

CHAPTER 14

COMPLIANCE, INSPECTIONS AND ENFORCEMENT UNDER THE ADVISERS ACT

CROSS REFERENCE GUIDE

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§ 14.01 Introduction

During the early years of the Advisers Act, investment adviser compliance was not necessarily a major priority of the SEC's programs. With substantial growth in the number of advisers, however, by the 1980s adviser compliance became a more significant focus of the SEC's inspection and enforcement programs, with the SEC bringing an increasing number of enforcement actions against investment advisers.¹ Ongoing concerns over the adequacy of the SEC's oversight resources led to the introduction of a number of bills in Congress in the early 1990s, proposing various approaches, but all aiming at increased oversight over investment advisers. These culminated in the 1996 amendments to the Advisers Act, which divided oversight between the SEC and the states.

The effect of the 1996 amendments, in conjunction with budgetary and organizational changes, was to increase the attention paid to adviser compliance, inspections and enforcement. This chapter discusses the elements of appropriately designed and implemented compliance and supervisory systems and the role that these systems can play in reducing exposure to enforcement actions. It also outlines the typical elements of an SEC compliance inspection or examination, and potential liabilities in SEC enforcement actions and private litigation.

§ 14.02 Investment Adviser Compliance

With limited exceptions, the Advisers Act itself does not expressly require that investment advisers establish and enforce written compliance procedures broadly designed to prevent and detect violations of the federal securities laws by their personnel.² Historically, the SEC applied its provisions to establish the indirect equivalent of such a requirement by citing the absence of such procedures and a

¹ At the end of fiscal 1960, only 1,867 advisers were registered with the SEC. SEC 1960 Annual Report at 184. By 1980, the number of registered advisers had tripled to 5,680. SEC 1980 Annual Report at 102. By 1996, the number of registered advisers had grown to over 22,000. S. Rep. No. 293, 104th Cong. at 3 (1996)(*citing* testimony by SEC Chairman Arthur Levitt). The number of enforcement actions has grown more or less commensurately. In 1960, the SEC instituted only six administrative proceedings and three civil actions against investment advisers. SEC 1960 Annual Report at 184-85. In 1999, the SEC brought 41 administrative proceedings and 7 civil actions against investment advisers. SEC 1999 Annual Report at 140, *available at* <http://www.sec.gov/about/annrep99.shtml>.

² *But see* 15 U.S.C. § 80b-4(A) (Section 204A requires the establishment of written policies and procedures to prevent the misuse of inside information). Regulation S-P expressly requires an investment adviser to “adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.” Section 248.30, 17 C.F.R. 248.30.

system for their application as the basis for enforcement action. The SEC made clear its view, through enforcement actions and not through rule-making, that investment advisers and their associated persons had a statutory duty to supervise advisory personnel that entails adopting and implementing written compliance procedures.³ In 2003, the SEC adopted rule 206(4)-7, which requires registered investment advisers to adopt written compliance policies and procedures.⁴

[1] Duty to Supervise

Section 203(e)(6) of the Advisers Act authorizes the SEC to sanction an investment adviser that fails to supervise any person acting on its behalf who violates the federal securities laws.⁵ Similarly, Section 203(f) authorizes the SEC to sanction a person associated with an investment adviser who fails to supervise any person subject to his or her supervision who violates the federal securities laws.⁶ These sections mirror Exchange Act provisions that impose on broker-dealers and their associated persons an analogous duty to supervise personnel⁷ and were enacted “to strengthen existing disciplinary controls over advisers by making the controls more comparable to the provisions of the Exchange Act.”⁸

The SEC has found that an adviser may have a duty to supervise not only its

³ An “associated person” or “person associated with an investment adviser” includes any partner, officer, or director of the adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by the adviser. *See* 15 U.S.C. § 80b-2(17).

⁴ *See* § 14.02[2].

⁵ Section 203(e)(6) (formerly Section 203(e)(5)) provides, in pertinent part, that the SEC may sanction any investment adviser that:

has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, the Commodity Exchange Act, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.

