Too Commonly Recurring Violations

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Introduction

Every year the Office of Compliance Inspections and Examinations ("OCIE") of the U.S. Securities and Exchange Commission ("SEC") issues a list of "examination priorities" – areas of focus for the year to come.[1] These, and other hot topics like custody, must be addressed by firms' compliance departments in setting priorities for testing and consideration during the required annual compliance program review under Rule 206(4)-7 (the "Compliance Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and throughout the year. And, of course, advisers will always want to be prepared to answer questions on examination about those priority areas should OCIE come to visit. While there are countless articles relating to each year's examination priorities, the purpose of this article is not to focus on those areas; rather, we are going to focus on those regulatory infractions that continue to lurk in the investment advisory industry.

Empirical evidence is often lost in the publicity of the priorities list and in risk alerts and speeches from the OCIE staff, which suggest that certain old standby areas continue to receive significant attention on examination and from the SEC's Division of Enforcement. With this in mind, this article explores five common deficiency areas that may not make the "hot topics" lists but that merit consideration by advisers: cherry picking, insider trading, performance advertising, advisory fees, and compliance program failures.

Cherry Picking

Investment advisers have a duty to act in the best interest of clients and to treat clients fairly and equitably over time when allocating investment opportunities. An SEC-registered investment adviser's failure to do so may cause the SEC to find a violation of Section 206[2] of the Advisers Act, and/or Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the "1934 Act") and to impose sanctions.

What is Cherry Picking?

For a variety of reasons, investment advisers allocate investment opportunities, including favorable but limited investment opportunities, among the adviser's

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proprietary and/or client accounts.[3] In such circumstances, the adviser has an incentive to allocate a disproportionate share of favorable investment opportunities and/or trades to its own account(s), to those client accounts with higher level of performance fees, or to other preferred accounts. Similarly, where an aggregated transaction is filled in several trades at different prices, an adviser has an incentive to allocate the more favorable trades to preferred accounts rather than use the average price achieved. Each of these scenarios presents opportunities for an investment adviser to "cherry pick" – *i.e.*, allocate a disproportionately greater percentage of favorable or unfavorable investment or trade opportunities to one or more accounts over others – investment opportunities to benefit its proprietary and/or certain client accounts.

Although not prohibited from allocating investment opportunities and trades among proprietary and/or client accounts, an adviser's failure to do so in a fair and equitable manner and consistently with the adviser's policies and procedures and client disclosures is a frequent source of enforcement proceedings. The SEC has historically viewed cherry-picking as a serious conflict of interest, expressing this view through a variety of channels.[4] In fact, the SEC has invested significant resources to monitor for cherry picking through, among other things, a risk analytic initiative in which "big data" is used to identify the unfair allocation of trades and investment opportunities.[5]

Actions to Seek to Mitigate Cherry Picking Concerns

There are a number of practical steps that SEC-registered investment advisers can take to mitigate the risk of enforcement or other remedial action for actual or perceived cherry picking. Specifically, advisers should consider:

- Adopting reasonably designed compliance policies and procedures to ensure that all clients eligible to participate in a particular investment or trade are treated fairly and equitably over time. [6] Such policies may include one or more pre-specified allocation formulas or methodologies, including:
  - *Pro rata*[7] based on the offered price or the day's transactions among the accounts with open orders for that security based on the average price obtained that day; or
  - Sequentially to specific accounts, pursuant to a determined order or on a random basis such that all accounts over time are given their share of desirable orders.
- "Bundling" client orders where possible to seek a reduction in execution cost, consistent with established SEC guidance regarding the allocation of bundled orders in a fair and equitable manner so that, over time, no one client or group receives a more favorable allocation to the detriment of other clients.
- Analyzing whether the investment opportunity or trade is otherwise suitable for a given client account, taking into consideration the account's applicable investment guidelines or other restrictions. However, advisers should periodically monitor such suitability judgments (if any) to ensure that the judgments do not, intentionally or unintentionally, result in favoring higher performance fee or proprietary accounts.
- Documenting the rationale for investment allocation decisions generally and with respect to investment opportunities more likely to draw scrutiny from the SEC upon examination (*i.e.*, initial public offerings).
- Ensuring that applicable policies provide for ongoing trade pattern monitoring, including for those accounts that are most likely to be the subject of cherry picking allegations.
- Ensuring that the investment adviser's allocation procedures are accurately described in the adviser's Form ADV Part 2A and, with respect to advisers to private funds, offering memoranda.
- Assessing the specific facts and circumstances of the investment adviser's operations, and whether the firm's applicable allocation procedures should require consistent trading activity among all accounts pursuing a similar investment strategy.

Insider Trading

According to the SEC's Fiscal Year End 2017 Annual Report (the "FY 2017 Report"),[8] the Division of Enforcement continues to devote significant resources to pursue actions involving insider trading. In fiscal year 2017, the SEC brought 41 insider trading actions against individuals and entities, representing approximately 9% of total standalone enforcement actions.[9] Although this

represents a decrease in insider trading-related standalone enforcement actions versus fiscal year 2016, recent U.S. Supreme Court and Second Circuit Court of Appeals decisions[10] and other factors are reasons to believe that insider trading continues to represent a high priority for the Division of Enforcement in 2018. Additionally, insider trading cases are also brought by prosecutors other than the SEC. As a result, SEC-registered investment advisers should take steps to seek to ensure that, in addition to not affirmatively trading on material, non-public information ("MNPI"), they continue to comply with Section 204A of the Advisers Act as well as Rule 204A-1 thereunder (the "Code of Ethics Rule") and to review their insider trading policies and procedures and code of ethics (and compliance therewith) to assess that these are appropriately designed, implemented, and enforced to protect against misuse of MNPI.

