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INVESTMENT ADVISERS

Preparing for Your SEC Audit: An Investment Adviser's Survival Guide

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With increased regulatory attention confronting registered investment advisers and investment companies, and with many hedge fund, private equity, and non-U.S. advisory firms newly registered with the Securities and Exchange Commission, effective compliance has become pivotal to a firm's success and survival. In this climate, the SEC repeatedly has suggested that investment advisers adopt a ''culture of compliance'' as fundamental to their business practices. To be adequately prepared, investment adviser compliance personnel, especially a firm's Chief Compliance Officer (CCO), should be well-informed regarding the agency's industry examination process. This requires understanding the mechanics of a typical examination and the issues on which examiners are likely to focus their attention.

The SEC's Inspection Program Generally

OCIE. The SEC's investment adviser inspection program is administered through its Office of Compliance Inspections and Examinations (''OCIE'') in Washington, D.C., and in eleven field offices located in Los Angeles, San Francisco, Denver, Salt Lake City, Chicago, Fort Worth, Atlanta, Miami, Philadelphia, New York and Boston. These offices also administer the SEC's broker-dealer and investment company inspection programs. (Although much of the following refers to the inspection of an investment adviser, most also applies to the inspection of an SEC-registered investment company.)

OCIE maintains its own page on the SEC website. Many of the SEC materials listed in the footnotes to this article can be found on that page, which is at http://www.sec.gov/about/offices/ocie.shtml.

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Authority and Scope.

Authority. The SEC's authority to conduct inspections of SEC-registered investment advisers is set forth in Section 204 of the Investment Advisers Act of 1940. That section provides that the SEC is authorized to conduct ''reasonable periodic, special, or other examinations'' ''at any time, or from time to time.'' This means that the SEC does not need to suspect wrongdoing in order to conduct an inspection. Rather, the SEC's authority is limited only by the provision that its inspections be reasonable. The same holds true for SEC-registered investment companies, based on authority provided in Section 31 of the Investment Company Act of 1940.

The SEC takes the position that it has authority to examine all records of a registered investment adviser, not just those the adviser is required to keep pursuant

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to Rule 204-2 under the Investment Advisers Act or (if applicable) Rule 31a-1 under the Investment Company Act. Records typically requested for review that go beyond those specified by those recordkeeping rules include audit reports and emails.

Investment advisers that are so-called ''exempt reporting advisers'' are subject to the SEC's inspection authority as well. However, those advisers are not subject to the Rule 204-2 recordkeeping requirements. The SEC has stated its intention not to conduct ordinary course inspections of exempt reporting advisers and instead plans to make information requests or office visits for these firms only on a ''for cause'' basis (e.g., following a tip or other indication that the agency should be concerned about the firm).[1]

The SEC also has made clear that it believes its jurisdiction extends, as a matter of public policy, to examinations of unregistered advisers. In that context, however, OCIE relies on the SEC's power to issue subpoenas rather than on authority explicit in the Investment Advisers Act. OCIE also may approach an unregistered firm and request that the firm ''voluntarily'' provide OCIE with information.

It perhaps goes without saying, but failure to comply with OCIE examination requests are treated by the SEC as violations of law and may be prosecuted.[2]

Scope. Following the black eye to the SEC represented by the Madoff fraud, the agency devoted considerable attention to revamping its examination program, with a view to conducting what it calls smarter and more efficient examinations. OCIE has sought to be relatively transparent in the course of the revamp, publishing a detailed overview of its examination program.[3] OCIE has said it has:

> 1. Placed ever more weight on using proprietary risk factor analysis to pick which specific advisers are selected for examination. For example, an adviser having custody of client funds, multiple industry affiliates or a history of regulatory issues (either on the part of the firm or its principals) can be expected to pose a higher risk of violations, and therefore is likely to be inspected more often. Similarly, advisers associated with products and services of current interest to the SEC staff are more likely to be inspected than other advisers. A 2011 SEC staff study noted that hedge fund firms are two to three times more likely to be deemed ''high risk'' under OCIE's risk factor analysis than are more conventional asset management firms.[4]
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> 2. Shifted the emphasis of the examination program from conducting a comprehensive review of every part of an adviser's operations towards a more focused review intended to zero in on areas deemed likely to pose an increased risk of compliance problems. In the years immediately following the revelation of the Madoff fraud, tremendous energy was devoted in the course of almost every examination to what the agency called ''asset verification'' – meaning confirmation with third-party custodians, transfer agents, etc. of the assets listed in a firm's client account statements.
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> 3. Increased the level of standardization in the examination process, so that – while every examination should be tailored – there is less regional office autonomy in planning and administering examinations. This is embodied in a new National Examination Manual and National Examination Workbook, neither of which is public at this point.
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> 4. Increased the role of ''TCR'' review (referring to tips, complaints and referrals collected by the agency) in both selecting firms for examinations and then focusing the examination itself once commenced.
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> 5. Enhanced the level of cooperation across divisions and offices within the SEC so that, for example, it is increasingly common for non-OCIE staff to participate in an examination.
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> 6. Depended more on subject matter experts in planning and administering examinations. OCIE is pushing to hire more experienced personnel to develop a cadre of ''Senior Specialized Examiners,'' e.g., CDO specialists, trading specialists, derivatives specialists, forensic accountants, etc.

