SEC's Supervision Initiative Reveals Deficiencies In Oversight Of Supervised Persons With Disciplinary Histories

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On July 23, 2019, the SEC's Office of Compliance Inspections and Examinations ("OCIE") summarized its findings after examining firms that previously employed or currently employ individuals with a history of disciplinary events. OCIE's observations were the result of conducting over 50 examinations of Registered Investment Advisers ("RIAs"). Most of the RIAs examined pursuant to the Supervision Initiative provided advisory services to retail investors.

OCIE evaluated the RIAs' compliance programs and supervisory oversight practices to determine if their policies and procedures were reasonably designed to detect and prevent violations of the Investment Advisers Act by the firm and its supervised persons. Although OCIE focused on policies and procedures pertaining to the activities of certain previously-disciplined individuals, it also scrutinized whether the disclosures in public statements, documents, marketing materials and filings were thorough, fair, and not misleading. OCIE was particularly concerned about how these firms addressed issues involving previously-disciplined individuals and their prior disciplinary events.

In addition, OCIE assessed whether the RIAs identified, addressed, and fully and fairly disclosed all material conflicts of interest that could affect the firm's advisory relationships. Examiners' primary concerns revolved around compensation arrangements and account management.

The examinations did not focus entirely on supervisory practices pertaining to individuals with prior disciplinary histories. During examinations, examiners reviewed the RIAs' supervisory practices firm-wide to evaluate their compliance culture and tone at the top.

OCIE finds deficiencies at most of the firms examined during the Supervision Initiative

Almost every RIA examined received a deficiency letter. Most of these deficiencies were compliance-related. Many deficiencies were found in the disclosure area, including undisclosed conflicts of interest.

Examiners found that RIAs' oversight of supervised persons with disciplinary histories was lacking in several areas. Nearly half of the disclosure-related deficiencies arose because the firms provided inadequate information regarding disciplinary events. Many omitted material disclosures regarding the disciplinary histories of certain supervised persons or of the RIA itself. Frequently, the disciplinary omissions occurred because the RIAs relied entirely on supervised persons to self-report these events. As a result, the firms provided incomplete, confusing, or misleading disciplinary information. They did not disclose information such as whether fines, judgments, or other disciplinary sanctions were imposed. Firms did not always update and deliver disclosure documents to clients in a timely manner.

Many of the RIAs examined did not adopt and implement compliance policies and procedures to address the risks associated with hiring and employing individuals with prior disciplinary histories. A number of firms did not implement policies and procedures to ensure that supervised persons' self-attestations completely and accurately described those events.

Additional observations from examiners involved in the Supervision Initiative

OCIE's Supervision Initiative identified a number of firm-wide practices that were not directly connected to the hiring and supervision of individuals with disciplinary histories. Examiners found that RIAs did not adequately supervise or set appropriate standards of business conduct for their supervised persons. Examiners noted that geographically-dispersed supervised persons were operating on their own, and their conduct was inconsistent with the RIA's policies and procedures. RIAs did not oversee whether the fees charged by supervised persons were disclosed and verify that the services for which clients paid were actually performed. Some clients paid for certain services they did not receive and were charged undisclosed fees.

OCIE observed that many RIAs did not take steps to ensure that those responsible for performing certain compliance policies and procedures were actually executing their duties, such as monitoring the appropriateness of client account types and maintaining accurate and current books and records. In some instances, RIAs adopted policies and procedures that were inconsistent with their actual business practices and disclosures.

In addition, annual reviews were sometimes insufficient. RIAs did not always take steps to adequately document the reviews and appropriately assess the risks faced by the firm.

Certain RIAs failed to fully disclose their compensation arrangements. Some of the RIAs did not disclose that forgivable loans were made to them or their supervised persons. Others failed to disclose incentives that could impact the level of trading the supervised person may place for a client.

OCIE recommendations for improving compliance

The Risk Alert offered advice to RIAs that hire or employ supervised persons with disciplinary histories such as:

- Adopting written policies and procedures that specifically address what must occur prior to the hiring of a supervised person with a disciplinary history;
- Enhancing due diligence practices when hiring supervised persons;
- Establishing heightened supervision practices when overseeing supervised persons with specific disciplinary histories;
- Adopting written policies and procedures addressing client complaints about supervised persons; and
- Expanding oversight of individuals in remote or branch offices, particularly when supervised persons with disciplinary histories are working there.

OCIE recommended that RIAs assess their supervisory, compliance, and/or other risk management systems and make changes where appropriate. The adequacy of supervisory, compliance and other risk management systems can only be judged in light of an RIA’s business model, as well as other facts and circumstances.

The SEC’s Risk Alert is available at OCIE Risk Alert – Supervision Initiative.pdf. It is a must-read for every RIA, even if it does not hire individuals with troublesome disciplinary histories.

If you have any questions regarding how the SEC’s Risk Alert impacts your firm and/or updating your compliance policies and procedures in light of the SEC’s findings, contact your Foreside Compliance Consultant.

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