Greenwich Compliance

SPOTLIGHT ON

2020 Update on SEC Examinations of Investment Advisers

The contents of this Spotlight have been prepared for informational purposes only and should not be construed as legal or compliance advice.

SEC Examinations

The purpose of U.S. Securities and Exchange Commission ("SEC") examinations is to ensure that investment advisory firms conduct their activities in compliance with federal securities laws and regulations. Compliance encompasses upholding disclosures made available to investors and establishing policies and procedures that effectively guide the firm's operations. The examinations are performed by the SEC's Office of Compliance Inspections and Examinations ("OCIE") out of Washington, D.C. and the 11 SEC regional offices as part of the National Examination Program ("NEP"). The NEP's stated goals are to improve compliance, prevent fraud, inform policy, and monitor risks.

The OCIE generally performs four specific types of examinations, although some are much more common than others. The four types are:

1. **Risk-Based Examinations.**
   These are exams that are based on an Adviser's risk profile or highly focused exams based on specific risks of the Adviser.

2. **Cause Examinations.**
   These are exams based on the reasonable belief that the adviser has potential violations of Federal securities laws. These exams can be prompted by press reports, complaints, regulatory referrals, or other causes. The SEC collects and coordinates the information from tips, complaints, and referrals.

3. **Special Purpose Examinations.**
   These are exams that include risk-targeted exam sweeps and risk assessments. Exam sweeps focus on specific types of risks to determine the extent, scope, and danger of the risk in the industry (e.g., cybersecurity risks, outsourced CCO risks).

4. **Correspondence Examinations**.
   Some regional offices, including New York, Chicago, and San Francisco, have been asking advisers to submit certain documents to the office for review. These reviews are then used to determine if the adviser requires an on-site examination.

The SEC determines which firms to examine based on a few factors. Those factors include a risk-based criterion, tips or complaints, and significant changes in a firm's business activities. In recent years, the OCIE has aimed to increase the number of advisers being examined, reaching 15% of SEC registered advisers in 2019 despite the government shut-down experienced early that year.[1]

Risk-Based Criterion and Scoring

OCIE uses risk-based assessments to help determine which firms to examine in a given year. In a risk analysis, investment advisers are assessed on multiple risk factors and given a numerical risk score. The risk score is used to determine the likelihood and frequency of an SEC-registered investment adviser being examined by the OCIE.

The Risk and Strategy Office ("RAS") within OCIE gathers data from Form ADV filings, marketing materials, and other disclosures to analyze potential risks. RAS looks at more than 50 different factors in developing risk assessments, which now even include geographic proximity to elderly investors in retirement homes.[2] The risk scores are developed from quantitative and qualitative measures, including but not limited to disciplinary history, complexity of strategy, custody structure, and any significant changes to the Form ADV filing.

For example, improper disclosures in the Form ADV filing will increase the risk score of an investment adviser. If the disclosures are out of date, services offered are misrepresented, or potential conflicts of interest are not properly disclosed, the risk score and the likelihood of examination increase. Marketing documents are also an area of focus, specifically any misrepresentations of performance or guarantees of returns.

The fee and compensation structure of an investment adviser can draw attention in the risk analysis in a number of ways. For instance, incorrect fee calculations, inflated asset values, and incentive-based compensation all add risk to the firm. Incentive-based compensation, for example, may lead to improper recommendations or investments, violating an adviser's fiduciary duty.

Affiliations with other firms, especially broker-dealers, increase an investment adviser's risk score by creating conflicts of interest. Even if the conflicts are properly disclosed, an affiliation with a broker-dealer requires stronger and more specific compliance policies to mitigate the affiliation-related risks. The affiliation would therefore increase the risk score and the likelihood of examination.[3]

---

[1] *2020 Examination Priorities*, SEC, 2 (2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[2] Melanie Waddell, *SEC Using More 'Tactical' Approach to Exams: Risk Chief*, ThinkAdvisor (2016), https://www.thinkadvisor.com/2016/04/14/sec-using-more-tactical-approach-to-exams-risk-chi/ (last visited August 5, 2020).

