

Insights: Alerts

SEC Sharpens Focus on RIA Compliance Programs, Part 1

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Throughout the year, every year, the SEC's Divisions of Examinations (f.k.a. OCIE) (the "Examinations Division") and Enforcement (the "Enforcement Division") each respectively release guidance, observations, and priorities explanations, most of which cover recurrent themes and perennial topics. Some are more salient and universally useful than others. In November 2020, the staff of the Examinations Division ("Examinations Staff") issued two risk alerts (the "Alerts") that, in our view, offer particularly helpful information that is important reading for anyone who is responsible for regulatory compliance of a federally-registered investment adviser.

The Alerts both provide helpful guidance regarding the creation and implementation of written policies and procedures, and the support and maintenance of a successful compliance program. Specifically, the first alert (the "Multi-Branch Alert")¹ describes observations from the Examination Division's 2016-2018 multi-branch initiative (the "Multi-Branch Initiative"), which examined federally-registered investment advisers with at least one office or place of business other than the adviser's principal "home" office. The second alert (the "Compliance Programs Alert")² more generally identifies frequent deficiencies relative to the Compliance Rule. A summary of the Multi-Branch Alert is provided below, and details regarding the Compliance Programs Alert will be summarized in an upcoming KTS legal alert.

Scope of the Multi-Branch Alert

As noted above, the Multi-Branch Alert provides helpful guidance regarding the compliance obligations of federally-registered investment advisers with multiple locations. However, the observations in the Multi-Branch Alert apply not only to large advisers with dozens or hundreds of supervised persons geographically dispersed across the country, but also to the following:

- **Advisers that have aggregated offices or previously independent "books of business" under one registered adviser.** In these instances, a single person or advisor-team who was previously a stand-alone adviser is now a supervised person(s) within a larger adviser, even if that single person or advisor-team continues to operate as they always did.
- **Advisers that permit telework conducted from remote locations,**³ particularly when the arrangement is not temporary in nature.
- **Any adviser with more than one place of business.**

In describing the motivations behind the Multi-Branch Initiative, Examinations Staff noted that multi-location advisers “continue to be an area of interest for examinations because they: (1) often advise retail clients, and (2) have unique risks and challenges related to the design and implementation of their compliance program and oversight of advisory services provided through remote offices.”⁴

Observations in the Multi-Branch Alert

Highlights of the Examination Staff's observations in the Multiple-Branch Alert are described below:

A. Compliance and Supervision Deficiencies.

1. Examinations Staff described compliance policies and procedures that were:

- (a) Inaccurate as a result of outdated information (e.g., references to obsolete entities; personnel that had changed titles, roles, or responsibilities; and vendors or service-providers that were no longer engaged by the adviser);
- (b) Inconsistently applied, from one location to the next, or by one adviser-team to the next;
- (c) Inadequately implemented because, among other things, the compliance department did not receive required records from geographically dispersed personnel; or
- (d) Not enforced.

2. Examinations Staff described a failure to either effectively design, fully implement, and/or properly test, evaluate and revise written policies and procedures. Examinations Staff noted that advisers too often:

- (a) Use off-the-shelf policies, rather than policies and procedures tailored to the adviser's business model and any unique services provided by specific supervised persons; and
- (b) Fail to provide substantive training, and then monitor, review, and/or test activities at each place of business to determine whether specific policies and procedures properly address the intended risks or conflicts at that branch.

3. With respect to treatment in policies/procedures and shortfalls in oversight and supervision, topics of particular concern included the following:

(a) **Custody.** With respect to custody, Examinations Staff noted that advisers:

- Adopted policies and procedures that did not limit supervised persons' ability to process withdrawals and deposits in client accounts, or to change a client's address of record.
- Had custody (apparently unintentionally given that they failed to comply with provisions of the Custody Rule) as a result of:
 - i. The adviser commingling the adviser's assets with client assets;
 - ii. The adviser or its supervised person acting as a trustee for a client;

- iii. The adviser (or its affiliated entity, under common control with the adviser) acting as general partner to a limited partnership (e.g., a private fund); and
- iv. Adviser personnel receiving client checks in branch offices and depositing these checks with the clients' custodians.

