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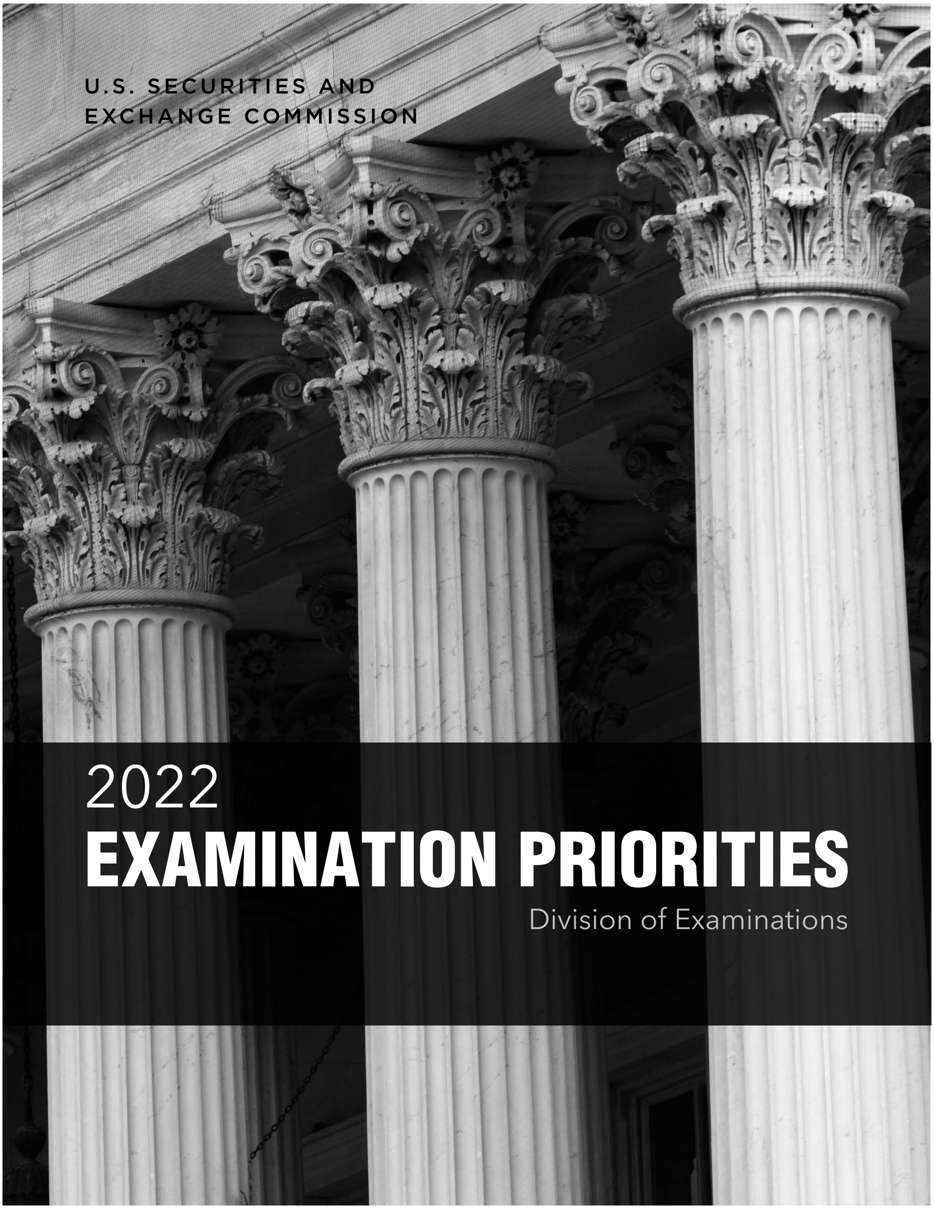
U.S. Securities and Exchange Commission, Division of Examinations 2022 Handbook Materials

- 2022 Examination Priorities (March 30, 2022), https://www.sec.gov/files/2022-exam-priorities.pdf
- Risk Alert: Recent Observations from Municipal Advisor Examinations (August 22, 2022) https://www.sec.gov/municipal-advisor-risk-alert-2022.pdf
- Risk Alert: Observations from Examinations in the Registered Investment Company Initiative (October 26, 2021), https://www.sec.gov/files/exams-registered-investment-company-risk-alert.pdf
- Risk Alert: Observations from Examinations of Advisers that Provide Electronic Investment Advice (November 9, 2021, https://www.sec.gov/files/exams-eia-risk-alert.pdf
- Risk Alert: Division of Examinations Observations: Investment Advisers' Fee Calculations (November 10, 2021), https://www.sec.gov/files/exams-risk-alert-fee-calculations.pdf
- Risk Alert: Observations from Examinations of Private Fund Advisers (January 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf
- Risk Alert: Investment Adviser MNPI Compliance Issues (April 26, 2022), https://www.sec.gov/files/code-ethics-risk-alert.pdf



U.S. SECURITIES AND EXCHANGE COMMISSION

2022

EXAMINATION PRIORITIES

Division of Examinations

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DIVISION OF EXAMINATIONS' LEADERSHIP MESSAGE

Richard R. Best
Acting Director

Joy G. Thompson
Acting Deputy Director

The Division of Examinations is pleased to share our examination priorities for fiscal year (FY) 2022. Last year, we acknowledged two important exam milestones, the elevation of the Office of Compliance Inspections and Examinations to the Division of Examinations and the 25th anniversary of a stand-alone examination program. This year, we mark another important milestone – a decade of publishing the Division's examination priorities.

The annual publication of our examination priorities furthers the SEC's mission and aligns with the Division's four pillars to promote and improve compliance, prevent fraud, monitor risk, and inform policy. The examination priorities have taken on greater prominence over the years and have become an important tool for the examination program. The publication of the examination priorities provides investors and registrants transparency into those areas we believe bring heightened risks to investors, registrants, and the markets.

If you were to review the Division's first priorities from February 2013, you might notice its relative brevity. But upon closer inspection, you would see that many of today's priorities address topics and themes similar to those that the examination program was prioritizing in 2013, and likely many years in between. These perennial priorities represent fundamental obligations under the federal securities laws and are frequently at the core of SEC-registrant operations. For example, the 2013 priorities included a focus on high risk areas such as conflicts of interest, disclosures of fees and expenses, safety of investor and client assets, sales practices, and oversight of systemically important and similarly situated organizations that are essential to the fair and orderly operation of our markets. And although the word "cyber" was not used until 2014, risks related to data compromises were highlighted as well as what has become a perennial focus on addressing the impact and governance surrounding the use of new and emerging technologies across registrant types.

Not all priorities are perennial, however. Each year, in developing our examination priorities, we engage in a deliberative process across the SEC to identify the areas we believe exhibit the highest risks to investors and the markets or are trending in that direction. Some areas take on more or less prominence in our examinations as the markets, technology, regulation, services provided to investors, and investor preferences evolve. However, it is important to note that as our priorities evolve, it does not mean we are no longer conducting examinations in areas not specifically noted in our priorities. Published priorities are not exhaustive, nor do they represent the only areas we will consider in assessing and identifying examination candidates.

Underpinning the last decade of published priorities is the desire to be transparent about the heightened risks that we see, to highlight many of the areas examinations will focus on in the year ahead, and ultimately to protect investors, prevent fraud, and promote and improve compliance. We hope that firms' leadership, including those in compliance, legal, risk, and information security, across the financial services industry will review the priorities and consider their firms' operations and internal controls in these higher-risk areas to avoid potential compliance weaknesses or failures.

Fiscal Year 2021

The Division completed 3,040 examinations in FY21, a 3% increase from FY20 and about on par with pre-Covid-19 pandemic examination totals in FY19. In addition to examinations, the staff conducted hundreds of registrant outreach meetings to monitor several very significant market events, including the volatility in the equity and options markets in early 2021 that touched on several of our program areas. And although numbers are just part of the story, underpinning the great exam numbers for FY21 is the continued perseverance of the staff of the Division and their unwavering commitment to the SEC's and the Division's mission to protect investors. We are incredibly proud of the staff's continued efforts this past year to perform meaningful examinations remotely while contending with the on-going impacts of the Covid-19 pandemic.

During FY21, the Division issued more than 2,100 deficiency letters. Through these letters, we have our most direct impact improving and promoting compliance and investor protection and addressing market risk. Most firms, as a result of the deficiency letters we issue, take steps to remediate the staff's findings. Frequently, remediation includes implementing changes to policies and procedures so they are more effective, updating regulatory filings so they are more clear and responsive, or improving the quality of disclosures made to investors to be more transparent. Deficiency letters have also prompted some firms to return fees and other charges back to investors and make corrections in how they were calculating those fees. To date, our FY21 examinations prompted firms to return more than $45M to investors. The Division also made more than 190 referrals of its examination findings to the Division of Enforcement. As we move further into FY22, we anticipate there will be more money returned to investors, and there will be additional referrals to Enforcement resulting from our FY21 examinations.

The Investment Adviser/Investment Company (IA/IC) Examination Program, the Division's largest program, completed more than 2,200 examinations of investment advisers in FY21, an increase from both FY20 and FY19. It also completed over 125 examinations of investment company complexes. In addition to the number of exams, an important metric is the percentage of SEC-registered investment advisers we examine each year. As the primary and often only regulator responsible for the oversight of this cohort of registrants, we closely track our coverage ratio and have targeted it to be 15% for the past several years. This year, the Division examined approximately 16% of RIAs, compared to 15% in FY20 and FY19. Although there was a slight increase in the coverage percentage in FY21, we will likely soon have to lower our annual coverage target as the growth in the number of RIAs continues to grow at a rate that far outpaces staffing increases. In FY21, we saw some of the fastest year-over-year growth ever, with a net addition of approximately 900 RIAs. And over the last five years, the number of RIAs has increased 20%, from approximately 12,250 to over 14,800.

The growth in the numbers of RIAs does not fully capture the increasing complexity of the asset management industry, and the resulting increased complexity of the compliance issues and risks covered by our examinations. For instance, the number of RIAs with AUM over $10 billion has increased by 30% in the past five years alone, and total AUM is now over $113 trillion, itself a nearly 70% increase from five years ago. In addition, approximately 60% of RIAs are affiliated with other financial industry firms, and more than 35% manage a private fund.

The Division's Broker-Dealer and Exchange Examination Program continued to conduct examinations focused on broker-dealers' compliance with Regulation Best Interest, wrapping up its initial exams to look for good faith compliance and kicking off the second phase of examinations with additional review of effectiveness of policies and procedures and transaction testing. In addition to the oversight of broker-dealers, BDX conducts examinations of municipal advisors, national securities exchanges, and transfer agents. The program completed nearly 450 examinations of these registrants in FY21.

The FINRA and Securities Industry Oversight (FSIO) Examination Program completed more than 115 examinations of FINRA in FY21, including examinations of key FINRA oversight areas, and held frequent monitoring meetings with FINRA on various aspects of its operations to assess and identify risk areas in these operations.

The Clearance and Settlement Examination Program conducted 15 examinations of clearing firms, including critically important work around the Systemically Important Financial Market Utilities (or SIFMUs). And our Technology Controls Program (TCP) completed 81 examinations, including examinations of entities subject to Regulation Systems Compliance and Integrity (SCI), RIAs and broker-dealers.

The Division also maintained its focus on transparency and support of compliance through outreach events and publications. Division staff participated in more than 150 conferences and outreach events, including a national outreach event for municipal advisors in October and regional outreach events for IA and IC compliance officers. We continued to maintain a steady pace of issuing Risk Alerts throughout the year as well. In FY21, the Division published nine Risk Alerts across a variety of topics. These Risk Alerts are designed to raise awareness of compliance and industry risks and are meant to encourage firms to think about their own policies and procedures in particular areas. The FY21 Risk Alerts include:

- Observations from Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices
- Investor Adviser Compliance Programs
- Observations from Examinations of Broker-Dealers and Investment Advisers: Large Trader Obligations
- Executive Order on Securities Investments that Finance Communist Chinese Military Companies
- The Division of Examinations' Continued Focus on Digital Asset Securities
- Compliance Issues Related to Suspicious Activity Monitoring and Reporting at Broker-Dealers
- The Division of Examinations' Review of ESG Investing
- Observations from Examinations of Investment Advisers Managing Client Accounts that Participate in Wrap Fee Programs
- Observations Regarding Fixed Income Principal and Cross Trades by Investment Advisers from an Examination Initiative

We intend to continue publishing Risk Alerts, providing observations from examinations and alerting the industry to potentially new compliance and market risks. We take our role to promote compliance to mean that part of our job is to raise awareness of compliance risks and share practices that aided an effective compliance strategy.

A Word About "Compliance"

With our name change last year to the Division of Examinations, some have speculated that the removal of "compliance" from the Division's name was intended to deemphasize our long-standing focus on, and commitment to, promoting compliance and to empowering compliance officers. Rest assured, that is not the case.

The importance of improving and promoting compliance remains at the forefront of the Division's work. We engage with Chief Compliance Officers and compliance staff routinely on each examination. In addition, we have continued to look for opportunities to engage with compliance professionals and the compliance community through various outreach initiatives. For example, as noted above, we conduct several national and regional compliance outreach programs each year for a variety of registrant types, and publish our priorities, Risk Alerts and other reports to provide transparency on many areas directly tied to compliance.

While many registrants demonstrate the value and importance they place on compliance, far too often we examine registrants where that is not the case. In last year's leadership message we highlighted compliance engagement across business lines, knowledgeable Chief Compliance Officers, and firm principals' commitment to compliance. It bears repeating– compliance officers must be empowered and receive support in the form of resources and a tone from the top that recognizes their contributions. Senior officers and executives empower compliance and compliance officers through their words and actions.

Another characteristic of an effective compliance program is resiliency, which has never been more apparent as we all continue to address pandemic-related change. Compliance programs and the written policies and procedures that embody them should be developed and designed to continue to be effective and withstand changes in, for example, market conditions, investor demand, key personnel, and registrant services or lines of business. A well-designed and resilient compliance program and compliance staff should be able to adjust, pivot, and address a range of conditions and scenarios.

In performing examinations, we have observed several commonalities of resilient compliance programs.

Inclusivity

The primary responsibility to develop and maintain a compliance program may be with the Chief Compliance Officer and others in a compliance department, but for most firms the foundation of a resilient compliance program requires participation and input across all business and operational lines. Staff from across a firm working in collaboration with compliance can bring additional expertise and diverse perspectives to the development of a compliance program and the design of effective controls. Additional benefits, including a sense of shared ownership and greater attention to implementation, can also result from an inclusive approach to compliance.

Change Management

A well thought out and well-designed compliance program will be flexible enough to adjust to known variables in operations and business, but will also have established processes in place to monitor effectiveness and to pivot or be updated when appropriate. As we have all experienced over the last couple of years, significant unanticipated events can occur as well as more incremental change that can compound over time or across operational lines, causing once effective policies and procedures or controls to become weak or ineffective. Compliance programs and related policies and procedures are not "set it and forget it" endeavors, and having a process in place to address new compliance risks and challenges is critical to resiliency.

Reviews and Testing

Periodic review and testing of policies and procedures is necessary to ensure the on-going adequacy and effectiveness of a compliance program. As the Commission has noted in the context of investment adviser compliance programs, reviews should consider compliance matters that arose previously, changes in business activities, and regulatory changes. Testing is also critical, as it provides a means to affirm that policies and procedures are operating as designed and to ensure the detection of outlier events or unusual patterns. An effective testing program, such as one that includes testing on a routine periodic basis at set intervals, when certain transactions occur, and over extended periods to look for patterns or emerging trends, deployed in conjunction with periodic reviews, significantly contributes to the on-going resiliency of a compliance program.

We fully anticipate that our focus on compliance, support of compliance, and compliance empowerment will continue and we look forward to continued engagement with the compliance community in the year to come.

Final Notes

Perhaps the most significant storyline of FY21 for the Division was the continued impact of the Covid-19 pandemic on us and the financial services industry generally. As we look back on the Division's results from the previous year and plan for the new initiatives and focus areas for the year to come, the theme of resiliency again comes to mind. Specifically, the resiliency of the Division's systems and controls, the resiliency of our operating posture and capacity, but most importantly, the resiliency of the 1000 plus person staff that make up the examination program. Their tenacity, commitment to mission and public service, and collaborative spirit is really the crowning achievement for the year. We are certain many firms share a similar sentiment for their own employees and the resiliency they have demonstrated.

Finally, the past year has brought change to the Division. We established the Office of Security-Based Swaps to carry out the Division's oversight responsibilities for security-based swaps entities registered with the Commission, including security-based swaps dealers, and to coordinate and collaborate with our colleagues in the Division of Trading and Markets and other offices and divisions as part of the newly launched Security-Based Swaps Joint Venture. We examined registrants for compliance for several new regulations, including amendments to Regulation NMS Rule 606 and the Investment Company Liquidity Risk Management Program Rule. And last, there was change in the senior leadership ranks of the Division with the departure of Director Pete Driscoll, Acting Director and Chief Counsel Dan Kahl, Deputy Director and co-head of the IA/IC examination program Kristin Snyder, and head of the Clearance and Settlement program Dan Gregus. We thank them for their service, and are fortunate that there are many great leaders in the Division to fill these gaps, including Joy Thompson, Natasha Greiner, and Lourdes Caballes who are currently leading as Deputy Director, co-head of the IA/IC examination program, and head of the Office of Clearance and Settlement, respectively.