Types of Examinations. In the past, OCIE and regional offices generally conducted three types of examinations:

Routine Compliance Examinations – When the SEC reviews an adviser's operations on a regular cycle to determine (i) whether the adviser is acting in accordance with disclosures made in its offering materials and with applicable federal securities laws and regulations and (ii) whether the adviser has established adequate systems and procedures to ensure compliance on a continuing basis.

PRACTICE TIP. No legal requirement exists compelling the SEC to provide notice of an exam. However, the SEC typically gives at least five days' notice prior to the commencement of a routine exam.

Examinations for Cause – When the SEC has reason to believe that something is wrong, based on public complaints, news coverage, rumors or tips.

PRACTICE TIP. Although examiners do not say whether a particular examination is routine or for cause, if there are indications an inspection is for cause, counsel should be notified immediately and the firm's examination posture should be adjusted accordingly. An examination conducted without prior notice to the firm is a significant cause for concern. In addition, whenever questions arise or requests are made for the production of documents that are outside the ''normal'' scope of an inspection, or that represent a repeated return to a theme by the examiners, this is a cause for concern.

Sweep Inspections – When the SEC targets advisers in a particular geographic region or engaged in certain

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[1] Remarks of SEC Chairman Mary L. Schapiro, ''Statement at SEC Open Meeting: Rules Implementing Amendments to the Investment Advisers Act of 1940 and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers'' (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211mls-items-1-2.htm (stating that the Commission does ''not intend to conduct routine examinations of'' exempt reporting advisers). Mr. Greene and Mr. Kanach authored a detailed overview of SEC rules that apply to exempt reporting advisers, available on the Shearman & Sterling LLP website at http://www.shearman.com/dodd-frank-act-rulemaking-sec-finalizes-exemptions-and-disclosure-requirements-for-investment-advisers-and-sets-compliance-for-early-2012-07-12-2011/.

[2] *See In re Matter of EM Capital Mgmt, LLC and Seth Richard Freeman*, Admin. Proc. File No. 3-15101 (Nov. 20, 2012), available at http://www.sec.gov/litigation/admin/2012/ia-3502.pdf.

[3] Examinations by the SEC's Office of Compliance Inspections and Examinations (Feb. 2012) (''Feb. 2012 OCIE Exams Overview''), available at http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[4] SEC Staff Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011) (''Jan. 2011 SEC Exam Study''), available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

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activities. Sweeps have included those in advance of SEC rulemakings on private funds and, more recently, a well-publicized sweep focused on the private equity industry.

Today there is considerably less distinction between routine and for cause examinations, and OCIE has abandoned the concept of a ''cycle'' examination scheduled simply based on the passage of time since a firm was last examined. Every examination instead is based on OCIE's proprietary risk factor analysis.

Frequency of Examinations. The SEC continues to struggle with its workload and in a 2011 report stated that it cannot examine every investment adviser with the frequency required to meet the agency's mission.[5] For its FY2011, the SEC examined only 8% of registered investment advisers. Fully 38% of registered investment advisers have never been examined, and many firms are finding that what in the past was an every five or six year examination cycle is stretching out beyond that.[6]

That said, the agency has a longstanding practice of ''following the money'' and is committed to regularly visiting the largest advisers and fund complexes. The agency also is making a continued push to visit newly registered advisers and newly formed fund families, for which the initial inspection may occur within 12 months of registration. OCIE at times has experimented with a model for newly registered advisers in which examiners conduct a ''short-form'' examination, using both a shorter document request list and a more targeted interview process. The goal is to quickly establish a view as to the strength of a newly registered firm's compliance framework. That view then informs when the firm is scheduled for a follow-up visit.

The emphasis on early contact and the possibility of a relatively streamlined first inspection is embodied in an October 2012 letter that was sent to all newly registered advisers to inform the firms that they are subject to the OCIE inspection program. Using language clearly intended to evoke the deterring effect of the proverbial cop-on-the-beat, these letters and their follow-on inspections were quickly dubbed by OCIE to be ''presence exams.''[7]

Presumably as a reflection both of travel budget limitations and the heightened government-to-government cooperation that would be required to send examiners overseas, non-U.S. firms have been examined much less frequently than U.S. resident firms. OCIE has, however, introduced what it calls ''desktop'' examinations that allow the SEC to inspect a non-U.S. firm using solely phone and email contacts. There also are occasional reports of on-site ''live'' examinations being performed by the SEC in places like London and Hong Kong (where the agency has strong mutual cooperation agreements in place with the local authorities).[8]

Focus Points of an Examination

Although SEC examiners recently have focused inspections on compliance documentation, many other matters will be of interest to the examiners.

