are taken to address risks to the achievement of the entity’s objectives.”<sup>1</sup> Although COSO has acknowledged that, “characteristics of smaller companies provide significant challenges for cost-effective internal control,” such as “obtaining sufficient resources to achieve adequate segregation of duties,” COSO states that, “smaller businesses usually can meet this challenge and succeed in attaining effective internal controls in a reasonably cost-effective manner.”<sup>2</sup></p> <p>In our experience, leading industry practices include:</p> <ul style="list-style-type: none"> <li>– Establishing a Board of Directors or Trustees (the “Board”) to provide oversight and guidance as well as setting the direction and tone for an organization;</li> <li>– Assigning executive officers oversight responsibilities to ensure that the Board’s guidance is implemented and adhered to within the organization; and</li> <li>– Assigning senior management with the responsibility for implementing the overall guidance received from the Board on a day-to-day basis.</li> </ul>
<p><b>Supporting Observation – Organizational Structure</b></p> <p>The Deputy Executive Director, as part of the executive and governance body of the SBA, serves in an oversight capacity. Individuals reporting to the Deputy Executive Director include the compliance professionals as well as the SIOs. In addition to his oversight responsibilities, the Deputy Executive Director performs, among other things, the following management functions:</p> <ul style="list-style-type: none"> <li>– Approving asset class policies;</li> <li>– Reviewing various contracts;</li> <li>– Performing client service work for trust funds and CAMP investors;</li> <li>– Approving compliance reports;</li> <li>– Serving as the secondary approver in connection with direct real estate acquisitions, private market fund investments, and annual investment work-plans (e.g., real estate, private equity and strategic investments);</li> <li>– Participating as a member of the “money market” product Investment Oversight group;</li> <li>– Serving as the secondary approver in connection with public market investment manager searches, hiring, and terminations;</li> <li>– Participating in investment manager monitoring; and</li> <li>– Participating in all management committees.</li> </ul>	

1 - “Internal Control – Integrated Framework” available at [http://www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm).  
 2 - “Internal Control over Financial Reporting - Guidance for Smaller Public Companies (Volume I: Executive Summary),” COSO, June 2006.



## Organizational – Recommendations & Observations Cont'd

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>At a minimum, the SBA should adopt and implement written procedures reasonably designed to prevent violations of applicable state statutory requirements as well as internally mandated policies and review those policies and procedures annually for their adequacy and effectiveness of implementation.</p>	<p><b>Relevant Regulatory Guidance</b></p> <p>The Compliance Program Rule requires registered investment adviser to, among other things, adopt and implement written compliance policies and procedures. Documented policies and procedures are generally considered an important part of a robust compliance program and sound internal controls.</p>
<p><b>Supporting Observation – Procedural Documentation</b></p> <p>The SBA maintains documented policies for the organization and publishes these policies on the SBA's intranet. While certain business units and groups have documented their procedures to support the implementation of the organizational policies, the form and the level of detail of these procedures are not consistent. Additionally, there is no central repository for existing procedures</p>	
<p><b>Item(s) for Consideration</b></p> <p>The SBA should review the universe of its processes to determine which ones require cross functional participation (e.g., investment guideline maintenance, security master file maintenance, etc) in order to implement communication channels (e.g., appropriate distribution lists, sub-committees, etc) to facilitate that all relevant parties are notified of changes in a timely and complete manner.</p>	<p><b>Leading Industry Practice</b></p> <p>Communication within an organization is a critical component for the control environment of an organization. Based on our experience, investment advisers implement communication policies designed to establish appropriate channels for communication flow as well as periodic opportunities (e.g., committee meetings, trainings) to exchange information across functions and between levels.</p>
<p><b>Supporting Observation – Communication of Key Issues</b></p> <p>The SBA does not currently have a consistent approach for communicating key operational issues across the organization, within business units, or with third parties. For example, changes regarding compliance monitoring are not always communicated to all relevant individuals.</p>	