15 U.S.C. § 80b-3(e)(6). *See also* TBA Fin. Corp., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 3051 (Dec. 7, 1983) (registered investment advisers have a continuing obligation to comply with provisions of the Advisers Act, including the duty to supervise persons acting on their behalf).

⁶ Section 203(f) incorporates by reference Section 203(e)(6). *See* 15 U.S.C. § 80b-3(f).

⁷ *See* 15 U.S.C. § 78o(b)(4)(E) (duty to supervise for broker-dealers); 15 U.S.C. § 78o(b)(6) (duty to supervise for associated persons of broker-dealers).

⁸ *In re* Shearson Lehman Brothers, Inc., Inv. Co. Adv. Act Rel. No. 1038, 1986 SEC LEXIS 726 (Sept. 24, 1986) (*citing* 116 Cong. Rec. 33,280 (daily ed. Sept. 23, 1970)).

own personnel, but also the personnel of a sub-adviser.⁹ In one proceeding, the SEC sanctioned an investment adviser for failure to respond appropriately to several “red flags” relating to actions by the portfolio manager involving valuation of portfolio securities of funds managed by an affiliated sub-adviser. Although the investment adviser had delegated the investment advisory function for these funds to the sub-adviser, the written agreement between the adviser and sub-adviser specifically stated that the provision of advisory services by the sub-adviser for these two funds was subject to the supervision of the investment adviser. Thus, even though the portfolio manager was an employee of the sub-adviser and not an employee subject to the direct supervision of the investment adviser, the SEC found that “in these circumstances” the investment adviser had also “become a supervisor of the Portfolio Manager.” SEC staff subsequently stated at conferences that the affiliation between the adviser and sub-adviser was not critical to the SEC’s finding of a duty to supervise and that the SEC would read a comparable duty in cases where the adviser and sub-adviser were not related.

[a] Associated Person as Supervisor

There is not a bright-line test for determining when a person associated with an investment adviser will be deemed to be acting in a supervisory capacity and thus potentially subject to liability for failure to supervise. However, the SEC has stated in the broker-dealer context that the determination whether “a particular person is a ‘supervisor’ depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.”¹⁰ According to the SEC, “the most probative factor that would indicate whether a person is responsible for the actions of another is whether that person has power to control the other’s conduct.”¹¹ Thus, an individual with direct responsibility to hire or fire and reward or punish employees clearly has supervisory authority over those persons.¹² More difficult, however, is the situation of “non-line” personnel such as compliance officers and in-house counsel, who generally do not have immediate responsibility and control over advisory personnel. In those cases, the

⁹ See *In re Western Asset Mgmt Co. and Legg Mason Fund Adviser, Inc.*, Inv. Co. Adv. Act Rel. No. 1980, 2001 SEC LEXIS 2042 (Sept. 28, 2001).

¹⁰ *In re John H. Gutfreund*, Exch. Act Rel. No. 31554, 1992 SEC LEXIS 2939 (Dec. 3, 1992).

¹¹ *In re Arthur James Huff*, Exch. Act Rel. No. 29017, 1991 SEC LEXIS 551 (Mar. 28, 1991). The SEC noted that, although a number of factors must be considered, “control . . . is the essence of supervision.” Release 29017.

¹² See, e.g., Release 29017; *In re Louis R. Trujillo*, Exch. Act Rel. No. 26635, 1989 SEC LEXIS 481 (Mar. 16, 1989).

SEC likely will look to the ability of those persons “to control at least some critical aspects of the behavior of the persons supervised.”¹³

[b] Response to “Red Flags”

The supervisory obligations imposed on investment advisers and their associated persons by Sections 203(e)(6) and 203(f) require a vigorous response to wrongdoing or any indications of wrongdoing.¹⁴ Especially when the knowledge of supervisors is limited to “red flags” or “suggestions” of irregularity, the SEC has been clear that supervisors cannot discharge their supervisory responsibility by mere reliance on the uncorroborated representations of employees.¹⁵ Instead, “[t]here must be adequate follow-up and review when a firm’s own procedures detect irregularities.”¹⁶

