



# RISK ALERT

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

November 19, 2020

## OCIE Observations: Investment Adviser Compliance Programs

### I. Introduction

This Risk Alert provides an overview of notable compliance issues identified by the Office of Compliance Inspections and Examinations (“OCIE”)\* related to Rule 206(4)-7 (the “Compliance Rule”) under the Investment Advisers Act of 1940 (“Advisers Act”).<sup>1</sup> Deficiencies related to the Compliance Rule have been among the most common cited by OCIE.<sup>2</sup>

Under the Compliance Rule, it is unlawful for an investment adviser registered with the Commission (“adviser”) to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser or any of its supervised persons. The Compliance Rule requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.<sup>3</sup>

The Compliance Rule does not enumerate specific elements that advisers must include in their policies and procedures. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.

The Compliance Rule also requires each adviser to review its policies and procedures no less frequently than annually to determine their adequacy and the effectiveness of their implementation. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any

---

\* The views expressed herein are those of the staff of OCIE. 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 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 OCIE staff and is not legal advice.

<sup>1</sup> This Risk Alert reflects issues identified in a sample of deficiency letters from recent adviser exams. This Risk Alert does not discuss all types of deficiencies or weaknesses related to the Compliance Rule that have been identified by staff.

<sup>2</sup> See OCIE Risk Alert, [The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers](#) (Feb. 7, 2017); OCIE Risk Alert, [Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest](#) (July 23, 2019); OCIE Risk Alert, [Observations from Investment Adviser Examinations Relating to Electronic Messaging](#) (Dec. 14, 2018).

<sup>3</sup> [Release No. IA-2204](#), Compliance Programs of Investment Companies and Investment Advisers (Dec 17, 2003).

changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures. Although the Compliance Rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.<sup>4</sup>

Finally, the Compliance Rule requires each adviser to designate a chief compliance officer (“CCO”) to administer its compliance policies and procedures. An adviser's CCO should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. The CCO should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.<sup>5</sup>

## II. Compliance Rule Deficiencies and Weaknesses Identified by OCIE

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

- A. Inadequate Compliance Resources. OCIE staff observed advisers that did not devote adequate resources, such as information technology, staff and training, to their compliance programs. For example:
- CCOs who had numerous other professional responsibilities, either elsewhere with the adviser or with outside firms, and who did not appear to devote sufficient time to fulfilling their responsibilities as CCO. While CCOs may have multiple responsibilities, OCIE observed instances where such CCOs did not appear to have time to develop their knowledge of the Advisers Act or fulfill their responsibilities as CCO.
  - Compliance staff that did not have sufficient resources to implement an effective compliance program. OCIE staff observed advisers that did not appear to devote sufficient resources, such as a lack of adequate training or insufficient staff, to their compliance functions. This affected the implementation of the compliance policies and procedures the adviser had adopted and compliance with fundamental regulatory requirements, such as performing annual reviews, accurately completing and filing Form ADVs or timely responding to OCIE requests for required books and records.
  - Advisers that had significantly grown in size or complexity, but had not hired additional compliance staff or added adequate information technology, leading to failures in implementing or tailoring their compliance policies and procedures.

---

<sup>4</sup> See *Id.*

<sup>5</sup> See *Id.*

B. Insufficient Authority of CCOs. OCIE staff observed CCOs who lacked sufficient authority within the adviser to develop and enforce appropriate policies and procedures for the adviser. For example:

- Advisers that restricted their CCOs from accessing critical compliance information, such as trading exception reports and investment advisory agreements with key clients.
- Advisers where senior management appeared to have limited interaction with their CCOs, which led to CCOs having limited knowledge about the firm's leadership, strategy, transactions, and business operations.
- Instances where CCOs were not consulted by senior management and employees of the adviser regarding matters that had potential compliance implications.

C. Annual Review Deficiencies. OCIE staff observed advisers that were unable to demonstrate that they performed an annual review or whose annual reviews failed to identify significant existing compliance or regulatory problems. For example:

- *Evidence of annual review*. Advisers that claimed to engage in ongoing or annual compliance reviews of their policies and procedures to determine their adequacy and effectiveness of their implementation, but could not provide evidence that one occurred.
- *Identification of risks*. Advisers that claimed to have performed limited annual reviews but failed to identify or review key risk areas applicable to the adviser, such as conflicts and protection of client assets.
- *Review of significant aspects of adviser's business*. Advisers that failed to review significant areas of their business, such as policies and procedures surrounding the oversight and review of recommended third-party managers, cybersecurity, and the calculation of fees and allocation of expenses.