[3] *SEC Examinations and Risk Assessment Process: 2007 CCOutreach Regional Seminars*, SEC (2007), https://www.sec.gov/info/cco/examprocess2007.pdf

While the above risk factors are considered every year, the SEC releases annual examination priorities for certain risk factors that will be considered more than other factors during that particular year. For instance, the 2020 SEC Examination priorities announced were the following:

1. **Retail Investors, including seniors and those saving for retirement**
   The OCIE is focused on disclosures of fees, expenses, and conflicts of interest related to investment advisers providing services to retail investors. An additional focus will be given to investments marketed to retail investors, particularly seniors, such as mutual funds and ETFs.

2. **Information Security, specifically on protecting clients' personal information**
   The priority for the OCIE is on an investment adviser's protection of client information. The review will focus on risk management, access control, data loss prevention, vendor management, and incident response and resiliency.

3. **Fintech, including digital assets and electronic investment advice**
   For digital assets, the OCIE will assess investment suitability, portfolio management and trading practices, safety of client assets, valuations, and compliance policies to specifically address digital asset risk. On the electronic investment advice front, namely robo-advisers, the OCIE is focused on SEC registration eligibility, cybersecurity, marketing, and policies to uphold fiduciary duty.

4. **Never-before and not recently examined Registered Investment Advisers**
   As in the past, the OCIE will focus on examining newly registered investment advisers and those that have not yet been examined. There is also a focus on registered investment advisers that have not been examined for several years to determine if compliance programs have been adopted to address past deficiencies or changing business models.

5. **Registered Investment advisers to Private Funds, especially those with separately managed accounts side-by-side with private funds.[4]**
   The priority for private fund advisers is for those that also provide portfolio management services to retail investors ("side-by-side management"). The review will encompass overall compliance risks, controls to prevent misuse of non-public information, conflicts of interest, and any affiliates used to provide services.

Examinations during COVID-19

Since the start of the pandemic, almost all SEC examinations have been off-site correspondence exams. Given the disruption already caused by the situation, OCIE has become more flexible with examination timing and the availability of personnel in hopes to minimize the additional disruption of examinations on firms. At the same time, OCIE is gathering information on COVID-

[4] *2020 Examination Priorities*, SEC, 9-16 (2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

19's impact on the industry through outreach to larger firms, focusing on new challenges to operational resiliency.

It naturally follows that there is a renewed interest in the examined advisers' Business Continuity Plans ("BCPs"). In reviewing a firm's BCP, OCIE focuses on written procedures regarding continuing operations and how effectively those procedures have been implemented. The most significant disruption, the-stay-at-home orders forcing many employees to work from home, raises many issues regarding oversight of employees and third-party service providers. With employees working from home on different networks for months, firms must be diligent in protecting clients' privacy rights. This protection should address any internal threats to the firm's data and new cyber security threats heightened by firm data existing on multiple networks, giving hackers more points of entry.

As of August 12, 2020, the OCIE has released a Risk Alert specific to COVID-19 risks. The alert, titled "Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers," addresses observations made by staff conducting examinations during the pandemic. Some of the observations include supervision of personnel in remote working environments, operational continuity and the necessary resources to ensure compliance with federal securities laws, and protection of sensitive information.

Given that personnel may be in remote working situations, supervisors may need to adjust their roles and frequency of communication to guarantee the same level of oversight. The importance of supervision is heightened by the fact that supervised personnel may be making investment recommendations in markets currently experiencing greater volatility and therefore greater potential for fraud. While business continuity plans have been implemented, many firms do not have plans specific to pandemics and long-term work from home policies. The current situation may require firms to provide additional resources to secure home servers and other relocation infrastructure to personnel working from home. As for sensitive information, the OCIE highlights three areas of concern: (1) remote access to networks and web-based applications; (2) increased use of personal devices; and (3) changes in the management of physical records. Firms can address these issues with increased employee training focused on best practices for using remote systems, sharing information online (e.g., encryption, password protection), and handling physical records at remote locations. [5]

