



RISK ALERT

DIVISION OF EXAMINATIONS

April 26, 2022

Investment Adviser MNPI Compliance Issues

I. Introduction

The Division of Examinations (“EXAMS”)* is issuing this risk alert to provide investment advisers, investors, and other market participants with information concerning notable deficiencies that the staff has cited related to Section 204A (“Section 204A”) of the Investment Advisers Act of 1940 (the “Advisers Act”) and Rule 204A-1 (the “Code of Ethics Rule”) thereunder. Deficiencies related to Section 204A and the Code of Ethics Rule have been among the most commonly observed by EXAMS.¹

Section 204A requires all investment advisers, registered and unregistered, to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser’s business, to prevent the misuse of material non-public information (“MNPI”) by the adviser or any person associated with the adviser.² The Code of Ethics Rule requires investment advisers that are registered or required to be registered under the Advisers Act to adopt a “code of ethics” (or “code”) that sets forth, among other things, the standard(s) of business conduct expected from the adviser’s “supervised persons” (*e.g.*, employees, officers, partners, directors and other persons who provide advice on behalf of the adviser and are subject to the adviser’s supervision and control). The Code of Ethics Rule requires certain supervised persons, called “access persons,”³ to report their personal securities transactions and holdings to the adviser’s chief compliance officer (“CCO”) or other designated persons.

* This Risk Alert represents the views of the staff of EXAMS. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the “SEC” or the “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by EXAMS staff and is not legal advice.

¹ See EXAMS Risk Alert, [The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers](#) (Feb. 7, 2017).

² See Section 204A of the Investment Advisers Act of 1940; see also *Investment Adviser Codes of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004) (“Code of Ethics Adopting Release”).

³ “Access persons” are any supervised persons who have access to non-public information regarding client transactions or reportable fund holdings, make securities recommendations to clients or have access to such recommendations that are non-public, and, for most advisers, all officers, directors and partners. See Advisers Act Rule 204A-1(e)(1).

The Code of Ethics Rule requires advisers to adopt a code of ethics that includes:

- Standard(s) of business conduct that the adviser requires of all its supervised persons that reflect the adviser's fiduciary obligations and those of its supervised persons;⁴
- Provisions requiring supervised persons' compliance with applicable federal securities laws;⁵
- Provisions requiring access persons to report, and the adviser to review, their personal securities transactions and holdings periodically;⁶
- Provisions requiring supervised persons to report any violations of the code of ethics promptly to the chief compliance officer or another designated person;⁷ and
- Provisions requiring the adviser to provide each supervised person with a copy of the code of ethics and any amendments, and requiring the supervised persons to provide the adviser with a written acknowledgment of their receipt of the code and any amendments.⁸

II. Compliance Issues Related to Section 204A

Below are examples of deficiencies and weaknesses associated with Section 204A observed by EXAMS staff:

- *Policies and procedures related to Alternative Data.* Exams staff observed advisers that used data from non-traditional sources (“alternative data”), but did not appear to adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through alternative data sources.⁹ For example:
 - Advisers did not appear to adequately memorialize diligence processes or follow them consistently and instead engaged in ad hoc and inconsistent diligence of alternative data service providers.
 - Advisers did not appear to have policies and procedures regarding the assessment of the terms, conditions, or legal obligations related to the collection or provision

⁴ Advisers Act Rule 204A-1(a)(1).

⁵ Advisers Act Rule 204A-1(a)(2).

⁶ Advisers Act Rule 204A-1(a)(3).

⁷ Advisers Act Rule 204A-1(a)(4).

⁸ Advisers Act Rule 204A-1(a)(5).

⁹ “Alternative data” refers to many different types of information increasingly used in financial analysis, beyond traditional financial statements, company filings, and press releases. Alternative data does not necessarily contain MNPI. Examples of “alternative data” include information gleaned from satellite and drone imagery of crop fields and retailers’ parking lots, analyses of aggregate credit card transactions, social media and internet search data, geolocation data from consumers’ mobile phones, and email data obtained from apps and tools that consumers may utilize.

of the data, including when advisers became aware of red flags about the sources of such alternative data.