D. Implementing Actions Required by Written Policies and Procedures. OCIE staff observed advisers that did not implement or perform actions required by their written policies and procedures. For example, staff observed advisers that did not:

- Train their employees.
- Implement compliance procedures regarding trade errors, advertising, best execution, conflicts, disclosure and other requirements.
- Review advertising materials.
- Follow compliance checklists and other processes, including backtesting fee calculations and testing business continuity plans.
- Review client accounts, *e.g.*, to assess consistency of portfolios with clients' investment objectives, on a periodic basis or on a schedule required in the adviser's policies.

- E. Maintaining Accurate and Complete Information in Policies and Procedures. The staff observed advisers' policies and procedures that contained outdated or inaccurate information about the adviser, including off-the-shelf policies that contained unrelated or incomplete information.
- F. Maintaining or Establishing Reasonably Designed Written Policies and Procedures. OCIE staff observed advisers that did not maintain written policies and procedures or that failed to establish, implement, or appropriately tailor written policies and procedures that were reasonably designed to prevent violations of the Advisers Act. For example, staff observed advisers that claimed to rely on cursory or informal processes instead of maintaining written policies and procedures. In addition, staff observed advisers that utilized policies of an affiliated entity, such as a broker-dealer, that were not tailored to the business of the advisers.

Where firms maintained written policies and procedures, OCIE staff observed deficiencies or weaknesses with establishing, implementing or appropriately tailoring their written policies and procedures in the following areas:<sup>6</sup>

- *Portfolio management.*
  - Due diligence and oversight of outside managers.
  - Monitoring compliance with client investment and tax planning strategies.
  - Oversight of third-party service providers.
  - Due diligence and oversight of investments, including alternative assets.
  - Oversight of branch offices and investment advisory representatives to ensure they are complying with the adviser's policies and procedures.
  - Compliance with regulatory and client investment restrictions.
  - Adherence with investment advisory agreements.
  
- *Marketing.*<sup>7</sup>
  - Oversight of solicitation arrangements.
  - Prevention of the use of misleading marketing presentations, including on websites.

---

<sup>6</sup> *Id.* (“We expect that an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser: Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions; Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (“soft dollar arrangements”), and allocates aggregated trades among clients; The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements; Safeguarding of client assets from conversion or inappropriate use by advisory personnel; The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction; Marketing advisory services, including the use of solicitors; Processes to value client holdings and assess fees based on those valuations; Safeguards for the privacy, protection of client records and information; Business continuity plans.”)

<sup>7</sup> See [The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers](#) (Sep. 14, 2017).

- Oversight of the use and accuracy of performance advertising.
- *Trading practices.*
  - Allocation of soft dollars.
  - Best execution.<sup>8</sup>
  - Trade errors.
  - Restricted Securities.
- *Disclosures.*
  - Accuracy of Form ADV.
  - Accuracy of client communications.
- *Advisory fees and valuation.*
  - Fee billing processes, including how fees are calculated, tested, or monitored for accuracy.
  - Expense reimbursement policies and procedures.
  - Valuation of advisory client assets.
- *Safeguards for client privacy.*
  - Regulation S-P.<sup>9</sup>
  - Regulation S-ID.
  - Physical security of client information.
  - Electronic security of client information, including encryption policies.
  - General cybersecurity, including access rights and controls, data loss prevention, penetration testing and/or vulnerability scans, vendor management, employee training or incident response plans.
- *Required books and records.* Written policies and procedures to make and keep accurate books and records as required under Rule 204-2 under the Advisers Act.
- *Safeguarding of client assets.* Written policies and procedures regarding custody and safety of client assets.
- *Business continuity plans.* The maintenance of adequate disaster recovery plans because the business continuity plans were not tested or did not contain contact information or designate responsibility for business continuity plan actions.<sup>10</sup>

---

<sup>8</sup> See OCIE Risk Alert, [Compliance Issues Related to Best Execution by Investment Advisers](#) (July 11, 2018).

<sup>9</sup> See OCIE Risk Alert, [Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies](#) (April 16, 2019).

<sup>10</sup> See OCIE Risk Alert, [SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year](#) (August 27, 2013).

### III. Conclusion

In response to these observations, many of the advisers modified their written policies and procedures to address the issues identified by OCIE staff. OCIE encourages advisers to review their written policies and procedures, including implementation of those policies and procedures, to ensure that they are tailored to the advisers' business and adequately reviewed and implemented.

---

*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.*

---