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Compliance Alert - RIAs Must Provide CCOs with Adequate Support

A June 23, 2015 enforcement action against a Chicago-based Registered Investment Adviser (“RIA”) alleged that the firm and several persons committed numerous compliance failures. The SEC did not bring an action against the firm’s inexperienced Chief Compliance Officer (“CCO”), because he attempted to improve the RIA’s program but was continually denied the resources needed to do so.

Among other violations, the RIA failed to conduct timely annual compliance program reviews in 2009 and 2010. The firm also failed during this time frame to implement and enforce provisions of its policies and procedures and code of ethics.

For about three years, the RIA placed or kept a substantial number of their clients in the investor share class of a fund that was managed by the firm. The clients paid an additional twenty-five basis points in fees, even though they were eligible for the less expensive institutional share class. Because it selected the more expensive share class for its clients, the RIA did not meet its duty to seek best execution for clients. The firm also failed to adequately disclose that it had a conflict of interest when selecting a share class that would generate higher fees for the firm.

Along with other sanctions, the SEC assessed huge civil money penalties against the firm and certain advisory personnel. Its former president was also suspended from working in the industry for twelve months. In addition, the firm reimbursed shareholders who paid higher fees because they were placed in the higher share class.

Although the CCO recognized that the RIA’s compliance program and testing needed further improvement, he did not have the knowledge, experience, or resources to adopt and implement an effective program. He also did not have the ability to conduct a thorough annual review.

The RIA’s former president did not make the compliance program a priority. He directed the CCO to put his research responsibilities ahead of his compliance obligations. The CCO was only able to spend ten to twenty percent of his time on compliance matters.

The CCO told the former president on many occasions that he needed help to fulfill his compliance responsibilities and the firm was not ready for an SEC exam. In response, the former president dragged his feet and told the CCO that the examination issues could be addressed at any time. The CCO obtained two proposals from compliance consulting firms, the first of which was rejected as being too expensive. No decision was made on the other proposal, even though the RIA failed for a second year to complete its annual compliance review.

One important lesson to be learned from this enforcement action is that the SEC expects an RIA to allocate significant resources (staff and budget) to its compliance department. Examiners will look at how much money the RIA spent on compliance in comparison to its revenue. In addition, while the SEC recognizes that CCOs working in smaller firms need to wear many hats and have numerous responsibilities, compliance should not be given short shrift. The enforcement action can be found at: <http://www.sec.gov/litigation/admin/2015/ia-4126.pdf>.