## Organizational – Recommendations & Observations Cont'd

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>The SBA should determine what constitutes best execution and the degree to which best execution obligations apply to each asset class. In order to enhance its current policies regarding trade allocation and counterparty monitoring, the SBA should consider establishing an oversight committee (e.g., trading oversight or brokerage committee) to periodically perform an independent review of current trading practices involving best execution as well as reviewing trade allocation practices and performance of counterparties on periodic basis.</p>	<p><b>Relevant Regulatory Guidance</b></p> <p>The doctrine of fiduciary duty is well established under the common law and embedded in many federal and state statutes, rules, and regulations.</p> <p>As a fiduciary, investment advisers have a duty to treat the clients in a fair and equitable manner, which includes achieving best execution on their behalf.<sup>3</sup></p> <p>In its release adopting Rule 206(4)-7, the SEC states that it expects compliance manuals to contain, among other things, "written procedures by which the adviser satisfies its best execution obligation." Although the SEC has not provided definitive guidance on the type of written procedures or compliance tests required by the SEC, based on our experience, many investment advisers adopt policies and procedures similar to those recommended by the CFA Institute.<sup>4</sup></p> <p>Trade allocation practices and brokerage arrangements have historically been and continue to be areas of focus for the SEC examination staff. Based on our experience, investment advisers implement committees to periodically monitor trade allocation practices as well as periodically review counterparties in connection with their trading and brokerage practices.</p>
<p><b>Supporting Observation – Trading and Brokerage Practices</b></p> <p>Although policy revisions are underway, the SBA could enhance independent oversight-controls (e.g., trade oversight committee, SIG) to:</p> <ul style="list-style-type: none"> <li>– Measure and monitor trade execution quality--execution price, speed of execution, market impact, etc.--outside of the asset classes. The SBA has not formally documented its criteria for determining what constitutes best execution over time: <ul style="list-style-type: none"> <li>• Domestic and Foreign Equities have not documented a best execution policy or procedures. Domestic and Foreign Equities monitor best execution for internally and externally managed portfolios via quarterly Plexus reports.</li> <li>• Fixed Income has not documented a best execution policy or procedures. Fixed Income executes some trades by receiving bids from several counterparties, which are recorded on trade tickets, and selecting the best price. An independent historic review of prices received and selected is not performed. Additionally, guidelines that outline which trades are executed via a competitive bidding process have not been developed.</li> </ul> </li> <li>– Monitor trade allocation practices <ul style="list-style-type: none"> <li>• In instances where trades were executed in an aggregated fashion, there were no look-back mechanisms in place to determine that post-trade allocations were in line with pre-determined allocations.</li> </ul> </li> <li>– Review formally counterparties on a periodic basis. <ul style="list-style-type: none"> <li>• Domestic and Foreign equities stipulate a periodic review in their respective broker dealer policies. However, a formalized review does not take place.</li> </ul> </li> </ul>	

3 - Securities Exchange Act Release No. 23170 (Apr. 23, 1986) - Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters

4 - Trade Management Guidelines, CFA Institute (8 November 2002). Available at [www.cfainstitute.org](http://www.cfainstitute.org).



## Organizational – Recommendations & Observations Cont'd

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>The SBA should enhance its current external investment adviser oversight framework to include periodic evaluations of external investment advisers' organizational structure, operations, compliance and business continuity plans.</p>	<p><b>Leading Industry Practice</b></p> <p>As an investment fiduciary, trustees or others entrusted to manage assets on behalf of third parties have an obligation to protect those assets under their control. The fiduciary duty remains despite arrangements to delegate a portion or all investment management responsibilities. Based on our experience, investment fiduciaries implement governance and/or due diligence frameworks designed to oversee the investment activities of external asset managers to whom they have delegated investment management responsibilities, including, but not limited to, periodically reviewing organizational structure, operations, compliance, and business continuity plans.</p>
<p><b>Supporting Observation – External Manager Oversight Framework</b></p> <p>The SBA's external manager oversight framework consists of, among other things, meeting with the external managers to discuss their investment process during the hiring process; on-going dialogue to discuss types of holdings, compliance challenges, and contract updates; and review of month-end investment compliance packages prepared by the external managers. In addition, Wilshire Associates ("Wilshire") provides quarterly reports that focus on investment performance and selected qualitative items (e.g., organizational changes). The SBA uses the information provided by Wilshire to place external managers on a "watch list." The external manager oversight framework, however, does not include an on-site operational and/or compliance due diligence component.</p>	
<p><b>Item(s) for Consideration</b></p> <p>The SBA should evaluate its organizational structure and existing resources to determine the practicability of creating a centralized compliance function with a dedicated CCO.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b></p> <p>Although the Compliance Program Rule requires registered investment advisers to designate a CCO, in footnote 74 of the adopting release, the SEC stated in relevant part that, "the [Compliance Program Rule] does not require advisers to hire an additional executive to serve as the compliance officer, but rather to designate an individual as the adviser's [CCO]."<sup>5</sup></p> <p>Given the complex nature of compliance, regulatory, and operational issues affecting asset management firms, most large and small organizations attempt to designate a dedicated CCO whose responsibilities are limited to compliance matters. While this may not be always practicable for smaller organizations, senior SEC officials have commented that, "the compliance function should be able to operate on its own initiative, without...influence from other parts of the business."<sup>6</sup></p>
<p><b>Supporting Observation –Independent Compliance Function</b></p> <p>The compliance function for the asset classes as well as fund-level statutory compliance ultimately reports to the Deputy Executive Director. With regard to Real Estate, Private Equity, and Strategic Investments, the compliance function resides within each asset class and reports into the respective SIO. Fixed Income and Equities compliance officers, as well as the SIOs, report to the Deputy Executive Director.</p>	