[c] Importance of Compliance Procedures

Section 203(e)(6) provides investment advisers and their supervisory personnel an affirmative defense to a failure to supervise charge.¹⁷ An investment adviser (or its supervisory personnel) will not be deemed to have failed to supervise any person if (i) it has established procedures and a system for applying such procedures that reasonably would be expected to prevent and detect securities law violations, and (ii) it reasonably has discharged its obligations under such procedures and system without reasonable cause to believe that the procedures were not being complied with.¹⁸ While Section 203(e)(6) does not expressly require that investment advisers establish written procedures and a system reasonably designed to detect and prevent securities law violations, the SEC has stated that investment advisers have “an obligation to create and follow such

¹³ See, e.g., *In re Robert J. Check*, Exch. Act Rel. No. 26367, 1988 SEC LEXIS 2483 (Dec. 16, 1988); *In re Michael E. Tennenbaum*, Exch. Act Rel. No. 18429, 1982 SEC LEXIS 2434 (Jan. 19, 1982). In *Check and Tennenbaum*, the SEC held non-line personnel of a broker-dealer firm responsible for failure to supervise.

¹⁴ See *In re Kemper Fin.Sers. Inc.*, Inv.Co. Adv. Act Rel. No. 1494, 1995 SEC LEXIS 1311 (June 6, 1995). For a discussion of failure to supervise cases against broker-dealers, see generally Harry J. Weiss and Jolie F. Zimmerman, *Trends In Failure To Supervise Cases: Responding To Red Flags*, 1 J. Inv. Compliance 11 (2000).

¹⁵ *In re Edwin Kantor*, Exch. Act Rel. No. 32341, 1993 SEC LEXIS 1240 (May 20, 1993).

¹⁶ John H. Gutfreund, *above*.

¹⁷ Section 203(f) incorporates by reference the safe harbor defense in Section 203(e)(6).

¹⁸ See 15 U.S.C. § 80b-3(e)(6).

procedures.”¹⁹ The SEC has sanctioned an adviser for relying too heavily on self-reporting and self-monitoring by employees to detect securities law violations and for not ensuring that employees actually read or understood the adviser’s compliance manuals.²⁰

[d] Failure to Supervise Cases

The SEC has brought a number of enforcement proceedings against investment advisers and their associated persons for failure to supervise advisory personnel. Those cases illustrate for advisers seeking to establish a defense against a failure to supervise charge the importance of not only developing but also strictly enforcing written compliance procedures.

[i] Investment Restrictions

Investment advisers and their associated persons have been sanctioned in a number of cases for failure to take reasonable steps to prevent and detect unauthorized trading in client accounts. In *Mitchell Hutchins Asset Management Inc.*,²¹ the SEC sanctioned an adviser for failure to supervise a fund manager who purchased certain interest-only and principal-only mortgage-backed securities in violation of the fund’s investment policies.²² The SEC noted that no one in a supervisory position within the firm reviewed the portfolio manager’s investments and, at least with respect to that manager, no one enforced the firm’s procedure that required portfolio managers to submit a monthly checklist indicating compliance with investment restrictions. Similarly, in *CS First Boston Investment Management Corp.*,²³ the SEC alleged that an adviser failed reasonably to supervise the portfolio manager of an offshore fund who purchased “risky derivative securities” that were inconsistent with the fund’s offering circular and investment policies. The SEC noted that the firm lacked adequate procedures to ensure that fund purchases complied with investment restrictions. In another case, *William T. Belko*, the SEC sanctioned a former principal of an investment adviser

¹⁹ *In re Shearson Lehman Brothers, Inc.*, Inv. Co. Adv. Act Rel. No. 1038, 1986 SEC LEXIS 726 (Sept. 24, 1986).

²⁰ *In re Back Bay Advisors, L.P.*, Inv Co. Adv. Act Rel. No. 2070, 2002 SEC LEXIS 2724 (Oct 25, 2002).

²¹ *In re Mitchell Hutchins Asset Mgmt. Inc.*, Inv. Co. Adv. Act Rel. No. 1654, 1997 SEC LEXIS 1793 (Sept. 2, 1997).