Overview of Insider Trading Prohibitions

The current regime governing U.S. insider trading law consists of various sources of governmental authority, including federal securities law and the rules and regulations promulgated thereunder, case law, and civil and criminal enforcement actions. The ban on insider trading[11] derives from Section 10(b) of the Exchange Act, which prohibits "any manipulative or deceptive device or contrivance" used "in connection with the purchase or sale of any security."[12] Further, Rule 10b-5 under the Exchange Act, a general antifraud rule which does not specifically reference trading on inside information, is, nevertheless, the most commonly utilized provision of the federal securities laws in prosecuting insider trading.13 The Advisers Act imposes additional insider trading-related requirements, including that investment advisers:

- Must "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse . . . of material, non-public information by such investment adviser or any person associated with such investment adviser";[14] and
- Comply with the personal securities transaction reporting and supervision requirement under the Code of Ethics Rule.

As a result, an investment adviser may be subject to enforcement or other remedial action even if the adviser does not affirmatively trade on MNPI. In fact, although Enforcement has invested in various market surveillance tools to seek to identify insider trading in violation of Section 10(b) and Rule 10b-5, advisers must also be vigilant to avoid enforcement or other remedial action for failing to adopt compliance policies and procedures reasonably designed to prevent insider trading and/or failing to comply with the Code of Ethics Rule. However, despite the number of actions brought by the Division of Enforcement over time, limited guidance exists regarding the specific policies and procedures that the SEC believes would be "reasonably designed" to prevent insider trading violations. Accordingly, investment advisers should develop robust internal policies and procedures that take into account the nature of their business and the ways in which they may be exposed to MNPI to avoid being subject to insider trading violations.[15]

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Actions to Seek to Mitigate the Risk of Insider Trading-Related Violations

There are a number of practical steps that SEC-registered investment advisers can take to mitigate the risk of enforcement for insider trading-related violations under the securities laws. Certain actions seek to mitigate the risk that an investment adviser or its employees misuse MNPI obtained in breach of a duty; others seek to mitigate the risks that the adviser's compliance program is deemed to provide inadequate controls over insider trading. Taken together, the following steps should help SEC-registered investment

advisers avoid enforcement or other remedial action, including circumstances where the SEC is not able to identify any signs of misuse of MNPI.

a. Misuse of Material Non-Public Information

To avoid the risk of misusing MNPI, SEC-registered investment advisers should consider the following:

- To the extent the adviser has contact with the issuer of a security or other third-party entity that may be in the possession of MNPI, advising such issuer or third-party that the adviser does not wish to receive any MNPI. Document such communications and codify this practice in compliance policies and procedures.
- If the adviser comes into possession of MNPI, not buying or selling securities of the issuer (or any derivative thereof) for its own account, the account of any entity controlled by the adviser, or any related party or family member. Do not pass the MNPI to any other person.
- Codifying in applicable compliance policies and procedures that if a particular adviser employee comes into possession of information that is, or could potentially be, MNPI concerning an issuer, such employee (a) should report such information to the chief compliance officer as soon as possible and (b) shall be restricted from trading any of the issuer's securities or derivatives thereof for the employee's personal account and the account of any adviser client until the information is no longer MNPI, by becoming publicly available or otherwise.
- Consider implementing information barriers as appropriate and, if consistent with the firm's business circumstances to avoid the risk of confidential information, including MNPI, in the possession of one or more employees (or reasonably likely to be in the possession of, in the ordinary course of business) restricting the investment activities of the firm's supervised persons. Subject any permitted communications and document access requests between segregated employee groups to periodic review.
- Including specific policies and procedures regarding the use of expert networks and other similar arrangements.
- Conducting periodic training for employees regarding the scope of then-effective compliance policies and procedures governing insider trading, including a discussion of MNPI and recent insider trading actions.

b. Violations of Section 204A

Similarly, SEC-registered investment advisers should continually seek to assess whether their written compliance program is reasonably designed to prevent violations of, among other things, insider trading restrictions. Specifically, advisers should, in addition to the recommendations set forth above:

- Confirm that any compliance policies and procedures adopted pursuant to Section 204A reflect the specific risks presented by the adviser's specific business model and operations (including the potential sources of MNPI), and that such policies and procedures are implemented.
- Annually obtain a signed acknowledgement from each supervised person acknowledging that they have read, understand, and agree to comply with the adviser's written policies and procedures.
- Survey annually (or more frequently if appropriate) employees' public company affiliations.
- Impose and monitor for compliance with restricted or other similar lists of securities in which supervised persons and/or employees are prohibited to invest (either on behalf of adviser clients or personally).
- Take such other steps as the adviser believes are reasonably necessary to seek to monitor for potential insider trading or tipping by supervised persons, including by considering the possibility of conducting monitoring of electronic communications of personnel.

