



**ACA**  
COMPLIANCE GROUP

## **SEC Examinations of Investment Advisers**

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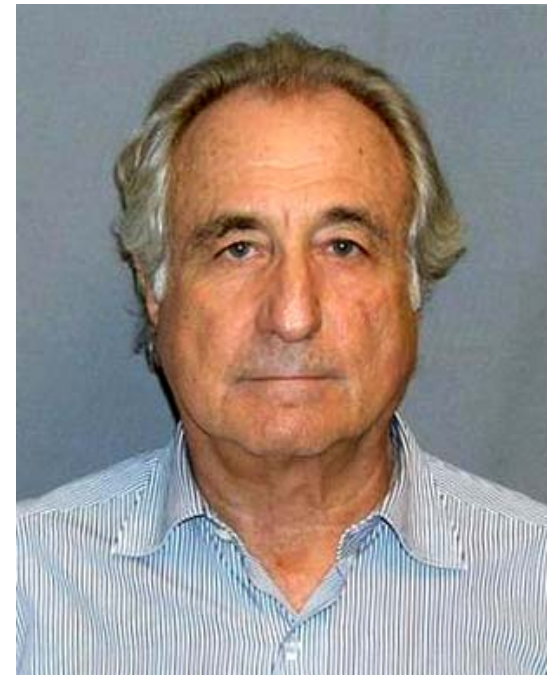
*“A strong and reinvigorated SEC will be on the beat like never before to catch wrongdoers.”*

– Mary Schapiro, SEC Chairman

Source: *Practicing Law Institute's "SEC Speaks in 2009" Program*, Washington, DC, February 6, 2009.

## Common Focus Areas

- Fraud Detection
- Insider Trading
- Portfolio Mandate Compliance
- Risk Management/Leverage
- Valuation



*“Almost all of the investment management exams are cause- or risk-based exams as distinguished from routine exams. . . .”*

– George Canellos, SEC New York Regional Director

*Source: Hedgefund.net, January 4, 2010*

*“We simply show up, because if there are allegations of wrongdoing we don't want to give firms a good deal of lead time to clean up.”*

– Gene Gohlke, Associate Director, SEC Office of Compliance Inspections and Examinations

*Source: Practising Law Institute Investment Management Conference, April 9, 2010, quoted in Investment News.*

## Authorization for Surprise Visits

*“All records (as so defined) of [registered] investment advisers are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors.”*

– Section 204 of the Investment Advisers Act of 1940

## Prepare Now For That Surprise Visit

- If the firm catalogues its efforts to address compliance issues that arise in the firm, it will have an audit trail that demonstrates the firm's ongoing compliance with Advisers Act requirements
  - Consider your firm's approach to compliance issues: is it documenting how it addresses risk issues as they arise?
  - Assure that documentation is available in non-privileged files

## Drivers of Risk-Based and TCR Examinations

- Risk-based Examinations: Firms selected based on
  - ❑ Risk ratings based on Form ADV Part 1, prior examinations, and RAVES
  - ❑ Industry experts hired by the SEC in specialized areas, including new “Senior Specialized Examiners”
  - ❑ Focused examination sweeps on specific issues, e.g., custody
- TCR (“Tip, Complaint, and Referral”) Examinations: Firms selected based on
  - ❑ “Leads” from the SEC’s new Office of Market Intelligence
  - ❑ Referrals from other divisions or offices, including the new Division of Risk, Strategy, and Financial Innovation
  - ❑ Public complaints and whistleblowers
  - ❑ Expect examiners to ask questions in other areas as well
- The SEC’s goal had been to examine 1/3 of high risk advisers every year, but it examined only 22% in 2009. As Associate Director Gohlke has acknowledged, shifts in examination focus and procedures will mean even fewer examinations
- Fewer examinations = longer examinations

## First Steps - When the SEC Comes Calling

- Don't panic -- even if you've been given no advance notice of the visit!
- And If you ARE given advance notice, do not expect the opportunity to reschedule.
  - ❑ SEC expects all but the smallest advisers to have back-ups for key positions.
  - ❑ If you need an extension, ask for it but do not expect to get one.
- Maintaining open lines of COMMUNICATION is critical for all examined firms.

## Make the Most of Any Advance Notice Received

- The potential scope may be broad, but examiners are likely to be focused on specific areas, given the SEC's risk-based approach.
- Ask about the scope and any focus areas – the examiners may just tell you!
- Carefully review the request letter (with counsel or consultant, as available)
  - ❑ Many of the items in the SEC request letter are ambiguous or overbroad. Clarify what you do not understand and narrow overbroad requests before the on-site examination.
- Ask about the expected length of the examination and the names/titles of SEC staff and management participating.
  - ❑ The SEC is making a concerted effort to coordinate examinations of dually registered or affiliated broker-dealers, investment advisers, and investment companies.
- Consider whether past deficiency letters, recent outlier performance (either positive or negative), client complaints, problem counterparties, or publicized SEC Enforcement focus areas (e.g., insider trading) may have spurred the examination. Be prepared to address the issues!

