The Division of Examinations' (Implied) Guidance to Investment Advisers: Consider Adopting Broker-Dealer Compliance Practices

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On November 9, 2020, the SEC's Office of Compliance Inspections and Examinations ("OCIE"), which has since been renamed the Division of Examinations, issued a Risk Alert[1] which discusses commonly found deficiencies as well as some risk-mitigating practices identified in its examinations of approximately 40 registered investment advisers ("RIAs") with branch offices. The examinations focused on the (i) overall compliance programs, with an emphasis on their codes of ethics, custody and general fiduciary duties as related to fees, expenses and advertising,[2] and (ii) delivery of investment advice, particularly oversight of recommendations, disclosure of conflicts of interests and allocation of investment opportunities.

OCIE's observations in the 2020 Risk Alert will be unsurprising to most compliance officers as each has been the subject of prior Risk Alerts or SEC enforcement actions which are well annotated in the 2020 Risk Alert. Moreover, none of the deficiencies and only a few of the suggested compliance practices are specific to firms with branch offices - most apply equally to all RIAs and dual registrants. In fact, the most noteworthy and perhaps curious aspect of the 2020 Risk Alert is that each of the practices identified by OCIE is already required in substantially the same form by brokers under FINRA rules, yet this detail is not acknowledged anywhere in the release.

This article (i) reviews how the regulatory focus on branches has expanded from being purely a broker concern to include RIAs; (ii) reviews the observations and suggestions offered by OCIE in the 2020 Risk Alert; and (iii) compares OCIE's suggested practices for RIAs to the regulations governing broker dealers. It also suggests that RIAs that are not already familiar with FINRA rules and practices may wish to develop their knowledge on these topics as OCIE is endorsing such practices for RIAs.

The SEC's Focus on Multi-Branch Offices

The Commission has long recognized that branch offices, which typically operate without onsite supervisory or compliance personnel, present a myriad of oversight challenges for brokers. Many of the concerns, such as inconsistent application of firm procedures and poor recordkeeping, have been directly addressed for brokerage firms since 1988 when the SEC approved the original predecessor to FINRA Rule 3110.[3] That rule required, among other things, the express designation of supervisors for each location at which securities business is conducted, the written assignment of each RR to a supervisor, a regular schedule of examinations for all branch locations, annual compliance training and approval of advertising. Almost twenty years later in 2004, Commission staff issued Staff Legal Bulletin No. 17: Remote Office Supervision ("Bulletin No. 17"), reminding brokers to be vigilant in their efforts to oversee branch locations and recommending many of the practices which OCIE includes in its 2020 Risk Alert for RIAs. In 2011, OCIE weighed in on the mandatory brokerage branch examination program when it issued a joint Risk Alert with the NASD titled *Broker-Dealer Branch Inspections* which included a helpful discussion of effective branch examination practices. In 2014, OCIE identified supervision of brokerage firm branches as a "core risk" in its second annual *Examinations Priorities* letter.

Over the next few years,[4] OCIE began linking branch supervisory failures at brokers to similar issues at RIAs in its *Examination Priorities*. In December 2016, OCIE launched a Multi-Branch Adviser Initiative[5] which expanded the focus from supervision to include a range of other risks

1. *Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices,* ("2020 Risk Alert").
2. Note that on December 22, 2020, the Commission adopted amendments to its advertising rules for RIAs.
3. In Notice to Members 88-84 the NASD (which changed its name to FINRA in 2007) adopted amendments to Article III, Section 27 of the Rules of Fair Practice which introduced the requirement for brokers to have formally prescribed supervision programs. It also required brokers to adopt and enforce written supervisory procedures and conduct an annual review of the businesses in which they engage, which are similar to but generally broader than the corresponding duties for RIAs under Rule 206(4)-7, adopted in 2004.
4. "We will focus on registered entities' supervision of registered representatives and financial adviser representatives in branch offices, including using data analytics to identify branches that may be deviating from compliance practices of the firm's home office." OCIE's 2015 *Examination Priorities letter*; "We will continue to review regulated entities' supervision of registered representatives and investment adviser representatives in branch offices of SEC-registered investment advisers and broker-dealers, including using data analytics to identify registered representatives in branches that appear to be engaged in potentially inappropriate trading." OCIE's 2016 *Examination Priorities letter*.
5. OCIE also included a reference to the broader risks of RIA branches in its 2017 Examination Priorities letter but omitted the topic in its 2018, 2019 and 2020 letters.

inherent in the RIA branch office model. That initiative involved examinations of 40 firms which were completed in 2018 and almost two years later, OCIE has just published its observations from those examinations in the 2020 Risk Alert.

