

# Legal Update

## SEC's OCIE Publishes Investment Adviser Branch Office Risk Alert

On November 9, 2020, the Office of Compliance Inspections and Examinations ("OCIE") of the US Securities and Exchange Commission ("SEC") published a risk alert<sup>1</sup> ("Risk Alert") discussing its observations from a series of examinations that focused on SEC-registered investment advisers operating from numerous branch offices<sup>2</sup> and with operations geographically dispersed from the adviser's principal or main office ("Initiative"). In this Initiative, OCIE staff assessed, among other things, the advisers' compliance and supervisory practices relating to advisory personnel working within the advisers' branch offices.

OCIE first highlighted compliance risks associated with branch offices advisers in its 2016 examination priorities, followed by an announcement of a related examination initiative later that same year.<sup>3</sup> OCIE stated that investment advisers with multiple offices continue to be an area of interest for examinations because these advisers (1) often advise retail clients and (2) have unique risks and challenges related to the design and implementation of their compliance programs and oversight of advisory services provided through remote offices.

Although the examinations conducted under this Initiative concluded in 2018, before the COVID-19 pandemic began, OCIE's observations as outlined in the Risk Alert and in OCIE's August 2020 risk alert regarding COVID-19 compliance matters<sup>4</sup> should still prove helpful to investment advisers in evaluating their policies, procedures and controls in the midst of the pandemic.<sup>5</sup>

The following Legal Update provides a summary of OCIE's observed deficiencies outlined in the Risk Alert, followed by a discussion of observed practices that seek to mitigate compliance risks.

### Observed Deficiencies

**General Observations About Branch Offices** – OCIE believes that the branch office model may pose certain risk factors that advisers should consider in designing and implementing their compliance programs and in supervising personnel and that these risks may be heightened when the main and branch offices have different operations or controls or ways of communicating. **EXAMPLE:** Advisers that do not monitor, review, and/or test their branch office activities may not be aware that the compliance controls they have adopted:

- are not effectively implemented or
- do not appropriately address the risks and conflicts in or unique to these remote locations.

**Compliance Program Issues** – OCIE staff observed that more than one-half of the examined advisers had compliance policies and procedures that were:

- inaccurate because they included outdated information, such as references to entities no longer in existence and personnel that had changed roles and responsibilities;
- not applied consistently in all branch offices;
- inadequately implemented because, among other things, the compliance department did not receive records called for in the policies and procedures; or
- not enforced.

Compliance issues often were related to the advisers failing to recognize that they had custody of clients' assets, failing to adequately implement and oversee their fee billing practices, or both.

**Custody Issues** – Some 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. In addition, advisers, perhaps unknowingly, had custody of their clients' assets due to a variety of practices, including instances where the adviser:

- comingled its assets with those of its clients;
- was the trustee for client accounts (or its supervised persons were trustees);
- was the general partner to an advised limited partnership;
- received client checks in branch offices and deposited these checks with the client custodians; and/or
- had various arrangements in place that gave it broad disbursement authority over client assets.<sup>6</sup>

**Fee and Expense Issues** – OCIE observed that some advisers did not have policies and procedures that included identifying and remediating instances where undisclosed fees were charged to clients. In addition, OCIE observed:

- policies and procedures governing such fees, including those related to wrap fee programs, that were not enforced;
- that most fee billing issues were related to the lack of oversight over fee billing processes, and in some cases, this resulted in overcharges to clients;<sup>7</sup>
- Advisers overcharging advisory fees to clients by:
  - using inaccurate fee calculations by, for example, misapplying tiered fee structures or employing incorrect valuations for the calculations;
  - inconsistently applying 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
  - charging fees at a rate that was different than the rates included in advisory agreements or on assets that were to be excluded from advisory fees.<sup>8</sup>

**Issues with Oversight and Supervision of Personnel** – OCIE observed supervision deficiencies related to:

- the failure to disclose material information, including disciplinary events of supervised persons;<sup>9</sup>
- portfolio management, such as the recommendation of mutual fund share classes that were not in the client's best interest;<sup>10</sup> and
- trading and best execution, including enforcing policies and procedures the adviser had in place.