## Protect the Firm's Documents Under FOIA

- Information produced to the SEC frequently contains sensitive business information. Once this information is placed in the SEC's files, it may be subject to public disclosure pursuant to the FOIA. To preserve confidentiality:
  - ❑ At the start of the examination, request confidential treatment under the FOIA.
  - ❑ Second, follow up with a written request that includes asking that documents be returned.
  - ❑ Follow up and ask for the documents back once the examination concludes.

## Preparing for the Examination

- **Contact Person** – Designate a contact person to control the examination. All requests for information from SEC staff should be directed to this contact person. This person will be responsible for:
  - Gathering information requested by the SEC.
  - Reviewing documents before they are produced to assure that irrelevant or privileged documents are not inadvertently produced.
  - Maintaining a record of all requests by the SEC and the documents produced in response to those requests.
  - Arranging for, attending, and keeping detailed notes of employee interviews conducted by SEC staff.
- **Facilities** – Arrange for comfortable facilities for SEC staff, including internet, telephone, and printer access as requested.
- **Inform Employees** – Let staff know that the SEC will be on site.
- **Do Not Lie** – A provision of the federal criminal code broadly prohibits false statements to SEC staff. This provision applies to oral statements as well as written representations, including unsworn statements.

## Polling Question #1

Your policies and procedures regarding Custody are outdated. You have been meaning to update them for months, but have not had time to do the work. The SEC just called and said they are coming to examine your adviser next week.

Do you

1. Update your Compliance Manual to address the issue, but only if you have procedures in place that are not identified in the current Manual?
2. Do nothing, so the SEC does not think you are trying to hide a deficiency?
3. Prepare a draft of proposed new Custody policies and procedures that the SEC can review?

## SEC Examination Approach – Don't Trust, Just Verify

*“The days when we could conduct verification on the premises of a single firm — looking at correspondence on letterhead, requesting manually signed documents, or downloading through a firm's computers — are behind us. Modern verification requires us to reach out directly to counterparties, custodians, and clients.”*

– John Walsh, OCIE General Counsel

Source: *Remarks at the 2009 NSCP National Meeting*, Philadelphia, PA, October 5, 2009.

## Asset Verification – Custodians

- As a routine part of most examinations, SEC staff are dedicating substantial resources to asset verification.
- Asset verifications are being conducted even when client and custodial arrangements appear to present a low risk of theft or misapplication.
- The initial document request list will typically ask for information and assistance in obtaining records directly from custodians and counterparties.
- Examiners may insist on visual inspection of hard assets (e.g., stock certificates, art) with an affiliated custodian.



## Asset Verification – Clients

- The SEC now has its examiners routinely contact clients as part of their asset verification testing.
- Examiners generally will **not** reveal who, or what groups of clients, they intend to contact.
- OCIE has established a standard form letter for client asset verification, which can be found at:
  - ❑ [http://www.sec.gov/about/offices/ocie/routine\\_account\\_information\\_confirmation.pdf](http://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf)

## Polling Question #2

The SEC examination staff has indicated that it may send asset confirmation letters to some of your clients in connection with its review.

Do you

1. Send your clients a letter alerting them to the possibility that the SEC may contact them as part of its routine examination procedures?
2. Send your clients a letter like that described in #1 but that also encourages your clients to vouch for your firm?
3. Do nothing, and wait for your clients to call if they have any questions?

## Insider Trading Reviews

- In response to major, recent insider trading prosecutions, the SEC is aggressively attempting to identify suspect trading and weak internal controls through its examination program.
- Examiners frequently request “Top 10 Winners and Losers” and check against release of public information on companies traded.
- **The SEC now makes email requests routinely. These may be voluminous and the firm needs to be ready to comply in a timely manner. The SEC expects to see that the adviser has incorporated email reviews into its own insider trading compliance program.**
- Expect examiners to probe analysts’ relationships with family or friends in the securities industry.
- Also expect examiners to probe information barriers and other internal controls over MNPI to assess their adequacy in addressing risks presented by the adviser and any affiliated entities.
- SEC staff will review the firm’s training programs against firm risks.

## Less Reliance on Representations By Senior Personnel

- While examiners welcome the views of senior management, Chief Compliance Officers and in-house lawyers, they frequently take steps to test the accuracy of these senior personnel's statements.
- Examiners may ask to question individual personnel for their understanding of the firm's insider trading prevention procedures.
- Examiners are making increasing use of interviews with lower-level staff, particularly those involved with handling of client assets and client communications.

## Risk Mapping and Internal Controls

- Firms are expected to have in place an ongoing, documented risk assessment process.
- Demonstrating to the SEC staff the firm's understanding of its risks and approach to mitigating them will streamline an examination.
- Common requests in this area include:
  - ❑ “Inventory of compliance risks that forms the basis for policies and procedures and notations regarding changes made to the inventory.”
  - ❑ “Documents mapping the inventory of risks to written policies and procedures.”
  - ❑ “Written guidance provided to employees regarding compliance risk assessment process and procedures to mitigate and manage compliance risks”

## Compliance Resources

- Expect both formal and informal questions about compliance resources.