²² The SEC also sanctioned the portfolio manager’s supervisor in a separate proceeding. See *In re Ellen Griggs*, Inv.Co. Adv. Act Rel. No. 1750, 1998 SEC LEXIS 1949 (Sept. 14, 1998).

²³ *In re CS First Boston Investment Mgmt. Corp.*, Inv.Co. Adv. Act Rel. No. 1754, 1998 SEC LEXIS 2031 (Sept. 23, 1998).

for not providing disclosure of unauthorized trading by his former firm's CEO. Although the principal did not execute any unauthorized transactions himself, and he confronted the CEO about the activity and eventually resigned from the firm and alerted legal counsel about the issue, he was found to have violated his duty to provide full and fair disclosure of all material facts about the unauthorized trading to his clients.²⁴

In two cases, *First Capital Strategists*²⁵ and *Rhumblin Advisers* (“*Rhumblin*”),²⁶ the SEC sanctioned investment advisers and their associated persons for failure to prevent and detect trading in violation of client guidelines. *First Capital Strategists* is particularly significant because it represents the first case in the Advisers Act context in which the SEC has sanctioned a person who was not directly responsible for supervising the employee in question.²⁷ In that proceeding, a trader “engaged in unauthorized unhedged day-trading of futures” inconsistent with guidelines governing a client account and took steps to conceal related losses. The SEC noted a number of compliance failures. Among other lapses, the adviser and associated persons failed to subject the trader's positions to a daily review to ensure that they were hedged, failed to inquire adequately about the trader's large volume of day-trading, failed to review order tickets and confirmations to verify the trader's activities, and failed to request that the trader submit a written profit and loss report on a regular basis. In addition to the firm, the trader's supervisor, and the person responsible for overseeing the administrative processing of trades, the SEC sanctioned the firm's director of research because, although not an immediate supervisor of the trader, he failed to take corrective action upon learning that responsible personnel were not reviewing the trader's positions. In *Rhumblin*, the SEC sanctioned the firm and its chief executive officer (“CEO”) for failure to take adequate steps to prevent unauthorized options trading in a client account by the firm's chief investment officer (“CIO”). The SEC noted that the firm lacked any procedures for monitoring the CIO's trading. Instead, the CEO “relied exclusively on unverified oral reports

²⁴ *In re* William T. Belko, Inv. Co. Adv. Act Rel. No. 2375, 2005 SEC LEXIS 775 (Apr. 6, 2005).

²⁵ *In re* First Capital Strategists, Inv. Co. Adv. Act Rel. No. 1648, 1997 SEC LEXIS 1646 (Aug. 13, 1997).

²⁶ *In re* Rhumblin Advisers, Inv. Co. Adv. Act Rel. No. 1765, 1998 SEC LEXIS 2117 (Sept. 29, 1998).

²⁷ See Bibb L. Strench and Robert P. Howard Jr., *SEC Brings a Record Number of Adviser Supervisory Cases*, 4 *The Investment Lawyer*, No. 10 (Oct. 1997).

from the CIO to monitor the options trading program.”²⁸

[ii] Personal Trading

In a number of proceedings, the SEC also has sanctioned investment advisers for failure to supervise the personal trading of personnel. In *Ronald V. Speaker and Janus Capital Corp.*,²⁹ a fund manager took advantage of an investment opportunity that would have been suitable for the fund without having first disclosed the opportunity to the fund and obtained the consent of an authorized disinterested employee of the fund. Although the adviser had reviewed the portfolio manager’s trades, the SEC found that the adviser had no mechanism in place to ensure that the portfolio manager satisfied the disclosure and consent requirement before taking the investment opportunity for himself.

