

SEC Examinations

Richards Kibbe & Orbe LLP and ACA Compliance Group Webcast Highlights Developments in SEC Examinations of Registered Investment Advisers, and How to Prepare for a Surprise Visit from the SEC

By Alisa Greenstein

Hedge fund advisers represent a significant priority for the Securities and Exchange Commission (SEC) in its rulemaking, enforcement and examination efforts. For hedge fund managers registered with the SEC as investment advisers, the SEC's examination program has become increasingly important; and significantly more hedge fund managers are likely to be required to register with the SEC in light of the Senate's passage of the Financial Stability Bill.

Pursuant to Section 204 of the Investment Advisers Act of 1940 (the Advisers Act), the books and records of any registered investment adviser (RIA) may undergo compliance examinations by SEC staff. These examinations aim to protect investors by determining whether RIAs are complying with the law, adhering to the disclosures that they have provided to their clients and maintaining appropriate compliance programs to ensure compliance with the law.

If the SEC examines an RIA, the RIA must provide examiners with access to all requested advisory records that it maintains. The RIA must also provide the SEC with access to the written policies and procedures required by law to prevent violations of federal securities laws. The policies and procedures, once implemented, should prevent violations from occurring, detect violations that have occurred and promptly correct any past violations. The RIA should also prepare for the examination staff to review communications with investors for consistency and accuracy. The failure

of this examination program to detect several high-profile investment adviser frauds, including the Ponzi scheme perpetrated by Bernard Madoff, has led to criticism of the SEC and increased the significance of the examination itself.

On April 22, 2010, Richards Kibbe & Orbe LLP partner Eva Marie Carney co-presented a webcast entitled "SEC Examinations of Investment Advisers" with Joel Sauer of the ACA Compliance Group. The webcast focused on some of the most important developments in RIA examinations. It addressed topics such as how to prepare for the visit, asset verification tests, e-mail requests, common exam deficiencies, and the SEC's enhanced subpoena powers. It also addressed various "polling questions" or hypotheticals as tutorials for the audience. This article summarizes the salient details of the presentation, including a step-by-step analysis of how an RIA can best prepare for and effectively manage an SEC examination, and the most common areas of focus during the examination.

The "Surprise" SEC Visit: What Registered Hedge Fund Managers Need to Know

Introduction

A surprise visit from the SEC may occur at any time, because the law subjects all records of an RIA to periodic review. Fittingly, then, the webcast began by recommending that RIAs prepare sooner rather than later for the inevitable

SEC visit. Specifically, it suggested that an RIA consider its approach to compliance issues and ensure that it adequately document how it addresses risk issues as they arise. It also urged each RIA to document the steps it takes to prepare for the visit to ensure it can build a more sustainable and repeatable process. The webcasters highly recommended that the RIA make any such documentation available in non-privileged files so as not to reveal any confidential and/or sensitive client or business information. If necessary to preserve confidentiality, an RIA may request confidential treatment under the Freedom of Information Act (FOIA), and follow up with a written request for the return of any documents once the examination concludes.

Types of Examinations

The webcast addressed two types of examinations, risk-based examinations and Tip, Complaint and Referral (TCR) examinations. For risk-based examinations, the SEC selects RIAs based on: (i) risk ratings based on factors such as the Form ADV Part One and prior examinations; (ii) industry experts hired by the SEC in specialized areas, including new “Senior Specialized Examiners”; and (iii) focused examination sweeps on specific issues (such as custody arrangements). The SEC selects RIAs for TCR examinations based on three criteria: (i) “leads” from the SEC Office of Market Intelligence; (ii) referrals from other divisions or offices, including the Division of Risk, Strategy, and Financial Innovations; and (iii) public complaints and whistleblowers. However, RIAs subject to TCR examinations should expect examiners to ask questions in other areas as well. Moreover, although the SEC examined only 22 percent of high risk advisers in 2009, the presenters cautioned that fewer examinations equals longer and more intense examinations.

First Steps – When the SEC Calls

According to the webcast, it is crucial for an RIA firm preparing for an SEC visit not to panic, even if the firm has received no advance notice. If the firm receives advance notice, it should not expect to reschedule. The SEC expects all but the smallest of investment advisers to have back-up for all key positions. If an RIA genuinely needs an extension of time, it can ask for an extension, but it should not expect to receive one.

If an RIA receives advance notice of an SEC visit, it must make every effort to derive the greatest value from the notice. Although the SEC may broaden the potential scope of any examination, its examiners will likely focus on specific areas, given its risk-based approach. As a result, the presenters advise any firm which receives advance notice to: (i) ask the SEC about the scope of the examination and its intended focus; (ii) carefully review the SEC request letter (with the assistance of counsel) for any ambiguous or overbroad items; and (iii) consider past deficiency letters, client complaints, recent performance (either positive or negative), or other publicized SEC Division of Enforcement focus areas. Finally, the webcast highly recommends that the firm ask about the expected length of the examination and the names and/or titles of SEC staff participating in the examination.