The Division's contact information can be found at https://www.sec.gov/contact-information/sec-directory. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify SEC staff at https://www.sec.gov/tcr. We welcome engagement between our staff and members of the public, and we appreciate hearing from the industry about new and emerging risk areas, products, and services.

Division of Examinations

2022
EXAMINATION PRIORITIES

The Division of Examinations (Division or EXAMS) prioritizes examination of certain practices, products, and services that it believes present potentially heightened risks to investors or the integrity of the U.S. capital markets. Examinations of these priority areas are grounded in our four pillars: promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy. Collectively, examinations and our other efforts, including publication of Risk Alerts and industry and investor outreach, are designed to support the SEC's mission to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets.

The Division will prioritize examinations of several significant focus areas that pose unique or emerging risks to investors or the markets, as well as examinations of core and perennial risk areas. Their importance to investors and the markets, coupled with the seriousness and frequency of observations in prior years' examinations, demonstrate the need for the Division to remain vigilant in these areas. And while all of the areas identified below are critical, this list of priorities is not comprehensive and these will not be the only issues the Division addresses in examinations, Risk Alerts, and industry and investor outreach. The Division continues to be flexible so that examinations may also cover new and exigent risks to investors and the marketplace as they arise.

I. SIGNIFICANT FOCUS AREAS

A. Private Funds

More than 5,000 SEC-registered investment advisers (RIAs), totaling over 35% of all RIAs, manage approximately $18 trillion in private fund assets deployed in a variety of investment strategies in various fund types, including hedge funds, private equity funds, and real estate funds. These private funds frequently have significant investments from state and local pensions with working family beneficiaries, charities, and endowments. The size and complexity of these RIAs vary widely from, for example, an adviser with a small closely-held private fund to an adviser managing hundreds of billions of dollars across multiple types of funds and strategies. In the past five years, there has been a 70% increase in the assets managed by advisers to private funds.

DID YOU KNOW?
In the past five years, there has been a 70% increase in the assets managed by advisers to private funds.

Given the significance of examination findings over the past several years, and the size, complexity, and significant growth of this market, the Division will continue to prioritize our focus on RIAs to private funds. Examinations will review issues under the Investment Advisers Act of 1940 (Advisers Act), including an adviser's fiduciary duty, and will assess risks, including a focus on compliance programs, fees and expenses, custody, fund audits, valuation, conflicts of interest, disclosures of investment risks, and controls around material nonpublic information (MNPI).

Specifically, EXAMS will continue to review: (1) the calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds; (2) the potential preferential treatment of certain investors by RIAs to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; (3) compliance with the Advisers Act Custody Rule, including the "audit exception" to the surprise examination requirement and related reporting and updating of Form ADV regarding the audit and auditors that serve as important gate-keepers for private fund investors; (4) the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales; and (5) conflicts around liquidity, such as RIA-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund.

The Division will also review private fund advisers' portfolio strategies, risk management, and investment recommendations and allocations, focusing on conflicts and disclosures around these areas. This will include, for example, review of private funds' investments in Special Purpose Acquisition Companies (SPACs), particularly where the private fund adviser is also the SPAC sponsor. In addition, EXAMS will review the practices, controls, and investor reporting around risk management and trading for private funds with indicia of systemic importance, such as outsized counterparty exposure or gross notional exposure when compared to similarly situated firms.

B. Environmental, Social, And Governance (ESG) Investing

RIAs and registered funds are increasingly offering and evaluating investments that employ ESG strategies or incorporate certain ESG criteria, in part to meet investor demand for such strategies and investments. There is a risk that disclosures regarding portfolio management practices could involve materially false and misleading statements or omissions, which can result in misinformed investors. This risk may be compounded by: (1) the lack of standardization in ESG investing terminology (*e.g.*, strategies that are referred to as sustainable, socially responsible, impact investing, and environmental, social, and governance conscious, which incorporate ESG criteria); (2) the variety of approaches to ESG investing (*e.g.*, a portfolio may be labeled as ESG because of consideration of ESG factors alongside traditional financial, industry-related, and macroeconomic indicators, among others; other portfolios may use ESG factors as the driving or main consideration in selecting investments; or some portfolios engage in impact investing seeking to achieve measurable ESG impact goals); and (3) the failure to effectively address legal and compliance issues with new lines of business and products.

The Division will continue to focus on ESG-related advisory services and investment products (*e.g.*, mutual funds, exchange-traded funds (ETFs), and private fund offerings). Such reviews will typically focus on whether RIAs and registered funds are: (1) accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures, including review of their portfolio management processes and practices; (2) voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates; or (3) overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (*e.g.*, greenwashing), such as in their performance advertising and marketing.

C. Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS

The Division will continue to address standards of conduct issues for broker-dealers and RIAs, with reviews focused on how they are satisfying their obligations under Regulation BI and the Advisers Act fiduciary standard to act in the best interests of retail investors and not to place their own interests ahead of retail investors' interests. Examinations will include assessments of practices regarding consideration of alternatives (*e.g.*, with regard to potential risks, rewards, and costs), management of conflicts of interest (*e.g.*, incentive practices that favor certain products or strategies over others), trading (*e.g.*, RIA best execution obligations), disclosures (*e.g.*, disclosures provided in Form ADV and Form CRS and made pursuant to Regulation BI), account selection (*e.g.*, brokerage, advisory, or wrap fee accounts), and account conversions and rollovers. For both broker-dealers and RIAs, examinations will focus on the effectiveness of compliance programs, testing, and training that are designed to support retail investors and working families receiving recommendations and advice in their best interests.

DID YOU KNOW?

The Division will continue to address standards of conduct issues for broker-dealers and RIAs, with reviews focused on how they are satisfying their obligations under Regulation BI and the Advisers Act fiduciary standard to act in the best interests of retail investors and not to place their own interests ahead of retail investors' interests.

Broker-dealer examinations will review firms' recommendations and sales practices related to SPACs, structured products, leveraged and inverse exchange traded products (ETPs), REITs, private placements, annuities, municipal and other fixed income securities, and microcap securities. Examinations will review practices, policies, and procedures concerning the evaluation of cost and reasonably available alternatives as they relate to recommendations of these products being in the investor's best interest. Examinations will also evaluate the compensation structures for financial professionals, including the conflicts created by such structures, and may focus examinations on the sales of securities by financial professionals that are highly compensated.

RIA examinations will focus on whether advisers are acting consistently with their fiduciary duty to clients, looking at both duties of care and loyalty, including best execution obligations, financial conflicts of interest and related impartiality of advice, and any attendant client disclosures. Focus areas include: (1) revenue sharing arrangements; (2) recommending or holding more expensive classes of investment products when lower cost classes are available (*e.g.*, RIAs that recommend no transaction fee mutual fund share classes that have 12b-1 fees in wrap fee accounts where the RIA may be responsible for paying transaction fees); (3) recommending wrap fee accounts without assessing whether such accounts are in the best interests of clients, including the impact of the move to zero commissions on certain types of securities transactions by a number of broker-dealers; and (4) recommending proprietary products resulting in additional or higher fees. Such reviews also will include an assessment of the adequacy of RIAs': (1) compliance policies and procedures designed to address conflicts and ensure advice in the best interest of clients, including the cost of investing; and (2) disclosures to enable investors to provide informed consent.

Dually registered RIAs and broker-dealers remain an area of interest for the Division, as do affiliated firms with financial professionals who service both brokerage customers and advisory clients. The focus areas of such examinations will be similar to those addressed above, but with particular emphasis on potential conflicts of interest present at these firms, including with regard to account recommendations and allocation of investments across different accounts. For example, examinations will include a focus on: (1) the sale or recommendation of high fee products; (2) the sale or recommendation of proprietary products of the firms or their affiliates; (3) incentives for financial professionals to place their own or their firms' interests ahead of customers/clients (*e.g.*, transactions that reduce costs to the adviser and increase expenses borne by the client); and (4) compensation structures that inappropriately influence investment recommendations. The Division will review whether these firms have implemented written policies and procedures to effectively mitigate and address conflicts and to minimize the risk of, and monitor for, misaligned incentives that may result in recommendations and advice to retail investors, such as seniors and working families that is not in their best interest.

D. Information Security and Operational Resiliency

Applying information security controls is critical to ensuring business continuity. Vigilant protection of data is also critical to the operation of the financial markets and the confidence of its participants. Failing to prevent unauthorized access, use, disclosure, disruption, modification, inspection, recording or destruction of sensitive records may have consequences that extend beyond the firm compromised to other market participants and retail investors. Accordingly, the Division will review broker-dealers' and RIAs' practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets.

Specifically, EXAMS will continue to review whether firms have taken appropriate measures to: (1) safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (2) oversee vendors and service providers; (3) address malicious email activities, such as phishing or account intrusions; (4) respond to incidents, including those related to ransomware attacks; (5) identify and detect red flags related to identity theft; and (6) manage operational risk as a result of a dispersed workforce in a work-from-home environment. In the context of these examinations, the Division will focus on, among other things, broker-dealers' and RIAs' compliance with Regulations S-P and S-ID, where applicable.

The Division will again be reviewing registrants' business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations. As the Division described last year, these efforts build on previous examinations and outreach in this area. In some cases, particularly in regard to systemically important registrants, examinations will account for certain climate related risks. The scope of these examinations will include a focus on the maturation and improvements to business continuity and disaster recovery plans over the years as well as these registrants' resiliency as organizations to anticipate, prepare for, respond to, and adapt to both sudden disruptions and incremental changes stemming from climate-related situations.

DID YOU KNOW?

The Division will again be reviewing registrants' business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations.

E. Emerging Technologies and Crypto-Assets

The Division has observed a significant increase in the number of RIAs choosing to provide automated digital investment advice to their clients (often referred to as "robo-advisers"), continued growth in the use of mobile apps by broker-dealers, and a proliferation of the offer, sale, and trading of crypto-assets. The Division will conduct examinations of broker-dealers and RIAs that are using developing financial technologies to review whether the unique risks these activities present were considered by the firms when designing their regulatory compliance programs.

DID YOU KNOW?
The Division will conduct examinations of broker-dealers and RIAs that are using developing financial technologies to review whether the unique risks these activities present were considered by the firms when designing their regulatory compliance programs.

RIA and broker-dealer examinations will focus on firms that are, or claim to be, offering new products and services or employing new practices (*e.g.*, fractional shares, "Finfluencers," or digital engagement practices) to assess whether: (1) operations and controls in place are consistent with disclosures made and the standard of conduct owed to investors and other regulatory obligations; (2) advice and recommendations, including by algorithms, are consistent with investors' investment strategies and the standard of conduct owed to such investors; and (3) controls take into account the unique risks associated with such practices.

Examinations of market participants engaged with crypto-assets will continue to review the custody arrangements for such assets and will assess the offer, sale, recommendation, advice, and trading of crypto-assets. In particular, EXAMS will review whether market participants involved with crypto-assets: (1) have met their respective standards of conduct when recommending to or advising investors with a focus on duty of care and the initial and ongoing understanding of the products (*e.g.*, blockchain and crypto-asset feature analysis); and (2) routinely review, update, and enhance their compliance practices (*e.g.*, crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices (*i.e.*, data integrity and business continuity plans). In addition, the Division will conduct examinations of mutual funds and ETFs offering exposure to crypto-assets to assess, among other things, compliance, liquidity, and operational controls around portfolio management and market risk.

II. INVESTMENT ADVISER AND INVESTMENT COMPANY EXAMINATION PROGRAM

A. Registered Investment Advisers

During a typical examination, the Division reviews the compliance programs of RIAs in one or more of the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures. The Division will assess whether policies and procedures are reasonably designed to prevent violations of the Advisers Act and its rules, including breaches of the RIA's fiduciary duty in violation of the antifraud provisions. Additionally, EXAMS will review compliance programs to examine whether they address that: (1) investment advice is in each client's best interest; (2) oversight of service providers is adequate; and (3) sufficient resources exist to perform compliance duties. In addition, to the extent that firms are using alternative data or data gleaned from non-traditional sources as part of their business and investment decision-making processes, reviews will include examining whether RIAs, including RIAs to private funds and registered funds, are implementing appropriate compliance and controls around the creation, receipt, and use of potentially MNPI.

DID YOU KNOW?
During a typical examination, the Division reviews the compliance programs of RIAs in one or more of the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures.

As part of its assessment of the effectiveness of a compliance program, the Division will review whether the firm has implemented oversight practices to mitigate any heightened risks. For example, whether RIAs: (1) employing individuals with prior disciplinary histories implemented heightened oversight practices for these individuals; (2) migrating from the broker-dealer business model reviewed whether recommendations to transition investor accounts to advised accounts were in the clients' best interests; and (3) operating from multiple branch offices have appropriately adapted their compliance programs to oversee the activities in their branches.

The Division will also continue to focus on RIA disclosures and other issues related to fees and expenses. In particular, EXAMS will concentrate on issues associated with: (1) advisory fee calculation errors, including, but not limited to, failure to adjust management fees in accordance with investor agreements; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts or pro-rated fees for onboarding clients.

As in previous years, the Division prioritizes RIAs and registered funds that have never been examined, including recently registered firms, and those that have not been examined for a number of years. Typically, these examinations focus on firms' compliance programs.

B. Registered Investment Companies, Including Mutual Funds and ETFs

The Division will continue to prioritize examinations of registered investment companies, including mutual funds and ETFs, given their importance to retail investors. The Division typically reviews certain perennial focus areas during its assessments of registered funds' compliance programs and governance practices. Perennial areas include, among other topics, disclosures to investors, accuracy of reporting to the SEC, compliance with the new rules and exemptive orders (including ETF rules and exemptive orders for non-transparent, actively managed ETFs, and custom baskets). As part of its review of registered funds' LRMPs, the Division will consider whether the programs are reasonably designed to assess and manage the funds' liquidity risk and review the implementation of required liquidity classifications, including firms' oversight of third party service providers.

DID YOU KNOW?
Perennial areas include, among other topics, disclosures to investors, accuracy of reporting to the SEC, compliance with the new rules and exemptive orders (including ETF rules and exemptive orders for non-transparent, actively managed ETFs, and custom baskets).

Certain types of registered funds, portfolio investments, and fund practices will be prioritized. Examples of the types of funds include: (1) money market funds, which remain an important part of the registered fund industry to retail and institutional investors for cash management and will be reviewed for compliance with applicable requirements, including stress-testing, website disclosures, and board oversight; and (2) business development companies, which will undergo reviews of their valuation practices, marketing activities, and conflicts of interest with underlying portfolio companies. The Division's focus on portfolio investments will include examinations of mutual funds investing in private funds to assess risk disclosure and valuation issues. EXAMS will also prioritize examinations of certain fund practices, including a focus on advisory fee waivers to assess the sustainability of services for firms that provide such waivers, and trading activities of portfolio managers that may be designed to inflate fund performance.

III. BROKER-DEALER AND EXCHANGE EXAMINATION PROGRAM

A. Microcap, Municipal, Fixed Income, and Over-The-Counter Securities

The Division remains committed to deterring microcap fraud, or fraud in connection with securities of companies with a market capitalization under $250 million. The Division will continue to prioritize examinations of broker-dealers for compliance with their obligations in the offer, sale, and distribution of microcap securities. Focus areas for examinations will include: (1) transfer agent handling of microcap distributions and share transfers; (2) broker-dealer sales practices and their consistency with Regulation BI; and (3) broker-dealer compliance with certain regulatory requirements, including the locate requirement of Regulation SHO, penny stock disclosure rules (*i.e.*, Rules 15g-2 through 15g-6 of the Securities Exchange Act of 1934 (Exchange Act)), and the obligation to monitor for and report suspicious activity and other anti-money laundering (AML) obligations.

States and local governments issue debt securities, referred to as municipal securities or municipal bonds, to finance a wide variety of public projects. Timely and accurate municipal issuer disclosure is vitally important to investors and the markets for these securities. The Division will examine the activities of broker-dealers, underwriters, and municipal advisors to assess whether these firms are meeting their respective obligations, as and to the extent applicable, in relation to municipal issuer disclosure.

In addition, the Division will examine broker-dealer trading activity in fixed income securities with a focus on sales practices; best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements, including disclosures relating to mark-ups and mark-downs.

The Division's focus on products and services will also include the sale of over-the-counter securities and whether broker-dealers recommending these securities are meeting their obligations under Regulation BI. Examinations will also assess compliance with revised Exchange Act Rule 15c2-11, which generally requires broker-dealers to refrain from publishing quotations in a quotation medium for an issuer's security when current issuer information is not publicly available (among other requirements).