Primary SEC Concerns. An SEC inspection may cover any of a broad range of matters, including among others: (a) filings and reports; (b) Form ADV, brochure (and supplement) disclosure and brochure (and supplement) delivery; (c) contracts; (d) custody; (e) books and records; (f) financial condition; (g) internal controls; (h) advisory services; (i) whether the adviser needs to be registered under securities laws other than the Investment Advisers Act; (j) portfolio management; (k) prohibited transactions; (l) conflicts of interest; (m) brokerage and execution; (n) wrap fee programs; (o) marketing and performance calculations; (p) compensation and client fees; (q) client referrals; and (r) litigation.

Current areas of heightened interest include:[9]

Disclosures – Disclosures of risks, conflicts of interest, valuations and expenses are being monitored closely.

Asset Verification – Again, examiners are clearly concerned about avoiding a repeat of a Madoff situation in which they conduct an examination of a firm and client assets cannot be verified through contacts with third-party custodians, transfer agents, etc.

Investment Performance – Perceived ''outlier'' performance is closely reviewed, as is veracity of performance claims and valuation generally.

Newly Registered Firms and New and Complex Products – Reflecting media and Congressional attention to products like CDOs, examiners often will spend more time on new and complex products than they will reviewing other, more traditional advisory services. The agency is also emphasizing its interest in inspecting newly registered hedge fund and private equity firms.

Risk Management – The SEC is pressing the financial services industry to invest in risk management resources and this is reflected in the examination process.

Inside Information – The SEC has been actively pursuing inside information cases over several years and this is reflected in the examination process.

Market Structure – With recent attention by the SEC and the media to market structure concerns, high frequency, quantitative and automated trading strategies can be expected to be of interest.

Portfolio Management – Examiners seek to understand how portfolio management decisions align with clients' mandates.

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[5] *Id.*

[6] These figures are drawn from testimony by OCIE Director Carlo di Florio before Congress in November 2011. Carlo di Florio, ''Management and Structural Reforms at the SEC: A Progress Report,'' Testimony Before the Subcommittee on Securities, Insurance and Investment, U.S. Senate Banking Committee (Nov. 16, 2011), available at http://www.sec.gov/news/testimony/2011/ts111611rk.htm.

[7] OCIE sent an Oct. 9, 2012 letter to all newly registered investment advisers. Per this letter (''Oct. 2012 Outreach Letter''), OCIE plans a three-stage process commencing with the welcome letter and related broad-based, non-firm specific outreach by OCIE, to be followed by examinations of individual firms, and concluding with a public report on the agency's experiences with newly registered firms. That letter is available at http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

[8] The Feb. 2012 OCIE Exams Overview (see note 3, *supra*) includes an extensive discussion of coordination with other regulators in the course of examinations. That report lists, for example, bank regulators, U.S. state regulators, and non-U.S. regulators as organizations with which coordinated exam activities have been undertaken.

[9] This listing is drawn from the personal experience of the authors, the Feb. 2012 OCIE Exams Overview and the Oct. 2012 Outreach Letter (see notes 3 and 7, *supra*).

Best Execution – Order placement practices continue to draw interest.

Trade Allocation and Cross Trades – Block and IPO trades, as well as cross transactions among client accounts, continue to draw interest.

Personal Trading – The personal trading of access persons, advisory representatives and proprietary accounts of the firm and its affiliates continues to draw interest.

Affiliate Transactions – The SEC has shown an interest in transactions among affiliates, both in connection with potential conflicts of interest and potential client consent requirements.

Role of Investment Company Boards – In the course of examinations of registered investment companies, there is rising SEC interest in the role of the fund board and therefore in traditional core board functions like review of service provider arrangements, valuations, etc.

Culture of Compliance. The SEC's routine request list now includes a lengthy section devoted to asking firms to show proof of an active compliance program, rather than simply the existence of the program. To fully understand a firm's commitment to compliance, examiners will expect to meet with individuals outside the legal and compliance departments. In particular, examiners will ask to meet with senior managers and to interview various ''front line'' employees, including portfolio managers, traders and operations personnel. Examiners also may ask for certain transaction-related and other information so that they can ascertain whether control procedures are being complied with and are effective. The following practice tips identify and discuss the most significant matters of interest to the SEC in assessing a firm's compliance program.

PRACTICE TIP. *Policies and Procedures* – Procedures should be in writing and should be user-friendly and reviewed and understood by relevant business personnel of the adviser. They should not be boilerplate and should be tailored to the specific needs and issues of the adviser.

PRACTICE TIP. *Monitoring* – Specific procedures for escalating exceptions reporting and resolving problems, which are core compliance functions, should be in place. There should be indications, such as documented meetings with senior management, that these functions are supported by the firm. In evaluating compliance monitoring, the SEC can be expected to look to:

- how compliance risk is reported;
- routine reports that go to senior management;
- regular evaluation of the effectiveness of controls; and
- exception reports and analysis tracking identified issues to the root of the problem.

