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Registration of Private Fund Managers – SEC Examinations

Part II-3: SEC Examinations and How to Prepare for Them

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Topics to Cover

- The Examination Process
- Preparing for the Examination
- Responding to SEC Requests
- How to Address Problems
- Responding to Deficiency Letters
- Post-Examination Compliance
- Identifying Risks and Conflicts of Interest

THE EXAMINATION PROCESS

The Examination Process

- Types of Examinations
  - Routine
  - Sweep Exams
  - For Cause
- Frequency of Routine Exams
  - Initial Exam
  - Risk Based Determination
- Possible Outcomes
  - Deficiency Letter (opportunity to respond)
  - Referral to Enforcement

The Examination Process

- Initial notification
- Initial SEC request list
- Initial document production
- On-site examination
- Initial presentation
- Interviews
- Review of documents
- Additional document requests
- Exit Interview
- Deficiency or “ No Further Action” Letter

SEC Examination Request List

- Certain general information to provide an understanding of the firm's business and investment activities.
- Information about the compliance risks that the firm has identified (and the written policies and procedures the firm has established and implemented to address each of those risks.
- Documents relating to the results of and output from the various transactional (quality control) and period (forensic) testing conducted to provide an understanding of how effectively a firm has implemented its compliance policies and procedures.
- Information regarding the results of any tests and follow-up actions taken by the firm to address shortfalls or breaches revealed by such tests to provide an understanding of steps taken by the firm to address the results of compliance reviews, quality control, forensic or transactional tests conducted.
- Information to perform testing for compliance in various areas.

PREPARING FOR THE EXAMINATION

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Preparing for the Examination

- Notify senior management and outside counsel
- Review all parts of Form ADV for accuracy
- Designate one legal or compliance person, typically the CCO, to serve as a coordinator and to manage the exam and the document request response
- Collect, organize and review documents
- Review the document request list to gain insight into the exam's focus
- Respond swiftly to the document request list, including timeframes for documents that cannot be accessed quickly
- Study previous reviews (internal and those done by third parties) for further insights

Preparing for the Examination

- Inform all staff of the SEC’s presence
- Provide the SEC team with a suitable conference room or other space that is onsite, private and away from the center of operations to prevent distractions
- Identify personnel to be interviewed by the SEC, make them readily available for interviews and personally attend the interviews (rather than have legal counsel do so)
- Request that the SEC provide at least one day’s notice of interview requests so preparations can be made and normal business operations are not disrupted
- If time permits, prepare personnel to be interviewed in advance by reviewing likely areas of inquiry; Make it clear that responses to questions from the SEC team must be truthful, complete and concise
- Personnel not in interviews should not have substantive discussions with the SEC

Preparing for the Examination

- Initial Documentation
  - Description of the firm’s business
  - Form ADV Part II
  - Annual Reviews
  - Risk Matrix
- Document Request List
- Identify Material Compliance Issues

SEC Examination Priorities*

- **Portfolio Management**: recent losses may provide an impetus for portfolio managers to trade more aggressively than they should or to deviate from investment objectives
- **Financial Controls**: advisers in precarious financial condition should be aware that they are obligated to disclose this fact to clients
- **Valuation**: focus on controls and procedures for valuation of illiquid and difficult-to-price securities.
- **Structured Products**: focus on products marketed as being relatively "safe," such as principal protected notes and other products, and the adequacy of disclosures
- **Controls and Processes at Recently Merged or Acquired Firms**: Compliance staff must help ensure that controls and processes do not fall through the cracks in a merged organization.

* From "SEC Examination Focus for 2009, Speech by Lori Richards <*http://sec.gov/news/speech/2008/spch102108lar.htm*>

SEC Examination Priorities

- **Short Selling; Market Manipulation:** OCIE will focus on compliance with new short sales rules and firms' policies and procedures to prevent employees from knowingly creating, spreading, or using false or misleading information to manipulate securities prices.
- **Other Areas of Focus**: OCIE also will continue to focus on other areas such as: suitability and appropriateness of investments for clients; disclosure; controls to prevent insider trading; trading, brokerage arrangements and best execution; proprietary and employees' personal trading; undisclosed payments; safety of customer assets; anti-money laundering; compliance, supervision and corporate governance.