Common Focus Areas

The webcast identified certain key areas of focus in its examinations. These areas include: fraud detection, portfolio mandate compliance, risk management/leverage, valuation and, particularly, insider trading. See [“Hedge Funds in the Crosshairs: The Law of Insider Trading in an Active Enforcement Environment,”](#) The Hedge Fund

Law Report, Vol. 3, No. 7 (Feb. 17, 2010). With regard to fraud detection, several issues commonly arise. Examiners often find a deficiency when hedge fund advisers who claim compliance with an outside firm's verification of performance do not actually do so. Additional issues include: (1) overstating returns and (2) failing to disclose whether results reflect dividends. The SEC examination staff also considers valuation of a fund's investment positions as a critical issue because the RIA typically receives management and performance fees or allocations based on the fund's net asset value. The SEC staff has indicated that it expects to see valuation policies and procedures detailed and tailored to the types of investments made by the fund and further expects to increase scrutiny based on the difficulty it finds to price an investment. In addition to pricing specific categories of investments, RIA policies and procedures should address the process by which it prices new investments, and the mechanism by which it determines pricing (e.g., a valuation committee that is kept independent of portfolio management). The market conditions of the past few years make controls over valuation critically important for hedge fund managers.

Preparing for the SEC Examination: The Action Plan

In order to adequately prepare for an SEC examination, the webcast outlined a concrete action plan for every RIA.

Contact Person

First, it said, each RIA should designate a contact person to control the SEC examination. It should then direct all requests for information from SEC staff to this person. This person should possess responsibility for: (i) gathering information requested by the SEC; (ii) reviewing documents

before producing them to assure that the RIA does not provide irrelevant or privileged documents inadvertently; (iii) maintaining a record of all requests by the SEC and the documents produced in response to those requests; and (iv) arranging for, attending, and keeping detailed notes of employee interviews conducted by SEC staff.

Facilities

The firm must arrange for comfortable facilities for SEC staff, including internet, telephone and printer access, as requested.

Inform Employees

The RIA should let all staff, and not just senior management, know that the SEC will appear on site so they can plan and act accordingly.

Do Not Lie

Obviously, the RIA should, under no circumstances, make a material misrepresentation to the SEC or its staff. The federal criminal code broadly criminalizes false statements to SEC staff. This provision applies to all oral statements as well as written representations, including unsworn statements.

Prepare for Asset Verification Tests – Custodians and Clients

The webcast cautions that the SEC now approaches examinations without any trust in the RIA. Everything must be verified. Thus, every RIA should expect to submit to asset verification testing. Indeed, SEC staff now dedicate substantial resources to asset verification testing as a routine part of an examination, even when client and custodial arrangements appear to present a low risk of theft or

misappropriation. An RIA may also receive document request lists asking for information and assistance in obtaining records directly from custodians and counterparties so that the SEC may verify the assets of custodians. SEC examiners may even insist on visual inspection of hard assets. And, finally, for asset verification of clients, the RIA should expect that the SEC examiners will generally not reveal who, or what groups of clients they intend to contact. Thus, to best prepare, every RIA should access the [standard form letter](#) of the Office of Compliance Inspections and Examinations (OCIE) for client asset verification.

Prepare for Insider Trading Reviews

In response to the many major recent insider trading prosecutions, the SEC is aggressively trying to identify suspect insider trading. Indeed, insider trading has become a major focus area in most, if not all, SEC examinations. SEC examiners frequently request to see a list of an adviser's "Top Ten Winners and Losers" in terms of stock performance and check this list against the release of any public information. The SEC also makes requests for e-mail disclosure routinely. These disclosures may be voluminous, so the firm needs to prepare to comply in a timely manner. The SEC also expects that every RIA has incorporated e-mail reviews into its own insider trading compliance program. As a result, every RIA must equip itself to handle such probes and should expect a review of its insider trading policy training programs. Finally, each RIA should expect that the SEC examiners will probe analysts' relationships with family or friends in the securities industry.

Prepare Lower-Level Staff for Possible Review

Interestingly, SEC examiners make increased use of interviews with lower-level staff, particularly those involved with the

handling of client assets and client communications. While examiners welcome the views of senior management, chief compliance officers and in-house lawyers, the examiners frequently test the accuracy of these senior personnel's statements by questioning lower level personnel for their understanding of the firm's insider trading prevention procedures.

Ensure Risk Mapping and Internal Controls Are in Place

Lastly, in preparing for an examination, the SEC expects each RIA to possess an ongoing, documented risk assessment process. Demonstrating that the RIA understands this process will help it to effectively navigate and master the examination process. Indeed, each RIA should expect to receive requests to review documents mapping the inventory of risks as well as any written policies and procedures or written guidance provided to employees regarding the compliance risk assessment process.