PRACTICE TIP. *Documentation* – Examiners increasingly focus on compliance policies and procedures maintained by an investment adviser, as well as documentary evidence that compliance programs are actually working. Examples of such documentary evidence include:

- Compliance calendars;
- Compliance checklists and workpapers;
- Results of reviews by compliance and internal audit departments, including reports to a registered fund's board;
- Minutes of internal committees devoted to best execution, valuation, code of ethics matters and the like;
- Exception reports; and
- Account and transaction reconciliations.

The Exam

How the SEC Prepares. SEC examiners responsible for an inspection usually read the adviser's Form ADV and review the adviser's website beforehand. They also make extensive use of Internet and media searches and should be assumed to have access to industry databases like those that compile hedge fund returns. This prepares them to check the adviser's operations for consistency with its public disclosures and public profile. Tips and complaints involving the adviser that have been received by the SEC typically are reviewed, as are previous reports prepared by the staff in connection with prior exams of the adviser. Going forward, it is expected that examiners also will use data collected from private fund managers on the SEC's new Form PF.[10]

In the past, firms largely expected form-letter requests from OCIE as the first step in the inspection. Increasingly, however, even the broad initial request list shows effort to customize the inspection to the firm.

How Advisers Prepare. As a first step, an advisory firm that is about to be inspected should designate an individual to serve as the exam coordinator and the primary contact for the SEC staff. Frequently, the point person will be the CCO or another senior member of the firm's legal or compliance teams. The particular next steps will depend on the nature of the adviser's business.

PRACTICE TIP. *Prior Exams*– Records relating to prior exams should be reviewed with a view to ensuring that any noted deficiencies have been corrected. Making the same mistakes twice is not only embarrassing and unnecessary, it is also a red flag for SEC examiners. Several recent SEC enforcement actions against investment advisers noted recurring issues in OCIE exams as a precipitating factor in the determination by the agency to sue the firms involved.[11]

PRACTICE TIP. *Educate Personnel* – A communication should be sent to all personnel informing them that the SEC staff soon will be arriving on the premises and requesting that they not have substantive discussions with the SEC staff unless the firm's exam coordinator is present. For personnel who can be expected to interact with the SEC staff, it is important to devote extra time and attention to their preparation. They should understand that they are being ''graded'' by the SEC staff on their apparent level of candor and cooperation. But they also should be aware that every examination carries risk to the firm and that their responses have to be appropriately measured and careful. This is the balancing act that is at the core of the examination response process. A registered fund's board typically will be notified and kept informed as the inspection proceeds; in some recent examinations, registered fund board members

[10] Mr. Greene and Mr. Kanach authored a detailed overview of the Form PF requirements, available on the Shearman & Sterling LLP website at http://www.shearman.com/dodd-frank-act-rulemaking—form-pf-inaugurates-era-of-detailed-reporting-by-managers-of-private-funds-11-14-2011/.

[11] *See* SEC Penalizes Investment Advisers for Compliance Failures, SEC Press Release 2011-248 (Nov. 28, 2011), available at http://sec.gov/news/press/2011/2011-248.htm.

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have been among those that examiners interviewed, though that it is not customary.

PRACTICE TIP. *Accommodations* – Be prepared to arrange for a conference room or office space for the SEC staff, which should be in a location that will not interfere with the adviser's daily operations. At a minimum, the examiners should have access to a private desk and telephone. Although the SEC staff will request such accommodations as a courtesy to their examiners, providing designated workspace also serves the purpose of preventing the staff from roaming freely through the firm's offices.

PRACTICE TIP. *Keep a List of Documents Delivered* – It is important to track all documents and other material provided to the SEC staff. Therefore, while you should provide a method to facilitate the duplication of requested records, do not permit the SEC staff to have direct access to a photocopier, scanner or fax machine. Make sure your SEC examiners understand this as part of the ground rules for their stay at the firm.

PRACTICE TIP. *SEC Visit and Interview* – Anticipate that the SEC staff will request an introductory walk-through of the advisory firm. This may be when the staff asks to speak to key personnel, including senior executives.

Commencing the Exam and Managing the Inevitable Requests for More Information. To commence an inspection, the SEC provides the adviser with a written statement that informs the adviser of the SEC's authority for requesting the information; the purpose for requesting the information; and the uses that will be made of the information. However, as previously stated, examiners will not say whether an examination is for cause or routine.

The staff generally will send a letter to the adviser stating when the examination team will arrive. The letter typically lists documents that the adviser must furnish to the examiners. As it may be a form letter, not tailored to the particular adviser to be inspected, there is room for limited negotiation at this stage (as described below). The initial letter will be followed over the course of the inspection by what may be dozens of so-called ''Additional Request'' (or AR) letters, each of which is typically shorter than the broad initial request for information and documents.

PRACTICE TIP. *Determine Who's on the Exam Team* – An increasing number of SEC examinations include both OCIE personnel and personnel from other parts of the agency. While agency personnel have repeatedly said that the most common reason for non-OCIE staff to join an examination team is ''training,'' the presence of non-OCIE staff is of interest to you as you plan your responses. Particularly if enforcement staff are present, you should treat this a cautionary point that colors your approach to the examination. It is appropriate at the outset of an examination to ask for each examiner's background. If an examiner is from the Enforcement Division, he or she is required to confirm that, but then will not say anything further as to why he or she is part of the examination.

