



# RISK ALERT

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

July 23, 2019

## Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest

### I. Introduction

*OCIE encourages advisers, when designing and implementing their compliance and supervision frameworks, to consider the risks presented by hiring and employing supervised persons with disciplinary histories and adopt policies and procedures to address those risks.*

As part of the Office of Compliance Inspections and Examination’s (“OCIE”) focus on protecting retail investors, the staff conducted a series of examinations to assess the oversight practices of SEC-registered investment advisers (“advisers”) that previously employed, or currently employ, any individual with a history of disciplinary events (“Supervision Initiative” or “Initiative”).<sup>1</sup>

The staff conducted over 50 examinations of advisers in 2017 as part of this Initiative. The advisers examined collectively managed approximately \$50 billion in assets for nearly 220,000 clients, the vast majority of whom were retail investors. Advisers were identified for examination through a review of information about disciplinary events and other legal actions involving supervised persons of the adviser, including legal actions that are not required to be reported on

Form ADV (e.g., private civil actions).<sup>2</sup>

The purpose of this Risk Alert is to raise awareness of certain compliance issues that OCIE observed by sharing the staff’s observations from these examinations.

### II. Relevant Regulations

The Supervision Initiative focused on advisers’ practices in certain areas, including:

<sup>1</sup> See [NEP Risk Alert: Examinations of Supervision Practices At Registered Investment Advisers](#) (Sept. 12, 2016). For purposes of the Supervision Initiative, and as referenced in this Risk Alert, “supervised persons” include principals and officers of the adviser, and other individuals performing services on behalf of the adviser (other than clerical), regardless of whether these individuals are independent contractors or employees of the adviser. See also Investment Advisers Act of 1940 (“Advisers Act”) Section 202(a) (25) (defining “supervised person”).

<sup>2</sup> See Form ADV, Part 2A, Item 9 and Part 2B, Item 3 (Disciplinary Information). All registered advisers must promptly disclose any legal or disciplinary events that would be material to a client’s or a prospective client’s evaluation of the adviser’s integrity or its ability to meet its commitments to clients. See also Advisers Act Rules 204-3(b) (4) and 204(2)(a)(14)(iii).

- *Compliance programs and supervisory oversight practices.* The staff reviewed whether compliance policies and procedures were reasonably designed to detect and prevent violations of the Advisers Act by the firm and its supervised persons, particularly those policies and procedures covering the activities of certain previously-disciplined individuals.<sup>3</sup>
- *Disclosures.* The staff focused on whether disclosures in public statements or documents (e.g., marketing materials) and filings were full and fair, included all material facts, and were not misleading.<sup>4</sup> Particular emphasis was placed on reviewing disclosures in these materials related to previously-disciplined individuals and their prior disciplinary events.<sup>5</sup>
- *Conflicts of interest.* The staff assessed whether the adviser identified, addressed, and fully and fairly disclosed all material conflicts of interest that could affect the advisory relationship, particularly those conflicts dealing with compensation arrangements and account management.<sup>6</sup>

The examinations did not focus solely on supervisory practices as they relate to the individuals with prior disciplinary histories. Rather, due to the importance that supervisory practices have in setting a strong “tone at the top” and compliance culture, the staff reviewed the advisers’ supervisory practices firm-wide.

### III. Staff Observations

The Initiative identified a variety of observed deficiencies across a range of topics. Nearly all of the examined advisers received deficiency letters. The vast majority of these deficiencies relate to compliance issues, but many relate to disclosure issues, including undisclosed conflicts of interest.

---

<sup>3</sup> Advisers Act Rule 206(4)-7. Section 203(e)(6) of the Advisers Act also highlights that establishing supervisory procedures reasonably designed to prevent and detect such violations and following these procedures are important steps an adviser should take in supervising persons subject to its supervision. The Commission has brought enforcement actions against advisers that did not adopt or implement any policies or procedures regarding their supervision of certain personnel. See, e.g., [In re James T Budden and Alexander Budden](#), Advisers Act Release No. 4225 (Oct. 13, 2015) (settled).

<sup>4</sup> An adviser’s obligation as a fiduciary is enforceable through Advisers Act Section 206. As fiduciaries, advisers must provide full and fair disclosure of all material facts to their clients and prospective clients. Also, it is unlawful for advisers to make untrue statements or omit any material facts in applications or reports filed with the Commission (Advisers Act Section 207) or to have advertising (as defined in Advisers Act Rule 206(4)-1) that is false or misleading or that contains any untrue statement of a material fact.

<sup>5</sup> See, e.g., [SEC v. Capital Gains Research Bureau, Inc.](#), 375 U.S. 180 (1963) and [Amendments to Form ADV](#), Advisers Act Release No. 3060 (Jul. 28, 2010) (“as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship”). See also [General Instruction 3 to Form ADV](#), which states that “[u]nder federal and state law, [an adviser is] a fiduciary and must make full disclosure to [its] clients of all material facts relating to the advisory relationship.”