Managing the Examination

Introductory Meeting

The first step of the actual on-site examination occurs at the introductory meeting. The SEC staff will request (or demand) to speak with at least one member of senior management to obtain an overall view of the RIA's organization, business, and control environment and compliance culture. Every RIA should take advantage of this opportunity to demonstrate to the SEC in a structured presentation what the webcast refers to as its "culture of compliance." This presentation should focus on items including, without limitation: (i) compliance resources; (ii) lines and frequency of reporting; (iii)

examples of mistakes and the adviser's responses; (iv) senior management's commitment to compliance (including regular communication of that commitment to personnel and attendance at training sessions); and (v) openness with regulators. The strength of this meeting will set the tone for the entire examination.

Early on, the SEC staff will also ask to discuss the RIA's overall compliance program as well as specific policies and procedures with the chief compliance officer. The SEC staff will then typically want to interview persons responsible for functions such as risk management, portfolio management, trade execution, research, back office/administration, information technology, anti-money laundering and marketing, in order to fully understand the RIA's operations and compliance controls. As stated, this examination may very well include discussions with lower-level personnel.

Organize the Background Information the SEC Will Likely Request

The initial phase of an SEC examination generally includes a review of the RIA's business and investment activities and its corresponding compliance policies and procedures. The examination staff will request information and documents and speak with RIA employees to ensure an understanding of its business and investment activities and the operation of its compliance program. Using the information it obtains, the staff will assess whether the RIA's policies and procedures effectively address its compliance risks. The initial phase also includes testing the firm's compliance program.

In order for the SEC to efficiently process the information assembled for the review, the webcast recommended that an RIA ensure that it organize certain basic information. As

stated, RIAs commonly receive a document request list from the SEC. Thus, each RIA should ensure that the information provided corresponds to the particular item number in the document request list. If the information provided responds to more than one SEC item request, the RIA may provide it once and refer to it multiple times. Obviously, if the SEC requests an item that does not apply to the RIA's business, it can indicate that such an item is not applicable. Commonly requested information includes, without limitation:

- General information such as organizational charts, demographic and other data for advisory clients, financial records and a list of all trades placed for clients.
- Information about the RIA's compliance risks and the written policies and procedures that the firm has established and implemented to address those risks. For example, it would include any inventory performed of the firm's compliance risks and its compliance manual.
- Documents relating to the firm's compliance testing, quality control analyses, surveillance, and/or other forensic or transactional tests. This information would include any warnings to, or disciplinary action of employees, changes in policies and procedures, redress to affected clients or other measures.

Responding to On-Site Document Requests

As the examination continues, the SEC staff will likely request to see additional documents and information. In order to satisfy these requests, an RIA should ensure that the contact person for the examination obtains the immediate attention of department heads and other personnel to promptly respond. At the same time, an RIA should not

hesitate to inform examiners if a particular request appears unduly burdensome or will take extensive time and resources to produce. Prompt and complete responses to document requests will typically lead to shorter examinations. And, the failure to produce documents in a timely manner during an examination may result in a referral to the SEC Division of Enforcement and, significantly, the issuance of a subpoena. Five specialized enforcement units now exist to focus and develop the SEC's expertise on bringing cases. The SEC has specifically dedicated one of these specialized units to asset management. As a result, the webcast suggests that this unit will become OCIE's "pipeline" unit for handling enforcement related matters.

Exit Interview

The conclusion of the on-site portion of the examination typically entails an exit interview with the SEC examiners. This constitutes the last, and most valuable, opportunity for the firm to correct any misunderstandings by the SEC staff and to provide additional proof of its position on an issue prior to the issuance of a deficiency letter.

Common Deficiencies

Every RIA hopes to avoid the deficiency letter. So, the webcast focused extensively on some of the most commonly reported deficiencies. The deficiencies include: inadequate

compliance program/resources, inadequate internal controls, missing books and records, custody of client assets, improper asset valuation, inadequate disclosures, improper trade allocations, false or improper advertising (especially performance claims), illegal personal trading, improper referral arrangements/use of solicitors and recidivism. The webcast advised every RIA to attempt to address these deficiencies before the examination. Moreover, if the SEC issues a deficiency letter, the recipient RIA must generally respond within 30 days. The RIA should ensure that it keeps any promises made to the SEC during the on-site examination or made in a response letter. Some RIAs frequently promise to take corrective action but fail to follow up. A past failure to take promised corrective action raises the RIA's risk profile and may even increase SEC staff scrutiny. The webcast concluded by reminding participants that the SEC retains deficiency letter responses and that the SEC reviews those responses before conducting subsequent examinations.

For more information regarding examinations by the SEC and the examination process, see the SEC document entitled: "[Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies.](#)"