Supervision deficiencies were particularly prevalent when the advisers oversaw branch office personnel with higher-risk profiles, and this included instances related to the identification and documentation of disciplinary events.

**Advertising Issues** – OCIE observed advertising deficiencies, including deficiencies in materials prepared by supervised persons located in branch offices and/or supervised persons operating under a name different than the primary name of the adviser (also known as “doing business as” or “DBAs”). **EXAMPLES:**

- performance presentations that omitted material disclosures;
- materials with superlatives or unsupported claims;
- professional experience and/or credentials of supervised persons or the advisory firm that were falsely stated in the materials; and
- third-party rankings or awards that omitted material facts regarding these accolades.<sup>11</sup>

**Issues with Codes of Ethics** – OCIE observed code of ethics deficiencies where advisers, and their supervised employees (including access persons), failed to:

- 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; review transactions and holdings reports;
- properly identify access persons; or
- include all required provisions in their codes of ethics (e.g., 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).<sup>12</sup>

**General Portfolio Management Issues** – More than one-half of the examined advisers were cited for portfolio management deficiencies, which often related to:

- oversight of investment decisions, including the oversight of investment decisions occurring within branch offices;
- disclosure of conflicts of interest; and trade allocation decisions.

**Investment Recommendation Issues** – The observed deficiencies often related to:

- *Mutual fund share class selection and disclosure* – Advisers purchased share classes of mutual funds that charged 12b-1 fees instead of lower cost share classes of the same mutual funds that were available to clients. The advisers stood to benefit from the clients paying for higher cost share classes, which created a conflict of interest that was not disclosed to clients;
- *Wrap fee programs* – Advisers failed to adequately assess whether programs were in the best interests of clients, erroneously charged commissions, misrepresented or failed to have appropriate disclosures regarding their wrap fee program (i.e., fees, trading away practices, and delegation of responsibility), or failed to implement appropriate oversight of trading away practices, including monitoring whether sub-advisers traded away. These practices typically caused clients to incur additional costs, such as ticket charges and other fees.
- *Rebalancing issues* – Advisers implemented automated rebalancing of accounts that caused clients to incur short-term redemption fees from mutual funds. Certain advisers did not consider whether these automated processes, which caused clients to pay additional fees, were in the best interest of the clients.

**Conflicts of Interest Issues** – Several advisers were cited for issues related to conflicts of interest that were not fully and fairly disclosed, such as expense allocations that appeared to benefit proprietary fund clients over non-proprietary fund clients. Several advisers also did not fully and fairly disclose financial incentives for the advisers and/or their supervised persons to recommend specific investments.

**Issues with Trading and Allocation of Investment Opportunities** – Advisers were cited for:

- a lack of documentation demonstrating the advisers' analysis regarding obtaining best execution for their clients;
- principal transactions without prior client consent;<sup>13</sup> and
- inadequate monitoring of supervised persons' trading, *including the improper allocation of block trade losses to clients rather than to the supervised persons.*

## Observed Mitigating Compliance Practices

OCIE observed a number of practices that sought to mitigate the risks associated with branch offices. These observations are summarized below.

**Compliance Policies and Procedures** – OCIE observed advisers with written compliance policies and procedures that:

- were applicable to all office locations and all supervised persons – regardless of whether these individuals were independent contractors or employees of the adviser;
- included unique aspects associated with individual branch offices; and
- specifically address compliance practices necessary for effective branch office oversight.

The staff observed that some advisers had policies and procedures to oversee all of their office locations (i.e., main and branch offices) and to address the specific activities taking place at, and the clients managed by, their branch offices. Regardless of whether the advisers had policies and procedures that were tailored for their branch offices, many firms had policies and procedures for compliance monitoring and oversight of branch offices, which typically included compliance reporting by their branch offices. For example, some advisers established:

- Uniform policies and procedures regarding main office oversight for monitoring and approving advertising, particularly in instances where branch offices were permitted to advertise through DBA websites;
- Centralized, uniform processes to manage client fee billing. Advisers with centralized, uniform processes tended to limit exceptions from these approved processes. These centralized processes mitigated instances in which supervised persons or branch offices had independent billing options or fee arrangements that deviated from client agreements or disclosures;
- Centralized processes for monitoring and approving personal trading activities for all supervised persons located in all office locations. For some advisers, the centralized process included an automated review and approval of personal trading requests and transactions. Many of these advisers also provided supervised persons with training related to their codes of ethics and personal trading policies.
- Uniform portfolio management policies and procedures, portfolio management systems, or both, across all office locations. For some advisers, trade orders were also centralized through the main office.