<sup>6</sup> Advisers Act Section 206. Also, [General Instructions to Form ADV](#), such as General Instruction 3, state that an adviser’s disclosure obligation “...requires that [the adviser] provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest [the adviser has] and the business practices in which [the adviser] engage[s], and can give informed consent to such conflicts or practices or reject them.”

## A. Staff Observations Specific to Disciplinary Histories

Some of the staff's observations related to advisers' oversight of supervised persons with disciplinary histories are discussed below.

- *Full and Fair Disclosure.* The staff observed that nearly half of the disclosure-related deficiencies of the advisers examined were due to the firms providing inadequate information regarding disciplinary events.<sup>7</sup> For example, advisers:
  - Omitted material disclosures regarding disciplinary histories of certain supervised persons or the adviser itself. Often the disciplinary omissions related to supervised persons occurred because the advisers solely relied on these supervised persons to self-report to the firms information about their required disclosures.
  - Included incomplete, confusing, or misleading information regarding disciplinary events. For example, they did not, as applicable: include the total number of events, the date for each event, the allegations, or whether the supervised persons were found to be at fault (i.e., whether fines, judgments or awards, or other disciplinary sanctions were imposed).<sup>8</sup>
  - Did not timely update and deliver disclosure documents to clients, such as updating Form ADV for new disciplinary events of supervised persons reported on CRD (e.g., Form U5s).<sup>9</sup>
- *Effective compliance programs.* The staff observed that many advisers did not adopt and implement compliance policies and procedures that address the risks associated with hiring and employing individuals with prior disciplinary histories. For example, advisers did not have processes reasonably designed to identify:
  - Whether the supervised persons' self-attestations regarding disciplinary events completely and accurately described those events. For example, some self-attestations contained information that did not fully or clearly describe the disciplinary events.
  - Whether the supervised persons' self-attestations that they were not the subject of reportable events or recent bankruptcies was in fact the case. For example, some

---

<sup>7</sup> All registered advisers must promptly disclose in Form ADV certain legal or disciplinary events that would be material to a client's or a prospective client's evaluation of the adviser's integrity or its ability to meet its commitments to clients. See [Amendments to Form ADV](#), Advisers Act Release No. 3060 (Jul. 28, 2010). See also generally, [Commission Interpretation Regarding Standard of Conduct for Investment Advisers](#), Advisers Act Release 5248 (June 5, 2019).

<sup>8</sup> See [Form ADV](#), Item 11 and Criminal Disclosure Reporting Page (DRP), which requires advisers to report details regarding certain disciplinary events.

<sup>9</sup> See [General Instructions to Form ADV](#), which specifies that an adviser must promptly file an "other-than-annual amendment" to its Form ADV when certain information becomes inaccurate in any way, including reportable disciplinary events. CRD (Central Registration Depository) is a database maintained by FINRA. It is used to store and maintain information on registered broker-dealers and their associated individuals. Many supervised persons of advisers are representatives of both broker-dealers and advisers.

supervised persons reported incorrectly to the adviser that they were not the subject of any reportable events during the reporting period or did not report information regarding recent bankruptcies.

## **B. Additional Staff Observations**

The staff reviewed advisers' firm-wide practices and observed issues that were not necessarily attributed directly to the firms' hiring and supervision of individuals with disciplinary histories. While some of these deficiencies are commonly identified in OCIE examinations, they were frequently identified during the Supervision Initiative examinations.

### ***Compliance and Supervision***

- *Supervision.* The staff observed that many advisers did not adequately supervise or set appropriate standards of business conduct for their supervised persons. In these instances, advisers' policies and procedures did not sufficiently document the responsibilities of supervised persons or did not clearly outline the expectations for these individuals. Examples include practices where the adviser did not:
  - Oversee whether fees charged by supervised persons were disclosed or assess whether the services clients paid for were performed. At some of these advisers, the staff observed instances in which clients paid for certain services they did not receive or were charged undisclosed fees.
  - Have advertising policies and procedures that provided sufficiently specific guidance to supervised persons who prepared their own advertising materials and websites. At these advisers, the staff observed the dissemination of advertisements that did not comply with the requirements of the advertising rule.<sup>10</sup>
  - Include reviewing activities of supervised persons, including supervised persons with disciplinary histories, working from remote locations as part of its monitoring activities. In many instances, staff observed that, unbeknownst to the advisers, geographically dispersed supervised persons were operating in a self-directed manner that was not consistent with the advisers' policies and procedures.
- *Oversight.* The staff observed that many advisers did not confirm that supervised persons identified as responsible for performing certain compliance policies and procedures were executing their duties, as prescribed. These advisers may have had policies and procedures that clearly assigned the individuals who were responsible for performing particular duties, but the firms did not implement them so that that these individuals performed the duties that were assigned to them, or did not document that these duties were performed according to the advisers' policies and procedures. In some instances, the duties included key regulatory and business responsibilities for advisers managing investor assets, such as:

---

<sup>10</sup> Advisers Act Rule 206(4)-1.