PRACTICE TIP. *Dialogue with SEC* – The SEC staff is usually receptive to engaging in a dialogue concerning an adviser's claim that certain documents that have been requested do not in fact need to be produced, typically because they are not relevant to the adviser's operations. The SEC staff also usually will be open to discussing which items need to be produced at the start of the inspection and which may be supplied through a ''rolling production'' even after the inspection is under way.

PRACTICE TIP. *Challenging the SEC's Requests* – Some advisers may seek to challenge certain SEC requests for documents as outside the scope of the SEC's inspection authority. Fund boards, too, may have an interest in maintaining the confidentiality of certain information. However, resistance should be used cautiously, as it may escalate the inspection. Also, the SEC may seek to get the information by invoking its broader power to investigate pursuant to Section 209 of the Investment Advisers Act or Section 42 of the Investment Company Act (each of which usually involves a subpoena).

PRACTICE TIP. *Service Providers* – If certain of the adviser's or fund complex's books and records are maintained by others, such as custodians and transfer agents, this must be pursuant to a written agreement that ensures such materials will be opened for regular SEC inspections. The inspection staff may ask to review these agreements.

PRACTICE TIP. *Being Organized Counts* – All presentations of materials to the SEC should be made in an orderly manner. Requested files should be neat, labeled and organized.

PRACTICE TIP. *Promptness Counts* – Some examiners are closely focused on the speed at which requested information and documents are produced and will draw negative conclusions from being left waiting. In the eyes of an examiner, ''prompt'' delivery often means within 24 hours.

Optimally, the adviser's exam coordinator will have an ongoing dialogue with the SEC's inspection staff and will be able to resolve the document requests in a mutually satisfactory manner. But no matter how good the relationship is between the exam coordinator and the SEC inspection staff, document production can set the stage for difficult issues. For example, issues of timing may arise for materials that must be newly created, which, in addition to potentially taking time to prepare, can require quality control review and sign-off before producing them to the SEC. A practical issue that is increasingly common is a request for information made of a newly registered adviser for records dating to periods prior to registration when the firm's recordkeeping protocols were less developed.

Sensitive or Legally Privileged Information

Another difficult issue may have to be faced when the staff seeks sensitive materials, such as a firm's privileged report related to an internal investigation of some suspected improper activity. The staff interest in internal investigations and internal audit reports is obvious. These provide an effective means to determine whether there have been any compliance lapses at the adviser. The advisory firm has a corresponding interest in keeping this matter private from both the SEC staff and also third parties. Sometimes these requests will extend to legally privileged information (a not uncommon circumstance when the SEC staff requests, as it sometimes does, large volumes of email). In consideration of these types of requests, an adviser's legal and compliance staff must address:

Impact – The impact of handing privileged documents over to the SEC staff on the ability to maintain the attorney-client privilege when access to such documents is requested by a third party.

PRACTICE TIP. There is no formal process for dealing with requests by the SEC staff for privileged documents. They are handled on a case-by-case basis by the SEC. In many cases, the SEC will be sensitive to the concerns of the advisory firm. However, in those cases where the SEC believes it has a real need to review a privileged document, it may persist in its request.

PRACTICE TIP. The SEC may request ''privilege logs'' of company attorneys in response to claims of privilege. A privilege log lists, with limited identifying information, materials withheld on the basis of privilege.

Return of Documents – Whether provisions can be made for the return of documents provided to the SEC.

PRACTICE TIP. Upon request of an adviser, the SEC staff will sometimes return documents produced during an inspection that contain sensitive information and agree not to retain a copy. As with dealing with questions of privilege, there is no formal process for requesting the return of documents; it is simply part of the dialogue between the firm and the inspection staff. However, such requests are granted sparingly by the SEC.

Confidentiality – Steps taken to ensure that sensitive documents are treated as confidential by the SEC and not provided to a third party.

PRACTICE TIP. A firm should always follow the procedure that the SEC has established for requesting confidential treatment under the Freedom of Information Act (''FOIA''), which allows parties to request records in the SEC's possession. Under FOIA, a request for records will be granted unless they are exempt from disclosure.[12] By clearly stating that the firm requests confidential treatment of its materials delivered to the SEC, the firm is laying the best groundwork possible to avoid later disclosure to the public.

Catch-All Questions

On occasion, the SEC staff may request responses to such broad, ''catch-all'' inquiries as those asking for a description of any compliance problems. In responding to a question of this nature, as when addressing more specific questions implicating privilege, legal counsel should be consulted. The goal will be to satisfy the staff request, while reasonably protecting the adviser's interests by not providing a ''roadmap'' to current issues.

PRACTICE TIP. As previously mentioned, part of the current examination request list focuses on internal controls and includes a varied, but interrelated set of questions about a firm's compliance infrastructure. Some firms today elect to respond to this part not on a piecemeal basis, but instead by offering a single presentation regarding internal controls that sets the stage for the examination as a whole. This is typically done in the first few days of the examination.