(b) **Fee billing practices.** With respect to fee billing practices, Examinations Staff noted that advisers:

- Adopted policies and procedures that did not explain how to identify and remediate instances where clients were erroneously charged fees (a.k.a. undisclosed fees);
- Due to a lack of home-office oversight, overcharged clients as a result of:
 - i. Miscalculated fees, resulting from misapplying tiered fees structures or incorrect valuations;
 - ii. Inconsistently applied fee reimbursements (e.g., advisory fee offsets for 12b-1 fees from certain mutual fund purchases, or refunds for prorated fees paid in advance by clients who terminated their accounts); and
 - iii. Charging fees in a different manner than as described in a client's advisory agreement (e.g., applying different rates or including assets in assets under management that were supposed to be excluded).
- As an example of the foregoing, Examinations Staff cited a settled enforcement matter in which a branch office mistakenly believed that the adviser's home office was automatically aggregating accounts for the purpose of applying certain fee discounts, whereas the home office expected that the branch would notify the home office of accounts that should be aggregated for the purpose of applying the discounts.

(c) **Advertising.** Examinations Staff noted the following with respect to advertising-related deficiencies:

- Problematic advertising was especially prevalent in offices operating under a DBA;
- Materials prepared and distributed by supervised persons outside of the adviser's home office included:
 - i. Performance presentations without required material disclosures;
 - ii. Superlatives or unsupported claims;
 - iii. Falsely stated professional experience and/or credentials of supervised persons; and

- iv. Third-party rankings or awards that omitted material facts regarding the rankings or awards.⁵

****KTS Practical Tip:** In examining their own advertising policies and procedures and practices, advisers should note that on December 22, 2020, the SEC announced its adoption of [the Marketing Rule](#), which will replace existing advertising and solicitation rules.

(d) **Code of Ethics.** Examinations Staff noted the following deficiencies related to advisers' codes of ethics:

- Supervised persons failed to:
 - i. Comply with reporting requirements (e.g., submitting reports less frequently than required or not at all);
- Advisers failed to:
 - i. Review transactions and holdings reports;
 - ii. Properly identify access persons for whom reporting and other limitations are required; and
 - iii. Include all required provisions in their codes of ethics (e.g., provisions regarding the prior review and approval of supervised persons' investments in private offerings, initial and annual holdings report submissions, and/or quarterly transaction report submissions).⁶

(e) **Trading practices and best execution.** With respect to trading practices and best execution, Examination Staff noted that advisers failed to:

- Properly document analysis regarding obtaining best execution for clients;
- Obtain prior client consent before completing principal transactions involving securities sold from the firms' inventory; and
- Monitor supervised persons' trading, including detecting/preventing the improper allocation of block trade losses to clients rather than the supervised person.

****KTS Practical Tip:** Advisers can meet their obligation to analyze and document best execution by annually asking their broker-dealers to complete a simple execution questionnaire, reviewing the results of the questionnaire, and maintaining the questionnaire and results in the adviser's records. Broker-dealers also routinely prepare and will provide execution information summaries upon request.

(f) **Expenses.** With respect to expenses, Examinations Staff noted that advisers failed to properly disclose:

- Expense allocations that appeared to benefit proprietary fund clients over non-proprietary fund (i.e., separately managed account) clients;
- Incentives for the adviser or its supervised person to recommend specific investments.

(g) **Investment recommendations and allocation of investment opportunities.** Examinations Staff noted that more than half of the examined advisers were cited for portfolio management deficiencies relating to the following:

- Trading allocation decisions; and
- Oversight of investment decisions occurring within branches, including:
 - i. Share class selection, and the adviser or supervised person's undisclosed conflict of interest relative thereto;
 - ii. Wrap fee program issues, including failing to assess whether a wrap fee program is in the client's best interest and failing to implement effective oversight of trading away practices (e.g., whether sub-advisers traded away), resulting in clients paying additional ticket charges and other fees; and
 - iii. Implementation of automated rebalancing of accounts that caused clients to incur short-term redemption fees from mutual funds.

(h) **Management and disclosure of conflicts of interest and other material information, including disciplinary events of supervised persons.**

- Examinations Staff cited to its [July 23, 2019, risk alert](#), which, among other things, highlighted weaknesses in supervision of individuals with a history of disciplinary events and processes for addressing them.