5 – "Compliance Programs of Investment Companies and Investment Advisers," December 17, 2003, Release Nos. IA-2204 and IC-26299

6 – Speech by SEC Staff: Compliance: Some Core Principles, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, April 20, 2005.



## Organizational – Recommendations & Observations Cont'd

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>The SBA should consider reviewing its compliance needs against its current compliance resource model to determine if it requires additional compliance resources.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b></p> <p>In a March 2008 speech, Lori Richards, the SEC's Director of the Office of Compliance Inspections and Examinations ("OCIE"), noted that compliance and supervision, portfolio management, including monitoring of investment guidelines, and safeguarding of assets are among the top 10 areas of concern for the SEC's inspection staff. In our experience, a leading industry practice is to map compliance requirements against resource allocation models to develop an understanding of available resources and identify any shortfalls to develop a staffing model in light of compliance risks.</p>
<p><b>Supporting Observation – Compliance Resource s</b></p> <p>There is one designated compliance manager to monitor investment guideline compliance for internally and externally managed fixed income portfolios. The Fixed Income Compliance Manager relies on Fixed Income Operations to monitor daily and monthly investment guideline compliance for the internally managed portfolios as well as the securities lending program. Fixed Income Operations has other responsibilities in addition to its investment compliance monitoring responsibilities.</p>	
<p><b>Item(s) for Consideration</b></p> <p>The SBA should develop, adopt, and implement compliance policies and procedures designed to meet internal investment policies as well as any applicable (state and/or federal) statutory requirements.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b></p> <p>Among other things, the Compliance Program Rule requires federally registered investment advisers to adopt and implement compliance policies and procedures and to assess, at least annually, those policies and procedures for their adequacy and effectiveness of implementation. In addition, it is our experience that it is becoming more commonplace for non-registered investment fiduciaries such as private equity firms, hedge funds, endowments, and foundations to adopt and implement formalized compliance policies and procedures similar to registered investment advisers.</p>
<p><b>Supporting Observation – Compliance Program</b></p> <p>The SBA has not implemented or adopted formal written policies and procedures regarding the roles and responsibilities of the compliance function at the SBA. Individuals tasked with performing certain compliance monitoring functions developed their own procedures with varying level of detail, coverage, and formality.</p>	
<p><b>Item(s) for Consideration</b></p> <p>The SBA should implement a training program for its compliance personnel to promote awareness of relevant requirements and hot topics.</p>	<p><b>Leading Industry Practice</b></p> <p>In public statements discussing compliance functions, senior SEC officials have stated that, "staff exercising compliance responsibilities should have the necessary qualifications, experience and professional and personal qualities to enable them to carry out their duties effectively."<sup>7</sup> As a leading industry practice, it is our experience that asset management firms, not only provide internal compliance training, but also engage outside counsel or other third parties to provide facilitated compliance and regulatory workshops, require that compliance professionals attend industry conferences, and participate in industry groups. These, among other practices, generally allow compliance personnel to be current on relevant regulatory requirements as well as hot topics and industry trends.</p>
<p><b>Supporting Observation – Compliance Training</b></p> <p>The SBA does not currently have a formal training program for its compliance professionals and/or its professionals that perform compliance functions.</p>	

7 – Full text of Ms. Richard's speech available at <http://www.sec.gov/news/speech/spch042005lr.htm>. Text of ISOCO discussion paper, "Compliance Function at Market Intermediaries," available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD214.pdf>.