Beware of Email and Other Electronic Communications

The SEC has an open-ended policy requiring investment advisers to (i) retain emails for an unspecified (but apparently lengthy) period and (ii) produce to SEC examiners any emails that they may request. This policy applies equally to large money management firms and to small financial planners. OCIE also has indicated that advisers should not only retain emails, but also should monitor email regularly as an internal compliance tool. The SEC's exam staff has been known to also ask for copies of other electronic communications, such as instant messages.

PRACTICE TIP. The examiners are likely to review email for at least several months from five or six key individuals in the organization. These emails should be reviewed one by one prior to production to the examiners, a process that can require a serious time commitment. This review process should be undertaken before the examiners arrive, as the examiners expect email production to be a matter of a day or two.

PRACTICE TIP. Many automated email management and analysis tools are available. But the simplest means of monitoring email is to be clear that firm email traffic is not private and conduct random checks of employee email. Asking employees questions about particular emails from time to time also can drive the point home.

Materials Prepared Specifically for an Examination

Not everything that the SEC requests in the course of an examination will be kept by the adviser in a form that is immediately ready for production to the examiners. This means that some information will be developed and reformatted specifically for purposes of the examination. While that this entirely appropriate and common, it also leaves room for confusion or miscommunication. There have been a number of recent enforcement actions in which the SEC has alleged that ''doctored'' documents were delivered to it or that materials were handed over in a manner that misleadingly made it appear as though the materials were standard firm records, rather than information prepared solely to meet SEC requests.[13] It is thus important when materials are delivered to the SEC staff to distinguish between existing records and newly prepared responses. Nothing should be backdated during the preparation process.

Meeting with the Examiners. At the outset of an inspection, the SEC staff likely will seek to meet with one or more senior executives of the advisory firm, including the CCO, in order to get an understanding of the adviser's business and operations. After this meeting, the

[12] FOIA allows parties submitting information to the SEC to seek confidential treatment for documents falling within designated categories. One category includes commercial or financial information that is of a kind not customarily disclosed by the submitter to the public. Generally, under these procedures, requests for confidential treatment must be written and submitted with the information. Such information should be: (i) produced separately from information for which confidential treatment is not being requested; (ii) marked as confidential; and (iii) accompanied by a written request for confidential treatment specifying the information for which confidential treatment is requested. In addition, a copy of the request for confidentiality (but not the records to which the request applies) should be sent to the FOIA Office, Securities and Exchange Commission, 100 F Street NE, Mail Stop 2736, Washington, D.C. 20549.The SEC recognizes that it is not feasible to follow these formal procedures in certain cases, such as when documents are provided during the course of an inspection. In such cases, the SEC staff person should be informed that confidential treatment is being requested. A written request for confidentiality must be submitted within 30 days of the submission of the information.The process is only finalized upon the request of a third party for the information. At this point, the SEC will notify the party that has requested confidentiality and ask for background substantiating the claim. Based on that information, the SEC will determine whether confidential treatment is warranted.

[13] *In re Matter of Legend Securities, Inc. and Salvatore Caruso*, Admin. Proc. File No. 3-14389 (May 16, 2011), available at http://www.sec.gov/litigation/admin/2011/34-64502.pdf.

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staff is then likely to ask to be given a walk-through of the premises. Then, the staff likely will take some time to review the documents they requested. Requests for additional documents and interviews can be expected throughout the examination. Over time, OCIE has put steadily more emphasis on interviews, so it should not be a surprise if a variety of the firm's staffers (senior management, portfolio managers, traders, risk managers, marketers and client relations staff, back office personnel, compliance staff, IT staff, etc.) are asked to sit down with the exam team before an inspection is completed. Again, one person should be assigned the function of inspection coordinator. The staff should be asked to direct all requests for documents or information to the exam coordinator.

There is no set formula for dealing with the inspection staff other than to be cooperative and reasonably responsive. As already suggested, it is never to the benefit of the management of the adviser to take an adversarial posture with the staff on routine inspections. Generally, the easier it is for the staff to do their work, the sooner they will be out of the adviser's offices. However, also as already suggested, an examination is a serious matter and both responses to specific requests and general interactions with the examination team should be treated with care by everyone at the firm. While the authors believe industry experience with this option is limited, OCIE also has established a ''hotline'' for resolving issues outside the normal course of conversations with the exam team and their immediate supervisors.[14]

PRACTICE TIP. *Managing the Process* – Keep track of the documentary information collected by the examiners by maintaining a parallel file that contains a copy of any materials that are given to them. Try also to maintain a log of people the examiners speak to (including dates, length of meetings and general topics). In this regard, the examiners should not be left unattended with any member of your staff. The exam coordinator should be present during all such interactions. Finally, it is critical to mentally debrief at the end of every day – try to think through the implications of issues that were discussed during the day and consider especially any points that appeared to trouble the examiners; do not hesitate to talk those through with internal and external counsel.

