

Client Update

Advisers Beware!

OCIE Announces Most Frequent Compliance Topics

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The staff of the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") has published a Risk Alert on the five compliance issues they most frequently identify as deficiencies in investment adviser examinations.¹ The five key compliance topics OCIE identified focus in particular on the rules under the Investment Advisers Act of 1940 ("Advisers Act") concerning compliance policies and procedures, custody, code of ethics, and books and records, as well as their policies for making required regulatory filings, especially Form D under the Securities Act of 1933 ("Securities Act"). Investment advisers should emphasize these issues in reviewing their compliance with the Advisers Act and its rules and in preparing for OCIE examinations.

COMPLIANCE RULE

Rule 206(4)-7 (the "Compliance Rule") requires registered investment advisers to (i) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, (ii) review the adequacy of these policies at least annually, and (iii) appoint a chief compliance officer responsible for their administration. The deficiencies identified by OCIE include compliance manuals (including "off-the-shelf" manuals) that were not sufficiently tailored to adviser-specific business practices (e.g., with respect to valuation procedures, trading practices, and types of clients). The staff also observed that investment advisers failed to conduct required annual reviews, did not address the adequacy of the policies and procedures or the effectiveness of their implementation, or did not address or correct problems identified in their annual reviews. Perhaps most importantly, the staff noted nonobservance of

¹ See OCIE, SEC, *The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers*, VI(3) NAT'L EXAM PROGRAM RISK ALERT (Feb. 7, 2017), <https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf>.

compliance policies, particularly those concerning employee behavior, expenses and marketing practices.

REGULATORY FILINGS

In connection with regulatory filings (such as Form ADV, Form PF and Form D), the staff observed the following deficiencies:

- *Form ADV*: Certain advisers made inaccurate disclosures in their Form ADV, such as incorrectly reporting custody information, regulatory assets under management, disciplinary history, types of clients and conflicts. In addition, the staff observed that several advisers failed to promptly file “other-than-annual” amendments when certain information on the form became inaccurate, and certain advisers failed to timely file their annual updating amendments.
- *Form PF*: Some advisers required to file Form PFs did not do so completely or accurately.
- *Form D*:² Certain advisers did not timely file or accurately report on these forms on behalf of their private fund clients.

CUSTODY RULE

Compliance with Rule 206(4)-2 (the “Custody Rule”) has been a longstanding priority of the SEC staff. The rule is complicated, however, and failure to comply with it has been the source of many exam deficiencies, enforcement actions and a 2013 OCIE Risk Alert noting widespread noncompliance.³ In this Risk Alert, the staff highlighted situations where advisers failed to recognize that they had custody of client assets and highlighted instances in which the adviser or a related person:

- has internet access to client accounts that permits the adviser to withdraw assets from the accounts by utilizing client usernames and passwords;

² Form D is required to be filed in connection with private fund offerings that rely on the exemption from registration under the Securities Act provided by Regulation D. These forms must be filed no more than 15 calendar days following the first securities sale in a private fund client’s offering.

³ See OCIE, SEC, *Significant Deficiencies Involving Adviser Custody and Safety of Client Assets*, III(3) NAT’L EXAM PROGRAM RISK ALERT (Mar. 4 2013), <https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>.

- has a power of attorney, which provides custody if the adviser is authorized to withdraw cash and securities of clients;
- acts as trustee for client trusts; or
- most importantly for private fund managers, acts as general partner for a fund client's pooled investment vehicle.

The Custody Rule requires registered investment advisers that have custody to undergo a surprise examination by an accounting firm. (Most private fund advisers avoid this requirement by providing limited partners with audited financial statements of the fund on an annual basis.) Among the deficiencies noted by the staff in connection with the surprise examination requirement was the provision by the investment adviser to the accountant of incomplete data regarding client accounts over which the investment adviser had custody, which meant that the accountant was not able to examine all of the required client accounts during its surprise examination. In addition, the staff observed indications suggesting that many surprise examinations may not have been actual "surprises" since they were conducted at the same time every year.

CODE OF ETHICS

Rule 204A-1 (the "Code of Ethics Rule") mandates (i) an ethics code that establishes a standard of business conduct, (ii) periodic reporting of the personal securities holdings and transactions of "access persons" to the chief compliance officer or another designated individual, and (iii) pre-approval from the adviser before such an access person may invest in a private placement or initial public offering. Deficiencies included not properly identifying access persons nor specifying holdings and transaction report reviews; untimely submission of such reports; and lack of required code descriptions in the Form ADV Part 2A brochure. In addition, the staff found that the required Form ADV disclosure that the code of ethics is available upon any client's or prospective client's request was often missing.

BOOKS AND RECORDS

Rule 204-2 (the "books and records rule") requires registered investment advisers to maintain specified books and records, which are generally an important focus of OCIE examinations. The staff noted deficiencies that included failing to maintain all the required books and records (e.g., advisory agreements, trading records, and general ledgers); inaccurate client records (including stale client lists and fee schedules); and separate sets of records that are inconsistent with one another.

CONCLUSION

The Risk Alert is designed to encourage advisers to “reflect upon their own practices, policies and procedures in these areas and to promote improvements in investment adviser compliance programs.” It also encourages investment advisers to take remedial measures to address deficiencies, such as enhancing written compliance procedures, policies or processes, changing business practices or devoting more resources or attention to the area of compliance. Investment advisers, whether or not they have been examined, should engage in thorough reviews of their compliance policies and practices and prepare for these to be focal points of future OCIE examinations.

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Please do not hesitate to contact us with any questions.