- Advisers did not appear to consistently implement their policies and procedures related to alternative data service providers. For example, advisers did not apply their due diligence process to all sources of alternative data. In addition, staff observed advisers that had an onboarding process for alternative data service providers, but did not have a system for determining when due diligence needed to be re-performed based on passage of time or changes in data collection practices. Staff also observed advisers that could not demonstrate, such as by producing documentation, that their policies and procedures had been consistently implemented.
- *Policies and procedures related to so-called “value-add investors.”*¹⁰ EXAMS staff observed advisers that did not have or did not appear to implement adequate policies and procedures regarding investors (or in the case of institutional investors, key persons) who are more likely to possess MNPI, including officers or directors at a public company, principals or portfolio managers at asset management firms, and investment bankers.
 - EXAMS staff observed advisers that did not have policies and procedures regarding MNPI risks posed by their “value-add investors.”
 - EXAMS staff also observed advisers that maintained MNPI policies and procedures regarding value-add investors, but the advisers did not correctly identify all of the value-add investors or correctly identify and track their relationships with potential sources of MNPI.
- *Policies and procedures related to “expert networks.”*¹¹ EXAMS staff observed advisers that did not appear to have or did not appear to implement adequate policies and procedures regarding their discussions with expert network consultants who may be related to publicly traded companies or have access to MNPI, including:
 - Tracking and logging calls with expert network consultants;
 - Reviewing detailed notes from expert network calls; and
 - Reviewing relevant trading activity of supervised persons in the securities of publicly traded companies that are in similar industries as those discussed during calls.

¹⁰ “Value-add investor” refers to clients or fund investors that are corporate executives or financial professional investors who may have MNPI.

¹¹ “Expert network” refers to a group of professionals who are paid for their specialized information and research services.

III. Compliance Issues Related to the Code of Ethics Rule

Below are examples of deficiencies associated with the Code of Ethics Rule identified by EXAMS staff.

- *Identification of access persons.* EXAMS staff observed advisers that did not identify and supervise certain employees as access persons in accordance with the Code of Ethics Rule. EXAMS staff also observed adviser codes that did not define “access person” or accurately reflect which employees are considered access persons.
- *Access persons did not obtain required pre-approval for certain investments.* EXAMS staff observed adviser access persons that purchased beneficial ownership in initial public offerings and limited offerings without requisite pre-approval. For example:
 - EXAMS staff observed advisers that did not include a provision in their codes requiring access persons to obtain pre-approval before directly or indirectly acquiring any interests in an initial public offering or limited offering.
- *Personal Securities Transactions and Holdings.* EXAMS staff observed deficiencies related to the required reporting of access persons’ personal securities transactions and holdings. For example:
 - *Review of holdings and transaction reports.* EXAMS staff observed advisers that could not produce evidence of supervisory review of holdings and transaction reports. In addition, EXAMS staff observed advisers that did not have policies and procedures in place to assign the CCO’s reporting to another member of the adviser – effectively permitting the CCO to self-review his/her own holding and transaction reports.
 - *Submission of holdings and transaction reports.* EXAMS staff observed situations in which the holdings and/or transaction reports were not submitted by access persons, the adviser’s code of ethics did not include provisions requiring access persons to submit reports, or the reports were not submitted within the timeframes reflected in the Code of Ethics Rule.
 - *Content of holdings and transaction reports.* EXAMS staff observed codes that did not require access persons to include the specified content set out by the Code of Ethics Rule in their transaction and holdings reports, including instances in which access persons did not include their investments in private placements.
- *Written acknowledgement of receipt of the code and any amendments.* EXAMS staff observed instances where supervised persons were not provided with a copy of the code or did not provide written acknowledgement of their receipt of the code or any amendments. In other instances, the code did not contain provisions to reflect the written acknowledgment requirement of Rule 204A-1(a)(5).

In addition, the Commission discussed in the Code of Ethics Adopting Release a number of practices that advisers should consider in crafting their codes.¹² Below are examples of related observations made by EXAMS staff:

- *Trading investments on restricted list.* The Commission stated that advisers should consider incorporating provisions into their codes to include “restricted lists” of issuers about which the advisory firm has inside information, and prohibit any trading in securities of those issuers while they remain on the restricted list. EXAMS staff observed instances where employees traded investments that were on the adviser’s restricted list.
- *Allocation of investment opportunities.* The Commission stated that advisers should consider incorporating procedures to ensure that investment opportunities must first be offered to clients before the adviser or its employees may act on them. The staff observed situations where the adviser or its employees purchased securities at a better price, ahead of the adviser’s clients in contravention of the adviser’s code.

IV. Conclusion

In response to the issues identified in the deficiency letters, many of the advisers modified their codes of ethics and written policies, procedures and practices to address the issues identified by EXAMS staff. The Division encourages advisers to review their practices, policies, and procedures in this area and to ensure they are in compliance with provisions of the Advisers Act and the rules thereunder.

This Risk Alert is intended to highlight for firms risks and issues that EXAMS 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.

¹² See Code of Ethics Adopting Release (stating that “[a]dvisory firms that have already adopted codes of ethics, however, commonly include many of the following elements, or address the following issues, which we believe that all advisers should consider in crafting their own procedures for employees’ personal securities trading.”).