In another case, *Alliance Capital Management L.P.*,³⁰ a fund manager received more favorable prices than clients when personally trading in the same security on the same day as client trades. Although the firm had written procedures in place requiring a closer review of personal trades executed at more favorable prices in the same security on the same day as client transactions, the SEC concluded that the firm “did not effectively conduct [that] limited review mandated for itself.” Moreover, the SEC concluded that the firm lacked adequate procedures for detecting all other personal trades made on the same day as client trades as well as any improper personal trades not made on the same day as client trades. Similarly, in *Nicholas-Applegate Capital Management*,³¹ the SEC found that an adviser lacked adequate procedures, and a system for applying those procedures, to prevent and detect improper personal trades. In that case, the adviser’s senior trader fraudulently allocated profitable day trades to his personal accounts rather than to an employee pension plan that he managed. Although the firm had policies that prohibited personal trading by employees in conflict with client accounts, the

²⁸ See also *In re Millennium Capital Advisors of Pennsylvania, Inc. and Louis J. Sozio, Inv. Co. Adv. Act Rel. No. 2092*, 2002 SEC LEXIS 3179 (Dec. 13, 2002) (in sanctioning adviser and manager for failing to supervise unauthorized trading, noting that compliance manual did not provide sufficient details regarding internal controls, that portfolio manager was not subject to separation of functions or to controls, and that the manager did not thoroughly review internal or external records).

²⁹ *In re Ronald V. Speaker and Janus Capital Corp., Inv. Co. Adv. Act Rel. No. 1605*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,901, 1997 SEC LEXIS 85 (Jan. 13, 1997).

³⁰ *In re Alliance Capital Mgmt. L.P., Inv. Co. Adv. Act Rel. No. 1630*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,941, 1997 SEC LEXIS 906 (Apr. 28, 1997).

³¹ *In re Nicholas-Applegate Capital Mgmt., Inv. Co. Adv. Act Rel. No. 1741*, 1998 SEC LEXIS 1701 (Aug. 12, 1998).

adviser had no procedures to review the senior trader's allocation decisions. The firm "had no written procedures or guidelines specifically for comparing the Senior Trader's personal trades to trades in the [employee pension plan] or for identifying conflicts of interest between his trades and the trades in the [employee pension plan]."

In *First Investors Management Company, Inc.*,³² the SEC sanctioned an adviser for failure to supervise the timely filing of personal trading reports required to be submitted by access persons of firms that manage registered investment companies.³³ Over a four-year period, only 30% of the adviser's access persons required to submit such reports did so. The SEC found that the adviser failed to institute necessary procedures to ensure access persons' compliance with their personal reporting requirements.

In *Dreyfus Corporation and Michael L. Schonberg*,³⁴ a fund manager allocated securities purchased in initial public offerings with the effect of favoring one registered investment company over three others he managed. In addition, he engaged in transactions on behalf of his funds involving the securities of seven companies in which he held a position acquired before his employment at the adviser. The adviser did not measure the impact of initial public offerings on fund performance to ensure that the result of the fund manager's allocation was equitable, nor did it institute procedures to ensure that fund transactions in securities he held personally did not give rise to a potential conflict of interest. The SEC sanctioned the adviser for failing to supervise the manager in connection with his allocation of initial public offering securities and for violating Section 17(j) of the Investment Company Act by not having procedures reasonably necessary to prevent violations of the adviser's code of ethics.

[iii] Trade Allocation

Failure to supervise cases also have involved the allocation of investment opportunities to proprietary or "special client" accounts. Two such cases were brought against Kemper Financial Services, Inc. In the first proceeding,³⁵ the

³² *In re First Investors Mgmt. Co., Inv. Co. Adv. Act Rel. No. 1316, 1992 SEC LEXIS 1401 (Feb. 12, 1992).*

³³ Rule 17j-1(c) of the Investment Company Act of 1940 generally requires access persons to submit personal trading reports within ten days after the end of the calendar quarter in which the personal securities transactions took place. *See* 17 C.F.R. § 270.17j-1(c).

³⁴ *In re Dreyfus Corp., Inv. Co. Adv. Act Rel. No. 1870, 2000 SEC LEXIS 941 (May 10, 2000).*

³⁵ *In re Kemper Fin. Servs., Inc., Inv. Co. Adv. Act Rel. No. 1387, 1993 SEC LEXIS 3426 (Oct. 20, 1993).*