## Organizational – Recommendations & Observations Cont'd

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b></p> <p>Although the SBA has delegated portions of its investment management responsibilities to external investment managers, it retains the responsibility for managing the assets in line with stated investment objectives. Therefore, the SBA should enhance its current investment compliance monitoring process to achieve a more timely review of portfolio holdings against investment guidelines.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b></p> <p>As an investment fiduciary, investment advisers have a duty to manage client assets consistent with client mandates, investment objectives, and restrictions.<sup>8</sup> In highlighting the fiduciary responsibilities of investment advisers, the SEC's Director of OCIE recently stated that the SEC's inspection staff regards portfolio compliance as one of the top 10 compliance areas.<sup>9</sup> These fiduciary duties continue regardless of whether the investment adviser has delegated all or portions of its investment management responsibilities to other investment fiduciaries (i.e., external investment managers). To this end, more investment advisers, large and small, are implementing tools to better monitor compliance with investment guidelines.</p>
<p><b>Supporting Observation – Investment Guideline Compliance Monitoring of Externally Managed Portfolios</b></p> <p>The SBA's Investment Manager Monitoring Guidelines (dated January 2007) do not include investment guideline compliance as a monitoring criteria. Rather, SBA relies on periodic external manager compliance attestations/certifications, which the SBA supplements with limited independent investment guideline checks performed by compliance managers, which occur on a six to eight week lag due to timely reporting of compliance data from the external managers to the custodian. (Note: It is our understanding that there is currently a two to six months backlog of attestations/certifications to review in Fixed Income.) Specifically:</p> <ul style="list-style-type: none"> <li>– Equities: receive quarterly and annual manager attestations. Current independent oversight does not include the majority of the investment guidelines.</li> <li>– Fixed Income: receive monthly manager attestations. Compliance checks only certain select investment guidelines.</li> </ul>	
<p><b>Item(s) for Consideration</b></p> <p>The SBA is subject to statutory investment guidelines. Accordingly, the SBA should develop and implement a process to regularly check compliance with these guidelines in addition to a data repository to house all of these statutory investment guidelines.</p>	<p><b>Leading Industry Practice</b></p> <p>As part of their account setup processes, it is our experience that some asset management firms have adopted and implemented account installation processes to identify, record, and store investment as well as statutory guidelines. In addition to their installation processes, leading asset management firms have developed (or engaged outside law firms that specialize in monitoring regulatory changes) processes and procedures to stay abreast of regulatory and/or statutory changes.</p> <p>In our experience, many investment advisers have implemented procedures to monitor relevant channels to ensure that they are in compliance with applicable regulatory requirements. Furthermore, investment advisers have a centralized register designed to hold applicable regulatory requirements, which is reviewed periodically for accuracy and completeness.</p>
<p><b>Supporting Observation – Statutory Requirements</b></p> <p>There are dedicated resources responsible for identifying new Florida statutory requirements but there is currently no systematic check to ensure their implementation across the asset classes. Some existing statutory requirements are monitored systematically through Investment Monitor, a BNY-Mellon system. Those that cannot be coded in Investment Monitor are not included in the periodic monitoring. The SBA does not currently perform any regular manual monitoring in connection with those statutory guidelines that it cannot systematically monitor.</p>	

8 – Speech by SEC Staff: Fiduciary Duty: Return to First Principals, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, February 27, 2006.

9 – Speech by SEC Staff: Focus Areas in SEC Examinations of Investment Advisers: the Top 10, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, March 20, 2008.