Face-to-Face Interaction

The dynamics of meeting the SEC staff will vary. However, it may be helpful to keep the following tips in mind:

PRACTICE TIP. *Examiners in Training* – Examiners learn on the job and may be placed in the field with only a few days training. This often means it will be necessary to educate examiners about your business or the industry generally. This also may make it difficult to ascertain who has decision-making authority and is leading the examination, as a junior examiner may take an apparently leading role as a training exercise.

PRACTICE TIP. *Number of Examiners* – Advisers should not be intimidated by the number of examiners that arrive for an examination. The government approaches cost issues differently than private industry and may send staff on an examination simply as a learning opportunity or even because a staffer has expressed interest in participating in a particular inspection.

PRACTICE TIP. *Evaluation of the CCO* – The SEC staff has clearly stated that the examination team will seek to assess the ''knowledge'' and ''competence'' of the CCO, especially in smaller firms. This process of evaluating the CCO often begins immediately during the SEC staff's initial on-site interview and continues informally throughout the examination.

PRACTICE TIP. *Special Considerations in Explaining Your Business* – If you believe your business model or investment strategies are out of the ordinary, consider taking the time early in an examination to offer a primer on the firm's business. Doing so can avoid confusion on the part of the examiners as they proceed with their exam, saving both you and the examination team time and aggravation.

PRACTICE TIP. *Caution Is the Better Part of Valor* – Be sure that you and your staff answer only those questions that are actually asked. The exception to this rule is when you believe you can avoid confusion or nip something in the bud by offering more information. But remember that nothing is ''off the record.''

How Long Will the Examiners Be There? The better prepared the adviser is to cooperate with the staff, the shorter the inspection will be. In a single adviser inspection, the on-site portion of the process can be expected to last a few weeks at minimum. Inspections of fund complexes, large advisers, or advisers working with registered funds and hedge funds, however, often take several months (and even a year or more is no longer out of the ordinary). Again reflecting the scars left on the agency by Madoff, there is an understandable – and very human – reluctance to ''close the file'' on any examination, which can result in a long phase-out period in which the examiners spend less and less time on-site but continue to return or submit follow-on information requests from time to time. It is not always clear when the SEC has ended the on-site portion of an exam.

Disclosure of the Examination to Third Parties. The SEC is prohibited by Section 210(b) of the Investment Advisers Act from (i) making public information about an investment adviser inspection, or (ii) disclosing information obtained as a result of an inspection without the approval of the SEC commissioners. This provision has not been read by the SEC staff to prohibit them from contacting an adviser's clients, service providers and brokers to obtain information in the course of an inspection.

The SEC also may provide information received during the course of an inspection to designated categories of governmental authorities, self-regulatory organizations, and other specified persons who must in turn keep such information confidential. This is authorized under Section 24(c) of the Securities Exchange Act and Rule 24c-1 thereunder.

Regardless of actions taken by the SEC, the firm may decide that it is necessary or appropriate to report on the inspection to various constituencies. For example, significant firm clients may have negotiated specific notice terms that include the right to be notified of regula-

[14] The OCIE Examination Hotline offers a choice to speak with either a senior-level attorney in OCIE's Office of the Chief Counsel in Washington, DC or a staff member in the SEC's Office of Inspector General. The Office of Inspector General is an independent office within the SEC that conducts audits of agency programs and investigates allegations of employee misconduct. The hotline number is (202) 551-EXAM or (202) 551-3926.

tory inspections as they occur. Or there simply may be the commercial expectation that such notice should be given. Financial investors or joint venture partners of the firm also may expect or be entitled to this information. Note, though, that there is no consensus as to the level of detail that needs to be provided, and many firms specifically decline to comment in detail on the results of the inspection findings. Any information that is shared must be accurate and should not be so vague or open-ended as to be misleading.[15]

Results of an Examination. The SEC inspection results can range from a ''deficiency letter'' (described below) to the institution of a civil enforcement action or even a criminal referral. It is rare but not unheard of to receive no further communications after an inspection is completed.

Exit Interview

Examinations almost always end with an ''exit interview'' that provides the last clear chance to settle any confusion or sway opinions. You typically (but, of course, not always) can tell from the exit interview what is going to happen next. Most likely it will be a deficiency letter identifying a variety of technical violations that can be cured quickly, allowing the organization to move on relatively easily.

PRACTICE TIP. The exit interview is the best opportunity to determine whether or not the staff has found problems. Although the staff is instructed not to discuss details of their findings at this time, it is often still possible to elicit areas in which they may have concerns. In this way, the firm can begin its own review and implement corrective action, if necessary, even before a formal notice is received from the SEC.

Internal SEC Reports

The inspection staff uses the materials obtained during the inspection and the information recorded on the inspection outline to prepare an internal examination report. The report, which include comments and supporting documentation, describes:

- possible violations or deficiencies;
- descriptions of any other matters requiring comment;
- brief descriptions of any ''unusual'' aspects of the registrant's business or background; and
- descriptions of each violation or deficiency in summary form.

As described below, if a staff deficiency letter is prepared and sent to the adviser, it will cover many of the same matters.