c. Code of Ethics Rule

In February 2017, OCIE issued a National Exam Program Risk Alert which cited deficiencies or weaknesses involving the Code of Ethics Rule as one of the five most frequently identified compliance topics in deficiency letters sent to SEC-registered investment advisers.[16] Further, although insider trading was not discussed in the *OCIE Priorities Report*, SEC-registered advisers should, nevertheless, consider assessing the appropriateness of their current code(s) of ethics to seek to mitigate the risk of deficiencies or weaknesses being identified in future examinations. Based on the deficiencies and weaknesses identified in the February 2017 Risk Alert, SEC-registered investment advisers should seek

to ensure that their Code of Ethics and related compliance policies and procedures:

- Identify all access persons.
- Specify requirements relating to the review of, and timeframes for submission of, holdings and transactions reports.
- Provide for the timely submission of holdings and transactions reports.
- Codify the requirement that a description of the code(s) of ethics be provided in Part 2A of the adviser's Form ADV.

Additionally, advisers who permit employees to rely on the Code of Ethics rule's exception for accounts over which the access person does not exercise direct or indirect influence or control should review recent SEC staff guidance on the exception.[17]

Performance Advertising

Performance advertising has long been a focus in SEC examinations. Today, advisers use websites, social media, blogs and blast messages as their main distribution channels and all of these media have far-reaching capabilities. Rule 206(4)-1 under the Advisers Act (the "Advertising Rule") governs adviser advertising, including performance advertising. The Advertising Rule includes four specific prohibitions[18] and general prohibitions on false, misleading, and incomplete advertisements. Nonetheless, the majority of the advertising rules are found in the multitude of guidance in the way of No-Action Letters, Risk Alerts, and enforcement cases in this area. Despite (and perhaps, in part, because of) the decades of accumulated law and lore in this area investment advisers continue to be found to be deficient (or worse) in their marketing materials.

On September 14, 2017, OCIE issued a new Risk Alert titled, *"The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers,"*[19] which was generated as a result of a recent exam initiative that focused on advisers who marketed accolades relating to their firms and professionals (the "Touting Initiative"). This Risk Alert focused on the most common regulatory examination deficiencies noted by the SEC regarding investment advisory firms' non-compliance with Advertising Rule.

Highlights of some of the most common deficiency areas noted in the Risk Alert include the following:

Misleading Performance Results

- Performance results in marketing materials must reflect the deduction of advisory fees.
- When comparing strategies to benchmarks, disclosures on the inherent limitations in those comparisons must be included.
- Hypothetical and back-tested performance results must contain disclosures that outline, among other things, all relevant material information about the results, including but not limited to an explanation of how the returns were derived.

Misleading One-on-One Presentations

- All one-on-one presentations showing gross of fee-only performance must include all materially relevant disclosures outlined in applicable SEC guidance, including the fact that the deduction of advisory fees will reduce the client's returns.

Misleading Claim of Compliance with Voluntary Performance Standards

- Firms claiming compliance to voluntary performance standards (*e.g.,* Global Investment Performance Standards or "GIPS®") must ensure they are complying with all required standards.

Cherry-Picked Profitable Stock Selections and Recommendations

- Marketing and advertising that present only a partial list of securities cannot cherry pick only profitable holdings, and must adhere to SEC No-Action Letters and regulatory guidance.[20]

Compliance Policies and Procedures

- Firms must have written policies and procedures reasonably designed to prevent deficient advertising practices. These should include, among other things, a process for compliance review and approval of advertising and marketing materials prior to their dissemination.

Misleading Use of Third Party Rankings or Awards

- Firms must disclose all facts related to third party rankings, ratings, or awards used in marketing and advertising, including selection criteria, who created the ranking or award, and whether the firm paid a fee to participate. Also, firms cannot publish only favorable rankings, ratings or awards.

Misleading Use of Professional Designations

- If a professional designation, title, or certification has lapsed, it can no longer be referenced in marketing or advertising materials.
- When using a professional designation, the minimum qualifications required to attain such designation must be included.

Testimonials

- Using testimonials (*i.e.*, statements attesting to or endorsing the firm's services) in marketing or advertising materials, including websites, social media, article reprints, and/or presentations is prohibited under the Advertising Rule.

The Risk Alert provides strong guidance on what investment advisers should consider prior to disseminating marketing materials and highlights a number of enforcement cases which help to formulate "lessons learned" for other registrants to consider.

Two recent enforcement cases highlight these and other common deficiencies found, that tend to repeated by investment advisers despite the SEC's guidance.

First, *In the Matter of Arlington Capital Management, Inc. and Joseph F. LoPresti* (IA Rel. No. 4885 (Apr. 16, 2018)), the SEC found that from 2012 to 2015, the investment adviser used misleading advertisements in written communications, weekly radio broadcasts and webcasts related to the performance of its model portfolios. Specifically, in some instances the adviser failed to disclose that the model was adjusted over time, which resulted in performance restatements under previous iterations of the model. In other instances, the adviser failed to prominently disclose that the performance results reflected hypothetical, backtested performance. If disclosures were provided, they often appeared in tiny print and lacked prominence. Moreover, in all cases, the firm failed to disclose that the performance returns were generated from models that were adjusted over the years with the benefit of hindsight. Finally, the adviser's advertising procedures were found to be inadequate. The firm's advertising procedures were not reasonably designed. They consisted of a lean, one-page document that failed to address how the adviser would ensure accuracy of performance advertising and how the adviser would comply with the requirements set forth in the Advisers Act. As a result, both the adviser and the firm's President and Chief Compliance Officer ("CCO") agreed to cease and desist from such activities and were censured, and Arlington Capital Management, Inc. agreed to pay a penalty of $125,000 and engage an independent compliance consultant to issue a Compliance Report on the adviser's advertising compliance program. Joseph F. LoPresti, who served as the firm's President and CCO, was found to lack sufficient oversight controls over performance advertising activities and agreed to pay a penalty of $75,000.

