



Regulatory Alert

Regulatory Insights for Financial Services

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SEC Examinations Risk Alert: Investment Adviser MNPI and Code of Ethics Compliance

The SEC's Division of Examinations highlights identified ethics and compliance issues relating to investment advisers' use of material nonpublic information. This release follows an earlier Risk Alert directed toward registered investment advisers to private funds calling out disclosure, due diligence, and conflicts of interest issues (see KPMG Regulatory alert [here](#)) as well as the SEC's 2022 Examination Priorities, which included advisers to private funds and standards of conduct as areas of "significant focus" (see KPMG Regulatory Alert [here](#)). SEC registered investment advisers should look to these areas when considering risk coverage, controls, and testing in anticipation of heightened regulatory attention to their compliance programs.

The SEC's Division of Examinations (EXAMS) issued a [risk alert](#) intended to inform investment managers, advisers, investors, and other market participants of "notable deficiencies" identified by EXAMS staff pertaining to compliance with Section 204A of the Investment Advisers Act of 1940, relating to the misuse of material non-public information (MNPI), and Rule 204A-1, the Code of Ethics Rule, thereunder. EXAMS notes that deficiencies related to Section 204A and the Code of Ethics Rule have been among those most commonly observed.

Compliance issues identified with Section 204A of the Advisers Act

EXAMS staff summarizes that Section 204A of the Advisers Act requires all investment advisers (registered and unregistered) to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of MNPI by the adviser or any person associated with the adviser.

In this regard, EXAMS staff found that some advisers did not have or appear to implement adequate policies and procedures related to:

- Potential risks associated with the receipt and use of MNPI through **alternative data sources** (i.e., nontraditional sources). For example, advisers:
 - Engaged in "ad hoc and inconsistent diligence of alternative data service providers"
 - Did not assess the terms, conditions, or legal obligations of the collection or provision of alternative data
 - Inconsistently implemented and/or documented due diligence pertaining to alternative data service providers.
- "**Value-add investors**," described as investors who are more likely to possess MNPI, including officers or directors at a public company, principals or portfolio managers at asset management firms, and investment bankers. EXAMS staff noted that some advisers did not correctly identify all value-add investors or adequately identify and track the



relationships between the investors and potential sources of MNPI.

- Communications with “**expert network**” **consultants** that may be related to publicly traded companies or have access to MNPI, including tracking and logging calls, reviewing detailed notes, and reviewing relevant trading activity.

Compliance issues identified with the Code of Ethics Rule

EXAMS staff summarizes that the Code of Ethics Rule requires investment advisers that are registered or required to be registered under the Advisers Act to adopt a code of ethics that sets forth the standard(s) of business conduct expected from the adviser’s “supervised persons” (e.g., employees, officers, partners, directors). Certain supervised persons, referred to as “access persons,” must report their personal securities transactions and holdings to the adviser’s chief compliance officer or other designated persons. (See *Note below*.)

Deficiencies and weaknesses identified by EXAMS staff relating to “access persons” and non-compliance with the Code of Ethics Rule included failures to:

- Define, identify, and supervise certain employees as access persons.
- Obtain required pre-approval for access persons acquiring interests in certain investments, including initial public or limited offerings.
- Report on the personal securities transactions and holdings of access persons, including:

- Producing evidence of supervisory reviews of holdings and transaction reports
 - Requiring access persons to submit reports
 - Specifying contents to be included in the reports.
- Provide supervised individuals with the adviser’s code and any amendments, or to receive from supervised individuals written acknowledgement of their receipt of the code and amendments.

(Note: “Access persons” are described as “any supervised persons who have access to non-public information regarding client transactions or reportable fund holdings, make securities recommendations to clients or have access to such recommendations that are non-public, and, for most advisers, all officers, directors and partners.”)

Other Issues

Separately, EXAMS staff also note that advisers should consider adding certain provisions into their Codes of Ethics, including:

- Prohibitions against any trading in securities of issuers that are on a “restricted list” of issuers about which the advisory firm has inside information.
- Procedures to ensure that investment opportunities are first offered to clients before the adviser or its employees may act on them.

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