DID YOU KNOW?

The Division's focus on products and services will also include the sale of over-the-counter securities and whether broker-dealers recommending these securities are meeting their obligations under Regulation BI.

B. Broker-Dealer Operations

Broker-dealers that hold customer cash and securities have a responsibility to ensure that those assets are safeguarded in accordance with the Customer Protection Rule and the Net Capital Rule. Examinations of broker-dealers will continue to focus on compliance with these rules, including the adequacy of internal processes, procedures, and controls, and compliance with requirements for borrowing fully paid and excess margin securities from customers. Examiners may also assess broker-dealer funding and liquidity risk management practices to assess whether firms have sufficient liquidity to manage stress events.

The Division will continue to examine broker-dealer trading practices. Examinations will focus on broker-dealer compliance with best execution obligations in a zero commission environment and compliance with Exchange Act Rule 606 order routing disclosure rules. The Division will continue to review potential conflicts of interest in order routing, such as conflicts arising from payment for order flow, including wholesaler payments or exchange rebates, and the possible effect any conflicts of interest may have on order routing decisions and best execution obligations. Examinations will also focus on large trader reporting obligations and broker-dealer compliance with Regulation SHO, including the rules regarding aggregation units and locate requirements.

The Division will also examine the operations of certain alternative trading systems for compliance with Regulation ATS, and in particular focus on consistency with their disclosures provided in Form ATS-N.

As in previous years, EXAMS will prioritize the review of firms that are engaged in activities that appear to require broker-dealer registration and those that may be involved in the illegal distribution of unregistered securities to ensure investors are receiving the benefits of the federal securities laws.

C. National Securities Exchanges

National securities exchanges provide marketplaces for facilitating securities transactions and, under the federal securities laws, serve as self-regulatory organizations responsible for enforcing compliance by their members with the federal securities laws and rules and the exchanges' own rules. The Division will examine the national securities exchanges to assess whether they are meeting their obligations under the federal securities laws and will focus on exchange regulatory programs to detect and discipline violations, and participation in National Market System (NMS) Plans. Examinations may also assess and compare any exchange advisory services offered to issuers regarding ESG initiatives.

D. Security-Based Swap Dealers (SBSDs)

The compliance date for registration of SBSDs and several other SBSD requirements was October 6, 2021. Initial examinations of these new registrants will focus on the policies and procedures related to compliance with the security-based swap rules generally (*e.g.*, trade acknowledgement and verification, recordkeeping and reporting, and risk management requirements).

DID YOU KNOW?
The compliance date for registration of SBSDs and several other SBSD requirements was October 6, 2021.

E. Municipal Advisors

The Division will examine whether municipal advisors have met their fiduciary duty and conflict disclosure obligations to municipal entity clients. The Division will also examine whether municipal advisors have satisfied their registration, professional qualification, continuing education, and supervision requirements.

F. Transfer Agents

The Division will continue to examine transfer agents' core functions: the timely turnaround of items and transfers, recordkeeping and record retention, safeguarding of funds and securities, and filing obligations with the Commission. Examination candidates will include, among others, never-before-examined transfer agents and transfer agents that service microcap or municipal bond issuers, use novel technologies (*e.g.*, blockchain or online crowdfunding portal applications), or engage in significant paying agent activity.

IV. CLEARANCE AND SETTLEMENT EXAMINATION PROGRAM

The Division will conduct, as required by Title VIII of the Dodd-Frank Act, at least one risk-based examination of each clearing agency designated as systemically important and for which the SEC serves as the supervisory agency. These examinations will focus on core risks, processes, and controls and will cover the specific areas required by statute, including the nature of clearing agencies' operations and assessment of financial and operational risk. Additionally, the Division will conduct risk-based examinations of other registered clearing agencies which have not been designated as systemically important. The Division will also examine both groups of clearing agencies for compliance with the SEC's Standards for Covered Clearing Agencies, which are rules that require covered clearing agencies to, among other things, have policies and procedures that address maintaining sufficient financial resources, protecting against credit risks, managing member defaults, and managing operational and other risks.

In addition, EXAMS will conduct risk-based examinations of SEC-registered clearing agencies to: (1) determine whether their respective risk management frameworks comply with the Exchange Act, and serve the needs of their members and the markets they serve; (2) assess the adequacy and timeliness of their remediation of prior deficiencies, including, for example, the role of senior leadership in the remediation process; and (3) examine other risk areas identified in collaboration with the SEC's Division of Trading and Markets and other regulators. Areas of focus may include margin, counterparty credit risk, disclosure framework, governance, recovery and wind-down, default management, liquidity risk management, and project management, among other things.

V. REGULATION SYSTEMS COMPLIANCE AND INTEGRITY

The Commission adopted Regulation SCI to strengthen the technology infrastructure of the U.S. securities markets. Regulation SCI entities include national securities exchanges, registered and certain exempt clearing agencies, FINRA, MSRB, plan processors, and alternative trading systems that meet certain volume thresholds. Among other things, these critical market infrastructure entities must establish, maintain, and enforce written policies and procedures reasonably designed to ensure that their systems' capacity, integrity, resiliency, availability, and security is adequate to maintain their operational capability and promote the maintenance of fair and orderly markets.

EXAMS will continue to evaluate whether SCI entities have established, maintained, and enforced written policies and procedures as required. Areas of focus will include: (1) whether the incident response policies and procedures of SCI entities are reasonably designed, with a particular focus on ransomware; (2) the use of third-party network infrastructure services to support critical functions; (3) policies and procedures pertaining to the return to the workplace or further hybridization of the workplace after the extended telework posture caused by the COVID-19 pandemic; and (4) whether SCI entities have established reasonably designed policies and procedures to identify and mitigate software supply chain risks, including secure code development practices of SCI entities.

VI. FINRA

FINRA oversees approximately 3,400 brokerage firms, 153,000 branch offices, and 618,000 registered representatives through examinations, enforcement, and surveillance. In addition, FINRA, among other things, provides a forum for securities arbitration and mediation, conducts market regulation, including by contract for a majority of national securities exchanges, reviews broker-dealer advertisements, administers the testing and licensing of registered persons, and operates industry utilities such as Trade Reporting Facilities.

EXAMS conducts risk-based oversight examinations of FINRA. It selects areas within FINRA to examine through a risk assessment process designed to identify those aspects of FINRA's operations important to the protection of investors and market integrity, including FINRA's implementation of new investor protection initiatives. The analysis is informed by collecting and analyzing extensive information and data, regular meetings with key functional areas within FINRA, and outreach to various stakeholders, including broker-dealers and investor groups. Based on the outcome of this risk-assessment process, EXAMS conducts inspections of FINRA's major regulatory programs. EXAMS also conducts oversight examinations of FINRA's examinations of certain broker-dealers and municipal advisors. From its observations during all of these inspections and examinations, EXAMS makes detailed recommendations to improve FINRA's programs, its risk assessment processes, and its future examinations.

VII. MSRB

MSRB regulates the activities of broker-dealers that buy, sell, and underwrite municipal securities, as well as the activities of municipal advisors. MSRB establishes rules for municipal broker-dealers (including registered municipal securities dealers) and municipal advisors, supports market transparency by making municipal securities trade data and disclosure documents available, and conducts education and outreach regarding the municipal securities market. EXAMS, along with FINRA and the federal banking regulators, conducts examinations of registered firms to assess compliance with MSRB rules. EXAMS also applies a risk assessment process, similar to the one it uses to oversee FINRA, to identify areas to examine at MSRB. Examinations of MSRB evaluate the effectiveness of MSRB's policies, procedures, and controls.

VIII. THE LONDON INTER-BANK OFFERED RATE (LIBOR) TRANSITION

The discontinuation of LIBOR could have a significant impact on the financial markets and may present a material risk for certain market participants, including the RIAs, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies overseen by the Division. Preparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation. EXAMS will continue to engage with registrants through examinations and outreach efforts to assess their exposure to LIBOR and their transition to an alternative reference rate, preparations for the cessation of many LIBOR rates beginning immediately after December 31, 2021, and the transition to an alternative reference rate, in connection with registrants' own financial operations, the exposures of their clients and customers, and their obligations when recommending LIBOR-linked instruments.

IX. ANTI-MONEY LAUNDERING

The Bank Secrecy Act requires financial institutions, including broker-dealers and registered investment companies, to establish AML programs that are tailored to address the risks associated with the firm's location, size, and activities, including customers they serve, the type of products and services offered, and the means by which those products and services are offered. These programs must, among other things, include policies and procedures reasonably designed to identify and verify the identity of customers and beneficial owners of legal entity customers, perform customer due diligence (as required by the Customer Due Diligence rule), monitor for suspicious activity, and, where appropriate, file Suspicious Activity Reports (SARs) with the Financial Crimes Enforcement Network. SARs are used to detect and combat terrorist financing, public corruption, market manipulation, and a variety of other fraudulent behaviors.

Given the importance of these requirements, the Division will continue to prioritize examinations of broker-dealers and registered investment companies for compliance with their AML obligations in order to assess, among other things, whether firms have established appropriate customer identification programs and whether they are satisfying their SAR filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs. The goal of these examinations is to evaluate whether broker-dealers and registered investment companies have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

DID YOU KNOW?
The goal of AML examinations of broker-dealers and investment companies is to evaluate whether they have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

X. CONCLUSION

These priorities reflect the Division's assessment of certain risks, issues, and policy matters arising from market and regulatory developments, information gathered from examinations, and other sources, including tips, complaints, and referrals, and coordination with other Divisions and Offices at the SEC as well as other regulators. While the Division will allocate significant resources to the examination issues described herein, it will also conduct examinations focused on and devote resources to new or emerging risks, products and services, market events, and investor concerns. The Division welcomes comments and suggestions regarding how it can better fulfill its mission to promote compliance, prevent fraud, identify and monitor risk, and inform SEC policy. Our contact information is available at https://www.sec.gov/exams. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify SEC staff at https://www.sec.gov/tcr.

U.S. Securities and Exchange Commission

DIVISION OF EXAMINATIONS

Washington, DC

RISK ALERT
DIVISION OF EXAMINATIONS

August 22, 2022

RECENT OBSERVATIONS FROM MUNICIPAL ADVISOR EXAMINATIONS[*]

With more than 450 municipal advisors ("MAs") currently registered with the SEC, the Division of Examinations continues to make the examination of MAs a priority.[1] The rules of the SEC and those of the Municipal Securities Rulemaking Board ("MSRB") address registration, disclosure of conflicts of interest, fiduciary duties, professional qualifications, and continuing education, among other aspects of MA operations.[2] In 2017, EXAMS published a Risk Alert that provided the staff's observations from a series of examinations of newly registered MAs, with a focus on deficiencies observed in the areas of registration, recordkeeping, and supervision.[3]

This Risk Alert reminds municipal advisors of their obligations and raises awareness among municipal advisors and other market participants of the most often cited deficiencies and weaknesses observed in recent MA examinations, which include many of the areas covered in the Risk Alert issued in 2017, as well as deficiencies and weaknesses related to municipal advisors' disclosure to clients. We encourage municipal advisors to review each of these areas and assess their compliance with each. In addition to the areas discussed below, the Division intends in the future for examinations to include a more prominent focus on the core standards of conduct and duties applicable to municipal advisors.

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[*] The views expressed herein are those of the staff of the Division of Examinations ("EXAMS" or the "Division"). 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 other 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 Division staff and is not legal advice.

[1] The Division's Examination Priorities for 2019, 2020, 2021, and 2022 include a focus on municipal advisors.

[2] Section 15B(b)(2) of the Securities Exchange Act of 1934 (the "Exchange Act") authorizes the MSRB to propose and adopt rules with respect to, among other things, municipal advisors providing advice to or on behalf of municipal entities or obligated persons. This Risk Alert does not address compliance by MAs or their affiliated municipal securities dealers with any FINRA rules that may apply.

[3] Division, "Observations from Municipal Advisor Examinations" (Nov. 7, 2017).

Staff Observations from Examinations of Municipal Advisors

A. Registration and Filings

Regulatory Framework. Section 15B(a)(1)(B) of the Exchange Act requires all MAs to register with the Commission before engaging in municipal advisory activities. Exchange Act Rule 15Ba1-2 requires an MA applying for registration to file Form MA. In addition, subject to certain exemptions, the rule requires an MA to file a Form MA-I for each natural person associated with the municipal advisor and engaged in municipal advisory activities on its behalf. Exchange Act Rule 15Ba1-5 requires an MA to update its Form MA annually, within a specific time frame, and to amend it promptly whenever a material event has occurred that changes the information previously provided. The rule also requires a municipal advisor to amend Form MA-I promptly whenever information on the form becomes inaccurate for any reason. After registering with the Commission, an MA must register with the MSRB on MSRB Form A-12 and pay to the MSRB initial and annual registration fees, pursuant to MSRB Rule A-12. Municipal advisors are also required to affirm the Form A-12 annually during the "Annual Affirmation Period" pursuant to MSRB Rule A-12(k) and update it within 30 days of any of the information on the form becoming inaccurate.

Observations. There was significant overlap between the types of registration and filing deficiencies and weaknesses observed in the 2017 Risk Alert and those that continue to be the most commonly observed deficiencies and weaknesses in recent examinations from which this Risk Alert draws:

- *Filings with Inaccurate, Incomplete, or Inconsistent Information.* The staff observed municipal advisors that filed their SEC Forms MA and MA-I with inaccurate or incomplete information, including with respect to information about an MA's affiliates, solicitation activities, other businesses, and the types of activities the MA engaged in with respect to municipal securities. For Form MA-I, there were municipal advisors that did not include accurate or complete information about their associated persons' other business and required disclosures such as customer complaints and tax liens. In addition, the staff observed MAs that provided information on SEC Form MA that was inconsistent with information provided on MSRB Form A-12.
- *Failure to Amend and Untimely Amendments.* The staff observed municipal advisors that did not file amendments to SEC Forms MA and MA-I and MSRB Form A-12 when information became inaccurate or when material events occurred, or did not file amendments in a timely manner. For example, there were MAs that did not amend their Form MA to reflect changes concerning ownership and disciplinary disclosures. Similarly, the staff observed MAs that did not amend Form MA-I to reflect changes in an associated person's employment or other business, or to add new disclosures involving civil judicial actions or judgment or liens. The staff also observed municipal advisors that did not amend their Form A-12 to reflect changes in items such as contact information and business activities.

- *Annual Filing Requirements.* The staff observed municipal advisors that (1) did not file annual updates to their SEC Form MA, in some instances for multiple years and/or (2) did not review, update, and affirm the information in MSRB Form A-12 on an annual basis.
- *MSRB Fees.* The staff observed municipal advisors that did not pay the required MSRB initial and annual registration fees.

B. Recordkeeping

Regulatory Framework. Exchange Act Rule 15Ba1-8 requires MAs to make and keep certain books and records for specified periods of time. MSRB Rules G-8 and G-9 further specify certain books and records that MAs must make and the periods of time that required books and records must be preserved, respectively.

Observations. The staff continues to observe deficiencies and weaknesses related to books and records requirements similar to those highlighted in the 2017 Risk Alert. For example, the staff observed municipal advisors that did not make or keep true, accurate, and current copies of some of the books and records required by the rules, or did not preserve such records, including in the following categories:

- Originals or copies of written communications relating to municipal advisory activities, particularly electronic communications, such as emails relating to municipal advisory activities that were sent from a personal email address, text messages on mobile devices, and instant messages.
- Financial or accounting documents, including cash reconciliations and general ledgers.
- Records concerning compliance with the MSRB's MA supervision and compliance rule (MSRB Rule G-44), including records of annual certifications and designations of chief compliance officers.
- Written consents to service of process from natural persons associated with the MA who engage in municipal advisory activities solely on behalf of such MA.
- Copies of documents created by the MA that were material to making a recommendation to a municipal entity or obligated person.
- Written agreements entered into by the MA with municipal entities and their employees, obligated persons, or otherwise relating to the MA's business.

C. Supervision

Regulatory Framework. MSRB Rule G-44 requires MAs to establish, implement, and maintain a system to supervise the MA activities of the municipal advisor and its associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations, including MSRB rules. An MA's supervisory system must provide for the establishment, implementation, maintenance, and enforcement of written supervisory procedures ("WSPs") that are reasonably designed to ensure that the conduct of the municipal advisory activities of the MA and its associated persons are in compliance with applicable rules. In addition, the WSPs must take into consideration factors such as the MA's size and organizational structure; nature and scope of municipal advisory activities; likelihood that associated persons may be engaged in relevant outside business activities; and any indicators of irregularities or misconduct.

Subject to certain exceptions, a municipal advisor's chief executive officer (or equivalent) must certify, annually, in writing that the MA has in place processes to establish, maintain, review, test, and modify written compliance policies and WSPs reasonably designed to achieve compliance with applicable rules. In addition, the rule requires an MA to designate one or more municipal advisory principals to be responsible for the supervision required by the rule and to designate an individual to serve as its chief compliance officer.