Next is *In the Matter of Virtus Investment Advisers, Inc.* (IA Rel. No. 4266 (Nov. 16, 2015), wherein the SEC found that Virtus Investment Advisers, Inc. ("Virtus") had made false performance advertising claims in filings with the Commission, in client presentations and other marketing materials from May 2009 to September 2013 due to allegedly misleading performance data provided to it by F-Squared Investments, one of its third-party sub-advisers. While the SEC acknowledged that Virtus had received from F-Squared and its President[21] exaggerated, inaccurate information about the history and performance of the third-party sub-adviser's AlphaSector strategy, Virtus allegedly relied upon F-Squared's representations without properly verifying them, and by doing so, Virtus itself made false and misleading statements about the past performance of the AlphaSector strategy by publishing inaccurate, false data as provided by F-Squared. In addition, the SEC alleged that the adviser's policies and procedures were inadequate and did not address controls surrounding how performance would be obtained from the sub-adviser, verified by Virtus and maintained as part of the firm's books and records. As a result, it was ordered that Virtus cease and desist from such activities, the adviser was censured and Virtus agreed to disgorge $13.4 million, pay $1.1 million in prejudgment interest and pay a $2 million penalty.

Other cases[22] support that advisers should be cognizant of the basis for the SEC's allegations in false performance advertising claims: failure to provide clear, transparent disclosure of all material factors or to substantiate the performance information presented can result in stiff fines and penalties in enforcement proceedings. Advisers, too, must adopt robust advertising policies and procedures to provide internal controls over their performance advertising activities.

Advisory Fees

While it may seem obvious, proper disclosure and assessment of advisory fees is one of the most important aspects of the adviser-client relationship that some advisers still fail to get right in the eyes of the SEC staff. Disclosures concerning fees are paramount in allowing clients to make informed decisions as to whether or not to engage an adviser, and the fees actually assessed by the adviser should mirror the advisory contract and any such disclosures. While conceptually this sounds straightforward, advisers continually find themselves in the cross-hairs of regulators for violations regarding fees. As a result, the SEC recently notified the financial industry that fees assessed to clients will be a point of emphasis during reviews. Specifically, the SEC is looking for advisers who are overcharging clients as compared to statements made as part of the advisory firm's Form ADV and/or client agreement.[23]

Common Compliance Issues Related to Advisory Fees

In April of 2018, OCIE released a Risk Alert[24] that detailed the most frequent advisory fee and expense compliance issues identified in recent examinations of investment advisers. The areas discussed by OCIE in its report include the following:

- Fee-Billing Based on Incorrect Valuations;
- Billing Fees in Advance or with Improper Frequency;
- Applying Incorrect Fee Rate;
- Omitting Rebates and Applying Discounts Incorrectly;
- Disclosure Issues; and
- Adviser Expense Misallocations.

This is not an exhaustive list however. We've seen several other instances where fees may be viewed as having been improperly assessed or disclosed. For example, OCIE has made known[25] that disclosures should be provided in the firm's Form ADV detailing whether the firm includes cash and cash equivalents in tabulations for "assets under management" when assessing fees. Additionally, for firms utilizing margin accounts, it is very important to disclose whether the firm assesses fees on "gross" or "net" assets. In other words, will the firm only charge fees on the amount of assets in the underlying client account, or the margin portion of the account? For example, in an account reflecting $100K in equities, but $25K is attributable to margin, will only $75K will be included when determining fees or the full $100K? It is assumed that unless expressly disclosed otherwise, firms who utilize margin will only charge fees on the net amount (or the $75K amount in the example above). Firms charging fees on the gross amount of assets must disclose this in their Form ADV and/or client agreement.

Practical Steps for Assuring Compliance Related to Advisory Fees

The amount and types of advisory fees can vary widely between firms and among clients or client types within a single firm based upon such factors as the services provided, types of investments and structure or type of client (*i.e.*, organized as a separate account versus private fund). Thus, the exact methodology employed by firms for the review, testing and disclosure of fees will vary as well. That being said, there are steps that all firms should take to ensure compliance in this area. The following, while not an exhaustive list, provides some practical steps to be followed:

a. Review Current Disclosures

While they may occur elsewhere, disclosures related to fees must always be provided to clients as part of the firm's Form ADV disclosures and be included as part of the client agreement (often as an attached fee schedule but sometimes addressed or modified through a side letter or amendment). While advisory firms are required to update their Form ADV filings at least annually, there is no such requirement for client agreements. As such, firms will often make revisions to their Form ADV to update and amend their fee disclosures, but fail to make the corresponding revisions to their client agreement. An investment adviser's fee schedules in client agreements must generally match the fee schedule discussed in Item 5 of ADV Part 2A[26] and marked in Item 5.E. of Form Part 1. However, advisers may disclose that fees are negotiable without disclosing what precise lower rates have been agreed to with particular clients. If an investment adviser's business model changes, the investment adviser must ensure that any clients affected by the change enter into new advisory agreements or an addendum to the advisory

