



NATIONAL EXAM PROGRAM

RISK ALERT

By the Office of Compliance Inspections and Examinations¹

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In this Alert:

Topic: *The five most frequent compliance topics identified in deficiency letters sent to SEC-registered investment advisers.*

Key Takeaways: *Advisers should review their compliance programs and practices in light of the topics noted in this Risk Alert.*

The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers

I. Introduction

The Office of Compliance Inspections and Examinations (“OCIE”) is providing a list of the five compliance topics most frequently identified in deficiency letters that were sent to SEC-registered investment advisers (“advisers”).² Within each of these topics, a few examples of typical deficiencies are discussed to highlight the risks and issues that examiners commonly identified. The five compliance topics addressed in this Risk Alert are deficiencies or weaknesses involving: (1) Rule 206(4)-7 (the “Compliance Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”); (2) required regulatory filings; (3) Rule 206(4)-2 under the Advisers Act (the “Custody Rule”); (4) Rule 204A-1 under the Advisers Act (the “Code of Ethics Rule”); and (5) Rule 204-2 under the Advisers Act (the “Books and Records Rule”).³ This information is intended to assist advisers during their compliance reviews.

II. Five Most Frequent Compliance Topics

Compliance Rule

The Compliance Rule makes it unlawful for an adviser to provide investment advice to clients unless the adviser: (1) adopts and implements written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised persons, of the Advisers Act and the rules that the Commission has adopted under the Advisers Act; (2) reviews, no less frequently than annually, the adequacy of its policies and procedures and the effectiveness of their implementation; and (3) designates

¹ The views expressed herein are those of the staff of OCIE. The Securities and Exchange Commission (the “SEC” or the “Commission”) has expressed no view on the contents of this Risk Alert. This document was prepared by SEC staff and is not legal advice.

² This Risk Alert reflects issues addressed in deficiency letters from over 1,000 investment adviser examinations that were completed during the past two years. Generalizations in this Risk Alert refer to observations within this sample of examinations.

³ This Risk Alert does not discuss other types of deficiencies or weaknesses that are cited less frequently in examinations but may result in significant harm to investors.

a chief compliance officer responsible for administering the compliance policies and procedures that the adviser adopts.⁴

Below are typical examples of deficiencies or weaknesses in connection with the Compliance Rule identified by the staff:⁵

- *Compliance manuals are not reasonably tailored to the adviser's business practices.* The staff noted that certain compliance programs did not take into account important individualized business practices such as the adviser's particular investment strategies, types of clients, trading practices, valuation procedures and advisory fees. Moreover, examiners continue to observe that some advisers use "off-the-shelf" compliance manuals that have not been tailored to the adviser's individual business practices.
- *Annual reviews are not performed or did not address the adequacy of the adviser's policies and procedures.* The staff observed that certain advisers did not conduct annual reviews of their compliance policies and procedures, as required by the Compliance Rule. In addition, the staff identified advisers that conducted annual reviews that did not address the adequacy of the advisers' policies and procedures and the effectiveness of their implementation. Staff also observed that advisers did not address or correct problems identified in their annual reviews.
- *Adviser does not follow compliance policies and procedures.* The staff observed that certain advisers appeared to not be following their compliance policies and procedures, as required by the Compliance Rule. Examples include advisers that do not perform certain internal reviews of their practices required by their compliance manual and advisers that do not adhere to certain practices relating to marketing, expenses or employee behavior required by their compliance manual.
- *Compliance manuals are not current.* The staff noted that certain compliance manuals contained information or policies that are no longer current, such as investment strategies that were no longer pursued or personnel no longer associated with the adviser and stale information about the firm.

Regulatory Filings

Advisers are obligated to accurately complete and timely file certain regulatory filings with the Commission. Among other filing requirements, Rule 204-1 under the Advisers Act requires advisers to amend their Form ADV at least annually, within 90 days of the end of their fiscal year and more frequently, if required by the instructions to Form ADV. Rule 204(b)-1 under the Advisers Act requires advisers to one or more private funds with private fund assets of at least \$150 million to complete and file a report on Form PF. In addition, Rule 503 under Regulation D of the Securities Act of 1933 generally requires issuers to file Form Ds. Advisers typically file Form Ds on behalf of their private fund clients. Generally, Form D is required to be filed no later than 15 calendar days after the first sale of securities in the offering of a private fund.

Below are typical examples of deficiencies or weaknesses with respect to adviser regulatory filing obligations identified by the staff:

⁴ Advisers Act Rule 206(4)-7. See Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. IA-2204 (Dec. 17, 2003).

⁵ The examples in this Risk Alert are illustrative only and do not reflect all types of deficiencies or weaknesses.

- *Inaccurate disclosures.* The staff observed that certain advisers made inaccurate disclosures on Form ADV Part 1A or in Form ADV Part 2A brochures, such as inaccurately reporting custody information, regulatory assets under management, disciplinary history, types of clients and conflicts.
- *Untimely amendments to Form ADVs.* The staff observed that certain advisers did not promptly amend their Form ADVs when certain information became inaccurate or timely file their annual updating amendments.
- *Incorrect and untimely Form PF filings.* The staff observed that certain advisers with an obligation to file Form PF did not complete the form accurately or completely.
- *Incorrect and untimely Form D filings.* The staff observed that certain advisers did not accurately complete and timely file Form Ds on behalf of their private fund clients.