Commonly Identified Deficiencies

The 2020 Risk Alert notes that the "vast majority" of RIAs examined were cited for at least one deficiency related to the Compliance Rule and more than half had deficiencies arising from their portfolio management practices. Since, as OCIE acknowledged, few of the exceptions were unique to firms with branches, it may be helpful to divide the deficiencies into three categories: (i) exceptions that arose specifically from having a branch network; (ii) problems that arose from having non-centralized controls/oversight which often are exacerbated by having remote offices; and (iii) deficiencies that apply to RIAs based on the overall strength of their compliance programs, without particular regard to the locations from which they operate.

The deficiencies identified in the 2020 Risk Alert that are specific to firms which utilize branches include:

- Inconsistent application of compliance policies and/or nonenforcement of such policies at branch offices;
- Inadequate recordkeeping because branch offices did not provide the central compliance department with records as mandated by the firm's policies;
- Receipt of client checks at branches which were then deposited at the clients' custodians, causing the firm to have custody.

Deficiencies that arise primarily from having non-centralized oversight include:

- Overcharges of fees resulting in misapplication of tiered fee discounts or charges on assets that should have been excluded from the fee;
- Violations of advertising rules, particularly among supervised persons operating under DBA names.

The remainder of deficiencies do not arise from geographic dispersion of firm personnel but from the culture of compliance, sufficiency of onboarding and training programs, level of testing and the general strength of the compliance program. This is by far the biggest group of exceptions and includes:

- Outdated compliance policies, such as references to entities no longer in existence and personnel who had changed roles and responsibilities;
- General failure of RIAs to recognize that they had custody of clients' assets;[6]
- Failure to identify and remediate undisclosed fees (including in wrap accounts) and/or to have policies addressing this issue and/or failure to enforce such policies;[7]

6. The deficiencies relating to custody generally arose because the advisers "did not have policies and procedures that limited the ability of supervised persons to process withdrawals and deposits in client accounts, change client addresses of record, or do both." Specific failures to recognize custody (other than the one noted as being specific to RIAs with branches) include instances in which the RIA

> (1) comingled its assets with those of its clients; (2) was the trustee for client accounts (or its supervised persons were trustees); (3) was the general partner to an advised limited partnership; . . . ; and/or (5) had various arrangements in place that gave it broad disbursement authority over client assets.

7. Specific examples of conduct giving rise to client overcharges include instances in which the adviser:

> (1) used inaccurate fee calculations by, for example, misapplying tiered fee structures or employing incorrect valuations for the calculations; (2) inconsistently applied fee reimbursements, including for advisory fee offsets for 12b-1 fees from certain mutual fund purchases and refunds for prorated fees paid in advance by clients who terminated their accounts; and (3) charged fees different than the rates included in advisory agreements or on assets that were to be excluded from advisory fees.

- Deficient oversight and supervision of supervised persons, including failure to identify and document disciplinary events, particularly with personnel with “higher-risk profiles;”[8]
- Improper allocation of block trades and block trade losses;
- Advertising deficiencies;[9]
- Code of ethics deficiencies;[10]
- Deficiencies arising from inadequate oversight of, or reasonable basis for, investment recommendations;[11]
- Inadequate disclosures regarding conflicts of interest;[12]
- Insufficient oversight of trading and allocation of investment opportunities.[13]

OCIE Observations Regarding Compliance Practices

The 2020 Risk Alert identifies a number of practices which may assist advisers in designing and implementing their compliance programs.[14] The suggestions roughly can be divided into six categories:

- Tailoring policies to address the specific business activities conducted by the firm at each location;
- Uniformity of policies and practices;
- Greater centralization of operations and supervision;
- Regular testing;
- Review of disciplinary histories of supervised persons and heightened supervision for such persons; and
- Periodic and ongoing compliance training.

Each of these suggestions is either required for brokerage firms under SEC or FINRA rules, or has been identified as a best practice for brokers for many years or, in some cases, decades.

Tailored Policies

OCIE notes that some advisers adopted and implemented written compliance policies and procedures regarding the specific activities taking place at each location. Other firms did not have custom policies directed to branches but addressed compliance monitoring of branches in their policies. This guidance is certainly useful but not novel, as advisers were encouraged in the 2003 adoption of Rule 206(4)-7 (the Compliance Rule”) to design their compliance programs