Observations. The staff continued to observe deficiencies relating to supervision, including many of the same types observed in the 2017 Risk Alert. Specifically, some of the most common deficiencies the staff observed related to the following topics:

- *Failure to Establish, Amend, or Design WSPs.* The staff observed municipal advisors that did not have any WSPs. Other MAs did not promptly amend their WSPs to reflect changes to applicable rules, such as the adoption of MSRB Rule G-42—which, among other things, establishes duties of care and loyalty and governs conflicts of interest and is discussed in the following section—and the MA advertising rule (MSRB Rule G-40, which became effective in 2019). In addition, WSPs appeared not to be reasonably designed, or were not implemented and enforced, to ensure compliance with applicable rules, including rules relating to gifts, gratuities, and expenses; the preservation of electronic communications; and the filing and updating of required forms. The staff also observed municipal advisors whose WSPs did not take into consideration their organizational structure, nature of their municipal advisory activities, or the relevant outside business activities of their associated persons.

- *Annual Reviews and Certifications.* The staff observed MAs that did not conduct required at-least-annual reviews of their WSPs and MAs whose chief executive officers did not annually certify, in writing, that the MAs had in place processes to establish, maintain, review, test, and modify WSPs.

D. Disclosure to Clients (MSRB Rule G-42)

Regulatory Framework. Among other things, MSRB Rule G-42 requires that before or upon engaging in municipal advisory activities, an MA must provide to its municipal entity or obligated person client full and fair disclosure, in writing, of all material conflicts of interest. The disclosure must be sufficiently detailed to inform the client of the nature, implications, and potential consequences of each conflict and include an explanation of how the MA addresses or intends to manage or mitigate each conflict. An MA that concludes it has no known material conflicts of interest based on the exercise of reasonable diligence must provide a written statement to the client to that effect. If a conflict cannot be managed or mitigated in a manner that permits the municipal advisor to act in the client's best interest, the municipal advisor must not engage in municipal advisory activity for that client.[4]

In addition, an MA must evidence each of its municipal advisory relationships by documents created and delivered to the municipal entity or obligated person client before, upon, or promptly after the establishment of the relationship. The rule specifies the minimum elements that must be included in the documentation, including but not limited to the scope of the municipal advisory activities to be performed and any limitations on the scope of the engagement. An MA must promptly amend or supplement relationship documents to reflect any material changes or additions and promptly deliver any amendment or supplement to the client.

<u>Observations.</u> The most often cited deficiencies and weaknesses under MSRB Rule G-42 included:

- *No Disclosure of Conflicts.* The staff observed municipal advisors that did not disclose in writing to their clients all material conflicts of interest including, for example, conflicts regarding:
    - The nature of relationships between the MA and other MAs that shared a common client; between the MA and other relevant parties, such as underwriters or other parties providing services to or on behalf of a municipal entity client; or between the MA and the municipal entity client itself.
    - Fee-splitting arrangements involving the municipal advisor.
    - Compensation for municipal advisory activities that was contingent on the closing of the transaction or the size of the transaction.
- *No Statement of Lack of Known Conflicts.* The staff observed municipal advisors that did not provide their clients with written statements that the MA has no known material conflicts of interest (where applicable).
- *Inadequate Documentation of Relationship.* The staff observed municipal advisors that did not document their advisory relationships, did not include in their documentation all of the required elements, or did not promptly amend or supplement such documents to reflect material changes.
- *Untimely Documentation or Disclosure.* The staff observed MAs that did not provide the required conflicts disclosure or documentation of municipal advisory relationship prior to or upon engaging in municipal advisory activities, or promptly after establishment of the relationship, as required by the rule.

[4] *See* Supplementary Material .02 to Rule G-42—Duty of Loyalty.

Conclusion

In sharing the information in this Risk Alert, EXAMS encourages municipal advisors to review their practices, policies, and procedures in these areas and to consider improvements in their compliance programs, as may be appropriate.

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.

RISK ALERT
DIVISION OF EXAMINATIONS

October 26, 2021

Observations from Examinations in the Registered Investment Company Initiatives*

I. Introduction

The Division of Examinations (the "Division") conducted a series of examinations that focused on mutual funds and exchange-traded funds (collectively, "funds") to assess industry practices and regulatory compliance in certain areas that may have an impact on retail investors ("RIC Initiatives" or "Initiatives"). The RIC Initiatives were announced in a Risk Alert in November 2018 and included in the Division's fiscal year 2019 priorities.[1] The RIC Initiatives focused on funds and/or their investment advisers ("advisers") that fell into one or more of the following six categories: (1) index funds that track custom-built indexes; (2) smaller ETFs and/or ETFs with little secondary market trading volume; (3) mutual funds with higher allocations to certain securitized investments; (4) mutual funds with aberrational underperformance relative to their peer groups; (5) mutual funds managed by advisers that are relatively new to managing such funds; and (6) advisers that provide advice to both mutual funds and private funds, both of which have similar strategies and/or are managed by the same portfolio managers.

This Risk Alert provides observations made by Division staff during examinations conducted under the RIC Initiatives, including examinations of more than 50 fund complexes – covering more than 200 funds and/or series of funds – and nearly 100 advisers. In conducting these examinations, the Division issued deficiency letters to some firms, while other firms did not receive deficiency letters. However, the Division believes the observations in this Risk Alert can assist all funds in assessing compliance risks. The more frequent deficiencies and weaknesses are summarized below. This Risk Alert is intended to highlight risk areas and assist funds and their advisers in developing and enhancing their compliance programs and practices.

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* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). 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 Division staff and is not legal advice.

[1] *See* Division, Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies (Nov. 8, 2018) and Division, 2019 Examination Priorities (December 18, 2018).

II. Focus of Initiatives

The scope of the examinations and focus areas selected for review were tailored to address the business practices, risks, and conflicts applicable to each of the six categories. However, across all examinations the staff generally assessed:

- *Effectiveness of the compliance policies and procedures of the funds and their advisers* to address certain risks – particularly in the areas of disclosures, portfolio management compliance, and conflicts of interest – and the efficacy of the oversight of funds' compliance programs by funds' boards.[2]

- *Disclosures by the funds to investors* in their prospectuses and other filings and shareholder communications, and by advisers to the funds' boards, regarding risks and conflicts in the highlighted areas.[3]

- *Fund governance practices*, particularly as they relate to the deliberative processes utilized by funds and funds' boards when exercising oversight of funds' compliance programs and assessing the practices and controls related to risks in the highlighted areas.[4]

III. Staff Observations from the Examinations

A. Compliance Program

Below are examples of deficiencies or weaknesses observed by the staff related to funds' and their advisers' compliance programs for portfolio management and other business practices, and board oversight of funds' compliance programs.

- *The staff observed funds and their advisers that did not establish, maintain, update, follow and/or appropriately tailor their compliance programs to address various business practices, including portfolio management, valuation, trading, conflicts of interest, fees and expenses, and advertising.* Examples include inadequate policies and procedures in the following areas:

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2 *See* Investment Company Act of 1940 ("IC Act") Rule 38a-1 and Investment Advisers Act of 1940 ("Advisers Act") Rule 206(4)-7. *See also* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IC-26299 (Dec. 17, 2003). Funds and advisers should adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws and the Advisers Act, respectively. Fund compliance programs should also include policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund (collectively, "service providers").

3 *See*, generally, IC Act Section 34(b), Securities Act of 1933 ("Securities Act") Section 17(a), Securities Exchange Act of 1934 Section 10(b), and Advisers Act Section 206(4) and Rule 206(4)-8 thereunder. Under the federal securities laws, it is unlawful to make untrue statements of material fact, or omit material information necessary to make other statements not misleading in registration statements, reports, and other documents filed with the Commission or provided to investors.

4 Each fund is required to have a board of directors, which is elected by shareholders to represent their interests. *See*, generally, IC Act Section 24(a) (requires a fund to file a registration under the Securities Act), Securities Act Section 6(a) (requires that a majority of the fund's directors sign the fund's registration statement), and IC Act Section 16(a) (requires that a director of a fund be elected by shareholders). A fund board's primary responsibility is to protect the interest of the fund and its shareholders, which may be adversely affected by any substantial ongoing conflicts of interest of the fund's investment adviser.

Compliance Oversight of Investments and Portfolios

- Monitoring for portfolio management compliance, including monitoring compliance requirements regarding trade aggregation, trade allocation and best execution, and senior securities and asset segregation.[5]

- Monitoring for adherence to each fund's specific investment restrictions (*e.g.*, investment concentration restrictions, limitations on investments in alternative investments, and/or restrictions on lower-rated securities).

- Monitoring for the specific risks associated with each fund's investments such as asset classes that present certain operational or other risks.

- Monitoring portfolios for compliance with the "Fund Names Rule," as applicable.[6]

- Addressing the administration of each fund's liquidity risk management program ("LRMP") and providing appropriate oversight of third-party vendors providing liquidity classifications of holdings for purposes of the funds' LRMP.[7]

- Providing appropriate oversight of the viability of smaller and/or thinly traded ETFs and oversight of their liquidation, as applicable, including communications with their shareholders.

Compliance Oversight of Valuation

- Maintaining an adequate compliance program for valuation of portfolio securities, including processes, controls, or both, that provide for due diligence and oversight of pricing vendors that provide evaluated prices for portfolio holdings for purposes of

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5 The Commission recently adopted new Rule 18f-4 for derivatives use by funds, which has a compliance date of August 19, 2022 (*see* Final Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (Nov. 2, 2020)). Prior to the compliance date for this new Rule, funds may choose to comply with Rule 18f-4 voluntarily, provided they no longer consider existing Commission and staff guidance and no-action letters that will be withdrawn on the compliance date.

6 *See also* IC Act Section 35(d) and Rule 35d-1 (requiring a fund to invest at least 80% of its net assets, plus any borrowings for investment purposes, in the particular type of investments, or in investments in the particular industry or industries, suggested by the fund's name).

7 *See* IC Act Rule 22e-4. *See also* Final Rule: Investment Company Liquidity Risk Management Programs, Release No. IC-32315 (Oct. 13, 2016). Open-end funds, including ETFs but not money market funds, are required to establish a written liquidity risk management program under Rule 22e-4 that will be overseen by the fund's board. Funds are required to classify the liquidity of each portfolio investment into one of four liquidity categories based on the number of days the fund reasonably expects the investment would be convertible to cash (or, in the case of the less-liquid and illiquid categories, sold or disposed of) without the conversion (or, in the case of the less-liquid and illiquid categories, sale or disposition) significantly changing the market value of the investment.

calculating the funds' daily net asset values.[8]

- Maintaining appropriate policies, procedures and/or controls for valuation of portfolio securities, including provisions that address potential conflicts and issues, such as where portfolio managers are permitted to provide input – as voting members of the valuation committee – on prices of securities in funds they managed.

Compliance Oversight of Trading Practices

- Addressing appropriate trade allocation among client accounts so that all clients are treated fairly, including instances where trades for fund clients are aggregated with trades for other client accounts, including sub-advised funds, wrap accounts, and other non-wrap client accounts.

- Preventing prohibited principal transactions with affiliates, prohibited joint transactions with affiliates, or both.[9]

- Identifying cross trades and preventing related violations of the legal requirements for cross trading and principal trading under the Advisers Act and the IC Act.[10]

- Addressing sharing of soft dollar commissions among clients to assess whether any client is disadvantaged.

Compliance Oversight of Conflicts of Interest

- Addressing advisers' conflicts of interest with funds and their service providers, such as certain "dual capacity" instances where the adviser to an index fund also acts as the index provider.

- Reviewing index providers and the services they provide for, among other things: (1) conflicts of interest with advisers, such as when they share personnel, are affiliated, and/or have business arrangements (*e.g.*, marketing support payments by index providers to advisers and/or revenue sharing payments by advisers to index providers); and (2) the sharing, or the potential misuse, of material non-public information.

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8 Examples of due diligence and oversight processes concerning pricing vendors include, but are not limited to, processes for reviewing variance reports on stale or outlier prices and formal price challenges. *See* Division of Investment Management, Valuation Guidance Frequently Asked Questions ("FAQs") (Feb. 11, 2016) and Final Rule: Money Market Fund Reform; Amendments to Form PF ("money market reforms release"), Rel. No. IC-31166 (July 23, 2014) regarding oversight of mutual fund pricing service providers (FAQs provide responses to questions related to valuation guidance for all mutual funds provided in the money market reforms release). *See also* IC Act Rule 2a-5 and Final Rule: Good Faith Determinations of Fair Value, Rel. No. IC-34128 (Dec. 3, 2020) (adopting Rule 2a-5). New Rule 2a-5, which has a compliance date of Sept. 8, 2022, updates the regulatory framework on valuation practices and a board of director's role in valuating securities of a registered investment company or business development company. Under this new regulatory framework, funds may choose to comply with Rule 2a-5 voluntarily prior to the compliance date, provided they no longer consider Commission and staff guidance and no-action letters that will be withdrawn on the compliance date.

9 *See* IC Act Sections 17(a) and 17(d), respectively.

10 *See* Advisers Act Section 206(3) and IC Act Section 17(a). The staff also observed cross trades where the funds did not comply with the requirements under IC Act Rule 17a-7 (if certain conditions are met, Rule 17a-7 permits trades between a fund and certain affiliated persons, where the affiliation arises solely because the two have a common adviser, directors, and/or officers).

Compliance Oversight of Fees and Expenses

- o Monitoring allocation of expenses between funds and their advisers, subject to any fee waivers by the adviser.

- o Reviewing fee calculations for any inconsistencies between a fund's contractual expense limitation and its disclosures regarding expenses included in operating expenses, subject to the expense cap.

Compliance Oversight of Fund Advertisements and Sales Literature

- o Reviewing and filing fund advertisements and sales literature, including review of fee and expense disclosures for whether they are fair, balanced and not misleading within the context in which they are made,[11] and, as applicable, the presentation of back-tested index returns (*e.g.*, the characteristics of back-tested index returns when compared to a fund's actual returns).

- o Reviewing affiliated index providers' websites – accessible through hyperlinks in the statements of additional information ("SAIs") of self-indexing funds – to assess whether the websites may be deemed fund sales literature that should be filed with the Commission or FINRA.[12]

- *The staff observed issues with funds' policies and procedures for their boards' oversight of the funds' compliance programs*. For example, the staff observed funds that did not:

  - o Have appropriate policies, procedures and processes for monitoring and reporting to their boards with accurate information, such as information regarding: (1) fees paid by the funds to financial intermediaries and other service providers for providing shareholder services; (2) the type of services provided by service providers; (3) pricing exceptions under the funds' valuation policies and procedures; (4) adviser's recommendation whether a fund's liquidation may be in the best interests of the fund and its shareholders;[13] and (5) portfolio compliance with senior securities and asset coverage requirements.[14]

  - o Provide appropriate processes as part of the respective fund board's annual review and approval of the fund's investment advisory agreement under Section 15(c) of the IC Act

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11 *See* FINRA Rule 2210(d).

12 *See* IC Act Section 24(b) and Rule 24b-3 (making it unlawful for any registered open-end investment company to transmit any advertisement, pamphlet, circular, form letter or other sales literature addressed to or intended for distribution to prospective investors unless the material has been filed with the Commission; filing of such material with FINRA is deemed to be filing with the Commission). *See also* SEC Interpretation: Use of Electronic Media, Investment Company Act Rel. No. IC-24426 (April 28, 2000) and Commission Guidance on the Use of Company Websites, Investment Company Act Rel. No. IC-28351 (August 1, 2008).

13 Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers, which includes both a duty of care and a duty of loyalty. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (Jun. 5, 2019).

14 *Supra* note 6.

regarding the board's considerations as to whether the adviser has any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients.[15]

  - Complete required annual reviews of the funds' compliance programs that address the adequacy of policies and procedures and effectiveness of their implementation.[16]

  - Ensure that the annual report from the respective fund's chief compliance officer addressed the operation of the policies and procedures of the fund's adviser,[17] including whether the adviser had policies and procedures in specific risk areas.

  - Adopt or maintain appropriate policies and procedures for the funds' boards to exercise appropriate oversight in instances where the funds' delegated responsibilities to their advisers that were not reflected in the advisers' compliance programs.[18]

B. Disclosure to Investors

Below are examples of deficiencies or weaknesses observed by the staff related to the funds' disclosures to investors in fund filings, advertisements, sales literature and/or other shareholder communications.

- *The staff observed funds had inaccurate, incomplete and/or omitted disclosures in their filings*. Examples include:

  - Omitted disclosures regarding: (1) certain principal investment strategies and/or risks of investing in the funds;[19] (2) potential conflicts associated with allocating investment opportunities among overlapping investment strategies;[20] and (3) change in the broad-

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15 *See* IC Act Section 15(c). For example, the board's considerations may include review of the adviser's responses to the 15(c) questionnaire provided to the adviser by counsel to the fund and/or counsel to the fund's independent directors.

16 *See* IC Act Rule 38a-1(a)(3).