## Organizational – Recommendations & Observations Cont'd

Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b>                      We have noted that investment advisers are adopting automated compliance systems to assist them in monitoring pre- and post-trade compliance and to ensure that they are managing client assets in accordance with client directives. Based on our experience, while some asset management firms use proprietary systems, others have implemented third party applications to monitor investment compliance.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b>                      Although the SEC does not specifically require investment advisers to implement automated investment compliance systems, senior SEC officials have indicated in public statements that a fiduciary duty arises for investment advisers with regard to portfolio compliance as “advisers have a duty to ensure that they are managing their clients’ money that is consistent with the clients’ direction.”<sup>10</sup> SEC officials have further noted that portfolio compliance is one of the top five deficiencies commonly uncovered during staff inspections. To enhance investment compliance practices, more asset management firms are implementing systems to facilitate monitoring of investment guidelines on a pre-trade basis.</p>
<p><b>Supporting Observation – Automated Pre- and Post-Trade Compliance Monitoring System in Connection with Internally Managed Portfolios</b>                      There is no consistent and comprehensive automated process in place to monitor pre- and post-trade compliance for the internally managed portfolios. Pre-trade compliance is largely driven by the portfolio managers’ knowledge and familiarity of the investment guidelines for both fixed income and equities.</p> <ul style="list-style-type: none"> <li>– The Equities Compliance Manager does not perform any pre-trade compliance checks and limited post-trade compliance checks on internal or external portfolios.</li> <li>– Fixed Income trades are entered into Bloomberg after execution, where they are screened against certain coded compliance parameters. While, Fixed Income Operations codes the rules into Bloomberg, it does not believe that all of the underlying data within Bloomberg necessary to evaluate the rules is reliable. Accordingly, Fixed Income Operations performs periodic manual post-trade compliance checks on all internal portfolios, including checklists for derivatives trades. The frequency of manual post-trade compliance checks varies across internally managed portfolios.</li> </ul> <p>There are no systematic processes or tools in place to automate pre- and post-trade compliance monitoring for equities and fixed income.</p>	
<p><b>Item(s) for Consideration</b>                      The SBA should evaluate the current document management needs of its Private Equity, Real Estate, and Strategic Investments asset classes and determine potential benefits gained from implementing an investor relationship management (“IRM”) system to facilitate and manage its record retention practices.</p>	<p><b>Leading Industry Practice and Relevant Regulatory Guidance</b>                      Rule 204-2 under the Advisers Act requires registered investment advisers to maintain and preserve certain books and records in connection with their investment advisory business in “an easily accessible place.” The SEC has provided guidance regarding the “accessibility” of retained records. The organization of the documents as well as the ability to retrieve the documents promptly (typically within 24 to 48 hours) are factors taken into consideration by the SEC when evaluating the adviser’s books and records.                      An emerging trend among alternative as well as traditional asset managers is to use Investor Relationship Management systems to help manage retention of various documents (e.g., offering memoranda, side letters, property descriptions and schedules, etc.).</p>
<p><b>Supporting Observation – Investor Relationship Management System/Data Repository</b>                      Private Equity maintains information regarding its deals, in particular, provisions of side letters and other agreements, in binders. The Real Estate Direct group maintains information regarding all direct property investments, joint ventures, and commingled funds in binders or electronic files. Neither group has an information/document management system or tool to store information related to previous, current, and potential investments in a central and easily accessible location.</p>	

10 – Speech by SEC Staff: Fiduciary Duty: Return to First Principals, Lori A. Richards, Director, Office of Compliance Inspections and Examinations, February 27, 2006.



