RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

November 9, 2020

Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices[*]

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE") conducted a series of examinations that focused on SEC-registered investment advisers operating from numerous branch offices and with operations geographically dispersed from the adviser's principal or main office ("Multi-Branch Initiative" or "Initiative").[1] This Initiative focused on, among other things, the assessment of the compliance and supervisory practices relating to advisory personnel working within the advisers' branch offices.[2]

This Risk Alert contains observations resulting from the examinations under the Initiative, including nearly 40 examinations of advisers' main offices combined with one or more examinations of each adviser's branch offices. These advisers collectively managed approximately $110 billion in assets for about 185,000 clients, the majority of whom were retail investors. Most firms selected for examination under the Initiative conducted their advisory business out of 10 or more branch offices.

The staff generally observed a range of deficiencies across the examinations. More specifically, some of the advisers had not fully implemented policies and procedures addressing advisory activities occurring in branch offices and in geographically dispersed operations. This Risk Alert discusses common deficiencies identified by OCIE staff. It also discusses examples of practices

---

[*] This statement represents the views of the staff of the Office of Compliance Inspections and Examinations. It is not a rule, regulation, or statement of the U.S. Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved of its content. This statement, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

[1] For purposes of this Initiative, the term branch means an office or "place of business" other than the adviser's "principal office and place of business" – both of which are defined in Rule 222-1 under the Investment Advisers Act of 1940 ("Advisers Act"). An adviser's principal office is where the firm regularly provides advisory services, solicits, meets with, or otherwise communicates to clients. The risks associated with multi-branch advisers were first highlighted in OCIE's 2016 Examination Priorities (*see* OCIE, "Examination Priorities for 2016" (January 11, 2016)) and became an examination initiative later that year (*see* OCIE Risk Alert, "Multi-Branch Adviser Initiative" (December 12, 2016)). These advisers continue to be an area of interest for examinations because they: (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.

[2] The examinations under this Initiative were concluded in 2018. OCIE will continue to monitor industry trends and practices, including telework conducted from dispersed remote locations, and will provide its observations to its colleagues in the Division of Investment Management. We note that 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* Form ADV and IARD Frequently Asked Questions: Form ADV Item 1.F).

certain advisers implemented which aimed to improve compliance and supervisory practices at those firms.

II. Initiative Focus and Relevant Regulations

The Multi-Branch Initiative focused on certain practices of advisers in the following areas:

- *Compliance programs and supervision*, including whether the adviser had adopted and implemented reasonably designed written policies and procedures under the "Compliance Rule."[3] The staff focused on advisers' compliance programs in both their main offices and branch offices, as well as on the oversight by the main offices of advisory services provided through branch offices. In particular, the staff reviewed firms' main and branch office practices for: (1) compliance with certain rules, such as the "Code of Ethics Rule"[4] and "Custody Rule";[5] and (2) consistency with fiduciary obligations, such as those related to fees, expenses, and advertising.[6]

- *Investment advice*.[7] The staff evaluated the processes by which firms' supervised persons located in branch offices provided investment advice to advisory clients, including the formulation of investment recommendations and the management of client portfolios. In conducting these examinations, the staff focused on the advisers': (1) oversight of investment recommendations, both within specific branch offices and across all of the advisers' branch offices; (2) management and disclosure of conflicts of interest; and (3) allocation of investment opportunities.

---

3 Advisers Act Rule 206(4)-7 requires SEC-registered advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and rules thereunder by advisers and their supervised persons. Advisers Act Section 203(e)(6) also highlights that establishing supervisory procedures reasonably designed to prevent and detect such violations and following these procedures are important steps advisers should take in supervising persons subject to their oversight.

4 Advisers Act Rule 204A-1 requires SEC-registered advisers to establish, maintain, and enforce their codes of ethics.

5 Advisers Act Rule 206(4)-2 requires SEC-registered advisers that have custody of their clients' funds or securities to safeguard those funds against theft, loss, misappropriation, or financial reverses of an adviser.

6 *See, e.g.*, In re Transamerica Financial Advisors Inc., Advisers Act Rel. No 3808 (April 3, 2014) (settled). In Transamerica, the Commission brought an enforcement action against an adviser that did not apply advisory fee discounts to certain retail clients in several of its programs, contrary to its disclosures to clients and its policies and procedures. A branch office mistakenly believed that the main office was automatically aggregating the accounts without the branch office's direction. As a result, the branch office did not notify the appropriate staff at the main office which accounts should be aggregated or whether certain clients had requested account aggregation. Advisers Act Section 206(4) and Rule 206(4)-1 prohibit SEC-registered advisers from using any advertisement that contains any untrue statement of material fact or that is otherwise misleading. Also, Advisers Act Sections 206(1) and (2) make it unlawful for an adviser "to employ any device, scheme or artifice to defraud any client or prospective client … [or] engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

7 Advisers Act Section 206 imposes a fiduciary duty on advisers (*see, e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (June 5, 2019)). An adviser must provide advice to a client that is in the best interest of the client, including advice that is suitable based on a reasonable understanding of the client's objectives. Advisers also must eliminate or at least expose through full and fair disclosure all conflicts of interest that might cause them – consciously or unconsciously – to render advice which is not disinterested.

III. Staff Observations

The staff observed 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 processes occurring in branch offices. These risks may be heightened when the main and branch offices have different practices. For 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 intended risks and conflicts in these remote locations. While many of the issues discussed below are not unique to advisers that use the branch office model, such entities may be more susceptible to the issues discussed herein because, among other things, geographically dispersed personnel may develop different practices or disparate ways of communicating.