agreement. Additional disclosures are required where fees include a performance component.[27]

b. Review Relationships with Third Parties

Depending upon the business model of the firm, advisers will often utilize third parties to assist in certain aspects of firm activities. For example, most firms utilize the services of an unaffiliated qualified custodian to maintain custody of client assets. Often, such custodians will facilitate having advisory fees paid directly to the adviser from the client account[28] to save the adviser from having to invoice the client directly. The billing valuation and methodology employed by such custodians can vary, so it is important not to assume a particular billing practice. For instance, while it is common to value the client's assets under management as of the close of business on the last business day of the preceding calendar quarter; certain custodians instead employ an "average daily balance" valuation methodology. It is important to understand the methodology employed in order to ensure that proper disclosures are made as part of the firm's Form ADV and client agreement.

Another example can be found when utilizing third-party advisers ("TPAs") to manage all or a portion of their client's assets. In these situations, the firm should disclose whether its fees are inclusive of, or in addition to, fees assessed by the TPA. If the TPA's fees are in addition to the firm's fees, it is important to also disclose when and how such fees are to be collected by the TPA.

c. Review Contracts

Advisers should periodically review client contracts, fee schedules and any related side letters to assure that fees are being billed as and at the rates set forth therein. In particular, the methods for calculating the fees and the assets on which they are charged sometimes vary and, for each client, must be as stated in the applicable agreements. This is particularly important when fees are subject to asset based breakpoints which may apply on a "householding" basis such that the total value of a relationship might trigger a different fee rate when a breakpoint is reached at the relationship level, although no breakpoint might have been reached in any particular account within the relationship on a stand-alone basis. Additionally, advisers who agree to "most favored nation" clauses ("MFN") should make sure that they are vigilant in reviewing future contracts and contract amendments to determine if any MFN is triggered, particularly as MFNs often require a degree of similarity as to size and type of account (or exclude certain types of other clients) as a condition precedent to a notice or fee rate adjustment. Where an MFN is triggered, advisers should promptly notify the impacted client(s) benefiting from the MFN and/or proactively adjust the fee rate, as required by the particular MFN. Advisers should consider maintaining an easy reference such as a matrix of all their client contracts including such relevant data as fee rates, breakpoints and MFNs to facilitate compliance with contractual requirements and to help in testing the adviser's billing practices.

d. Testing of Billing Practices

Advisory firms registered with the SEC are required by the Compliance Program Rule to perform an annual review of the firm's policies and procedures. Part of that review should include firm billing practices. What tests should be performed will differ based upon the activities of the firm. However, at a minimum, the following tests should be considered:

- Sample a statistically relevant number of client accounts that were previously billed to ensure that fees assessed match with fees disclosed in the respective client agreement and the firm's Form ADV;
- If a "sliding" or "tiered" fee schedule is utilized, test to make sure clients are being billed such amounts as may be dictated by the schedule, and that any growth/reduction in client accounts that would cause the client to receive higher/lower fees as a result is properly monitored and reflected in the billing;[29]
- Review any unique client billing arrangements or fee structures whereby the client has negotiated fees that may differ from the firm's traditional fee structure to ensure accurate billing practices;
- Review the firm's polices related to aggregation of client accounts for billing and breakpoint purposes (*i.e.*, by household, by client, etc.) and sample a statistically relevant number of client accounts to ensure such aggregation practices have been followed; and
- Test any performance-based fee arrangement for conformity with the advisory contract and disclosures, proper calculation and compliance with Section 205(a)(1) of the Advisers Act or the available exceptions thereunder (*i.e.*, the qualified client exception).

- Confirm that any MFNs have not been triggered or, if triggered, appropriate notice and/or adjustment has been provided to impacted clients.

As mentioned above, while firms should be performing such reviews no less than annually, changes in firm practices or regulatory changes could cause the firm to perform such reviews more often. The timing and frequency of such reviews should be predicated upon the facts and circumstances unique to the firm.

e. Utilize Technology

For those firms that employ a quarterly or monthly billing schedule, the client billing process can be onerous. Furthermore, billing clients based on the average daily account balance becomes even more difficult without technology support. It's also important to note that many state-registered advisory firms are required to send separate billing invoices to clients in addition to statements sent by the client's custodian. Investing in the proper technology can help simplify and automate the client fee billing and invoicing process to improve operational efficiency and reduce errors.

Compliance Program Failures

Annual Reviews

Pursuant to Rule 206(4)-7 under the Advisers Act, all SEC-registered investment advisory firms must perform, no less than annually, a review of their compliance programs (an "Annual Review"). This includes testing the compliance program's efficacy to ensure that the internal controls of the organization are reasonably designed to prevent or at least detect and respond to violations and circumvention of the Advisers Act. The Annual Review is a critical component of your compliance program and is subject to review by the SEC during an examination. While there is no specific format to follow for the Annual Review (nor does the Rule require that the Annual Review or its results be committed to writing[30]), the advisory firm's Annual Review should take into consideration whether the current policies and procedures are still adequate and effective, particularly as its business grows and possibly changes. In addition, the development of potential and actual conflicts along with new technology deployments should be considered when evaluating potential new risks of the organization and its clients.