17 *See* IC Act Rule 38a-1(a)(4)(iii)(A). The staff also observed a number of instances of inaccurate Form ADV disclosures by advisers, including: (1) disclosure of investment allocation practices and trade monitoring practices inconsistent with actual practices; (2) inadequate disclosure of differences between a private fund and a mutual fund with similar, if not identical, investment strategies and overlapping investment managers; (3) omission of sub-advised funds from the investment company advisory business; (4) omission of certain advisory client accounts over which the adviser or a related person had custody; (5) failure to disclose change in ownership following spin-off of broker-dealer affiliate; and/or (6) inaccurate disclosure concerning receipt of soft dollar benefits.

18 The staff also observed advisers that did not have annual reviews of their compliance program that were consistent with Advisers Act Rule 206(4)-7(b).

19 *See* Item 9(b)(1) of Form N-1A, which requires a fund to disclose its principal investment strategies (including the type or types of securities in which the fund invests or will invest principally). Instruction 2 to Item 9(b)(1) of Form N-1A states that a fund shall, in determining whether a strategy is a principal investment strategy, consider, among other things, the amount of the fund's assets expected to be committed to the strategy, the amount of the fund's assets expected to be placed at risk by the strategy, and the likelihood of the fund's losing some or all of those assets from implementing the strategy. *See also* Item 9(c) of Form N-1A, which requires a fund to disclose the principal risks of investing in the fund, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return.

20 The staff also observed instances where advisers that managed mutual funds and private funds with similar strategies or were managed by the same portfolio managers did not disclose conflicts, including failure to disclose conflicts associated with their allocation of investment opportunities. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (Jun. 5, 2019).

based indexes used for comparison of funds' performance.[21]

- o Inconsistent and/or inaccurate disclosure concerning the funds' net assets and net expense ratios, contractual expense limitations, and/or operating expenses subject to the contractual expense limitation.

- o Did not disclose in the funds' SAIs required information concerning standing committees of a fund's board and accurate information regarding the number of accounts and total assets managed by the portfolio managers within each of the required categories.[22]

- *The staff observed funds that had inaccurate, incomplete, and/or omitted disclosures on a variety of advertising and sales literature-related topics*, such as: (1) investment strategies and portfolio holdings; (2) the differences in investment objective between predecessor and successor funds; (3) inception dates; (4) funds' expenses, contractual expense limitations, and/or expense ratios; (5) average total returns and/or gross expenses and net expenses;[23] (6) performance information not disclosed with the required legends;[24] (7) awards received for fund performance;[25] (8) weighting of index constituents in the benchmark index; (9) methodologies for calculating the performance of the benchmark index; (10) differences in holdings, risk, and volatility between the broad-based and bespoke indexes used for performance comparisons; and/or (11) composition of index used for performance comparisons.

C. Staff Observations Regarding Compliance and Disclosure Practices

The staff observed various practices with respect to funds' and their advisers' compliance programs, the boards' oversight of funds' compliance programs, and disclosure practices that funds and their advisers may find helpful in their compliance oversight practices. Below is a sampled list of practices that may assist funds and their advisers in designing and implementing their compliance programs.

- *Certain funds and their advisers adopted and implemented compliance programs that provided for the following:*

  - o Review of compliance policies and procedures for consistency with practices (*e.g.*, funds reviewed their advisers' compliance manuals for specific policies and procedures addressing various risk areas for which the funds had delegated responsibility to their

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21 *See* Instruction 2(c) of Item 4 of Form N-1A.

22 *See* Item 17(b)(2) and Item 20 of Form N-1A, respectively (Item 20 requires accounts and assets managed information by the following three categories: registered funds, other pooled investment vehicles, and other accounts).

23 *See* Securities Act Rule 482(d)(5) (requires that total returns and any non-standardized performance be disclosed with equal prominence). *See* FINRA Rule 2210(d)(5) and FINRA Notice to Members 06-48, "SEC Approves Amendments to NASD Rules 2210 and 2211 to Require Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material" (gross and any net operating expense ratios should be disclosed in a fair and balanced manner).

24 Securities Act Rule 482(b)(3).

25 The staff observed instances where funds did not disclose material facts regarding awards received for fund performance, *e.g.*, the selection criteria for the award, the amount of any fee paid by the adviser to receive or promote the award, the number of other funds that applied and received the award, or whether the adviser was required to be a member of an organization to receive the award.

advisers).

- Conducting periodic testing and reviews for compliance with disclosures (*e.g.*, review whether funds are complying with their stated investment objectives, investment strategies, restrictions, and other disclosures) and assess the effectiveness of compliance policies and procedures in addressing conflicts of interests (*e.g.*, review trade and expense allocation policies and procedures in light of potential conflicts that may exist among the various types of accounts managed by the adviser).

- Ensuring compliance programs adequately address the oversight of key vendors, such as pricing vendors (*e.g.*, written pricing vendor oversight processes include reviewing variance reports on stale or outlier prices and price challenges).

- Adopting and implementing policies and procedures to address: (1) compliance with applicable regulations (*e.g.*, to identify cross trades, where applicable, and prevent related violations); (2) compliance with the terms and conditions of applicable exemptive orders and any disclosures required to be made under the order; and (3) undisclosed conflicts of interest, including potential conflicts between funds and/or advisers and their affiliated service providers.

- *Certain funds' boards provided oversight of funds' compliance programs by assessing whether:*

  - The information provided to the board was accurate, including whether funds' and their advisers were accurately disclosing to the boards: (1) funds' fees, expenses and performance, and (2) funds' investment strategies, any changes to the strategies, and the risks associated with the respective strategies.

  - The funds were adhering to their processes for board reporting, including an annual review of the adequacy of the funds' compliance program and effectiveness of their implementation.

- *Certain funds adopted and implemented policies and procedures concerning disclosure, such as those that required:*

  - Review and amendment of disclosures in funds' prospectuses, SAIs, shareholder reports or other investor communications consistent with the funds' investments and investment policies and restrictions.

  - Amendment of disclosures for consistency with actions taken by the funds' boards, as applicable.

  - Update of funds' website disclosures concurrently with new or amended disclosures in funds' prospectuses, SAIs, shareholder reports or other client communications.

  - Review and testing of fees and expenses disclosed in funds' prospectuses, SAIs, shareholder reports or other client communications for accuracy and completeness of presentation.

- Review and testing of funds' performance advertising for accuracy and appropriateness of presentation and applicable disclosures.

III. Conclusion

In response to these observations, many of the funds and their advisers revised their compliance policies and procedures, amended disclosures, or changed certain practices. In sharing the information in this Risk Alert, the Division encourages funds and their advisers to review their practices, policies, and procedures in these areas and to consider improvements in their compliance programs and disclosure practices, as appropriate.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) 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.

RISK ALERT
DIVISION OF EXAMINATIONS

November 9, 2021

Observations from Examinations of Advisers that Provide Electronic Investment Advice*

I. Introduction

Advisers have been providing automated digital investment advisory services to retirement plan participants and retail investors for more than two decades; however, the Division of Examinations ("Division") has recently observed a significant increase in the number of investment advisers choosing to provide automated digital investment advisory services to their clients. These advisers either exclusively provide online services or supplement their traditional investment advisory services by using proprietary software, third party software, or a combination thereof. Millions of investors, individually and through their employer-sponsored retirement plans, now entrust their savings to advisers that provide their investment advisory services online, via mobile applications, or both (also known as robo-advisers).

The use of automated digital investment advisory services ("robo-advisory services") can have important investor protection implications. On the one hand, automation can offer significant benefits, including providing convenient, accessible, and lower cost services for investors and enhancing operational efficiency for advisers. When robo-advisers fail to comply with their regulatory obligations, however, investors may experience poor outcomes. If, for example, a robo-adviser's client survey process does not appropriately capture a client's risk tolerance, it could result in advice to invest in securities that are not aligned with the client's best interest. Similarly, if a robo-adviser is programmed to act on conflicts of interest that raise the costs or decrease the quality of the services provided, the client may be harmed as a result of the adviser's putting its own interests ahead of its clients.

The Division conducted a series of examinations to assess the practices of advisers providing robo-advisory services.[1] Under its Electronic Investment Advice Initiative (the "Initiative" or "eIA

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* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). 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 Division staff and is not legal advice.

1 The Division previously focused on examining advisers that provide advisory services through the Internet, including prior to the adoption of the exemption from the prohibition on Commission registration for Internet advisers pursuant to Advisers Act Rule 203A-2(e) (the "Internet adviser exemption") (*See* Exemption for Certain Investment Advisers Operating Through the Internet, Advisers Act Rel. No. 2091 (Dec. 12, 2002) ("IA-2091")). There is no standard industry nomenclature to describe advisers that provide electronic advisory services. The term "Internet adviser" herein refers to robo-advisers that registered with the Commission in reliance on this exemption. In addition, the Division's observations from multiple robo-adviser examinations were considered when drafting the guidance published by the SEC's Division of Investment Management ("Investment Management") on robo-advisers and informed the development of the Initiative's scope (*See* Investment Management, Guidance Update: Robo-Advisers (Feb. 23, 2017)

Initiative"), the staff sought to obtain a better understanding of how robo-advisers were operating their firms, providing advisory services to retail and institutional clients, and satisfying their regulatory obligations under the Investment Advisers Act of 1940 ("Advisers Act"). In particular, the staff focused on how robo-advisers were upholding their fiduciary duty to: (1) provide clear and adequate disclosure regarding the nature of the advisers' services and performance history; and (2) act in their clients' best interests.

The purpose of this Risk Alert is to raise awareness of certain compliance issues the Division observed while conducting examinations of advisers providing, or claiming to provide, robo-advisory services, including advisers that operate, recommend, or sponsor discretionary investment advisory programs.[2]

In order to gain a broad understanding of the industry, the Division selected advisers to examine under the eIA Initiative that had different business models, client types, investment practices, assets under management, and bases for SEC-registration. The examined advisers: (1) provided robo-advisory services to employer-sponsored retirement plans ("retirement plans") and/or retail investors, including retirement plan participants; (2) sold, licensed, or otherwise granted interactive, digital platform access to third parties, such as advisers, broker-dealers, and banks; and/or (3) provided advisory or sub-advisory services to an interactive, digital investment platform.

II. Examination Focus and Relevant Regulations

A. Provision of Electronic Investment Advice

Examinations focused on the advisers' robo-advisory practices in several areas. In addition to a broader review of these advisers' adherence to their fiduciary duty,[3] the staff specifically examined the advisers':

- *Compliance programs* to assess whether compliance policies and procedures, particularly those related to the provision of robo-advisory services, were adopted, implemented, reasonably designed, and tested at least annually.[4]

("Guidance") for additional information). The eIA Initiative included Internet advisers as well as other advisers that provided electronic investment advice either exclusively or in addition to traditional investment advisory services (together, "advisers").

2 Discretionary investment advisory programs may raise implications under the Investment Company Act of 1940 ("Company Act"). *See* Final Rule: Status of Investment Advisory Programs under the Investment Company Act of 1940 ("Adopting Release"), Company Act Release No. 22579 (Mar. 24, 1997) (although investment advisory programs are typically sponsored by investment advisers, Rule 3a-4 is available to any investment advisory program, regardless of whether the sponsor, for example, is excepted from the definition of investment adviser, such as a bank, or is required or permitted to be registered under the Advisers Act). For this Risk Alert, the use of "operate" or "operating" includes advisers that operate a discretionary investment advisory program, recommend such a program, or both.

3 *See*, *e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (Jun. 5, 2019) ("Fiduciary Release") ("[T]he duty of care requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives… The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. In other words, an… adviser must not place its own interest ahead of its client's interests."). The Commission has recently brought an action against a robo-adviser that did not uphold its duties of loyalty and care. *See* In re SoFi Wealth, LLC, Advisers Act Rel. No. 5826 (Aug. 19, 2021) (settled) (alleging that the adviser harmed clients by investing in certain affiliated securities and lacked written policies and procedures designed to prevent such harm).

4 Advisers Act Rule 206(4)-7 ("the Compliance Rule") requires SEC-registered advisers to adopt, implement, and annually review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and rules thereunder by advisers and their supervised persons. *See also* Compliance Programs of Investment Companies and Investment

- *Formulation of investment advice* to evaluate whether advisers gathered sufficient information from clients to form a reasonable belief that clients were receiving investment advice that was in their best interest based on each client's financial situation and investment objectives.[5] Where applicable, the staff also reviewed conflicts of interest disclosures and "customization" representations for adequacy and accuracy.[6]

- *Marketing and performance advertising practices* for compliance with the "Advertising Rule."[7] Also, if relevant, the staff reviewed whether the advertised securities selection and portfolio management techniques were used when managing client accounts.

- *Data protection practices* to understand the firms' policies and procedures regarding client data protection, including cybersecurity practices.[8]

- *Registration information* to determine whether the advisers were eligible for SEC registration as investment advisers.

B. Use of Discretionary Investment Advisory Programs

Advisers that provide electronic investment advice may also sponsor or operate investment advisory programs, including for example, wrap fee programs and asset allocation programs that allocate client assets among mutual funds or exchange-traded funds. These programs are designed to provide the same or substantially similar professional portfolio management services to a large number of individual clients ("retail clients") and are commonly used to manage retail clients'

Advisers, Advisers Act Rel. No. 2204 (Dec. 17, 2003) ("IA-2204") ("Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns."). In the context of this Initiative, staff reviewed advisers' practices, policies, and procedures addressing, among other things, advisers' fiduciary duty to: (1) act in their clients' best interest; (2) not place their interests ahead of their clients' interests; and (3) make adequate and accurate disclosures.

5 *See* Advisers Act Section 206 (anti-fraud provision that imposes a fiduciary duty on advisers). *See also* supra Fiduciary Release at note 3 ("[I]n order to avoid liability under this antifraud provision, an investment adviser should have sufficient information about the prospective client and its objectives to form a reasonable basis for advice before providing any advice about these matters.").

6 *See* supra Guidance at note 1 (information must be presented in a manner that clients are likely to read, if in writing, and understand).

7 Advisers Act Rule 206(4)-1 ("Advertising Rule") prohibits any adviser that is registered or required to be registered under the Advisers Act from, among other things, using any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading. The Commission recently adopted amendments to the Advertisements Rule, creating a merged rule (the "Marketing Rule") that will replace the existing Advertising Rule and Rule 206(4)-3 (addresses cash solicitations). The Marketing Rule became effective on May 4, 2021, and has a compliance date of November 4, 2022. The staff anticipates that some advisers may seek to comply with the new marketing rule in advance of the compliance date. In conjunction with these amendments, the Commission adopted amendments to Form ADV, to provide the Commission with additional information about advisers' marketing practices, and Rule 204-2 (requires advisers to make and keep certain books and records). *See* Investment Adviser Marketing, Advisers Act Rel. No. 5653 (Dec. 22, 2020) ("IA-5653").

8 *See* Privacy of Consumer Financial Information (Regulation S-P), Advisers Act Rel. No. 1883 (Jun. 22, 2000) (adopting rules implementing the privacy provisions of Subtitle A of Title V of the Gramm-Leach-Bliley Act with respect to financial institutions regulated by the SEC) ("Regulation S-P Release") and Identity Theft Red Flags Rules, Advisers Act Rel. No. 3582 (Apr. 10, 2013) ("Regulation S-ID Release") (adopting rules and guidelines to require certain regulated entities to establish programs to address risks of identity theft). *See also* Division (published as OCIE) Report on Cybersecurity and Resiliency Observations (Jan. 27, 2020).

individual accounts and retirement plans (*e.g.*, 401(k) plans) on a discretionary or nondiscretionary basis.

Certain discretionary investment advisory programs may meet the definition of an "investment company" under the Company Act.[9] To address this concern, the Commission adopted Company Act Rule 3a-4 as a nonexclusive safe harbor.[10] An investment adviser that sponsors or operates a discretionary investment advisory program should consider the program's status under the Company Act. Furthermore, if the program intends to rely on the Rule 3a-4 safe harbor, then the program's sponsor or operating adviser should consider whether the program is in compliance with the Rule's conditions.[11]

Where advisers recommended discretionary investment advisory programs, the staff reviewed whether such programs could be considered investment companies pursuant to the Company Act. More specifically, the staff inquired as to whether the advisers were aware of how these programs were organized and whether they were being operated in accordance with the nonexclusive safe harbor provided by Rule 3a-4.

III. Staff Observations

Nearly all of the examined advisers received a deficiency letter, with observations most often noted in the areas of: (1) compliance programs, including policies, procedures, and testing; (2) portfolio management, including, but not limited to, an adviser's fiduciary obligation to provide advice that is in each client's best interest; and (3) marketing/performance advertising, including misleading statements and missing or inadequate disclosure. The staff also observed, among other things,

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9 The Commission has indicated that discretionary investment advisory programs that provide each client with individualized treatment and the ability to maintain indicia of ownership of the securities in their accounts are not investment companies. *See* Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice, Advisers Act Rel. No. 5833 (Aug. 27, 2021). *See also* supra Guidance at note 1 ("[R]obo-advisers should consider whether the organization and operation of their programs raise any issues under the other federal securities laws... in particular Rule 3a-4 under the… Company Act"). Company Act Section 3(a)(1) defines the term investment company generally to include any "issuer" that is engaged primarily in the business of investing, reinvesting, or trading in securities. The definition of "issuer" includes any organized group of persons, whether or not incorporated, that issues or proposes to issue any security. For a detailed discussion of why a discretionary investment advisory program may meet the definition of investment company and may be deemed to be issuing securities, *see* Status of Investment Advisory Programs under the Investment Company Act of 1940, Company Act Rel. No. 21260 (Jul. 27, 1995) (revised proposal of Rule 3a-4).