A. Compliance and Supervision

- *Compliance programs.* The vast majority of the examined advisers were cited for at least one deficiency related to the Compliance Rule. In particular, the staff observed that more than one-half of these advisers had compliance policies and procedures that were: (1) inaccurate because they included outdated information, such as references to entities no longer in existence and personnel that had changed roles and responsibilities; (2) not applied consistently in all branch offices; (3) inadequately implemented because, among other things, the compliance department did not receive records called for in the policies and procedures; or (4) not enforced. The Compliance Rule 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.[8] Examples of compliance program-related shortcomings in these two areas are discussed below.

    - *Custody of client assets.* 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.

        - Advisers had custody of their clients' assets due to a variety of practices, including instances where the adviser: (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; (4) received client checks in branch offices and deposited these checks with the client custodians; and/or (5) had various arrangements in place that gave it broad disbursement authority over client assets. By taking these actions, the examined advisers, perhaps unknowingly, had custody of client assets and were therefore required to follow the provisions of the Custody Rule.

    - *Fees and expenses*. Advisers did not have policies and procedures that included identifying and remediating instances where undisclosed fees were charged to clients. In addition, policies and procedures governing such fees, including those related to wrap fee

---

[8] OCIE issued a Risk Alert that highlighted custody-related issues, including failure by advisers to recognize that they have custody (*see* OCIE, "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" (March 4, 2013)) and a Risk Alert that addressed advisory fee-related issues (*see* OCIE, "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers" (April 12, 2018)).

programs, were not enforced. 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.

  - Clients were overcharged advisory fees in a variety of ways, such as when 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.

- *Oversight and supervision of supervised persons*. Supervision deficiencies related to: (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. 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.[9]

- *Advertising*. Advisers often had deficiencies related to advertising, both generally and specifically regarding the 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 of problematic advertisements included: (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.

- *Code of ethics.* Several of the advisers were cited for code of ethics deficiencies because they 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.[10]

---

9 OCIE issued a Risk Alert of findings from its "Supervision Initiative" that highlighted weaknesses identified in oversight practices of SEC-registered advisers that previously employed, or currently employ, any individual with a history of disciplinary events (*see* OCIE, "Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest" (July 23, 2019)). This Risk Alert also provided examples of processes that could help firms address similar weaknesses identified during the Multi-Branch Initiative examinations.

10 OCIE issued a Risk Alert highlighting deficiencies or weaknesses with respect to advisers' compliance with the Code of Ethics Rule (*see* OCIE, "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (September 14, 2017)).

B. Investment Advice

- *Portfolio management*. More than one-half of the examined advisers were cited for deficiencies related to portfolio management practices. These often were related to: (1) oversight of investment decisions, including the oversight of investment decisions occurring within branch offices; (2) disclosure of conflicts of interest; and (3) trading allocation decisions. Examples of the issues observed are discussed below.
  - *Oversight of, or reasonable basis for, investment recommendations.* Observations of deficiencies associated with the oversight or assessments of investment recommendations were often related to mutual fund share class selection practices and disclosures of such practices, as well as investment recommendations and disclosures associated with wrap fee programs. For example, the staff identified:
    - *Mutual fund share class selection and disclosure issues.* 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 program issues.* 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 disclosures*. 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.[11]
  - *Trading and allocation of investment opportunities.* Advisers were cited for: (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

---

[11] *See* supra n. 7. The Commission provided the following guidance on what constitutes full and fair disclosure of conflict of interest: (1) the appropriate level of specificity, including the appropriateness of stating that an adviser "may" have a conflict, and (2) considerations for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients.

supervised persons' trading, including the improper allocation of block trade losses to clients rather than to the supervised persons.[12]

C. Staff Observations Regarding Compliance Practices

During 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. The practices noted below do not constitute a comprehensive list of practices necessary for a firm to meet its legal obligations and not every practice on the list may be applicable to all types of firms. Rather, the list contains a sample of observed practices that that may assist advisers in designing and implementing policies and procedures under the Compliance Rule.

- *Advisers adopted and implemented written compliance policies and procedures that: (1) were applicable to all office locations and all supervised persons – regardless of whether these individuals were independent contractors or employees of the adviser; (2) include unique aspects associated with individual branch offices; and (3) 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

[12] *See* supra n. 7. As a fiduciary, an adviser has the duty to seek best execution of a client's transactions, including where the adviser has the responsibility to select broker-dealers to execute client trades. It also must disclose any conflicts related to the allocation of investment opportunities among eligible clients. An adviser's compliance program should "include procedures by which the adviser satisfies its best execution obligation" and the firm should document its annual review of this obligation. *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (December 17, 2003) and Advisers Act Rule 204(2). In addition, a variety of legal requirements and provisions may be implicated when executing principal and cross trades, including Advisers Act Sections 206(1), (2), and (3) and Rules 206(3)-2 and 206(4)-7. S*ee* OCIE, "Investment Adviser Principal and Agency Cross Trading Compliance Issues" (September 4, 2019).

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.

- *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 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.*

- *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.[13]

- *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.

IV. Conclusion

The examinations within the scope of this review resulted in a range of actions. In response to the staff's observations, advisers elected to amend disclosures, revise compliance policies and procedures, or change certain practices. In sharing the information in this 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.

---

[13] *See* supra n. 9. All registered advisers must promptly disclose in Form ADV certain legal or disciplinary events that would be material to a client's or a prospective client's evaluation of the adviser's integrity (*see* Amendments to Form ADV, Advisers Act Release No. 3060 (July 28, 2010)).

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.