'Back at the Branch'

Senior SEC staff (e.g., District Branch Chiefs and/or District or Regional or Administrators) will review the internal report and recommend whether further action should be taken. Such further action ranges from the forwarding of a deficiency letter to the adviser to the institution of a civil or criminal enforcement action.[16] If no formal enforcement action is contemplated, the senior staff member directly responsible for a specific review normally will not consult formally with other senior staff in the review process and the inspection will be completed either through a deficiency letter and/or follow-up conferences with the adviser or other regulatory action. (If, as a result of the inspection, the SEC staff determines preliminarily that enforcement action may be appropriate, the review process would include enforcement staff at this stage.) Rarely will an inspection be terminated without at least a deficiency letter; indeed, recent agency statistics show that approximately 80% of all inspections end with a deficiency letter (and in approximately 40% of inspections OCIE internally classifies the deficiencies found as ''significant'').[17] Indicative of the length of time that the agency can keep an inspection formally open, it is OCIE's stated goal to close an inspection report within 120 days of completing the fieldwork portion of the inspection and that goal is met only approximately 50% of the time.[18]

Deficiencies, Responses and Follow-ups

Upon receipt of a deficiency letter, the adviser should take immediate action to correct each deficiency and ensure that it will not recur. Counsel also should be consulted as soon after receipt of a deficiency letter as possible. The deficiency letter will request a response as to what actions have been taken (with that response generally due within thirty days, although reasonable extensions typically of a few weeks are considered routine). The response should address the identified deficiencies one by one and, whenever applicable, should specify any corrective actions taken since the examination and explain how recurrence will be prevented.

PRACTICE TIP. While the deficiencies may be minor, they will be viewed as serious if they are allowed to recur. Any deficiencies noted will be specifically reviewed in the next inspection, which depending upon the nature of the deficiencies, may be sooner rather than later. As suggested above, firms are also under increasing commercial pressure from their clients and fund investors to discuss the results of an examination, potentially adding an additional audience to the deficiency process.

PRACTICE TIP. In the past, so-called sweep examinations would only infrequently end in the issuance of deficiency letters. It is no longer surprising, however, for a firm that participates in a sweep examination to receive a deficiency letter.

In an ''exam gone bad,'' SEC enforcement attorneys are likely to follow up the exit interview, either shortly thereafter or after a firm's written response to the deficiency letter is submitted. In a smooth exam, you are likely never to hear back from the staff following submission of the response letter and are left, after a few months, to cross your fingers and assume that ''silence is golden.'' In a new wrinkle on the post-exam process,

[15] *See, e.g., In re Aletheia Research and Management, Inc., et al.*, Admin. Proc. File No. 3-14374 (May 9, 2011), available at http://www.sec.gov/litigation/admin/2011/34-64442.pdf (citing the firm for alleged misleading responses to clients regarding the results of prior SEC examinations of the firm).

[16] Emphasizing the close links between OCIE's examination programs and SEC enforcement activity, the opening pages of the Feb. 2012 OCIE Exams Overview (*see* note 3, *supra*) prominently list enforcement cases derived from OCIE referrals. Public remarks by senior SEC enforcement officials attribute a significant percentage of the cases brought by the Enforcement Division's Asset Management Unit to referrals from OCIE. *See, e.g.*, Robert Kaplan, then Co-Chief of the Asset Management Unit, Remarks at Federal Bar Association Panel ''Understanding the SEC's Changing Role in Mutual Fund Regulation'' (Nov. 1, 2011) (estimating that 20-30% of the unit's caseload comes from exam referrals).

[17] SEC FY2013 Budget Request to Congress, available at http://www.sec.gov/about/secfy13congbudgjust.pdf.

[18] *Id.*

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OCIE has announced a program in which approximately 5% of examinations will be tagged internally by OCIE for a check-up visit by the examiners. The purpose of that return visit – likely to be scheduled six to ten months after the initial examination's conclusion – will be to confirm that any agreed corrective steps undertaken by the firm have been implemented to OCIE's satisfaction.[19]

PRACTICE TIP. The SEC has said that a large number of deficiency letter citations relate to disclosure issues, often relating to a firm's Form ADV or fund documents. Other issues that regularly generate citations include (a) portfolio management controls (e.g., procedures to assure consistency with client mandates) and recordkeeping (e.g., allocation statements), (b) personal trading (especially recordkeeping and failures to review personal trades), (c) marketing issues such as performance calculations and misleading or otherwise inappropriate performance comparisons, and (d) brokerage issues such as inadequate best execution controls.

PRACTICE TIP. Approximately 10% of recent SEC exams resulted in enforcement referrals, representing a steady increase from around 5% ten years ago. Technical violations (e.g., failing to keep a particular required record) are not likely to result in enforcement. Rather, it is the ''sexier'' issues like self-dealing or misleading disclosure that drive enforcement referrals.

[19] ''OCIE Announces 'Checkup' Exams'', *Compliance Reporter* (Nov. 5, 2012) (reporting remarks of OCIE Deputy Director Andrew Bowden at the National Society of Compliance Professionals 2012 National Membership Meeting).