*"Do you think now that we're doing fewer illegal things we can scale back the legal department?"*

## Managing the Examination – They’re Here for How Long?

*“Culture is a key measure of whether a [compliance] program is effective or not. It is the first thing that employees tune in to – there is nothing employees notice more than when the leaders in a culture say one thing and do another. So, culture is a critical enabler of effective compliance programs.”*

- Carlo di Florio, Director of OCIE

Source: *Remarks at the SEC’s CCO Outreach National Seminar*, Washington, DC, January 26, 2010.

## Introductory Meeting

- Standard SEC Request: “Soon after the staff begins its fieldwork, the staff would like to speak with at least one member of senior management to obtain an overall view of the Adviser’s organization, business, and control environment and compliance culture.”
- Every adviser should take advantage of this opportunity to demonstrate to the the SEC its “culture of compliance.” This presentation should focus on:
  - ❑ Compliance resources (do not forget compliance resources in other departments)
  - ❑ Lines and frequency of reporting
  - ❑ Examples of mistakes and the adviser’s responses
  - ❑ Senior management’s commitment to compliance (demonstrated through regular communication of that commitment to personnel, attendance at training sessions, etc.)
  - ❑ Openness with regulators
  - ❑ At least one member of senior management should attend this initial meeting to speak to the adviser’s culture of compliance.

## Establish a Good Working Relationship with the Examination Team

- During the examination, foster goodwill not only by providing a suitable workspace for the team, but assuring that the Contact Person updates the Staff updated on progress in fulfilling particular requests
- Remain entirely professional, and avoid confrontation.
- At the same time, do not wait until the end of the examination to state your position if you disagree with an examiner's assessment on a particular point. This can avert an unfounded deficiency finding.

## Responding to On-Site Document Requests

- Do the outreach necessary to ensure that the Contact Person for the examination gets the prompt attention of department heads and other personnel needed to respond to requests.
- Do not hesitate to inform examiners that a particular request appears unduly burdensome or will take extensive time and resources to produce. The staff may be receptive to a suggestion on how to narrow or modify a request.
- Ensure all documents are reviewed for both relevance and privilege before they are provided. But do streamline this review as much as possible. The examination staff is less willing than ever to accept pre-review as a reason for delayed document production.
- Remember: Prompt and complete responses to document requests will (typically) lead to shorter examinations.

## OCIE Pipeline to the Division of Enforcement

- The SEC's Division of Enforcement has greatly streamlined the process for initiating a formal investigation, reducing the amount of paperwork and reviews required. The authority to approve investigations and issue subpoenas has been delegated to senior officials in the SEC's regional offices.
- Over the last year OCIE made more referrals to Enforcement. Between 8% and 9% of OCIE's examinations in 2009 were referred to Enforcement, up from an average of 5% in prior years.
- Failure to produce documents in a timely manner during an examination may result in a referral to Enforcement and prompt issuance of a subpoena.
- There are now five specialized Enforcement units designed to focus and develop the SEC's expertise on bringing cases in the unit areas. One of these specialized units is dedicated to Asset Management. Expect this to be OCIE's "pipeline" unit.

## Polling Question #3

The SEC is wrapping up the on-site portion of its examination of your adviser, but the examiners indicate that, due to time constraints, they are inclined to skip the usual exit interview.

Do you

1. Insist on an on-site exit interview before the examiners depart?
2. Ask to schedule an off-site exit interview within the next week or two?
3. Do nothing, and wait for the SEC to get back with you on its findings?

## Exit Interview

- SEC examiners typically offer to conduct an exit interview at the conclusion of the on-site portion of the examination.

**This is usually the last realistic opportunity to correct misunderstandings by the staff and provide additional proof of your position on an issue prior to issuance of a deficiency letter. Make the most of it!**

## Common Deficiencies: Focus on Internal Controls

- Inadequate Compliance Program/Resources
- Inadequate Internal Controls
- Missing Books and Records
- Custody of Client Assets
- Asset Valuation
- Disclosures
- Trade Allocations
- Advertising, Especially Performance Claims
- Personal Trading
- Referral Arrangements/Use of Solicitors
- Recidivism

## Polling Question #4

Has your adviser ever been asked to provide a copy of a past SEC deficiency letter as part of a potential client's due diligence process?

1. Yes.
2. No.
3. I don't know.

## Is it Over, and What's Next?

- Examiners are generally required to produce examination reports and any deficiency letters within 120 days of the end of the on-site examination, absent supervisory approval. Examiners are required to notify registrants in writing if the examination is not concluded in 120 days.
- If a deficiency letter is issued, the recipient firm generally is required to respond within 30 days.
- A firm's response appropriately may advocate for the firm's position on important issues, but it is critical to communicate to the SEC that the adviser "gets" compliance.
- Most importantly, **keep promises that are made to the SEC during an on-site examination or in a response letter.** Firms frequently promise to take corrective action; some firms fail to follow up as promised. The SEC retains firms' deficiency letter responses and reviews them before it conducts subsequent firm examination. A past failure to take promised corrective action raises the firm's risk profile and may well heighten SEC staff scrutiny.

Any Questions?



Please join ACA for further discussion at E-Coffeehouse.



- <http://www.acacompliancegroup.com/ecoffeehouse/>