## Organizational – Recommendations & Observations Cont’d

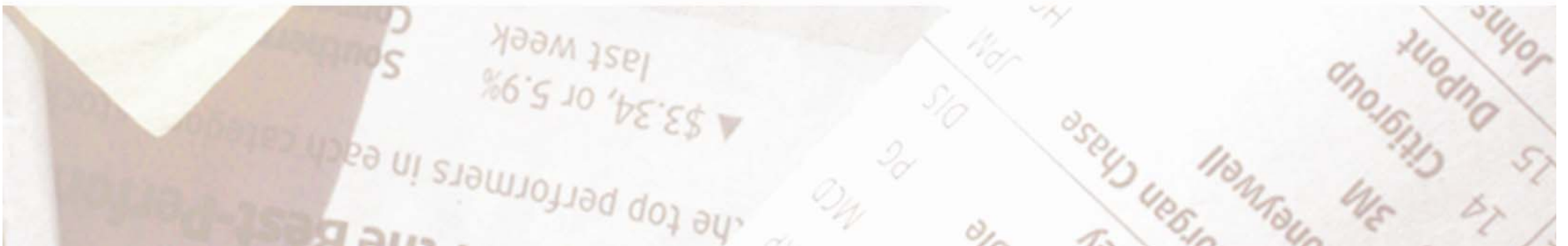
Recommendation(s)	Our Understanding of Leading Practice(s)
<p><b>Item(s) for Consideration</b> The SBA should develop and adopt a valuation policy, which will standardize and formalize the current valuations processes and establish oversight over all relevant activities performed by different groups.</p>	<p><b>Leading Industry Practice</b> Based on our experience, it is a common practice for registered investment advisers develop and adopt a valuation policy, which is overseen by a valuation committee on a periodic basis (e.g., monthly or quarterly). The policy typically establishes criteria for when a security needs to be priced by the organization and what types of steps the personnel should take to assign an appropriate value.</p>
<p><b>Supporting Observation – Oversight of Valuations</b> The SBA does not currently have a process to oversee internal valuations. The Accounting and Financial Operations groups share responsibilities for security valuation, develop their respective valuation policies, and value securities as deemed appropriate. Additionally, for Private Equity assets as well as swaps, Accounting and Financial Operations do not have documented and formalized procedures to validate the accuracy of valuations provided by relevant counterparties.</p>	
<p><b>Item(s) for Consideration</b> The SBA should consider centralizing its performance calculation process to one functional area (outside of the asset class) for consistency and efficiency.</p>	<p><b>Leading Industry Practice</b> Based on our experience, registered investment advisers usually will have a dedicated analytics group that is responsible for calculating performance across all asset classes. The analytics group would gather relevant information, perform the calculation using consistent methodologies, and follow-up on discrepancies as necessary.</p>
<p><b>Supporting Observation - Process for Validating Performance Calculations of the Independent Performance Measurement Provider—BNY-Mellon</b> The internal SBA performance calculation process and methodology is not centralized or consistent. Investment management personnel generate performance numbers in the individual asset classes. Public market asset classes and the IPE group utilize their own tools and techniques to calculate performance and must individually provide the performance figures to BNY-Mellon. BNY Mellon reconciles its performance calculations to the figures generated by the SBA and external managers when applicable, and the IPE group performs oversight over the rate of return reconciliation process.</p>	
<p><b>Item(s) for Consideration</b> The SBA should identify relevant systems and implement system access controls to ensure that only appropriate employees have access to information and the ability to edit it.</p>	<p><b>Leading Industry Practice</b> System access controls are a critical component of an organizations overall compliance efforts as well as technology infrastructure. IT departments maintain access profiles for individual employees to allow individuals access to job-relevant information. Access controls allow for different levels of access (e.g., read only, modification) and facilitate maintenance of data integrity within an organization.</p>
<p><b>Supporting Observation – System Access Controls</b> Several individuals within Domestic Equity, Foreign Equity, and Fixed Income that perform asset management functions also have write access to Eagle STAR. The SBA does not currently have access controls in place to prevent unauthorized access to Eagle STAR (e.g., employees may sign into Eagle STAR under another user’s log-on and password).</p>	

This document is intended solely for the internal use of the State Board of Administration of Florida, and should not be used or relied upon by any other person or entity



## Appendix II

### Documents Read





## Documents Read

The SBA provided the following documents in response to our request for information at the inception of Phase 1, which commenced on September 3, 2008. According to the SBA, the documents provided were the most current, up-to-date versions as of the time of the request.

<b>Enterprise Wide</b>	<ul style="list-style-type: none"> <li>• Complete 10 level Policies</li> </ul>
<b>Domestic Equities</b>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• Wilshire Manager Research Report (example)</li> <li>• On-Site Due Diligence Report (example)</li> </ul>
<b>Foreign Equities</b>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• Correspondent Broker Network Report (example)</li> <li>• Affiliated Transactions Report</li> <li>• Annual Contract Compliance/Best Fee Certification</li> <li>• Annual Soft Dollar Form</li> <li>• Commission Brokers Letter</li> <li>• Commissions Recapture Form (example)</li> <li>• Derivatives Form (example)</li> <li>• Holdings Report (example)</li> <li>• Proxy Voting Summary</li> <li>• Mellon Reconciliation Letter and Excel File (example)</li> <li>• ADV Forms (example)</li> <li>• NAV Report (example)</li> <li>• Purchase and Sale Report (example)</li> <li>• Portfolio Valuation Report (example)</li> <li>• Income Report (example)</li> <li>• Performance Summary (example)</li> </ul>