Preparation

Even before notice of an upcoming examination, registered advisers must establish and maintain effective programs to comply with federal securities laws. Operating with a detailed compliance program at all times will prepare the firm for when an examination is scheduled. Once established, the compliance programs should be continuously monitored and tested for

[5] *Risk Alert: Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers*, OCIE (2020), https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf

resiliency and effectiveness. Advisers should adopt a top-down approach, in which management shows strong support and commitment to maintaining the compliance program. Below are some specific areas advisers can focus on to ensure preparedness for an examination:

- **Compliance Manuals** should genuinely reflect a firm's compliance policies and procedures in practice, meet regulatory requirements, and emphasize a commitment to the policies they outline;
- The **Chief Compliance Officer** ("CCO") should take charge of the firm's response to examinations and actively implement the compliance program throughout the firm;
- Advisers should prioritize **Recordkeeping** and keep records organized so as to respond effectively and quickly to document requests;
- Advisers should use **Risk Assessments**, either through internal or external sources, to measure current and potential risks; and
- Advisers should address **Firm-Specific Risks** in the adopted compliance policies and procedures.

At the base level, an OCIE examination will look at the firm's policies surrounding portfolio management, proprietary trading, disclosures to clients, trading practices, and cybersecurity protections. These areas apply to all investment advisers and therefore will be reviewed in almost all examinations.[6]

Top Deficiencies in Recent Years

Through published OCIE Risk Alerts, we can understand common areas of deficiency that the SEC has identified through its examinations. Since other advisers have been found to have issues in these policies and procedures, it is important to pay special attention to the published risk alerts.

1. **Customer Records and Information in Network Storage – Use of Third Parties.[7]**
   Advisers had insufficient oversight of third party-provided storage solutions and insufficient data classification procedures.

2. **Compliance issues related to Regulation S-P – Privacy Notices and Safeguard Policies.[8]**
   Policies were non-existent or inefficient in safeguarding customer records and information. Specific areas of concern include personal devices, unsecure networks, and departed employees.

---

[6] *Information for Newly-Registered Investment Advisers*, SEC (2010), https://www.sec.gov/divisions/investment/advoverview.htm

[7] *Risk Alert: Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features*, OCIE (2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf

[8] *Risk Alert: Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies*, OCIE (2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Regulation%20S-P.pdf

3. **Compliance Issues related to the Cash Solicitation Rule.**[9]
   Advisors had put in insufficient efforts to establish solicitor disclosure documents, client acknowledgements, and overall solicitor compliance.

4. **Cybersecurity Examination Observations.**[10]
   In this area, observations of industry practices include access rights and controls, data security, incident management, vendor management, and cybersecurity training.

5. **Compliance issues related to Advisory Fees and Expenses.**[11]
   Advisers were found billing based on inaccurate account valuations, at inconsistent frequencies, with the wrong fee rate, and without proper disclosures.

In addition to these recent deficiencies, SEC-registered investment advisers should pay special attention to the 2020 SEC Examination priorities explained in the above sections. All risk will be considered, but recent deficiencies and stated priorities will be weighted more heavily.[12]

Takeaway

OCIE emphasizes the importance of establishing and maintaining a culture of compliance. By actively implementing a compliance program, an adviser can address the unique and evolving risks of the firm and industry at large. To keep compliance programs up to date, advisers should test their policies and procedures and understand recent deficiencies and priorities. When an examination does come, an adviser with a strong compliance program and a strategy for addressing OCIE requests will be better prepared than those without.

[9] *Risk Alert: Investment Adviser Compliance Issues Related to the Cash Solicitation Rule*, OCIE (2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf

[10] *Cybersecurity and Resiliency Observations*, OCIE, 2-3 (2020), https://www.sec.gov/files/OCIE%20Cybersecurity%20and%20Resiliency%20Observations.pdf

[11] *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, OCIE (2018), https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf

[12] *2020 Examination Priorities*, SEC, 9-16 (2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.