RESPONDING TO SEC REQUESTS

Responding to SEC Requests

- Control the process of fulfilling all document requests and keep track of documents provided, with documents readily available should questions arise
- Log privileged documents to protect privilege; however, the SEC may assert their right to access the documents
- Review e-mails for privileged communications
- Closely coordinate internal review and related documents with legal counsel before submitting documents to the SEC; this includes annual compliance program review documents
- Make every effort to resolve issues identified during the exam before the inspection’s end and inform the onsite examiners as progress is made

ADDRESSING PROBLEMS

Addressing Problems

- Assessment
  - Tone of the Examination
  - Length of the Examination
  - Specific Concerns
- Inexperienced or confused examiners
- Disagreements about interpretation of obligations
- Inability to provide timely and appropriate responses
- Elevating the issue

RESPONDING TO DEFICIENCY LETTERS

Responding to Deficiency Letters

- Debrief interviewed staff and document lessons learned
- Verify that all immediate modifications and solutions to the deficiency or problem are reflected in the SEC's deficiency letter
- Decide who will draft a response to the SEC's deficiency letter and who will comment and review (e.g., auditors, outside counsel)
- Respond appropriately and promptly to the SEC (within 30 days)

Common Examination Deficiencies

- Form ADV and disclosure failures
- Ineffective internal controls
- Failure to maintain adequate books and records
- Issues with trade allocations, brokerage arrangements and best execution
- Improper personal trading
- Failure to comply with custody rules
- Inaccurate past performance results
- Inaccurate fee calculations
- Failure to supervise

POST-EXAMINATION COMPLIANCE

Post Examination Compliance

- Look at a deficiency letter as an opportunity to address and make changes
- Review policies, procedures and disclosures and update as needed Plan to train staff on changes to
- policies and procedures
- Incorporate areas of deficiencies into the annual compliance review process
- Update risk assessment
- Retain files of documents provided during the examination

IDENTIFYING RISKS AND CONFLICTS OF INTEREST

Risks – Possible risk areas identified by the SEC

- Adviser relies heavily on a paper-based record-keeping system.
- Adviser continuously updates its website.
- Adviser manages several strategies and has varying account types (i.e., institutional, retail, pooled investment vehicles).
- Adviser regularly loses existing clients and obtains new clients.
- Adviser employs portfolio managers with impressive performance returns that were earned while employed elsewhere.
- The adviser has limited personnel resources.
- Advisory staff performs multiple functions (such as compliance oversight and marketing).
- Portfolio managers' compensation is performance-based.
- Performance is heavily marketed and is responsible for most of the adviser's new business.
- Adviser completes requests for proposals and/or provides information for performance and consultant databases.
- Thinly traded securities, derivatives, or other difficult-to-value investments are included in performance figures.

Adviser Duties

A U.S. investment adviser (whether or not registered under the Investment Advisers Act of 1940) has specific fiduciary duties to its investment advisory clients and is required to disclose all material conflicts of interests to those clients.

“Conflicts of Interests” Defined

- Conflicts of interest for Investment Advisers Act purposes is not specifically defined by statute or rule.
- Conflicts of interest are generally thought to include:
  - situations that cause an investment adviser's interests to diverge from those of its clients;
  - situations that might lead the adviser to favor one client over another; and
  - situations that might cause the adviser to render advice that is not disinterested.

Two Categories of Conflicts

- Institutional – Conflicts between the interests of the institution and the client.

- Individual – Conflicts between the interests of advisory personnel and the client.

Examples of Potential Conflicts - Gifts and Travel and Entertainment ("T&E")

- Description: Personnel of investment advisers are provided with gifts and T&E by service providers.
- Scenario: In order to generate orders and commission dollars, broker-dealers and registered representatives of broker-dealers offer hedge fund personnel gifts, travel and entertainment perks, such as tickets to concerts and sporting events.
- Potential Conflict: Choosing the best or most cost-efficient service provider vs. continued receipt of gifts and T&E.

Examples of Potential Conflicts – Payments to Affiliates

- Description: Affiliate of investment adviser is selected to act as service provider for the investment adviser's clients.
- Scenario: An investment adviser that manages a hedge fund selects one of its affiliates to act as the administrator for the hedge fund. The affiliate is not a very good administrator.
- Potential Conflict: Choosing the best or most cost efficient service provider vs. the desire to engage an affiliate as service provider.

Examples of Potential Conflicts – Referral Fees

- Description: Investment adviser pays a third party to refer clients.
- Scenario: Investment adviser (which has a bad investment performance track record) engages a third party to locate potential clients and makes periodic payments to that third party in an amount based on the size of the accounts referred.
- Potential Conflict: Third party solicitor's desire to effect a successful referral vs. the referred client’s need to understand the true quality of the investment adviser’s abilities.

Examples of Potential Conflicts - Allocations of Investment Opportunities

- Description: Securities in short supply are an appropriate investment for multiple clients.
- Scenario: Investment adviser manages multiple clients: (i) a hedge fund which charges a performance fee; (ii) an investment company; and (iii) a non-fee paying personal account of the owner of the investment adviser's largest client.
- Potential Conflict: The desire of the investment adviser to maximize the performance fee that it receives from the hedge fund and/or to curry favor with the owner of the investment adviser's largest client vs. acting in the best interests of all of the investment adviser's clients.