## Documents Read Cont'd

<p><b>Fixed Income</b></p>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• Investment Policy Guidelines (examples)</li> <li>• Watchlist Summary and Memo (example)</li> <li>• June 2008 Reports (examples) – Statement, Duration Contribution, Net Asset Value Report, US Investment Report</li> <li>• June 2008 External Manager Reports (examples)</li> <li>• SEC Lending Monthly Compliance Procedures (example)</li> </ul>
<p><b>Private Equity, Strategic Investments</b></p>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• General Partner Relationships – Expected Timing of Next Fundraising</li> <li>• 2008 – 2009 Private Equity Investment Strategy</li> <li>• 2008 – 2009 Strategic Investments Work Plan</li> <li>• Private Equity Investment Process Outline and Chart</li> </ul>
<p><b>Real Estate</b></p>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• Desk Procedures</li> <li>• Investment Management Reporting Requirements</li> <li>• Monthly Compliance Package (example)</li> <li>• Direct Owned Investment Executive Summary for Multifamily Rehab (example)</li> <li>• Direct Owned Annual Business Plan (example)</li> <li>• Direct Owned Investment Monthly Operational Report (example)</li> </ul>
<p><b>Equities Compliance</b></p>	<ul style="list-style-type: none"> <li>• BARRA Holdings Based Risk Reports (examples)</li> <li>• Monthly Compliance Report (example)</li> <li>• Largest Domestic Equity Holdings Report (example)</li> <li>• Domestic Equity Derivatives Screen (example)</li> <li>• External Manager Quarterly Compliance Notification</li> <li>• Annual Compliance Certification</li> </ul>
<p><b>Fixed Income Compliance</b></p>	<ul style="list-style-type: none"> <li>• Monthly Packet for Account Type (examples)</li> </ul>



## Documents Read Cont'd

<p><b>ERMC</b></p>	<ul style="list-style-type: none"> <li>• Work Scope</li> <li>• 2007 Consolidated Business Unit Risk Management Plans</li> <li>• ERM Master Plan Development</li> <li>• Investment Policy Guidelines - Local Government Investment Pool</li> </ul>
<p><b>Accounting</b></p>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• Global Pricing Guidelines</li> <li>• Pricing Hierarchy</li> <li>• Accounting and Reporting Procedures</li> <li>• Cash Transfer/Asset Transfer Instruction Template</li> <li>• Debit Interest Form (example)</li> <li>• Florida Claims Forms (examples)</li> <li>• BNY-Mellon Oversight Survey and Results by Department</li> <li>• BNY-Mellon Quarterly Performance Tracking</li> <li>• Florida East and West Collateral Reports (examples)</li> <li>• Issuer Entity Form</li> <li>• External Manager Account Reconciliation (example)</li> <li>• Internally Managed Account (Mellon to Pace) Reconciliation (example)</li> <li>• Swaps Held Form (example)</li> <li>• Counterparty Swap Statements (examples)</li> <li>• Write Downs and Write Offs Policy</li> </ul>
<p><b>Accounting Information Systems</b></p>	<ul style="list-style-type: none"> <li>• 20 Level Policies</li> <li>• Eagle PACE Corporate Action Upload Template</li> <li>• Eagle PACE Manual Price Upload Template</li> <li>• Eagle to Peoplesoft Reconciliation Procedures</li> <li>• Desk Procedures (Carolyn Walker)</li> <li>• Ratingswatch Application Procedures</li> <li>• Reverse Sweep Procedures</li> </ul>



## Documents Read Cont'd

### Financial Operations

- Position Descriptions and Daily Tasks
- Asset Transfer Templates (examples)
- Failed Trades Forms (examples)
- Futures MTM Form (example)
- Short Term Pricing Exceptions (example)
- Short Term Interest Earned (example)
- Standish Interest (example)