Custody Rule

Advisers with custody of client cash or securities must comply with the Custody Rule.⁶ An adviser has custody if it or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.⁷ For example, an adviser that serves as the general partner, managing member or other comparable position of a pooled investment vehicle (“PIV”) generally has custody of client assets because the position typically gives legal ownership or access to client funds and securities.⁸ An adviser also has custody if it has an arrangement under which it is authorized or permitted to withdraw client funds or securities.⁹ The Custody Rule prescribes a number of requirements designed to enhance the safety of client assets by protecting them from unlawful activities or financial problems of the adviser.¹⁰

Below are typical examples of deficiencies or weaknesses with respect to the Custody Rule identified by the staff:

- *Advisers did not recognize that they may have custody due to online access to client accounts.* An adviser’s online access to client accounts may meet the definition of custody when such access provides the adviser with the ability to withdraw funds and securities from the client accounts. The staff observed that certain advisers may not have properly identified custody as a result of them having access to online accounts using clients’ personal usernames and passwords.
- *Advisers with custody obtained surprise examinations that do not meet the requirements of the Custody Rule.* The staff observed that certain advisers did not provide independent public

⁶ Advisers Act Rule 206(4)-2. See Custody of Funds or Securities by Investment Advisers, Advisers Act Rel. No. 2968 (Dec. 30, 2009).

⁷ Advisers Act Rule 206(4)-2(d)(2).

⁸ Advisers Act Rule 206(4)-2(d)(2)(iii).

⁹ Advisers Act Rule 206(4)-2(d)(2)(ii).

¹⁰ Advisers Act Rule 206(4)-2. For more information regarding Custody Rule issues that have been observed during OCIE examinations in the past, please see Significant Deficiencies Involving Custody and Safety of Client Assets, OCIE Risk Alert (March 4, 2013).

accountants performing surprise examinations with a complete list of accounts over which the adviser has custody or otherwise provide information to accountants to permit the accountants to timely file accurate Form ADV-Es. In addition, staff observed indications suggesting that surprise examinations may not have been conducted on a “surprise” basis (*e.g.*, exams were conducted at the same time each year).

- *Advisers did not recognize that they may have custody as a result of certain authority over client accounts.* The staff observed that certain advisers did not appear to recognize that they may have custody over client accounts as a result of having (or related persons having) powers of attorney authorizing them to withdraw client cash and securities. Other examples of custody that appeared unrecognized include when advisers or their related persons served as trustees of clients’ trusts or general partners of client PIVs.

Code of Ethics Rule

The Code of Ethics Rule requires an adviser to adopt and maintain a code of ethics.¹¹ The Code of Ethics Rule sets forth a number of requirements, including that each adviser’s code of ethics must: (1) establish a standard of business conduct that the adviser requires of all its supervised persons; (2) require an adviser’s “access persons” to periodically report their personal securities transactions and holdings to the adviser’s chief compliance officer or other designated persons; and (3) require that access persons obtain the adviser’s pre-approval before investing in an initial public offering or private placement. In addition, an adviser must provide each supervised person with a copy of the code of ethics and any amendments, and require their supervised persons to provide the adviser with a written acknowledgement of their receipt. An adviser also must describe its code of ethics in its Form ADV Part 2A brochure and indicate that the code of ethics is available to any client or prospective client upon request.¹²

Below are typical examples of deficiencies or weaknesses with respect to the Code of Ethics Rule identified by the staff:

- *Access persons not identified.* The staff observed that certain advisers did not identify all of their access persons (*e.g.*, certain employees, partners or directors) for purposes of reviewing personal securities transactions.
- *Codes of ethics missing required information.* The staff observed that certain advisers’ codes of ethics did not specify review of the holdings and transactions reports, or did not identify the specific submission timeframes, as required by the Code of Ethics Rule.
- *Untimely submission of transactions and holdings.* The staff observed that certain access persons submitted transactions and holdings less frequently than required by the Code of Ethics Rule.
- *No description of code of ethics in Form ADVs.* The staff observed that certain advisers did not describe their codes of ethics in their Part 2A of Form ADVs and did not indicate that their codes of ethics are available to any client or prospective client upon request.

¹¹ Advisers Act Rule 204A-1. See Investment Adviser Code of Ethics, Advisers Act Rel. No. IA-2256 (July 2, 2004).

¹² See Item 11A of Form ADV, Part 2A.

Books and Records Rule

The Books and Records Rule requires advisers to make and keep certain books and records relating to their investment advisory business, including typical accounting and other business records as required by the Commission.¹³

Below are typical examples of deficiencies or weaknesses with respect to the Books and Records Rule identified by the staff:

- *Did not maintain all required records.* The staff observed that certain advisers may not have maintained all the books and records required by the Books and Records Rule, such as trade records, advisory agreements and general ledgers.
- *Books and records are inaccurate or not updated.* The staff observed that certain advisers had errors and omissions in their books and records, such as inaccurate fee schedules and client records or stale client lists.
- *Inconsistent recordkeeping.* The staff observed that certain advisers maintained contradictory information in separate sets of records.

III. Conclusion

The examinations within the scope of this review resulted in a range of actions. Advisers took remedial measures such as enhancing written compliance procedures, policies or processes, changing business practices or devoting more resources or attention to the area of compliance. In addition, where appropriate, the staff referred examinations to the Division of Enforcement for further action.

In sharing the information in this Risk Alert, OCIE hopes to encourage advisers to reflect upon their own practices, policies and procedures in these areas and to promote improvements in investment adviser compliance programs.

This Risk Alert is intended to highlight for firms risks and issues that the 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 may not be applicable 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.

¹³ Advisers Act Rule 204-2.