a. Considerations for Conducting Your Compliance Testing and Annual Review

The SEC provided some guidance in its adopting release regarding the performance of annual reviews, noting that an investment adviser should consider, among other things: (1) any compliance matters that arose during the previous year, (2) any changes in the adviser's or its affiliates' business activities, and (3) any changes in the Advisers Act or applicable regulations that may require a revision to the compliance program. Further, in a 2005 speech,[31] Gene Gohlke (retired), formerly of OCIE, provided guidance on how the SEC may evaluate advisers during examinations in the way of Annual Review testing. He explained that traditionally, there are three forms of compliance testing: transactional, periodic and forensic.

i. Transactional Testing

A transactional compliance test is performed around the time an activity occurs, thereby occurring through the year as opposed to a set time

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period. For example, a transactional test occurs when a portfolio manager performs a transaction on behalf of a client account and ensures there is compliance with client guidelines and restrictions prior to commencing the trade. Another transactional test occurs when comparing each allocation of an investment among client accounts in accordance with the firm's allocation policy. Obtaining pre-approval for a personal trade before the time of execution by compliance's review of the request against the restricted and watch list is another type of transactional test.

ii. Periodic Testing

A periodic compliance test is performed at appropriate intervals rather than concurrently with each transaction to verify compliance with relevant requirements. For example, a periodic

test occurs when client imposed guidelines and restrictions are reviewed against guidelines recorded in the order management system and the client's advisory contract to ensure they are accurate. Another periodic test occurs when reviewing soft dollar transactions and denoting those with unusually high commissions to ascertain which broker-dealer firms are most frequently used and why. Reviewing quarterly personal trading statements for potential front running abuses or insider trading is another type of periodic test.

iii. Forensic Testing

A forensic compliance test is performed over time to see if patterns are emerging that could indicate circumvention of firm policies or federal securities laws. While at first these tests may only raise suspicion and not conclusively indicate that a violation occurred, over time forensic testing can help to detect trends that evidence misconduct. For example, a forensic test occurs when a portfolio manager compares the performance of a client's account with relevant benchmarks or reviews dispersion amongst client accounts that are managed in the same style or manner. Reviewing personal trades for profitable trades over time for the same securities or in comparison with client trades is another example of a forensic test.

For each of the firm's policies, it is important to develop these tests, which should evolve each year to ensure that the adviser's compliance program is not being circumvented. One approach you may wish to consider using in order to track compliance testing is the development of a compliance testing calendar. This will help to categorize which items to review monthly, quarterly or annually, and can help to ensure that periodic and forensic tests, which comprise the Annual Review, are conducted throughout the year rather than all within one brief interval of time. Once the review is complete, document what was tested, how, and your findings, and report up to senior management as appropriate.

Based on testing results, the chief compliance officer ("CCO") can implement adjustments to the firm's policies, procedures and/or internal controls to enhance their adequacy and effectiveness in preventing, detecting and correcting violations. All such adjustments should be documented and maintained in a designated file. Further, advisers are required to keep any records documenting their annual review for five years from the end of the fiscal year in which the annual review was performed.[32]

Competency of the Chief Compliance Officer

The objective of a firm's compliance program is to prevent, detect and correct violations of securities laws. To this end, investment advisers registered, or required to be registered, under Section 203 of the Advisers Act are required to establish and maintain a compliance program in accordance with Rule 206(4)-7 of the Advisers Act. One of the requirements of this Rule is that the advisory firm designate a CCO who is responsible for administering the firm's compliance program.

According to the adopting release for Rule 206(4)-7 under the Advisers Act, the CCO must be an individual who is competent and knowledgeable regarding the Advisers Act, and empowered with full responsibility and authority to develop appropriate policies and procedures. The adopting release further states that the CCO should have a sufficient position of seniority and authority within the adviser's organization to enforce and compel the adherence of others to the compliance program.

One of the best ways to improve the compliance function at a firm is to improve the knowledge and skills of the compliance personnel, including the CCO. In this regard, professional development is critical especially because new challenges, new business developments and new regulations are a constant occurrence. There are numerous conferences, roundtables, professional designations and training programs dedicated to the professional development of compliance personnel, and mentoring can be an invaluable tool. The internet provides a wealth of information and law firms and consulting firms have frequent newsletters and blogs that dispense valuable information, usually at no cost. General knowledge and skills are important but just as important is specific knowledge of your firm's business model, personnel and clientele. We refer to this as "local knowledge." Local knowledge is developed through interaction and learning from your co-workers. CCOs should, therefore, be involved in or at least apprised of any material business decisions and developments.

Conclusion

Advisers must remain vigilant to protect against compliance failures in these areas. Dusting off the

sections of the manual that have covered these old standbys from time to time, running appropriate review and testing for potential weaknesses and breaches and conducting periodic training can help to assure that the adviser continues to be in compliance with rules, regulations and guidance.

ENDNOTES

* Michelle L. Jacko, Esq. is also Founder and CEO of Core Compliance & Legal Services, Inc., a compliance consultation firm.

