

SEC Risk Alert Regarding Investment Adviser Compliance Issues (January 2021)

The Division of Examinations (formerly the Office of Compliance Inspections and Examinations) (the “DoE”) of the Securities and Exchange Commission (“SEC”) recently issued a Risk Alert that provides an overview of compliance issues identified by its staff when they examined registered investment advisers in the last half of 2020.

This Risk Alert is important because, among other factors, the exams on which it was based specifically included the DoE’s review of registrants’ policies and procedures relative to the so-called “Compliance Rule” (Investment Advisers Act Rule 206(4)-7) – in other words, the Risk Alert catalogs weaknesses identified by the DoE staff among investment management compliance programs (as opposed to, for example, regulatory risks in specific business functions, such as trading, marketing, client onboarding, etc.).

Moreover, the Risk Alert effectively serves as a roadmap regarding the DoE’s examination priorities for 2021, in that it presents the subject-matter areas within the compliance area which the DoE has identified are inadequately managed and resourced.

Below is a summary of several examples of investment manager compliance program deficiencies identified by DoE staff in connection with the Compliance Rule:

1. Inadequate resources were allocated to compliance programs, including, in particular, to information technology, experienced staff, and training. As examples, DoE noted the following:
 - (a) Some chief compliance officers (“CCOs”) had numerous additional non-compliance responsibilities, either in other roles within the same investment manager or with unaffiliated firms.
 - (b) This meant that persons filling the CCO role did not have “sufficient time to fulfill” their compliance responsibilities.
 - (c) This also was an indication to DoE staff that CCOs may not have time to develop their knowledge of the Advisers Act, which is fundamental to their ability to perform their CCO responsibilities.
 - (d) Underlying compliance staff were not allocated “sufficient” resources to implement an effective compliance program. In particular:
 - (i) Underlying compliance staff lacked adequate training and support personnel to perform their jobs.
 - (ii) Some registrants’ businesses had “significantly grown in size or complexity,” but the firms did not hire additional compliance staff or add “adequate” IT and other resources, which led to both failures to customize required policies and procedures, and failure to implement customized policies and procedures.

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- (iii) In all instances involving resource inadequacies, there was a failure to implement the compliance policies and procedures the firms had adopted.
- 2. CCOs lacked “sufficient authority” within the registrant to develop and enforce appropriate policies and procedures. As examples, staff observed the following:
 - (a) CCOs were restricted by the registrant’s management from accessing critical compliance-related information.
 - (b) The registrant’s senior management limited its interaction with CCOs, which, in turn, limited CCOs’ knowledge about the registrant’s leadership, strategy, transactions, and business operations.
 - (c) CCOs were not consulted by the registrant’s senior or other managers and employees in relation to matters that had potential compliance consequences.
- 3. Registrants were unable to demonstrate that an annual review for a particular period had been completed, or produced evidence of an annual review that failed to identify significant existing or potential compliance issues. As examples, DoE staff noted the following:
 - (a) Some registrants could not produce evidence of even a single year for which an annual review had been performed, even though the registrants each had policies and procedures requiring the firm to conduct an annual review.
 - (b) Some registrants produced written annual reviews that failed to identify, analyze, or discuss risk areas considered most relevant to the registrant, including in relation to conflicts of interest involving the registrant, custody of client assets, and calculation of fees and allocation of expenses.
 - (c) Some registrants produced annual reviews indicating that they had failed to review significant components of their businesses.
- 4. Investment managers did not implement or perform actions required by their written policies and procedures. As examples, DoE staff identified the following:
 - (a) Registrants did not implement training programs for their employees.
 - (b) Registrants did not implement procedures regarding various subject-matter requirements, including in relation to trade errors, compliance with the “Advertising Rule,” best execution obligations, conflicts of interest disclosures, and other requirements.
 - (c) Registrants did not review marketing materials.
 - (d) Registrants developed compliance checklists but did not utilize them, or utilized them in an incomplete manner.
 - (e) Registrants did not review client accounts, as required consistent with their fiduciary and other obligations, and consistent with registrants’ Form ADV disclosures.

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5. DoE staff identified numerous categories of inadequacies and weaknesses relating to written policies and procedures, including the following:
 - (a) Registrants utilized “off-the-shelf” policies and procedures that contained information unrelated to the registrant, or which was incomplete.
 - (b) Registrants’ policies and procedures included outdated or inaccurate information about the firm.
 - (c) Registrants had numerous gaps in specific categories of policies and procedures, including in relation to the following areas:
 - (i) Compliance with regulatory and client investment restrictions under account and other advisory agreements.
 - (ii) Monitoring compliance with client investment strategies.
 - (iii) Valuation of client assets.
 - (iv) Custody of client assets.
 - (v) Oversight over the use and accuracy of performance advertising.
 - (vi) Accuracy of Form ADV and of client communications.
 - (vii) Fee billing practices, including how fees are calculated, tested, or monitored for accuracy.
 - (viii) Expense reimbursement practices.
 - (ix) Oversight of service providers and branch offices.
 - (x) Privacy and cybersecurity.
 - (xi) Maintenance of required books and records.
 - (xii) Business continuity plans.

The substance of this Risk Alert emphasizes the importance for registered investment advisers of periodically reviewing their written policies and procedures to ensure that they remain accurate relative to the registrant’s changing needs, objectives, and business processes.

The Risk Alert also specifically highlights that the SEC will assess whether a registrant has ensured that its CCO is sufficiently experienced to perform in the role, and that they have adequate resources and authority to implement an effective compliance program.

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