Division of Examinations Risk Alert: Investment Adviser MNPI Compliance Issues

On April 26, 2022 the Division of Examinations of the United States Securities & Exchange Commission published a Risk Alert detailing investment adviser deficiencies related to Section 204A of the Advisers Act and Rule 204A-1 under the Advisers Act. By way of review, Section 204A of the Advisers Act requires all investment advisers to establish, maintain, and enforce written policies and procedures to prevent the misuse of material non-public information (MNPI) by the adviser or any person associated with the adviser. Rule 204A-1 under the Advisers Act (the Code of Ethics Rule) requires advisers to adopt a code of ethics that, among other things, includes:

- Standards of business conduct for the adviser's Supervised Persons;
- Personal securities transaction and holding disclosure by the adviser's Access Persons;
- Securities transaction pre-clearance requirements for Access Persons;
- Reporting of violations of the code of ethics; and
- Procedures for the delivery of the code of ethics to all Supervised Persons and the acknowledgment of receipt by Supervised Persons.

Deficiencies Associated with Section 204A

Alternative Data
The Division of Examinations notes advisers who used data from non-traditional sources (alternative data) but did not adopt or implement policies and procedures to address the potential risk of receipt and use of MNPI through such sources. The Division of Examinations provides the following examples:

- Advisers not adequately memorializing or consistently following the diligence process related to alternative data providers;
- Advisers not having policies and procedures regarding the assessment of the terms, conditions, or legal obligations relating to the collection or provision of such data; and
- Advisers not consistently implementing their policies and procedures related to alternative data service providers.

Value-Add Investors
The Division of Examinations notes advisers who did not implement policies and procedures regarding investors who are more likely to possess MNPI, such as officers or directors of public companies, portfolio managers at asset management firms and investment bankers (Value-Add Investors). In addition, the Risk Alert notes advisers who maintained such policies and procedures but did not correctly identify Value-Add Investors or correctly identify and track their relationships with potential sources of MNPI.

Expert Network Consultants
The Division of Examinations notes advisers who did not appear to have adequate policies and procedures regarding their discussions with expert network consultants who may be related to public companies or have access to MNPI (Expert Network Consultants). These inadequacies include the failure to execute such things as:

- Tracking and logging calls with Expert Network Consultants;
- Reviewing detailed notes from Expert Network Consultant calls; and
- Reviewing Supervised Person trading activity in companies that are in similar industries to those industries discussed during calls.

Deficiencies Related to the Code of Ethics Rule

Following are deficiencies related to the Code of Ethics Rule noted in the Risk Alert:

- Failure to define and/or properly identify Access Persons;
- Access Person failure to obtain required pre-approval for certain investments;
- Advisers being unable to produce evidence of review of Access Person holdings and transaction reports;
- Advisers not having in place policies and procedures to assign the CCO's reporting to another member of the adviser – effectively permitting the CCO to self-review their own holdings and transaction reports;
- Failure of Access Persons to submit holdings and transaction reports;
- The content of holdings and transactions reports not being in compliance with the requirements of the Code of Ethics Rule; and
- Supervised Persons not receiving the code of ethics or otherwise failing to obtain written acknowledgment of receipt of the code of ethics by Supervised Persons.

The Division of Examinations provides the following examples of practices for advisers to consider in crafting their code of ethics:

- Incorporating provisions into their code of ethics to include restricted lists of issuers about which the adviser has inside information, and prohibiting any trading in those securities while they remain on the restricted list; and
- Procedures to ensure that investment opportunities are first offered to clients before an adviser and its employees may act on them.

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