** Michael L. Sherman's practice focuses on counseling investment advisers (including advisers to hedge funds), investment companies, business development companies and other financial institutions in regulatory, corporate and compliance matters. Much of his work involves helping clients with issues related to investment adviser registration, compliance policies and procedures, marketing and advertising (including Global Investment Performance Standards), investment company status questions, and regulatory issues and examinations. Mr. Sherman has assisted advisers specializing in non-standard asset classes such as CLOs (collateralized loan obligations), real estate and tax credit with applying the Investment Advisers Act and the Investment Company Act to their unique businesses and vehicles – recently he has advised on matters arising in connection with the new risk retention rules for CLO sponsors.

† Robert R. Boeche II provides strategic legal counsel to investment advisers, broker-dealers, private funds and other financial professionals. He advises clients on all aspects of formation, registration, and ongoing operations. He regularly counsels clients regarding the legal issues surrounding all matters of business entity formation, including state filings, document preparation, and general corporate governance matters as well as succession planning. Mr. Boeche is responsible for drafting contracts, sales agreements, and client disclosure documents, as well as reviewing/preparing regulatory responses. He has extensive experience in all matters of investment adviser registration and compliance, including advising clients on solicitation and marketing activities.

†† Nicholas DiLorenzo advises U.S. registered investment companies and their investment advisers on a wide variety of regulatory, compliance and business matters. He has assisted clients with developing and launching new funds, regulatory and compliance matters relating to existing funds, fund reorganizations and requests for exemptive relief from the Securities and Exchange Commission. Mr. DiLorenzo also advises boards of directors/trustees of U.S. registered investment companies on fund governance and fiduciary oversight matters.

1 *See* 2018 National Exam Program Examination Priorities, U.S. Securities and Exchange Commission – Office of Compliance Inspections and Examinations (pub. avail. at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf) (the "OCIE Priorities Report").

2 *See, e.g.*, *In re* Valor Capital Asset Management, *et al.*, Advisers Act Release No. 4864 (Mar. 6, 2018) (adviser placed trades through an omnibus brokerage account and then allocated profitable trades to adviser's account while placing unprofitable trades into the client accounts); *see also* SEC v. Strategic Capital Management, LLC and Michael J. Breton, Litigation Release No. 23867 (June 23, 2017) (partial settlement); *In re* Gerson Asset Management, Inc., *et al.*, Advisers Act Release No. 2457 (Dec. 2, 2005); *In re* Zion Capital Management LLC, *et al.*, Advisers Act Release No. 2200 (Dec. 11, 2003); SEC v. Slocum, Gordon & Co., Litigation Release No. 17688 (Aug. 20, 2002); SEC v. Gobora, Litigation Release No. 17555 (June 11, 2002); SEC v. Alan Brian Bond, *et al.*, Litigation Release No. 17099 (Aug. 10, 2001); SEC v. Frederick Augustus Moran, *et al.*, Litigation Release No. 14861 (Apr. 3, 1996).

3 For example, an adviser may be required to allocate securities for which there is a limited supply or demand among multiple clients, including, among other examples, shares purchased in an initial public offering, certain fixed-income, small-capitalization, and international securities, as well as private investment opportunities. An adviser may also be required to make allocations decisions when it aggregates the purchases or sales of securities of multiple clients to, among other things, obtain better execution terms and manage fairly simultaneous trading in the same security by different clients. *See SMC Capital,* SEC No-Action Letter (Sept. 5, 1995).

4 Dabney O'Riordan, then Co-Chief of the Asset Management Unit of the SEC's Division of Enforcement, explained at the 2017 SEC Speaks Conference that advisers should expect to receive heightened levels of scrutiny related to investment allocation issues including: (i) whether advisers allocate more favorable trades to their own accounts rather than to their clients; (ii) whether advisers allocate more favorable trades to accounts where the advisers earn higher fees; and (iii) whether advisers allocate trades in a manner inconsistent with its disclosures to clients or with its policies and procedures.

5 See "Conflicts, Conflicts Everywhere" – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View," Speech by Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement (Feb. 26, 2015) (pub. avail. at https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html).

6 Although the SEC has not defined what would constitute a "fair and equitable" allocation methodology, the SEC did offer related guidance in the SMC Capital, Inc. No-Action Letter (Sept. 5, 1995) ("SMC Capital"). In that letter, the SEC staff allowed an adviser to aggregate orders for client accounts, including accounts in which affiliates of the adviser had an interest, so long as appropriate disclosure was made to clients (both in the Form ADV and in a separate disclosure to clients) and adequate safeguards to ensure equitable allocation to clients were implemented. The SEC staff indicated that these safeguards should include pre-allocation statements setting forth which account orders were being aggregated, assurance that no client would be favored over another, and average pricing (with costs shared on a *pro rata* basis).

7 For equity securities, pro rata allocations may be based on account size, account current holdings of an issuer, and/or the proportion of each account's target amount of that type of security bears to the total amount desired by all accounts. For fixed-income securities, the sequential method may be more practical because of the fungibility of fixed-income securities in the market.

8 *Annual Report: A Look Back at Fiscal Year 2017*, U.S. Securities and Exchange Commission Division of Enforcement (pub. avail. at https://www.sec.gov/files/enforcement-annual-report-2017.pdf).

9 *Id.* at 15.

10 *Salman v. United States, 137 S. Ct. 420 (2016) (holding that* the "personal benefit" requirement of insider trading law may be met by "making a gift of confidential information" to a trading relative or friend); *United States v. Martoma*, No. 14-3599, Dkt. No. 174-1 (2d Cir. Aug. 23, 2017) (finding that insider trading does not require proof of a "meaningfully close personal relationship" between a tipper and tippee).