**Compliance Testing and Reviews** – Some advisers performed compliance testing or periodic reviews of key activities at all branch offices at least annually, with some firms conducting reviews more frequently. Examples of compliance oversight and testing of branch office activities included:

- Validating that branch offices undertook compliance or supervision reviews of their portfolio management decisions, both initially and on an ongoing 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.

**Disciplinary Events and Heightened Supervision** – Advisers established compliance policies and procedures to check for prior disciplinary events when hiring supervised persons and periodically confirming the accuracy of disclosure regarding such information. In addition to initially reviewing for disciplinary histories when hiring personnel, some advisers also had procedures that included periodically reviewing disciplinary histories, documenting such reviews, and providing heightened supervision of individuals with disciplinary histories.

**Compliance Training** – Advisers required compliance training for branch office employees. Most advisers required compliance-related training for branch office employees, targeting areas identified as needing improvement based on their branch office reviews. Typically such training was required semi-annually or at least annually.

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In concluding the Risk Alert, OCIE encourages advisers, when designing and implementing their compliance and supervision frameworks, to consider the unique risks and challenges presented when employing a business model that includes numerous branch offices and business operations that are geographically dispersed and to adopt policies and procedures to address those risks and challenges.<sup>14</sup>

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## Endnotes

- <sup>1</sup> Observations from OCIE’s Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices, SEC OCIE Risk Alert (November 19, 2020), available at <https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf>
- <sup>2</sup> For purposes of the Initiative, a branch office is an office or “place of business” other than the adviser’s “principal office and place of business” as those terms are defined in Rule 222-1 under the Investment Advisers Act of 1940 (“Advisers Act”).
- <sup>3</sup> Exam Priorities for 2016, SEC OCIE (Jan. 11, 2016), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf> and Multi-Branch Adviser Initiative, SEC OCIE National Program Risk Alert (December 12, 2016), available at <https://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf>
- <sup>4</sup> Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers, SEC OCIE Risk Alert (August 12, 2020), available at <https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf>
- <sup>5</sup> The staff in the Division of Investment Management stated that it would not recommend enforcement action if a firm does not update its Form ADV in order to list the temporary teleworking addresses of its employees (see <https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item1f> )
- <sup>6</sup> See, generally, Significant Deficiencies Involving Adviser Custody and Safety of Client Assets, SEC OCIE National Program Risk Alert (March 4, 2013), available at <https://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>
- <sup>7</sup> Advisers should maintain policies and procedures regarding the appropriate calculation of, and adherence to, advisory fees contractually agreed to in the applicable investment advisory agreement with the respective client. Miscalculation of fees, even those resulting in clients being charged less than their contractual fee rates, will likely be viewed as a compliance deficiency by OCIE examination staff.
- <sup>8</sup> See also Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers, SEC OCIE National Program Risk Alert (April 12, 2018), available at <https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf>
- <sup>9</sup> Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest, SEC OCIE Risk Alert (July 23, 2019), available at <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf>
- <sup>10</sup> Share Class Selection Disclosure Initiative, SEC Division of Enforcement, available at <https://www.sec.gov/enforce/announcement/scsd-initiative>
- <sup>11</sup> See also the SEC’s proposed amendments to the Advisers Act’s advertising rule. Investment Adviser Advertisements; Compensation for Solicitations, Advisers Act Release No. 5407 (Nov.4, 2019), available at <https://www.sec.gov/rules/proposed/2019/ia-5407.pdf>
- <sup>12</sup> The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers, SEC OCIE National Program Risk Alert (Sept. 14, 2017), available at <https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf>
- <sup>13</sup> Investment Adviser Principal and Agency Cross Trading Compliance Issues, SEC OCIE Risk Alert (Sept. 4, 2019), available at <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Principal%20and%20Agency%20Cross%20Trading.pdf>
- <sup>14</sup> Risk Alert at 7.

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