10 Rule 3a-4 only applies to discretionary investment advisory programs. *See* supra Adopting Release at note 2. ("A nondiscretionary program (*i.e.*, one in which the investor has the authority to accept or reject each recommendation to purchase or sell a security made by the portfolio manager, and exercises judgment with respect to such recommendations), generally will not meet the definition of investment company under the Investment Company Act or issue securities that are required to be registered under Section 5 of the Securities Act, regardless of whether the program is operated in accordance with the provisions of [R]ule 3a-4.").

11 *See* supra Adopting Release at note 2 ("Whether a program that operates outside of [R]ule 3a-4 is an investment company is a factual determination and depends on whether the program is an issuer of securities under the… Company Act and the Securities Act [of 1933]… [Rule 3a-4] is not intended… to create any presumption about a program that is not organized and operated in the manner contemplated by the [Rule]… Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice, whether or not the advice is provided to clients through an investment advisory program."). Rule 3a-4 is designed to address only the status of the program under the Company Act, not the obligations of any investment adviser under the Advisers Act. Accordingly, the steps required to meet the conditions to Rule 3a-4 may not satisfy an adviser's obligations under the Advisers Act, including its fiduciary obligations to clients participating in an investment advisory program. *See* supra Fiduciary Release at note 3.

advisers that were relying on, but not acting in accordance with, the Internet adviser exemption and Company Act Rule 3a-4. Additional details regarding these observations are described below.

A. Electronic Investment Advice

- *Compliance programs*. Most advisers had inadequate compliance programs, typically as a result of either a lack of written policies and procedures or having ones that were insufficient for their operations, unimplemented, or untested.[12] Specifically, the staff observed advisers that did not:

  - Include elements in their policies and procedures specific to their use of an online platform and/or other digital tools for the provision of investment advice, such as assessing whether the advisers': (1) algorithms were performing as intended; (2) asset allocation and/or rebalancing services were occurring as disclosed; and/or (3) data aggregation services did not impair the safety of clients' assets as a result of the adviser having direct or indirect access to clients' credentials (*e.g.*, pins and passwords).[13] Additionally, advisers using business-to-business platforms (*e.g.*, "white-label platforms") lacked policies and procedures that addressed the platform providers' attention to these matters.

  - Undertake a sufficient review of their policies and procedures at least annually to determine their adequacy, the effectiveness of their implementation, or both. For example, in addition to not addressing the above practices, many advisers did not detect inadequacies or non-compliance with their marketing and performance advertising practices, and several failed to recognize that certain practices constituted custody, causing the adviser to violate the "Custody Rule."[14]

  - Comply with the "Code of Ethics Rule."[15] For example, some advisers did not: (1) receive the required holdings and/or transaction reports from all access persons, typically because not all access persons had been identified; (2) obtain or maintain the required written acknowledgements from all supervised persons confirming receipt of the advisers' codes; and/or (3) include in their codes all required provisions.

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12 *See* supra IA-2204 at note 4 ("[A]n adviser should identify… factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.") *See also* supra Guidance at note 1 ("In developing its compliance program, a robo-adviser should be mindful of the unique aspects of its business model.").

13 Some robo-advisers offer data aggregation services, through which a client can view all or a portion of their personal financial information on the adviser's platform, such as outside bank and brokerage account information (e.g., assets, debt, transaction activity).

14 Advisers Act Rule 206(4)-2 requires advisers that are registered or required to be registered under the Advisers Act, and that have custody of their clients' funds or securities, to take several steps that are designed to safeguard those clients' assets against theft, loss, misappropriation, or financial reverses of the adviser. Advisers have custody if they hold, directly or indirectly, client funds or securities, or have the authority to obtain possession of them. Examples of an adviser that has indirect access or the authority to obtain possession of clients' funds or securities include a firm that has access to a client's log-in credentials, has personnel who serve as a trustee to a firm client, or accepts client checks for investment that are made payable to the adviser.

15 Advisers Act Rule 204A-1 requires any adviser that is registered or required to be registered under the Advisers Act to establish, maintain and enforce a code of ethics that, at a minimum, includes certain provisions. Among these are provisions requiring the adviser's access persons to: (1) report, and the adviser to review, their personal securities holdings and transactions; and (2) obtain pre-approval of certain investments from the adviser.

- *Portfolio management – oversight.*[16] Many advisers were not testing the investment advice generated by their platforms to clients' stated or platform-determined investment objectives or otherwise satisfying their duty of care. The staff observed advisers that:

    - Either lacked written policies and procedures that would allow the firms to develop a reasonable belief that the investment advice being provided to clients was in each client's best interest based on the client's objective, or adopted policies and procedures that were inadequate or not followed. A review of practices revealed that, while advisers commonly used questionnaires to collect client data, some firms relied on just a few data points to formulate investment advice. This raised the concern that the questions did not elicit sufficient information to allow the adviser to conclude that its initial and ongoing advice were suitable and appropriate for that client based on the client's financial situation and investment objectives.[17] In addition, many advisers did not periodically evaluate whether accounts were still being managed in accordance with the clients' needs, such as by inquiring about any changes in their financial situation or investment objectives or having clients update or retake their questionnaires.[18]

    - Lacked written policies and procedures related to the operation and supervision of their automated platforms, increasing the risk of algorithms producing unintended and inconsistent results (*e.g.*, due to coding errors or coding insufficient to address unforeseen or unusual market conditions, such as those caused by geo-political events, substantial oil price movements, or interest rate changes). The staff observed, among other things, rebalancing errors and other trade errors at firms that lacked adequate oversight of their automated platforms.

    - Lacked written policies and procedures to prevent violations of legal requirements related to their duty to seek best execution. For example, some advisers did not conduct, or document the details of, a best execution review, while others did not appear to be aware of their best execution obligations at all.

- *Portfolio management – disclosures and conflicts*.[19] The staff observed inaccurate or incomplete disclosures in many advisers' Form ADV filings, including those related to conflicts

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16 *See* supra Fiduciary Release at note 3 (stating that an adviser has a fiduciary duty to: (1) provide advice that is in the best interest of its client, which requires the adviser to make a reasonable inquiry into the client's investment objectives and have a reasonable belief that the advice is in the client's best interest; (2) seek best execution; and (3) provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship). *See also* supra IA-2204 at note 4 ("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.").

17 *See* supra Guidance at note 1 (suggesting written policies and procedures a robo-adviser should consider adopting and implementing).

18 While the duty of care applies to all advisers, this observation generally was noted in the context of advisers operating investment advisory programs. *See* Section III.B. of this Risk Alert for additional information regarding sponsor and operator reliance on Rule 3a-4.

19 *See* supra Fiduciary Release at note 3 ("[t]o meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship... In addition, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser-consciously or unconsciously-to render advice which was not disinterested... In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent... Whether the disclosure is full and fair will depend upon, among other things, the nature of the client, the scope of the services, and the

of interest, advisory fees, investment practices, and ownership structure. In addition, more than half of the advisers included hedge clauses and/or other exculpatory language in their advisory agreements, "terms of use and conditions," or other documents that may not align with their fiduciary duty.[20] Examples of omitted, inaccurate, or incomplete disclosures include instances where the advisers:

- Had purported third-parties recommend the advisers or provide execution services for advisory clients, but did not disclose that these parties were, in fact, affiliated with, and received compensation from, the advisers for the referrals, trades executed, or both.

- Omitted or had insufficient disclosure regarding how the adviser collects and uses information gathered from a client to generate a recommended portfolio, or how and when rebalancing occurs.[21]

- Omitted disclosures regarding processes for addressing profits and losses from trade errors.

- Provided inconsistent disclosures in various documents regarding advisory fee calculations.

- *Performance advertising and marketing*. More than one-half of the advisers had advertisement-related deficiencies.[22] For example, the staff observed advisers that:

  - Made misleading or prohibited statements on their websites, such as: (1) using vague or unsubstantiated claims that could cause an untrue or misleading implication or inference to be drawn regarding the advisory services provided, investment options available, performance expectations, and costs incurred in investing (*e.g.*, a comparative analysis of adviser-offered versus other products and services); (2) misrepresenting SIPC protections by implying that client accounts would be protected from market declines;[23] (3) using press logos (*e.g.,* ABC, CNN, Forbes) without links or disclosure that would explain their relevance; and (4) referring to, or providing links to, positive third party commentary, without disclosing the relevance, any conflict of interest (*e.g.,* adviser compensation), or both.[24]

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material fact or conflict"). *See also* supra IA-2204 at note 4 ("Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.").

20 *Id* (stating the Commission's view an adviser's federal fiduciary duty may not be waived, though its application may be shaped by the agreed-upon scope of its advisory relationship, and, "[a] contract provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act...").

21 *See* supra Guidance at note 1 (providing examples of information a robo-adviser should consider disclosing).

22 The Commission has brought actions against advisers that provided electronic investment advice and made false or misleading statements in their advertisements. *See*, *e.g.*, In re Hedgeable, Inc., Advisers Act Rel. No. 5087 (Dec. 21, 2018) (settled) (alleging that the adviser disseminated false and misleading marketing materials and performance data) and In re Wealthfront, LLC, Advisers Act Rel. No. 5086 (Dec. 21, 2018) ("Wealthfront") (settled) (alleging that the adviser falsely stated that it monitored client accounts to avoid making wash sale transactions).

23 SIPC does not protect against investment losses. SIPC protects the custody function of a broker-dealer in the event the broker-dealer should fail. The limit of its protection is $500,000, which includes a $250,000 limit for cash.

24 The Commission has brought actions against advisers that published advertisements that omitted material information, including robo-advisers. *See* supra Wealthfront at note 22 (adviser allegedly selectively republished certain social media posts that made

- Used materially misleading performance advertisements on their websites, including hypothetical performance results of an investment model applied retroactively without including disclosures that would make the presentation not misleading.[25]

- Provided inadequate or insufficient disclosure about "human" services (*e.g.*, whether interactions with live individuals are available, mandatory, or restricted; whether they cost extra; or whether the client is assigned a financial professional).[26]

- *Cybersecurity and protection of client information*. The staff observed that while all of the advisers had business continuity plans, and the vast majority had implemented written policies and procedures regarding identifying and recovering from cybersecurity events, fewer advisers had policies and procedures that addressed protecting the firm's systems and responding to such events. The staff also observed advisers that were not in compliance with Regulation S-ID, Regulation S-P, or both because they: (1) had "covered accounts," but lacked written policies and procedures designed to detect, prevent, and mitigate identity theft; (2) lacked or did not implement written policies and procedures addressing compliance with certain elements of Regulation S-P; and/or (3) did not deliver initial and/or annual privacy notices to all clients when required to do so.[27]

- *Registration matters*. Nearly half of the advisers claiming reliance on the Internet adviser exemption were ineligible to rely on the exemption, and many were not otherwise eligible for SEC-registration. This has been a common finding for many years.[28] The staff observed advisers that: (1) did not have an interactive website; or (2) provided advisory personnel who could expand upon the investment advice provided by the adviser's interactive website or otherwise provide investment advice to clients, such as financial planning.[29] The staff also

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positive statements about its services, including ones made by individuals that it knew or should have known had an economic interest in promoting the adviser, without disclosing this conflict of interest).

25 Newly adopted amendments to Rule 206(4)-1 generally limit an adviser's use of hypothetical performance in advertisements provided to investors who have access to the resources to independently analyze such information and have the financial expertise to understand the risks and limitations of such performance presentations. *See* supra IA-5653 at note 7.

26 Advisers that provide electronic investment advice should disclose their use of algorithms and explain the degree of human involvement in the oversight and management of individual client accounts. *See* supra Guidance at note 1.

27 *See* supra Regulation S-P Release and Regulation S-ID Release at note 8. *See also* Division (published as OCIE), Risk Alert: Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P - Privacy Notices and Safeguard Policies (Apr. 16, 2019) (highlighting the requirements of Regulation S-P and common areas of non-compliance observed by the staff).

28 The Commission has cancelled the registration of advisers claiming reliance on the Internet adviser exemption for not satisfying the requisite conditions and also brought actions against them. *See*, *e.g.*, Ajenifuja Investments, LLC; Order Cancelling Registration Pursuant to Section 203(h) of the Investment Advisers Act of 1940, Advisers Act Rel. No. 5110 (Feb. 12, 2019) (finding that adviser was registered as an Internet adviser for over three years and in that time period did not have an interactive website and did not demonstrate any other basis for registration eligibility). *See also* In re RetireHub, Inc., Advisers Act Rel. No. 3337 (Dec. 15, 2011) (settled) (alleging that the adviser was never an Internet adviser because, over the course of its registration, it did not provide investment advice exclusively through an interactive website, advised more clients than permitted through personal contact, or both).

29 *See* supra IA-2091 at note 1 and Advisers Act Rule 203A-2(e)(1)(i) (stating that the Internet adviser exemption is available only to an adviser that provides investment advice to clients *exclusively* through an "interactive website," except as permitted by the *de minimis* exception). The *de minimis* exception permits an adviser relying on the rule to advise clients through means other than its interactive website, so long as the adviser had fewer than 15 of these non-Internet-based clients during the preceding 12 months. Thus, an adviser relying on this exemption for SEC registration generally cannot offer non-interactive website based services to its clients.

observed that some advisers' affiliates were operating as unregistered investment advisers because they were operationally integrated with the respective advisers. Such affiliates could not rely on the Internet adviser's registration as a basis for their own registration, as such reliance is prohibited under Advisers Act Rule 203A-2(e)(iii).[30]

B. Discretionary Investment Advisory Programs

The staff reviewed the use of discretionary investment advisory programs ("programs") by more than two dozen advisers under the eIA Initiative. During these examinations, the staff assessed whether the programs provided each retail client with individualized treatment and enabled clients to maintain certain indicia of ownership of the securities in their accounts as required for reliance on Company Act Rule 3a-4. Where compliance with Rule 3a-4 was not specified or observed, the staff reviewed whether alternative measures that addressed their status under the Company Act were being employed. The staff also examined whether advisers had adequate disclosures about the programs that addressed implications under the Company Act and had adopted and implemented effective written policies and procedures to address the provisions of Rule 3a-4 or any alternative measures employed to address Company Act status questions.

- *Reliance on the nonexclusive safe harbor provisions of Rule 3a-4*. Advisers recommending programs commonly provided the same or similar investment advice on a discretionary basis to a large number of their advisory clients, frequently using asset allocation portfolios that they, an affiliate, or a third-party created. Often, these advisers:

    - Were unaware that the programs they sponsored or operated may be unregistered investment companies. Many had clients with similar investment objectives that received the exact same investment advice, were placed in the same model portfolio, and invested identically as other clients. Some advisers recognized these issues and claimed reliance on Rule 3a-4, but others neither specifically claimed reliance on Rule 3a-4 nor claimed to be employing any alternative measures.[31]

    - Claimed that programs they sponsored or operated were relying on Rule 3a-4, but the programs or adviser did not comply with all of the provisions of the safe harbor. Many advisers had compliance policies and procedures that were inadequate in addressing adherence with Rule 3a-4, were not implemented, or both. Advisers that sponsor or operate discretionary investment advisory programs that are relying on the safe harbor afforded under Rule 3a-4 should adopt compliance policies and procedures that are reasonably designed to validate that such programs are, in fact, consistent with the Rule's provisions.[32]

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30 *See* Investment Management No-Action Letter to Richard Ellis, Inc. (Mar. 18, 1981) and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Rel. No. 3222 (Jun. 22, 2011) (discussing principles of adviser integration and applicability of Advisers Act Section 208(d)). *See also* supra IA-2091 at note 1 (Internet advisers cannot rely on the Internet adviser exemption as their basis for registration with the Commission if another adviser in a control relationship with them relies on the Internet adviser's Internet adviser registration as the basis for its own registration under Advisers Act Rule 203A-2(b), the "related adviser" exemption).

31 *See* supra Adopting Release at note 2 (Rule 3a-4 does not create any presumption about a program that does not meet the rule's provisions).