Examples of Potential Conflicts – Side by Side Management

- Description: An investment adviser manages multiple accounts with the same or overlapping investment objectives and/or strategies.
- Scenario: An investment adviser manages a registered investment company and a much smaller hedge fund, each of which focuses on small cap publicly-traded equity securities. The registered investment company is large enough to make purchases that can impact the price of securities in the small cap market. The hedge fund has among its investors employees of the investment adviser. The hedge fund charges a performance fee and charges a higher management fee than the registered investment company.
- Potential Conflicts: In order to obtain the benefit of the performance fee paid by the hedge fund and to increase assets under management to obtain a higher management fee, the investment adviser is incentivized to put the interests of the hedge fund ahead of those of the registered investment company by, among other things: (i) allocating better securities to the hedge fund; or (ii) causing the hedge fund to buy shares of Company X, then causing the registered investment company to buy enough shares of Company X to raise the price of the Company X shares owned by the hedge fund, then causing the hedge fund to sell its shares of Company X, thereby reaping a profit derived from the artificially inflated price.

Examples of Potential Conflicts – Cross Trades and Principal Transactions

- Description: An investment adviser causes one client to sell securities to another client.
- Scenario A: Investment adviser manages two hedge funds (Fund X and Fund Y). Fund X focuses on debt and Fund Y focuses on equity. The portfolio manager of both hedge funds is the same person. Neither the investment adviser nor the portfolio manager own an interest in Fund X or Fund Y and both Funds pay the same management and performance fees. The portfolio manager's best friends are investors in Fund Y. Notwithstanding their respective focuses, each of Fund X and Fund Y is permitted to own debt and equity. The portfolio manager causes Fund X to sell some of its equity holdings to Fund Y.
- Potential Conflict: Favoring friends in Fund Y vs. doing what's in the best interests of both funds.
- Scenario B: Same as Scenario A, except that the principals of the investment adviser, including the portfolio manager, own more than 25% of Fund X, which is the selling hedge fund.
- Potential Conflict: Sale of the securities at a price that is favorable to Fund X to benefit the principals of the investment adviser who own an interest therein vs. the interest of Fund Y in paying the lowest potential price for its investments.

Examples of Potential Conflicts – Trade Sequencing

- Description: An investment adviser can choose to “bunch” or not bunch trades of its clients. A client’s investment experience may differ depending upon the order and timing of order entry.
- Scenario: An investment adviser manages 2 hedge funds, 2 registered investment companies, and 3 wrap fee programs (each of which has built into its documentation language to the effect that assuming best execution is being obtained, the sponsoring broker of the wrap fee program will execute program trades).
- Potential Conflict: The interest of the investment adviser in realizing the best returns for its highest fee paying clients vs. the interest of each client in obtaining the highest returns for the lowest cost.

Examples of Potential Conflicts – Valuation

- Description: An investment adviser is responsible for valuing the securities held in its client's accounts.
- Scenario: An investment adviser has 2 clients, a hedge fund and a private equity fund. The hedge fund pays the investment adviser an annual management fee, payable monthly, and an annual performance fee, each based on the value of the hedge fund's assets. The private equity fund pays an annual management fee based on committed capital for the first 4 years and then on invested capital for the last 6 years of the fund (in each case, subject to reduction for portfolio companies written down or off) and a performance fee based on realized gains. Several investments held by the private equity fund have suffered setbacks and have lost significant value.
- Potential Conflict (Private Equity): Writing off assets that have lost value vs. keeping management fees at current rates.
- Potential Conflict (Hedge Fund): Interest of the investment adviser in to receiving high fees by valuing the hedge fund's assets at a high level funds (or causing the value to artificially increase) vs. the interests of investors in paying appropriate management and performance fees.

Red Flags for Further Analysis for Potential Conflicts of Interest

- Relationships - Preferential treatment to certain investors/clients
- Side pockets
- Soft dollars/directed brokerage
- Personal fees and expenses paid by the adviser
- Relationships with certain types of investors
- Affiliated/related persons transactions
- Loans to principals that are never repaid or repaid at inappropriate rates
- Fund assets used as collateral for personal investments
- Shorter or no lock-up periods for principals/relatives
- Better liquidity for affiliated investors
- Better transparency/access to portfolio holdings for principals/affiliates

Helpful Resources

- SEC CCO Outreach website - http://www.sec.gov/info/iaicccoutreach.htm
- 2009 SEC Examination Focus - http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf
- Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs - http://www.sec.gov/info/cco/adviser_compliance_questions.htm
- Recent SEC Examination Request List – www.sec.gov and provided

Thank you

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