

SEC OCIE Risk Alert Update: Supervision of Disciplined Individuals

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On July 23, 2019, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) released a Risk Alert summarizing the findings of a recent series of exams focused on oversight practices of SEC-registered investments advisers ("advisers") that previously or currently employed an individual with a history of disciplinary events (the "Supervision Initiative"). The OCIE Staff focused on advisers' practices with respect to three requirements under Advisers Act Rule 206: (1) whether the advisers' compliance programs "were reasonably designed to detect and prevent violations of the Advisers Act by the firm and its supervised persons;" (2) the fullness and fairness of their public statements and disclosures; and (3) whether all material conflicts of interest that could affect the advisory relationship, particularly with respect to compensation arrangements and account management, were fully and fairly disclosed. Though the OCIE Staff paid particular attention to the interaction between these three requirements and the previously-disciplined individuals, it is important to note that they also reviewed practices firm-wide, and thus their findings are applicable even to advisers not overseeing a previously-disciplined individual.

Advisers should take note of the observed deficiencies identified below, which were identified as the most frequent compliance issues identified as part of the Supervision Initiative:

- **Full and Fair Disclosure:** The OCIE Staff noted that nearly half of the disclosure-related deficiencies they observed were due to firms furnishing inadequate information regarding disciplinary events, including: (1) the omission of material disclosures regarding disciplinary histories, often related to reliance only on the self-reporting of previously-disciplined individuals; (2) the inclusion of incomplete, confusing, or misleading information with respect to disciplinary events, for example not including the total number of events, the allegations, or the finding of fault; and (3) the lack of timely updates and delivery of disclosure documents to clients.
- **Compliance Programs:** The OCIE Staff highlighted that it was clear many advisors had not adopted compliance programs that addressed the risks associated with employing previously-disciplined individuals. The failure was two-pronged, as there were no processes reasonably designed to identify whether the self-attestations of previously-disciplined individuals were complete and accurate, or whether the previously-disciplined individuals' were being truthful in their claims that they were not the subject of reportable events or recent bankruptcies.

The OCIE staff also made a point to highlight several advisers were adopting compliance programs that were inconsistent with their business practices and disclosures. These inconsistencies were frequently in the areas of commissions, fees, and expenses.

The OCIE staff further noted that many of the advisers' annual compliance reviews were inadequate, as they were not being appropriately documented or used to assess risk areas.

- **Supervision:** The OCIE Staff observed that many advisors did not have in place adequate supervision or standards of conduct for supervised persons. These practices included instances where the adviser did not: (1) oversee whether fees charged by supervised persons were disclosed or whether the services paid for were performed; (2) have advertising policies and procedures that provided guidance to supervised persons preparing their own materials and websites; and (3) review activities of supervised persons working remotely, even if they had no prior disciplinary histories.
- **Oversight:** The OCIE staff noted that many advisers were not confirming whether supervised persons responsible for the oversight of compliance procedures were actually performing their supervisory duties adequately. This included neither review of the appropriateness of client account types opened nor the maintenance of records and books necessary to provide investment

management or supervisory services to clients.

- **Undisclosed Conflicts of Interest:** The OCIE staff highlighted that there were frequently advisers who had in place undisclosed compensation arrangements with the potential to impact the impartiality of the advice provided to clients. Some examples include loans made to advisers or supervised persons contingent on client-based incentives, which may have impacted the investment decision making process, as well as situations where supervised persons were required to incur transaction costs, therefore creating incentives to lower trade volume.

In conclusion, the OCIE staff recommends five ways to address the weaknesses they discussed:

1. Adoption of written policies and procedures designed to address what must occur before the hiring of previously-disciplined individuals;
2. Strengthening of due diligence practices in hiring is recommended to better identify whether a potential hire has a history of disciplinary events; practices such as background checks, internet and social media searches, personal reference checks and other background reviews were cited as some examples of practice employed (but noting that practices in this area may vary among advisers);
3. As part of the post-hiring process, establishing of heightened supervisory practices with respect to the oversight of previously-disciplined individuals;
4. The creation of oversight procedures for those operating out of remote offices (in particular with respect to supervised persons with disciplinary histories operating remotely; and
5. Adoption of written policies with respect to addressing client complaints related to supervised persons.

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