[11] At its most basic level, insider trading is considered to be a purchase or sale of a security on the basis of material non-public information about that security or issuer, in breach of a duty of trust or confidence that is owed with respect to such information. Under the classical and misappropriation theories of insider trading, scienter is also a required element.

[12] Rule 10b5-1 promulgated under the Exchange Act.

[13] *See* In re Cady, Roberts & Co., 40 SEC 907 (1961) (first case suggesting that trading on inside information violates Rule 10b-5). As stated in Rule 10b5-1:

The "manipulative and deceptive devices" prohibited by Section 10(b) of the [Exchange] Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

[14] *See* Section 204A of the Advisers Act. Similar requirements are imposed under the laws of many States.

[15] Section 204A of the Advisers Act, which imposes the requirement to establish, maintain, and enforce MNPI policies applies to any adviser which is subject to Section 204 of the Act (*i.e.*, advisers other than those that are exempt from registration under Section 203(f)). As a result, the obligation applies to any adviser that is required to be SEC registered and to exempt reporting advisers relying on Section 203(f) or Section 203(m) of the Advisers Act.

[16] *Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers*, Office of Compliance Inspections and Examinations (Feb. 7, 2017) (pub. avail. at https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf) ("February 2017 Risk Alert").

[17] *Personal Securities Transactions Reports by Registered Investment Advisers: Securities Held in Accounts Over Which Reporting Persons Had No Influence or Control*, SEC Division of Investment Management Guidance Update No. 2015-03 (June 2015) (pub. avail. at https://www.sec.gov/investment/im-guidance-2015-03.pdf) (the "Guidance"). The access person transactions and holdings reports required under Rule 204A-1 concern reportable securities in which the access person has direct or indirect beneficial ownership. However, Rule 204A-1(b)(3)(i) provides that access persons are not required to submit transactions or holdings reports with respect to securities held in accounts over which the access person has no direct or indirect influence or control. The Guidance addressed this exception, providing that while the fact that a trustee or third-party manager has management or discretionary investment authority over an access person's trust or personal account would not, by itself, enable reliance on the Rule 204A-1(b)(3)(i) exception, additional controls may support a reasonable belief that an access person had no direct or indirect influence or control over the trust or account, thereby permitting reliance on the exception. Such controls "should be reasonably designed to determine whether the access person actually had direct or indirect influence or control over the trust or account."

[18] Specifically, in addition to the general prohibition, the Advertising Rule prohibits (i) the use of testimonials; (ii) reference to any past, specific recommendations made by the adviser that were profitable, unless the advertisement sets out a list of all recommendations made by the adviser within the preceding period of not less than one year; (iii) any representation that any formula or other device can be used to make investment decisions without disclosing prominently the limitations and difficulties with respect to its use; and (iv) any representation that any report, analysis, or other service will be provided without charge unless the report, analysis, or other service will be provided without any obligation whatsoever.

[19] Available at https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.

[20] *See*, for example, The TCW Group, SEC Staff No-Action Letter (Nov. 7, 2008) *available at* https://www.sec.gov/divisions/investment/noaction/2008/tcwgroup110708.htm; Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998) *available at* https://www.sec.gov/divisions/investment/noaction/franklinmanagement121098.pdf; and Investment Counsel Ass'n of America, Inc., SEC Staff No-Action Letter (Mar. 1, 2004) *available at* https://www.sec.gov/divisions/investment/noaction/ica030104.htm.

[21] See *In the Matter of F-Squared Investments* (IA Rel. No. 3988 (Dec. 22, 2014) whereby F-Squared was the subject of a separate SEC administrative proceeding regarding the AlphaSector strategy's hypothetical back-tested performance.

[22] See, for example, *In the Matter of Jeffrey Slocum & Assocc., Inc. & Jeffrey Slocum* (IA Rel. No. 4647 (Feb. 8, 2017)) and *In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.* (IA Rel. No. 3456 (Sep. 5, 2012)

[23] See *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, Office of Compliance Inspections and Examinations (Apr. 12, 2018) (pub. avail. at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).

[24] https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).Id.

[25] *Id.*

[26] Such information may be omitted for any brochure offered only to certain "qualified purchasers."

[27] In particular, advisers should describe the fees used as well as relevant risks and conflicts and, if some but not all clients pay performance-based fees, further disclosure related to "side-by-side" management conflicts must be included. *See* Form ADV, Part 2A, Item 6. Such

[28] Advisers who perform such billing practices are subject to 206(4)-2, the "custody rule," under the Advisers Act.

[29] As noted earlier, it is important to also be cognizant of the basis on which breakpoints are measured.

[30] Of course, as is said of unwritten constitutions, an annual review not well-evidenced is not worth the paper it is printed on.

[31] *Speech by SEC Staff: Remarks Before the Fund of Funds Forum – SEC Expectations for Regulatory Compliance*, Gene A. Gohlke (Nov. 14, 2005) (pub. avail. at https://www.sec.gov/news/speech/spch111405gag.htm).

[32] *See* Rule 204-2(17)(a)(ii). While Rule 206(4)-7 does not require a written report, related Rule 38a-1 under the Investment Company Act of 1940, as amended, requires a fund CCO to provide a written report related to the compliance program to the fund's board at least annually.

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