8. Examples of supervision deficiencies include:
(1) the failure to disclose material information, including disciplinary events of supervised persons; (2) portfolio management, such as the recommendation of mutual fund share classes that were not in the client’s best interest; and (3) trading and best execution, including enforcing policies and procedures the adviser had in place.
For more information on these types of deficiencies, see OCIE’s Risk Alert *Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest* (July 23, 2019).
9. Examples of problematic advertisements include:
(1) performance presentations that omitted material disclosures; (2) superlatives or unsupported claims; (3) professional experience and/or credentials of supervised persons or the advisory firm that were falsely stated; and (4) third-party rankings or awards that omitted material facts regarding these accolades.
As noted in footnote 2, the Commission recently adopted amendments to its advertising rules for RIAs.
10. These deficiencies included several instances in which firms failed to:
(1) comply with reporting requirements, including by submitting transactions and holdings reports less frequently than required by the rule or not submitting such reports at all; (2) review transactions and holdings reports; (3) properly identify access persons; or (4) include all required provisions in their codes of ethics. Examples of provisions omitted from codes of ethics include those requiring: a review and approval process prior to supervised persons investing in limited or private offerings; initial and annual holdings report submissions; and/or quarterly transaction report submissions.
11. For the most part, these deficiencies have been the subject of significant regulatory attention in recent years, including mutual fund share class selection and wrap fee disclosures. OCIE also identified a failure by some advisers to consider whether certain automated processes, which caused clients to pay additional fees, were in the best interest of the clients.
12. These included “expense allocations that appeared to benefit proprietary fund clients over non-proprietary fund clients” and advisers who “did not fully and fairly disclose financial incentives for the advisers and/or their supervised persons to recommend specific investments.”
13. Commonly found deficiencies were based on
(1) the lack of documentation demonstrating the advisers’ analysis regarding obtaining best execution for their clients; (2) completing principal transactions involving securities sold from the firms’ inventory without prior client consent; and (3) inadequate monitoring of supervised persons’ trading, including the improper allocation of block trade losses to clients rather than to the supervised persons.
14. As with all such suggestions, OCIE reminds that the suggested practices they are not required, firms may achieve compliance without adopting them, and implementing them may not be sufficient to insulate firms from regulatory exposure. Interestingly, OCIE noted that “[d]uring the course of these examinations, the staff observed a range of practices with respect to branch office activities that firms may find helpful in their compliance oversight efforts,” yet in only a few instances did OCIE indicate that these practices were actually effective at the firms at which they were observed.

to fit their businesses. And since at least the 1990s, FINRA has directed brokers to design their supervisory systems by taking into account the “number and geographic location of offices and personnel.”

Uniform Policies and Practices

OCIE notes that some firms adopted the same policies for all supervised persons, whether they are employees or independent contractors, a matter which captured regulatory attention in the brokerage arena years ago. The NASD recognized the risks inherent in the geographical dispersion and the independent contractors’ engagement in businesses outside of the registered firm as early as 1986 when it cautioned that

> A significant number of NASD members employ registered persons who engage in securities-related activities, on a full- or part-time basis, at locations away from the offices of the members. These off-site representatives, often classified for compensation purposes as independent contractors, may also be involved in other business enterprises such as insurance, real estate sales, accounting or tax planning. They may also operate as separate business entities under names other than those of the members. The NASD, in the course of its disciplinary proceedings, has observed a pattern of rule violations and other regulatory problems stemming from factors inherent in these arrangements and the manner in which they are effectuated.
>
> Irrespective of an individual’s location or compensation arrangements, **all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member**. The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements. (Emphasis in original.)

Employment status is relevant for tax and benefits purposes but is immaterial for SEC rules. Firms must have sufficient access and authority to meaningfully supervise the investment advisory activities of all their supervised persons.

Centralization of Operations and Supervision

Centralization is essentially uniformity in action, a means to enhance the likelihood that the firm’s policies will be applied consistently and correctly. In contrast to some of the other recommendations, OCIE indicates that centralized training, centralized oversight of personal trading and client orders, centralized fee billing and centralized approval of advertisements are practices that correspond with fewer deficiencies.

The examples offered by OCIE echo the recommendations made in 2004 in Bulletin No. 17, in which Division of Market Regulation staff advised brokers to adopt “centralized technology to monitor the trading and handling of funds in remote office accounts” to minimize the opportunity for RRs to subvert firms’ oversight and detection. Further, FINRA Rule 3110 requires supervisory review of all transactions including both customer orders and personal trades of registered persons; FINRA Rule 3210 requires RRs to obtain the consent of the broker with which they are registered prior to opening a brokerage account at another firm; and FINRA Rule 2210 requires supervision and in some cases, filing with FINRA, all “retail communications” which not only includes all advertisements but also any written (including electronic) communication distributed or made available to more than 25 retail investors within any 30 calendar-day period.

Oversight of transaction/fee billing is not expressly mentioned in FINRA rules but it is governed by Rule 3110's broad mandate for firms to designate "an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for *each type of business in which it engages for which registration as a broker-dealer is required.*" (Emphasis added.) Since charging a transaction fee is one of the hallmarks of brokerage activity, each broker should have oversight of such charges and identify the person(s) charged with supervising it.