32 *See* supra Adopting Release at note 2 ("Each person relying on [R]ule 3a-4 is responsible for demonstrating its compliance with the [R]ules' provisions... The Commission... strongly recommends that a sponsor of an advisory program seeking to rely on

- *Establishing client accounts*. To rely on Rule 3a-4, sponsors or another person designated by a sponsor (*e.g.*, the adviser recommending the program) must obtain information from each client regarding the client's financial situation and investment objectives and inquire as to whether the client wishes to impose any reasonable restrictions on the management of the client's account. This information must be obtained at the opening of the account and updated periodically thereafter. Advisers observed not complying with these provisions:

    - Used questionnaires to gather information pertinent to providing individualized advice that included a very limited number of data points, potentially increasing the risk of not providing clients with individualized advice or acting in their clients' best interests.[33]

    - Did not allow clients to impose reasonable restrictions, or placed obstacles impeding their ability to do so. Many advisers engaged in practices that were inconsistent with this Rule 3a-4 requirement, which allows clients to designate particular securities or types of securities that should not be purchased or that should be sold if held. Some advisers expressly prohibited the imposition of any restrictions, while others appeared to impede clients from imposing reasonable restrictions. Examples include advisers that:

        - Required the selection of a different model portfolio if any restrictions were requested, established unduly restrictive requirements (*e.g.*, investment thresholds that very few clients likely would attain, or only allowed specific securities), or warned of negative consequences that may result from applying restrictions (without further explanation).

        - Did not disclose to clients, or did not disclose adequately, that they could impose reasonable restrictions on the management of their accounts or provided inaccurate or insufficient information regarding the client's ability to impose such restrictions.

- *Ongoing communications*. An adviser relying on the safe harbor must contact each client at least annually to: (1) update the client's financial situation or investment objectives; and (2) determine if the client wishes to impose any reasonable restrictions on the management of the client's account or reasonably modify existing restrictions. In addition, at least quarterly, an adviser must provide its clients with written notification to contact the adviser with any changes to such information. The adviser (or sponsor) also is required to make a person sufficiently knowledgeable about the account and its management reasonably available to the client for consultation. The staff observed issues with advisers meeting these requirements, including instances where advisers:

    - Did not request with the required frequency information regarding clients' financial situations and investment objectives. Many advisers did not satisfy the Rule's quarterly notification provision, as they contacted clients only once or twice per year. Nevertheless,

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[R]ule 3a-4 establish and implement written policies and procedures, and a system for applying such procedures, that are reasonably designed to ensure that the program operates in the manner contemplated by the rule.").

33 Questionnaires varied greatly in the quantity and quality of information requested. Such advisers generally offered a very small set of responses from which a client could choose. Commonly requested investment profile data points include items such as age, income, retirement status, and investment goals. *See also* Section III.A. *Portfolio management – oversight* observations.

most of the communications were in writing and indicated how clients should convey changes to the adviser.

  - Did not communicate with clients about their ability to impose new, or modify existing, reasonable restrictions. Many advisers did not provide written notice to their clients at least quarterly, or contact their clients at least annually, regarding the client's ability to add or change reasonable restrictions on their accounts.[34]

  - Provided clients with limited or no access to advisory personnel knowledgeable about the account and its management. Advisers sometimes limited client communication to technical support (*e.g.*, navigating the adviser's website) and general customer service support (*e.g.*, directing investors to educational materials). At firms where advisers made advisory personnel available to clients to address this Rule provision, there generally were access limitations or restrictions. For example, only clients who met certain account size thresholds were eligible for these services.

- *Account statements*. Rule 3a-4 requires the sponsor of a discretionary investment advisory program, or a person designated by the sponsor, to provide each client with a statement, at least quarterly, that contains certain information. The staff observed general compliance with this provision.

- *Client rights*. Rule 3a-4 provides for the retention by clients of certain indicia of ownership, to the same extent as if the clients held the securities and funds outside of the discretionary investment advisory program. However, the staff observed advisers that:

  - Restricted their clients' ability to withdraw cash or securities from their accounts. For example, some advisers limited the types of permitted withdrawals (*e.g.*, cash-only).

  - Did not allow clients to vote proxies or to delegate that right to a third-party for any or all securities, or required clients to request this right.

  - Appeared not to ensure that clients were being sent legally required documents (*e.g.*, trade confirmations and prospectuses).

  - Did not allow clients to have the legal right to proceed, directly as a security holder, against the issuer of any security in the client's account, as prescribed in Rule 3a-4.

III. Staff Observations on Ways to Improve Compliance

Due to the assorted advisers included in the eIA Initiative, the staff observed a wide range of compliance practices. As a result, while not all of the practices noted below may be universally applicable, they may assist advisers in developing and maintaining adequate and effective policies and procedures under the Compliance Rule.

- *Adopting, implementing, and following written policies and procedures that are tailored to the adviser's practices.* Advisers cited for compliance program-related deficiencies often had

34 Compliant advisers contacted clients and also indicated how clients should convey their requests to the adviser.

multiple deficiencies across more than one category (*e.g.*, disclosure, marketing, or portfolio management). Conversely, advisers with compliance programs that appeared to be adequate and effective were not cited for deficiencies related to: (1) portfolio management (*e.g.*, best interest advice, best execution, and practices being inconsistent with disclosures); (2) custody; and (3) books and records. Such advisers also rarely had deficiencies related to marketing, performance advertising, or billing practices.

- *Testing algorithms periodically to ensure that they are operating as expected.* At advisers where algorithm-related testing was performed at least quarterly, the staff observed the following practices:

  - Testing frequently was performed by the advisers' algorithm designers/software developers, but rarely in isolation. Most included one or more other groups in their testing process, such as portfolio management, compliance, internal audit, and information technology ("IT") staff.

  - Where compliance was included in the process, compliance staff performed independent testing and also relied on work performed by others.

  - Exception reports or other reporting mechanisms commonly were used and frequently involved a combination of high-level and account-specific results. Reports often were reviewed by algorithm designers/software developers and compliance staff, but many firms also had portfolio management staff and/or IT staff review them.

- *Safeguarding algorithms*. Most advisers employed safeguards to prevent unauthorized algorithm changes, such as exclusively limiting code access to certain persons and providing compliance staff with advance notice of substantive algorithm changes or overrides (usually during the development process). Advisers using white-label platforms generally could not modify the platform's underlying code but reported that platform providers would notify them of changes.

IV. Conclusion

The examinations conducted within the scope of this review resulted in a range of actions. In response to the staff's observations, some advisers elected to amend disclosures and marketing materials, modify or eliminate performance advertisements, revise compliance policies and procedures, improve data protection practices, and/or change other practices.

The Division encourages advisers providing electronic investment advice to review their portfolio management practices and related disclosures; performance advertising and marketing materials; and written policies and procedures, including the implementation and testing of those policies and procedures, to ensure that they are consistent with the Advisers Act and the rules thereunder, as well as other federal securities laws, as applicable. Advisers relying on the Internet adviser exemption also are encouraged to review their registration eligibility.

The Division encourages advisers that recommend discretionary investment advisory programs to assess whether clients are being provided with individualized advice and whether sufficient policies, procedures, and practices are being employed to prevent such programs from being deemed unregistered investment companies and securities.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) 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.

RISK ALERT
DIVISION OF EXAMINATIONS

November 10, 2021

Division of Examinations Observations: Investment Advisers' Fee Calculations[*]

I. Introduction

It is important for clients to receive timely and accurate information regarding fees and expenses when hiring an investment adviser because every dollar an investor pays in fees and expenses is a dollar not invested for the investor's benefit. Thus, the staff from the Division of Examinations (the "Division") often reviews whether advisers, among other things: have adopted and are following policies and procedures that are reasonably designed to result in the fair and accurate charging of fees; and have disclosed their fees with sufficient clarity for their clients to understand the costs associated with their services.[1]

The Division recently concluded a national initiative that focused on advisory fees, predominantly those charged to retail clients ("Advisory Fees Initiative" or "Initiative"). This Initiative assessed the various ways in which investment advisers charge fees for their services, as well as evaluated the adequacy of fee disclosures and the accuracy of fee calculations.[2] The staff conducted approximately 130 examinations of SEC-registered investment advisers under this Initiative ("examined advisers") and identified deficiencies related to the advisory fees charged during most of these examinations.

The advisory fee-related deficiencies observed often resulted in financial harm to clients, including: (1) advisory fee calculation errors, such as over-billing of advisory fees, inaccurate calculations of tiered or breakpoint fees, and inaccurate calculations due to incorrect householding of accounts;[3] and (2) not crediting certain fees due to clients, such as prepaid fees

* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). 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 Division staff and is not legal advice.

1 The Division has identified disclosures regarding the costs of investing as an examination priority since 2018 (*see* Division, Examination Priorities for 2018, 2019, 2020, and 2021).

2 Other types of compensation, such as fees received in connection with client investments, were included within the scope of the Initiative to the extent that these fees related to the advisory fee calculations (*e.g.*, advisory fees were to be reduced by any transaction-based compensation received by the advisers' supervised persons). The staff also focused on additional compensation-based conflicts of interest identified during the examinations, if applicable.

3 *See*, *e.g.*, In re Retirement Capital Strategies Inc., Advisers Act Rel. No. 5065 (Nov. 19. 2018) (settled) (alleging that the adviser inconsistently applied tiered "breakpoints" that reduced advisory fees as the total amount of client assets under

for terminated accounts or pro-rated fees for onboarding clients. In addition, the staff observed fee-related compliance and disclosure issues. The Investment Advisers Act of 1940 ("Advisers Act") establishes a fiduciary duty for investment advisers.[4] Advisers that fail to adhere to the terms of their agreement and disclosures, or otherwise engage in inappropriate fee billing and expense practices, may violate their fiduciary duties and the Advisers Act, including its antifraud provisions.[5]

The Division previously published a Risk Alert highlighting compliance issues observed by the staff related to advisory fees ("Advisory Fees Risk Alert").[6] In this follow up Risk Alert, the Division is supplementing the Advisory Fees Risk Alert by providing greater detail on certain compliance issues observed during the recent Advisory Fees Initiative examinations, including additional details regarding the staff's observations in the two areas outlined above.

II. Focus of Advisory Fees Initiative

All of the examined advisers provided investment advice to retail clients; however, they had a wide range of assets under management, business operations, staffing levels, and affiliations. The scope of the Advisory Fees Initiative included a review of the examined advisers' compliance policies, procedures, and practices related to advisory or other fees charged and the related disclosures provided to clients. More specifically, examiners typically reviewed the following areas:

- *The accuracy of the fees charged by the examined advisers.* The staff reviewed the accuracy of the advisory fees charged and whether the advisers overcharged clients.
- *The accuracy and adequacy of the examined advisers' disclosures*. The staff reviewed the disclosures provided to clients related to the advisory fees billed, including whether certain types of assets should be excluded for fee billing purposes.[7]
- *The effectiveness of the examined advisers' compliance programs and accuracy of their books and records*. When reviewing advisers' compliance programs, the staff reviewed the

management increased and failed to aggregate or "household" related account balances of the same client and clients within the same household for the purposes of achieving the advisory fee breakpoint discounts).

4 An adviser's federal fiduciary obligations are enforceable through Advisers Act Section 206. *See*, generally, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (June 5, 2019) ("Fiduciary Interp.").

5 *See* Fiduciary Interp. *supra* note 4 ("The investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship"). *See also*, In re Barclays Capital Inc., Advisers Act Rel. No. 4705 (May 10, 2017) (settled) (alleging that the adviser violated Advisers Act Section 206(2) by incorrectly calculating the advisory fees based on, among other things, a billing methodology that differed from the advisory agreements); In re Morgan Stanley Smith Barney, LLC, Advisers Act Rel. No. 4607 (Jan. 13, 2017) (settled) (alleging that the adviser violated Advisers Act Section 206(2) by charging clients advisory fees that did not reflect negotiated discounts).

6 Division, Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018).

7 *See* Fiduciary Interp. *supra* note 4 ("In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent"). *See also* Advisers Act Section 207 (stating that it is unlawful for advisers to make untrue statements or omit any material facts in applications or reports filed with the Commission).

adequacy of policies and procedures or other operational documents related to advisory fee billing practices and the calculation of assets under management used for fee billing purposes.[8] In addition, the staff reviewed policies and procedures related to the valuation of unique or hard-to-value assets.[9] Lastly, the staff assessed whether the examined advisers made and kept books and records that were true and accurate.[10]

An adviser that engages in inappropriate fee billing and other fee-related deficient practices may have regulatory implications beyond these areas of focus. Therefore, the staff recommends reviewing this Risk Alert in conjunction with the Advisory Fees Risk Alert and other SEC and staff-issued guidance for a discussion of the legal requirements and helpful resources regarding Commission actions and interpretative guidance relevant to this topic.[11]

III. Staff Observations[12]

While investment advisers continue to have assorted advisory fee arrangements and use a wide variety of calculation methodologies, the staff observed that the typical examined adviser: (1) had a standard fee schedule with tiered fee levels based upon assets under management; (2) quarterly assessed its advisory fees; (3) deducted advisory fees directly from clients' accounts; (4) calculated fees based on the account value at the beginning or ending date of the billing period; (5) used software or third-party service providers to calculate fees; (6) documented advisory fees with clients through written advisory agreements or contracts; and (7) combined family account values when such actions resulted in lower fees (*i.e.*, householding of accounts). Understanding these general characteristics may be helpful when reviewing the deficiencies noted below.

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[8] *See* Advisers Act Rule 206(4)-7 (requiring any adviser that is registered or required to be registered under the Advisers Act to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and the rules thereunder, review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering their policies and procedures).

[9] *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2242 (Dec. 17, 2003) (noting that an adviser's compliance policies and procedures should, among other things, address its "processes to value client holdings and assess fees based on those valuations").

[10] Advisers Act Rule 204-2 requires every adviser registered or required to be registered with the Commission to make and keep true, accurate, and current certain books and records relating to its advisory business.

[11] *See*, *e.g.*, Form ADV Part 2, Item 5 and General Instruction 3 (requiring an adviser to disclose its compensation arrangements and reminds advisers of their fiduciary duty and related disclosure obligations, including providing "sufficiently specific facts" to allow clients to understand the adviser's conflicts and business practices and give informed consent or reject them); and Division of Investment Management, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (last modified Oct. 18, 2019) (discussing certain compensation arrangements and related disclosure obligations arising from both the adviser's fiduciary duty and Form ADV).

[12] While the staff's observations focus on advisers' calculations of retail client fees, many of the principles and disclosure obligations also apply to other types of client accounts (*e.g.*, institutional and fund clients) and forms of compensation (*e.g.*, direct or indirect receipt of services, fees, or payments from third-parties servicing client accounts).

A. Notable Deficient Practices

Advisory Fee Calculations

- *Several examined advisers charged advisory fees inaccurately*. These inaccurate calculations were due to a variety of errors, including:

  - *Inaccurate percentages were used to calculate advisory fees*. For example, the staff identified examined advisers that, among other things: (1) charged fees that were different from contractually agreed-upon rates; (2) used the incorrect fee schedule (*e.g.*, used the schedule intended for clients domiciled in a country other than the United States); (3) failed to convert all clients to their new or updated fee schedule; and (4) had errors in fee percentages manually entered into their portfolio management systems.

  - *Advisory fees were double-billed.* Such errors were typically due to oversights, such as not updating a system following a change in billing practices.

  - *Breakpoint or tiered billing rates were not correctly calculated.* Often these issues related to tiered fee schedules not being applied correctly or applied at all.

  - *Householding of client accounts were not correctly calculated*. In such instances, the examined advisers did not aggregate client or family accounts and/or apply the declining fee schedule, as applicable.

  - *Incorrect client account valuations were used.* For example, examined advisers included in their account valuations: (1) assets that disclosures stated would be excluded from the fee calculations, such as legacy positions; (2) stale account balance information as a result of the loss of data during transitions of portfolio management systems; (3) incorrect valuation dates for client billings; and (4) inaccurate account values due to timing differences in cash and dividend transactions in electronic custodial feeds compared to the available balance at the custodian (*e.g.*, certain pending deposits may be excluded from available balance).

- *Several examined advisers either did not refund prepaid fees on terminated accounts or did not assess fees for new accounts on a pro-rata basis.* The staff identified the following issues, among others, related to refunding prepaid fees:

  - *Inconsistently refunding unearned fees*. The examined advisers were obligated – by disclosures, advisory contracts, or both – to refund unearned advisory fees, but the examined advisers were inconsistent in providing refunds to clients (*i.e.*, provided refunds to some clients, but not others) or were unnecessarily delayed in providing such refunds, sometimes for several years post termination.

  - *Requiring clients to provide written requests to refund unearned advisory fees*. In these instances, the examined advisers had policies to refund prepaid advisory fees only upon written notice from clients.[13] Thus, the examined advisers kept the unearned advisory fees for clients that: (1) terminated the advisory relationship through their custodians, rather than notifying the adviser directly; or (2) did not specifically request a refund of prepaid fees when terminating the relationship.

False, Misleading or Omitted Disclosures

- *Several of the examined advisers were identified as having a range of disclosure issues.* The issues identified were related to incomplete or misleading Form ADV Part 2 brochures and/or other disclosures, including disclosure that: (1) did not reflect current fees charged or whether fees were negotiable; (2) did not accurately describe how fees would be calculated or billed; and (3) was inconsistent across advisory documents, such as stating the maximum fee in an advisory agreement that exceeded the fees disclosed in the adviser's brochure. The staff also identified examined advisers that did not have any written agreements or documentation establishing the client fee amount.