### Investment Policy & Economics

- Ennis Knupp Quarterly Investment Review
- Performance Reports (examples)
- Rebalancing Report (examples)
- Monthly and Quarterly Reports to Trustees (examples)
- Weekly Economic Write-Up (example)
- Eagle PACE Budget Request
- Ennis Knupp Memo – 2007-2008 Investment Performance and Funding Status
- 2007 Investment Policy Review
- 2008 Informal Asset Liability Study
- Watch List Summary and Memo (examples)
- Risk Budget Reports
- Domestic Equities and Fixed Income Strategic Reviews
- Benchmark Inventory (example)
- Board Report (example)
- Cash Journal (example)
- FSBA Reconciliation Template (example)
- SBA/Mellon Reconciliation s(examples)



## Documents Read Cont'd

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### Information Technology

- 20 Level Policies
- Bloomberg Corporate Actions Data License
- Eagle/Peoplesoft Transaction Processing Document
- 2008 Investment Processes
- 2008 Operations and Accounting Processes
- Price Batch Template
- Ratings Watch Instructions
- SBA System Inventory



# Appendix III

## Personnel Interviewed





## Personnel Interviewed

<p><b>Investment Management</b></p>	<ul style="list-style-type: none"> <li>• <b>Domestic Equities</b> – Karen Matthews (Director of Operations), Subhasis Das (Director of Research), Joe Wnuk (Portfolio Manager), Jennifer Myers (Equity Trader)</li> <li>• <b>Foreign Equities</b> – Raymond Sherlock (Manager of Investment Analytics), Tim Taylor (Senior Portfolio Manager)</li> <li>• <b>Fixed Income</b> – Debbie McCoy (Manager of Portfolio Strategy), Kevin Ceurvorst (Manager of Credit and Research), Lisa Collins (Manager of Operations &amp; Securities and Lending), Richard Smith (Portfolio Manager), Tom Fernald (Senior Portfolio Manager/External Management)</li> <li>• <b>Private Equity &amp; Strategic Investments</b> – Jim Treanor (Senior Investment Officer)</li> <li>• <b>Real Estate</b> – Jeff Smith (Senior Portfolio Manager), Lynne Gray, (Portfolio Manager), Sara Geiger (Portfolio Manager), Stephen Spook (Senior Acquisitions Manager)</li> </ul>
<p><b>Operations</b></p>	<ul style="list-style-type: none"> <li>• <b>Accounting</b> – Amy Crumpler (Director of Accounting), Sarah Clemmons (Accounting Control Manager), Donna Senn (Accounting Manager), Marlene Reid (Senior Accountant)</li> <li>• <b>Accounting Information Systems</b> – Carolyn Walker (Senior Accountant), Deborah McCranie (Senior Computer Analyst III), Jane Zody (Accounting Information Systems Manager), Susan Maurer (Senior Computer Analyst III)</li> <li>• <b>Financial Operations</b> – Donna Owens (Treasury Operations Specialist II), Jeanne Hunnewell (Investment Operations Specialist II), Kelly Foisy (Investment Operations Specialist II), Kim Phillips (Senior Treasury Operations Specialist III), Lori Guido (Director of Financial Operations), Nina Willis (Investment Operations Manager)</li> </ul>
<p><b>Compliance &amp; ERMC</b></p>	<ul style="list-style-type: none"> <li>• <b>Equities Compliance</b> – Lori McKnight (Manager of Public Equities Compliance)</li> <li>• <b>Fixed Income Compliance</b> – Sheilah Smith (Manager of Fixed Income Compliance)</li> <li>• <b>ERMC</b> – Long Yang (Enterprise Risk Management &amp; Compliance Manager)</li> </ul>
<p><b>Other</b></p>	<ul style="list-style-type: none"> <li>• <b>Deputy Executive Director’s Office</b> – Kevin SigRist (Deputy Executive Director), Ben Latham (Research &amp; Compliance Manager)</li> <li>• <b>Investment Policy &amp; Economics</b> – John Benton (Director of Performance Measurement &amp; Policy Research), Milena Tzigantcheva (Director of Risk Management)</li> <li>• <b>Corporate Governance</b> – Mike McCauley (Senior Officer – Corporate Governance)</li> <li>• <b>Mellon Bank Client Services</b> – Jerri Jones (Vice President of Client Service)</li> </ul>



# Deloitte.