



# NATIONAL EXAM PROGRAM

## RISK ALERT

*By the Office of Compliance Inspections and Examinations<sup>1</sup>*

**Volume V, Issue 3**

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**Topic:** *Review of Compliance and Supervision Practices at Registered Investment Advisers.*

**Key Takeaways:** *OCIE staff intends to conduct examinations of registered investment advisers that employ or contract with supervised persons that have a history of disciplinary events. These examinations will focus on evaluating the effectiveness of advisers' compliance programs, supervisory oversight practices, and disclosures to clients and prospective clients, particularly relating to the potential risk associated with financial arrangements initiated by supervised persons with a disciplinary history.*

## **Examinations of Supervision Practices At Registered Investment Advisers**

### **I. Introduction**

The Office of Compliance Inspections and Examinations' ("OCIE") 2016 Examination Priorities include examining compliance oversight and controls of registered investment advisers that have employed or employ individuals with a history of disciplinary events, including individuals that have been disciplined or barred from a broker-dealer.<sup>2</sup> Such individuals may present an increased risk of future misconduct,<sup>3</sup> and thus can present harm to clients. OCIE is undertaking an initiative to examine the supervision practices and compliance programs of registered investment advisers that employ individuals with a history of disciplinary events in the financial services sector (the "Supervision Initiative"). These examinations will assess such advisers' business and compliance practices, particularly those practices related to the firms' supervision of higher-risk individuals.<sup>4</sup> OCIE is issuing this Risk Alert to provide additional information concerning the Supervision Initiative.

<sup>1</sup> The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other Securities and Exchange Commission ("SEC" or "Commission") staff, including staff of the Division of Investment Management ("IM"). The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

<sup>2</sup> See [OCIE, Examination Priorities for 2016 \(January 11, 2016\) \("OCIE 2016 Priorities"\)](#).

<sup>3</sup> See, e.g., Mark Egan, Gregor Matvos, and Amit Seru, "The Market for Financial Adviser Misconduct," National Bureau of Economic Research Working Paper No. 22050 (Feb. 26, 2016). While this study focuses on FINRA-registered broker-dealer representatives ("financial advisors"), the study's principal conclusions regarding recidivist misconduct are relevant to investment advisory supervised persons. The study concludes that financial advisors with disciplinary histories are five times more likely to engage in misconduct than the average "financial advisor." The study also states that while approximately half of the offenders lose their job after the misconduct, 44 percent of the offenders are reemployed in the financial services industry within one year.

<sup>4</sup> As referenced in this OCIE Risk Alert, advisory "employees" or "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. Also, see Section 202(a)(25) of the Investment Advisers Act of 1940 ("Advisers Act"), which defines "supervised person."

## II. Background

Advisers that employ or hire supervised persons with disciplinary events should be mindful of their supervisory obligations and may want to consider heightened supervision of such individuals. This includes disciplinary events that occurred during the individual's employment with the adviser and prior employment.

OCIE's Supervision Initiative will focus on registered advisers' compliance programs and particularly on the supervision of supervised persons that may pose increased risks to advisory clients. Examinations will assess whether registered advisers have implemented policies and procedures specific to the risks presented by employees with disciplinary history, focusing on the compliance cultures and tone at the top of the examined advisers.

## III. Examinations

OCIE (the "staff") is using OCIE's analytical capabilities to evaluate information from a variety of sources to identify registered advisers for examinations under this initiative. These sources include SEC databases and filings as well as external sources. Examples of factors that the staff is using to identify exam candidates include: disciplinary information that is reported on an adviser's Form ADV;<sup>5</sup> information about other legal actions (*e.g.*, private civil actions) not required to be reported on Form ADV, but which are nonetheless relevant to the advisory services offered to clients; and information from SEC enforcement actions, which barred or suspended individuals from certain financial industries.

The Supervision Initiative examinations will focus on the following key risk areas:

- **Compliance Program.** Rule 206(4)-7 under the Advisers Act requires each adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. Examiners will review the registered adviser's practices surrounding its hiring processes, ongoing reporting obligations, employee oversight practices, and complaint handling processes. An important component of the examinations is to evaluate whether the advisers foster robust compliance cultures and tone at the top. The tone at the top is critical to setting the ethical environment of the organization and preventing misconduct.
- **Disclosures.** As a fiduciary, an investment adviser has a duty to make full and fair disclosure of all material facts.<sup>6</sup> Advisers Act Section 207 provides that, in any registration application or report filed with the Commission under Section 203 or 204, it is unlawful for any person willfully to make any untrue statement of a material fact or willfully to omit to state a material fact which is required to be stated therein. This standard applies to statements made in an adviser's Form ADV Part 1 and brochure. An adviser must update its brochure at least annually (and more frequently, if required by the instructions to Form ADV) and notify clients of any material changes.<sup>7</sup> Examiners will likely review registered advisers' practices regarding their disclosures of regulatory, disciplinary, or other actions with a focus on assessing the accuracy, adequacy, and effectiveness of such disclosures.

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<sup>5</sup> See Form ADV (Item 11 of Part 1A; Item 9 of Part 2A, and Item 3 of Part 2B). The form requires advisers to disclose certain disciplinary events of the firm (and its advisory affiliates including the adviser's supervised persons) occurring within the past 10 years, which are presumptively material.

<sup>6</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). See also [General Instructions to Part 2A of Form ADV](#).

<sup>7</sup> See Section 204 of the Advisers Act and Rules 204-1(a) and 204-3, thereunder. See also Form ADV, Part 2A, Instruction 4; In [the Matter of Everhart Financial Group, Inc. et al](#), Advisers Act Release No. 4314, (Jan. 14, 2016).

- **Conflicts of Interest.** As a fiduciary, an investment adviser has a duty to make full and fair disclosure of all material facts, including all material conflicts of interest that could affect the advisory relationship.<sup>8</sup> Examiners will assess the conflicts of interest that a registered adviser or supervised person may have. Particular attention will be given to conflicts that may exist with respect to financial arrangements (*e.g.* unique products, services, or discounts) initiated by supervised persons with disciplinary events.
- **Marketing.** Advisers frequently use marketing materials to solicit new clients or retain existing clients. Rule 206(4)-1 under the Advisers Act prohibits an adviser from including certain representations in its advertisements or marketing materials. Examiners will review a registered adviser's advertisements including pitch-books, website postings, and public statements to identify any conflicts of interests or risks associated with supervised persons with a history of disciplinary events.

#### IV. Conclusion

In sharing the focus areas for the Supervision Initiative, OCIE hopes to encourage advisers to reflect upon their own risks, practices, policies, and procedures in these areas and to consider making improvements in their advisory compliance programs where necessary.

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*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 risk 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.*

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<sup>8</sup> See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). See also, [General Instructions to Part 2A of Form ADV](#).