  Examples of issues with fee-related disclosures the staff observed, include:

  - *Cash flows and their effect on fees*. The staff observed disclosures that were inconsistent with the examined advisers' practices or were insufficient in describing how cash flows (*e.g.*, deposits and withdrawals) may impact client advisory fees, such as how a client will be billed for large deposits made mid-billing cycle.

  - *Timing of advisory fee billing.* The staff observed examined advisers that provided inaccurate disclosures regarding the timing of their fee billing. In some cases, advisers disclosed that advisory fees would be billed in advance, but elected to have some or many clients billed in arrears (and vice versa). In addition, although some examined advisers' fee disclosures stated that clients would be billed based on the average-weighted daily capital balances during the quarter, many of the clients' advisory agreements stated that fees were calculated in arrears based on the value at quarter-end. Lastly, some examined advisers did not disclose any information about the timing of advisory fee billing.

  - *Valuations for fee calculations*. Some examined advisers provided inaccurate disclosures about the values used to calculate advisory fees, such as using the month end account values rather than the disclosed average daily account values.

  - *Minimum fees, extra fees, and discounts.* Some examined advisers did not fully disclose a variety of other fee-related topics. Examples include examined advisers that did not disclose: (1) platform administration fees assessed (and that the fees could be avoided if clients elected to have their advisory accounts managed without using the platforms); (2) actual or minimum asset-based fee rates charged to clients; (3) the negotiability of fees or falsely disclosed that fees were not negotiable when they, in fact, could be negotiated; (4) the process for implementing householding and eligibility criteria; and (5) fees related to participating in wrap fee programs and non-wrap accounts.

[13] *See*, *e.g.*, Monitored Assets Corp., Advisers Act Rel. No. 1195 (Aug. 28, 1989) (settled) (alleging that adviser violated the anti-fraud provisions of the Advisers Act by refunding prepaid advisory fees only to certain clients).

Missing or Inadequate Policies and Procedures

- *Many of the examined advisers did not maintain written policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both.* Although some of these advisers had informal or unwritten practices in these areas, the staff considered such issues to be relevant to the operations of the adviser, and thus should be captured in written policies and procedures. Below are some examples of the staff's observations in this area:

    - *Policies and procedures that specifically address fee calculations.* The staff identified examined advisers with policies and procedures that were generic in nature and did not address specifics related to the processes for computing, billing, and testing advisory fees. In some cases, the examined advisers had no policies for testing or monitoring fee calculations.

    - *Policies and procedures to address material advisory fee components.* The staff observed examined advisers' policies and procedures missing a variety of critical advisory fee components that were relevant to the firms' businesses, including: (1) valuation of illiquid or difficult-to-value assets included in the assets for the calculation of advisory fees; (2) fee offsets, such as those offered for 12b-1 fees; (3) fee reimbursements for terminated accounts, where the client prepaid fees; (4) prorating fees for additions or subtractions of assets in accounts; and (5) family account aggregation (householding) or the application of breakpoints for fee calculations.

Inaccurate Financial Statements

- *The staff observed issues or inaccuracies with financial statements at several examined advisers with respect to advisory fees.* These issues included examined advisers in potential financial distress (*e.g.*, substantial balances on loans or lines of credit)[14] and examined advisers not properly: (1) recording pre-paid advisory fees as liabilities; or (2) maintaining their financial statements. Some examples include:

    - *Not recording all advisory fee income, administrative fee revenue, and compensation expenses in general ledgers and on financial statements.* These examined advisers did not record such gross revenue and expenses in their books and records because they were exchanged for other goods and services (*e.g.*, IT support) or did not record advisory fees paid directly to investment adviser representatives.

    - *Using a cash and modified cash basis of accounting, but preparing financial statements on an accrual basis of accounting.* These examined advisers incorrectly classified client advisory fees as "accounts receivable."

[14] *See* Form ADV, Part 2A, Item 18 (requiring an adviser to disclose any financial condition that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority or custody of client funds or securities or if the adviser requires or solicits prepayment of more than $1,200 in fees per client, six months or more in advance).

B. Staff Observations Regarding Industry Practices

During the examinations, the staff observed advisers implementing a range of policies and practices to address their legal and regulatory obligations related to the compliance issues identified above. Recognizing that there is no such thing as a "one-size fits all" approach, the staff is providing these observed examples of policies and practices to assist advisers with compliance in these areas.

- *Adopt and implement written policies and procedures addressing advisory fee billing processes and validating fee calculations.* The staff generally observed fewer errors when the examined advisers had specific written policies and procedures addressing the supervision, calculation, review, and billing of advisory fees.

- *Centralize the fee billing process and validate that the fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures*. The staff observed that the examined advisers with centralized billing – rather than billing that was dispersed throughout the adviser with separate, supervised persons preparing and invoicing client billing statements – had fewer clients being billed incorrectly or client accounts being calculated inconsistent with the advisers' written policies and procedures.

- *Ensure resources and tools established for reviewing fee calculations are utilized*. The staff observed that checklists and other resources for reconciling client fee calculations with client advisory agreements may be useful tools when used consistently by all advisory personnel.

- *Properly record all advisory expenses and fees assessed to and received from clients, including those paid directly to advisory personnel.*

IV. Conclusion

Advisory fee calculation and billing has been, and continues to be, an area that warrants routine review during investment adviser examinations. The staff's observations and examination findings often lead to advisers returning money owed to clients due to fee billing and calculation errors, or to the improvement of advisers' compliance programs, policies, and procedures that foster prevention of future advisory fee issues. In sharing the information in this Risk Alert, the Division encourages advisers to review routinely, refine, and improve, as appropriate, their fee billing policies, procedures, and practices and address new risks as they are identified. In addition, advisers should review their disclosures regarding such practices to ensure that clients are provided with full and fair disclosure of all fees and expenses and related material conflicts of interest.

This Risk Alert is intended to highlight for firms risks and issues that Examinations staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) 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.

RISK ALERT
DIVISION OF EXAMINATIONS

January 27, 2022

Observations from Examinations of Private Fund Advisers

I. Introduction

On June 23, 2020, the Division of Examinations ("EXAMS") published a Risk Alert (the "2020 Private Fund Adviser Risk Alert") providing an overview of compliance issues observed by EXAMS staff* in examinations of registered investment advisers that manage private funds ("private fund advisers").[1] In light of the significant role of private fund advisers in the financial markets, we are publishing this risk alert detailing additional observations: (A) failure to act consistently with disclosures; (B) use of misleading disclosures regarding performance and marketing; (C) due diligence failures relating to investments or service providers; and (D) use of potentially misleading "hedge clauses."[2]

More than 5,000 SEC-registered investment advisers, approximately 35% of all SEC-registered advisers, manage approximately $18 trillion in private fund assets.[3] In the past five years alone, we have observed substantial growth in reported private fund assets, which have increased by 70% in that period. These assets are deployed through a variety of investment strategies employed by hedge funds, private equity funds, and real estate-related funds, among others. The size and complexity of advisers vary widely from, for example, an adviser with a private fund limited to investors made up of friends and family, to an adviser with a worldwide footprint managing multiple private funds with hundreds of billions of dollars in assets. This Risk Alert is intended to assist private fund advisers in reviewing and enhancing their compliance programs, and also to provide investors with information concerning private fund adviser deficiencies.

II. Legal Background

An investment adviser's fiduciary duty under the Investment Advisers Act of 1940 ("Advisers

* 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 EXAMS Risk Alert, Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) (the "2020 Private Fund Adviser Risk Alert").

2 The observations in this Risk Alert and the 2020 Private Fund Adviser Risk Alert were drawn from over 5 years of examinations of private fund advisers. This Risk Alert, the 2020 Private Fund Adviser Risk Alert, and The Five Most Frequent Compliance Topics (Feb. 17, 2017) (for all advisers) reflect observations of the EXAMS staff regarding private fund advisers and are intended to assist private fund adviser compliance staff.

3 Form ADV data current as of November 30, 2021.

Act") comprises a duty of care and a duty of loyalty.[4] This means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client. This combination of care and loyalty obligations requires the investment adviser to act in the "best interest" of its client at all times. Although investment advisers owe their clients a fiduciary duty under the Advisers Act, that fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client.[5]

In addition, Advisers Act Rule 206(4)-8 prohibits investment advisers to pooled investment vehicles from: (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Advisers Act Rule 206(4)-7 (the "Compliance Rule") requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules that the Commission has adopted under the Advisers Act by the adviser or any of its supervised persons. In developing its policies and procedures, an adviser should identify matters that create risk exposure for the adviser and its clients in light of the firm's particular operations and then design compliance policies and procedures that address those risks. The Compliance Rule also requires advisers to review, no less frequently than annually, the adequacy of the policies and procedures established and the effectiveness of their implementation.

III. Private Fund Adviser Deficiencies[6]

A. Conduct Inconsistent with Disclosures

EXAMS staff has observed the following failures to act consistently with material disclosures to clients or investors:

- *Failure to obtain informed consent from Limited Partner Advisory Committees, Advisory Boards or Advisory Committees (collectively "LPACs") required under fund disclosures.* EXAMS staff observed private fund advisers that did not follow practices described in their limited partnership agreements ("LPAs"), operating agreements, private placement memoranda, due-diligence questionnaires, side letters or other disclosures ("fund disclosures") regarding the use of LPACs. For example, staff observed private fund advisers that failed to bring conflicts to their LPACs for review and consent, in

[4] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019) ("Fiduciary Interpretation").

[5] *See* Fiduciary Interpretation.

[6] This Risk Alert does not address all deficiencies among private fund advisers. In addition to the 2020 Private Fund Adviser Risk Alert, EXAMS also published, for example, a risk alert on February 7, 2017, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers, which identifies deficiencies across all types of investment advisers.

contravention of fund disclosures. EXAMS staff also observed private fund advisers that did not obtain consent for certain conflicted transactions from the LPAC until after the transaction had occurred or obtained approval after providing the LPAC with incomplete information in contravention of fund disclosures.

- *Failure to follow practices described in fund disclosures regarding the calculation of Post-Commitment Period fund-level management fees.* EXAMS staff observed private fund advisers that did not follow practices described in fund disclosures regarding the calculation of the fund-level management fee during a private fund's Post-Commitment Period.[7] EXAMS staff observed that such failures resulted in investors paying more in management fees than they were required to pay under the terms of the fund disclosures. For example, private fund advisers did not reduce the cost basis of an investment when calculating their management fee after selling, writing off, writing down or otherwise disposing of a portion of an investment. Other private fund advisers used broad, undefined terms in the LPA, such as "impaired," "permanently impaired," "written down," or "permanently written down," but did not implement policies and procedures reasonably designed to apply these terms consistently when calculating management fees, potentially resulting in inaccurate management fees being charged.

- *Failure to comply with LPA liquidation and fund extension terms.* EXAMS staff observed advisers that extended the terms of private equity funds without obtaining the required approvals or without complying with the liquidation provisions described in the funds' LPAs, which, among other things, resulted in potentially inappropriate management fees being charged to investors.

- *Failure to invest in accordance with fund disclosures regarding investment strategy.* EXAMS staff observed private fund advisers that did not comply with investment limitations in fund disclosures. For example, the staff observed private fund advisers that implemented an investment strategy that diverged materially from fund disclosures. EXAMS staff also observed advisers that caused funds to exceed leverage limitations detailed in fund disclosures.

- *Failures relating to recycling practices.* "Recycling" refers to contractual provisions that allow a fund to add realized investment proceeds back to the capital commitments of investors. EXAMS staff observed private fund advisers that did not accurately describe the "recycling" practices utilized by their funds or omitted material information from such disclosures. In some instances, this failure may have caused private fund advisers to collect excess management fees.

- *Failure to follow fund disclosures regarding adviser personnel.* EXAMS staff observed advisers that did not adhere to the LPA "key person" process after the departure of

[7] Advisers to private equity funds typically assess a management fee based on a percentage of limited partner capital commitments during the period of time the fund deploys capital ("Commitment Period"). The basis of the amount used to calculate this fee, however, is generally reduced to "invested capital," less dispositions, write downs and write offs after the Commitment Period ("Post-Commitment Period"). These arrangements vary in accordance with contractual provisions.

several adviser principals or did not provide accurate information to investors reflecting the status of key previously-employed portfolio managers.

B. Disclosures Regarding Performance and Marketing

EXAMS staff has observed private fund advisers providing to investors or prospective investors misleading track records or other marketing statements that appear to violate Rule 206(4)-8.[8] In addition, Advisers Act Rule 204-2(a)(16) requires advisers to maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of any or all managed accounts or securities recommendations. EXAMS staff has also observed failures by private fund advisers to maintain these required records.

- *Misleading material information about a track record.* EXAMS staff observed private fund advisers that provided inaccurate or misleading disclosures about their track record, including how benchmarks were used or how the portfolio for the track record was constructed. For example, the staff observed advisers that only marketed a favorable or cherry-picked track record of one fund or a subset of funds or did not disclose material information about the material impact of leverage on fund performance. In addition, the staff observed private fund advisers that utilized stale performance information in presentations to potential investors or track records that did not accurately reflect fees and expenses.

- *Inaccurate performance calculations.* EXAMS staff observed private fund advisers that presented inaccurate performance calculations to investors. For example, the staff observed private fund advisers that used inaccurate underlying data (*e.g.,* data from incorrect time periods, mischaracterization of return of capital distributions as dividends from portfolio companies, and/or projected rather than actual performance used in performance calculations) when creating track records, thereby leading to inaccurate and potentially misleading disclosures regarding performance.

- *Portability - failure to support adequately, or omissions of material information about, predecessor performance.* EXAMS staff observed private fund advisers that did not maintain books and records supporting predecessor performance at other advisers as required under Advisers Act Rule 204-2(a)(16). In addition, the staff observed private fund advisers that appeared to have omitted material facts about predecessor performance. For example, the staff observed private fund advisers that marketed incomplete prior track records or advertised performance that persons at the adviser were not primarily responsible for achieving at the prior adviser.

- *Misleading statements regarding awards or other claims.* EXAMS staff observed private fund advisers that made misleading statements regarding awards they received or characteristics of their firm. For example, the staff observed private fund advisers that

8 The Commission adopted significant revisions to Advisers Act Rule 206(4)-1 that address the marketing of private funds. The rule, which advisers must comply with by November 4, 2022, provides additional specificity regarding misleading marketing materials. In addition to Rule 206(4)-1 and Rule 206(4)-8, the anti-fraud provisions of the federal securities laws, *e.g.,* Section 206 of the Advisers Act, Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934, may apply to this activity.

marketed awards received, but failed to make full and fair disclosures about the awards, such as the criteria for obtaining them, the amount of any fee paid by the adviser to receive them, and any amounts paid to the grantor of the awards for the adviser's right to promote its receipt of the awards. The staff also observed advisers that incorrectly claimed their investments were "supported" or "overseen" by the SEC or the United States government.

C. Due Diligence

As a fiduciary, an investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives. A reasonable belief that investment advice is in the best interest of a client also requires that an adviser conduct a reasonable investigation into the investment that is sufficient to ensure that the adviser is not basing its advice on materially inaccurate or incomplete information.[9]

EXAMS staff observed potential failures to conduct a reasonable investigation into an investment, to follow the due diligence process described to clients or investors, and to adopt and implement reasonably designed due diligence policies and procedures pursuant to the Compliance Rule:

- *Lack of a reasonable investigation into underlying investments or funds.* EXAMS staff observed advisers that did not perform reasonable investigations of investments in accordance with their policies and procedures, including the compliance and internal controls of the underlying investments or private funds in which they invested. In addition, the staff observed advisers that failed to perform adequate due diligence on important service providers, such as alternative data providers and placement agents.

- *Inadequate policies and procedures regarding investment due diligence.* EXAMS staff observed private fund advisers that did not appear to maintain reasonably designed policies and procedures regarding due diligence of investments. For example, the staff observed private fund advisers that outlined a due diligence process in fund disclosures, but did not maintain policies and procedures related to due diligence that were tailored to their advisory businesses.

D. Hedge Clauses

Whether a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser's liability (a "hedge clause") is misleading and would violate Sections 206(1) and 206(2) of the Advisers Act depends on all of the surrounding facts and circumstances.[10] EXAMS staff observed private fund advisers that included potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses could be inconsistent with Sections 206 and 215(a) of the Advisers Act.

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9 *See* Fiduciary Interpretation.

10 *See* Fiduciary Interpretation.

IV. Conclusion

Examinations of private fund advisers have resulted in a range of actions, including deficiency letters and, where appropriate, referrals to the Division of Enforcement. In response to these observations, many of the advisers modified their practices to address the issues identified by EXAMS staff. The Division encourages private fund advisers to review their practices, and written policies and procedures, including implementation of those policies and procedures, to address the issues identified in this Risk Alert.

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.

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.

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[*] 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

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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.").

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