B. Guidance and Recommendations

Registrants often ask their examiners for instruction regarding how best to comply with an area under review during an exam. While Examination Staff is generally prohibited from providing such legal guidance, Examination Staff provides guidance collectively to the industry through alerts such as the Multiple Branch Alert. The alert sets out observed deficiencies and observed effective practices. Specifically, the Multiple Branch Alert encourages advisers to:

- Adopt and implement (including through training, testing, annual reviews and enhancements) policies and procedures that apply to all locations and all supervised persons, regardless of the person's tenure or title, whether such persons are employees or independent contractors of the adviser; and
- Ensure there are policies and procedures in place, including a method for oversight to ensure compliance therewith, to address any business model, client type, or function that is unique to a specific branch, supervised person, or team.

In addition, the Multiple Branch Alert highlighted the following important and recommended components of a compliance program:

- **Centralization is critical to ensure consistency and effective oversight.**

- Even if branches have tailored procedures, an adviser should still have uniform policies and procedures regarding home office oversight of each branch, including a centralized process for monitoring and approving advertising, particularly for those permitted to advertise through DBA websites.
- Client fee billing should be centralized and uniform. It is challenging to allow supervised persons to have independent billing options or fee arrangements that deviate from standard client agreements and firm-level disclosures.
- Processes for identifying access persons, and for monitoring and approving personal trading activities for supervised persons, should be centralized and, if possible, automated.⁷
- All supervised persons should utilize the same portfolio management/trading system, and policies and procedures governing portfolio management and investment recommendations should be uniform. Some advisers also centralize the trade order function in the home office (so that client-facing supervised persons hand off order processing to a dedicated trading team within the adviser).
- While not stated in the Multiple Branch Alert, regulatory recordkeeping should also be centralized. Allowing records to be retained by individual locations or persons, whether saved on a local hard drive, kept in hard copy, or maintained in a CRM system, can be problematic, especially when the contract is between the supervised person and the CRM provider (not between the adviser and the provider). The adviser's required records should be accessible to, safeguarded by, and at all times in the custody and control of the adviser's home office.
- Advisers should establish and implement policies and procedures to check for prior disciplinary events both before hiring supervised persons and periodically thereafter to ensure the continued accuracy of all required disclosures. Often times a simple Google search can yield quite a lot of important information.⁸

- **Testing is paramount.**

- Each branch location should undergo periodic, internal compliance testing.
- Self-reporting via attestations or the like are not an effective substitute for testing.

- **Training is paramount.**

- Advisers should conduct compliance trainings upon first onboarding a supervised person, whenever a new policy is implemented, and routinely thereafter (semi-annually, or at least annually).
- Training on regulatory requirements and the adviser's policies and procedures should be mandatory and administered by the home office to ensure consistent, comprehensive directions and

expectations.

- The adviser should provide compliance training for branch employees, and such training should be targeted to address topics identified during the branch office's internal compliance testing as needing improvement or further emphasis or explanation.

If you have any questions about the Alerts or adviser compliance programs generally (e.g., training programs for adviser CCOs, rubrics for reviewing and updated policies and procedures, etc.), please feel free to contact us.

By the Investment Management and Broker-Dealer Team at Kilpatrick Townsend & Stockton.

Footnotes

¹SEC Office of Compliance Inspections and Examinations, Risk Alert, *Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices* (November 9, 2020), <https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf> (hereinafter, "Multiple-Branch Alert").

²SEC Office of Compliance Inspections and Examinations, Risk Alert, *OCIE Observations: Investment Adviser Compliance Programs* (November 19, 2020), https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf.

³In the Multi-Branch Alert's footnotes, Staff explained that while the multi-branch initiative was conducted from 2016 to 2018, the Division continues to monitor supervised persons' remote work arrangements. Staff also noted that the Division of Investment Management has stated that it would not recommend enforcement action if a firm does not update its Form ADV to reflect "temporary teleworking addresses of its employees." Multi-Branch Alert, *supra* note 1, at note 2.

⁴Multi-Branch Alert, *supra* note 1, at note 1.

⁵*Id.*

⁶*Id.*

⁷Automated process reduce the risk of human error. However, even automated functions must be routinely tested and validated to ensure the process is working as intended. Risk management controls should also be implemented to ensure an automated process is not inadvertently changed by technicians without an understanding of the regulatory implications of an automated system's functions.

⁸Advisers should be mindful of any applicable federal and state privacy and employment laws when conducting more expansive background and/or credit searches. Those with access to the results of such searches should be limited to those that need to know. Reportable information not already included on a supervised person's Form U4 should be promptly updated.

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