- Monitoring the appropriateness of client account types. For example, although outlined within the advisers' policies and procedures, the firms did not review whether at account opening the type of account selected was appropriate (e.g., wrap fee versus separately managed account), document that an assessment of the type of account took place, or document the factors considered in making these assessments.
  - Maintaining true, accurate, and current books and records, including those necessary to provide investment supervisory or management services to clients (e.g., maintaining a list of all accounts in which the adviser is vested with discretionary authority), to determine the financial standing of the firm, or to identify individuals with access to sensitive information.
- *Compliance policies and procedures.* The staff observed that several advisers had adopted policies and procedures that were inconsistent with their actual business practices and disclosures. Areas of inconsistent compliance practices most frequently cited by the staff involved those addressing commissions, fees, and expenses (e.g., solicitation fees, management fees, compensation related to hiring personnel, and oversight of firm compensation practices, including such practices within branch offices).
- *Annual compliance reviews.* The staff observed that advisers' annual reviews were insufficient because the firms did not take steps to adequately document the reviews and appropriately assess the risk areas applicable to the firms, or identify certain risks at all.

#### ***Disclosure of Conflicts of Interest***

- *Compensation arrangements.* The staff observed that several advisers had undisclosed compensation arrangements, which resulted in conflicts of interests that could have impacted the impartiality of the advice the supervised persons gave to their clients. For example, some of these advisers did not disclose that:
  - Forgivable loans were made to the advisers or their supervised persons, the terms of which were contingent upon certain client-based incentives that may have unduly influenced the investment decision-making process, resulted in higher fees and expenses for the affected clients, or both.
  - Supervised persons were required to incur all transaction-based charges associated with executing client transactions, which created incentives for the supervised persons to trade less frequently on behalf of their clients.

#### **IV. Staff Observations on Ways to Improve Compliance**

Some of the compliance and supervisory policies and procedures the staff observed at certain advisers may help other firms address the weaknesses discussed above. For example, advisers that hire or employ supervised persons with disciplinary histories may want to consider, among other things:

- *Adopting written policies and procedures that specifically address what must occur prior to hiring supervised persons that have reported to the adviser disciplinary events.* Most of the examined advisers that had recently hired supervised persons that had reported to the adviser disciplinary histories had written policies and procedures specifically addressing what to do before hiring such individuals. The staff observed that, almost all of the firms' written policies and procedures required investigations of the disciplinary events and several also required ascertaining whether barred individuals were eligible to reapply for their licenses.
- *Enhancing due diligence practices associated with hiring supervised persons to identify disciplinary events.* The examined advisers utilized a wide array of due diligence measures as part of their hiring processes. The staff observed that, while the advisers' practices varied, in addition to the practices noted above, for firms with written hiring policies and procedures, these procedures more consistently included conducting background checks (e.g., the firms confirmed employment histories, disciplinary records, financial background and credit information), conducting internet and social media searches, fingerprinting personnel, utilizing third parties to research potential new hires, contacting personal references, and verifying educational claims. In addition, some advisers:
  - Requested that potential new hires provide the firm with copies of their Form U5s, when applicable.
  - Reviewed new hires' Form U5 filings 30 or more days after they are hired (this type of procedure may identify termination notices the new hire did not disclose that were filed after the hiring decision was made), when applicable.
  - Initially checked CRD/IARD for supervised persons' filings and re-checked the filing information after a designated period of time, such as three months later.
- *Establishing heightened supervision practices when overseeing supervised persons with certain disciplinary histories.* The staff observed that many of the advisers had not adopted supervision practices or compliance procedures that addressed the risks associated with employing supervised persons with prior disciplinary histories (e.g., disciplinary histories relating to misappropriation, unauthorized trading, forgery, bribery, and making unsuitable recommendations). However, the examined advisers with written policies and procedures specifically addressing the oversight of supervised persons with disciplinary histories were far more likely to identify misconduct by supervised persons than advisers without these written protocols.
- *Adopting written policies and procedures addressing client complaints related to supervised persons.* The staff observed that advisers with written policies and procedures addressing client complaints related to their supervised persons were more likely to have reported the receipt of at least one complaint related to their supervised persons. In addition, these advisers were consistently more likely to escalate matters of concern raised in these complaints than advisers without written protocols.

- *Including oversight of persons operating out of remote offices in compliance and supervisory programs, particularly when supervised persons with disciplinary histories are located in branch or remote offices.*

## **V. Conclusion**

The examinations within the scope of this review resulted in a range of actions. In response to the staff's observations, some advisers elected to amend disclosures, revise compliance policies and procedures, or change other practices. OCIE encourages advisers, when designing and implementing their compliance and supervision frameworks, to consider the risks presented by, as well as the disclosure requirements triggered by, the hiring and employing of supervised persons with disciplinary histories and adopt policies and procedures to address those risks and disclosure requirements.

In sharing the information in this Risk Alert, OCIE is encouraging advisers to reflect upon their practices, policies, and procedures and to consider ways that they may improve their supervisory practices and compliance programs.

---

*This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

---