Regular Testing

OCIE notes that some advisers performed compliance testing or periodic reviews of key activities at all branch offices at least annually, including conducting the following tests:

- Validating that branch offices undertook compliance or supervision reviews of their portfolio management decisions, both initially and on an on-going basis;
- Designating individuals within branch offices to provide portfolio management monitoring, primarily to assess whether investment recommendations were consistent with clients' investment objectives or recommendations;
- Consolidating the trading activities occurring within branch offices into the advisers' overall testing practices;
- Conducting compliance reviews that did not solely rely on self-reporting by personnel.

All of these tests are similar to practices required by brokers. In addition to the requirements referenced above, FINRA Rule 3110(a) requires, among other things

> (4) The designation of one or more appropriately registered principals in each OSJ and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.
> (5) The assignment of each registered person to an appropriately registered representative(s) or principal(s) who shall be responsible for supervising that person's activities.

Rule 3110(b)(2) mandates that "[t]he supervisory procedures required by this paragraph (b) shall include procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the investment banking or securities business of the member."

Further, 3110(b)(6)(c)(1) prohibits RRs from supervising themselves, which is another way of prohibiting a firm from relying solely on self-reporting. As for testing the branch activity, that is required under 3110(c) and addressed extensively by Commission staff in Bulletin No. 17 and the 2011 *Broker-Dealer Branch Inspections* Risk Alert.

Review of Disciplinary Histories/Heightened Supervision

Since disclosure of certain disciplinary events of IARs is required on Form ADV 2B, and reference to the existence of such events is required on the new Form CRS, firms need to inquire about such events during onboarding and periodically thereafter. OCIE suggests that firms check the accuracy of the IAR disclosures periodically, document the reviews and impose heighted supervision on IARs with disciplinary histories. Each of these suggestions is already a required practice for brokers.

As far back as 1994, the SEC, NASD and NYSE issued a report recommending, among other things, that brokers "should be required to improve compliance systems designed to oversee and

review employee conduct. Improvements would include the ability to identify individuals, before hiring, whose disciplinary history indicates a pattern of sales practice abuse. Additionally, firms should be able to identify registered representatives generating large numbers of sales practice related customer complaints, arbitrations and settlements, and develop the technical capability in the main office to conduct account reviews for suitability on a regular basis." Shortly thereafter, the same regulators, now joined by NASAA, added the recommendation that "[f]irms that hire registered persons that have a history or pattern of customer complaints, disciplinary actions, or arbitrations are responsible for imposing close supervision over these persons. 'Normal' supervision is simply not enough; firms must craft special supervisory procedures tailored to the individual representative."[15] Bulletin No. 17 also emphasizes that the risks of associating with RRs with disciplinary histories are amplified in branch offices.

Some of those suggestions evolved into FINRA Rule 3110(e), a relatively new duty in FINRA's supervision rule, which imposes an affirmative duty on brokers to investigate "the good character, business reputation, qualifications and experience of an applicant" prior to registering the applicant, and to make reasonable efforts to verify all of the information on his/her Form U4. This process includes reviewing prior regulatory filings such as the Forms U4 or U5 and searching public records. Regulatory Notice 15-05 further suggests that "[f]irms also may wish to consider private background checks, credit reports and reference letters for this purpose."

Ongoing Compliance Training

OCIE notes that most of the firms they examined conducted annual or semi-annual compliance-related training for branch office employees which focused on areas identified as needing improvement based on their branch office reviews. Timely training to remediate deficiencies is a very strong practice for all firms. FINRA Rule 3110(a)(7) requires brokers to conduct compliance meetings no less than annually for all registered persons "at which compliance matters relevant to the activities of the representative(s) and principal(s) are discussed." Additionally, FINRA Rule 1240(b) requires firms to "maintain a continuing and current education program for its covered registered persons to enhance their securities knowledge, skill and professionalism." Brokers must consider and develop a written training plan at least annually which "must take into consideration the member's size, organizational structure and scope of business activities." At a minimum, the training plan must include ethics, professional responsibility, suitability, sales practice considerations and investment and risk factors for securities products and services offered by the member. Further, the *Broker-Dealer Branch Inspections* Risk Alert emphasized that branches should develop plans of corrective action based on exceptions noted in the firm's examination of the branch. Many firms include focused training to for branch personnel as part of the correction action.

Conclusion

OCIE's 2020 Risk Alert identifies a number of common problem areas for RIAs. Firms should review their own practices to assess whether they suffer from the same or similar deficiencies and consider how to mitigate their own risks. As firms consider these or other aspects of their compliance programs, they may wish to familiarize themselves with FINRA requirements as OCIE has plainly, albeit tacitly, recommended that RIAs adopt such practices. This article introduces many of the relevant rules but if RIA compliance professionals are not already well versed in broker-dealer compliance, they may wish to delve deeper. NSCP has extensive resources which can help. ■

15. 1996 Joint Regulatory Sales Practice Sweep Report