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Examinations

Seven Recommendations to Assist Private Fund Managers in Navigating Heightened SEC Examination and Enforcement Activity

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For private fund managers, long accustomed to relative autonomy from federal regulators, the past few years have heralded an almost unfathomable sea change. Fund managers now find themselves the recipients of unprecedented attention from the Securities and Exchange Commission's (SEC's) two largest divisions – the Office of Compliance Inspections and Examinations (OCIE), responsible for conducting examinations of registered investment advisers, and the Division of Enforcement (Enforcement), which investigates potential violations of the federal securities laws and has the power to seek remedies ranging from monetary penalties to industry bars.

This dual-pronged scrutiny of private fund managers stems from a perfect storm of interrelated events over the past few years. The 2010 passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) required many hedge fund and private equity fund managers to register with the SEC for the first time, opening their books and records to review by the OCIE staff. At roughly the same time, Enforcement underwent a major reorganization and shift in priorities, focusing significant resources on investment advisers generally, and the private equity and hedge fund industries in particular.

And while the changing focus of these SEC programs has been in the works for several years, it has begun to be most keenly felt in just the past few months. Perhaps best signifying the current state of affairs is one of the first public statements made by new SEC Chair Mary Jo White last month. Chair White, a former U.S. Attorney under President Clinton renowned for her prosecutions of mobsters and terrorists, could be expected to focus her attention on the SEC's enforcement program. Yet in her Congressional testimony in support of the SEC's fiscal 2014 budget proposal, White called the beefing up of the investment adviser exam program one of her top priorities.[1] She sought funding to hire 250 additional investment adviser examiners. Coupled with an additional 75 new examiners for broker-dealers and other regulated entities, this would represent a 33% increase in OCIE's manpower. In contrast, the 2014 budget proposal seeks a less than 10% increase in Enforcement staffing, and about a 15% increase in SEC staffing overall.[2] And while Congressional frugality in the age of sequestration makes it unlikely that such an ambitious budget increase will be fully granted, there can be little doubt where the SEC's new leadership is placing its firing power.

Fund managers who fail to prepare for the gathering storm of SEC examinations already underway – coupled with the implications of heightened Enforcement attention – do so at their own peril. This article describes the gathering storm and provides seven practical recommendations to assist private fund managers to prepare for and navigate heightened examination and Enforcement scrutiny from the SEC staff.

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Exams of Newly-Registered Private Fund Advisers

Dodd-Frank, as implemented by SEC rules which became effective in mid-2011 and mandated compliance by March 2012, requires advisers to hedge funds, private equity funds and other private funds with assets under management of at least $150 million to register with the SEC (subject to certain exceptions).[3] According to an October 2012 SEC report, over 1,500 private fund advisers registered with the SEC since the implementation of Dodd-Frank, bringing to a total of over 4,000 SEC-registered advisers who manage at least one private fund.[4]

At the same time, Dodd-Frank also relegated investment advisers with $25 million to $100 million in assets under management from SEC registration to registration with state securities authorities, a.k.a. "The Switch," thereby freeing up SEC resources to focus on new registrants. At least, that's the theory. In reality, fewer registrants than predicted switched to state oversight, in part due to asset growth.[5] Meanwhile, the magnitude of assets managed by the new registrant pool is far in excess of the assets managed by mid-sized advisers who deregistered with the SEC. As explained by Commissioner (and then-Chair) Elisse Walter in her February 2013 testimony before the Senate Banking Committee, the 1,500 newly-registered advisers to hedge funds and private equity funds were offset by around 2,250 smaller advisers undergoing the switch to state registration; however, the new registrants reported over $3 trillion in assets under management, versus only $115 billion in assets for the departing advisers. More significantly, as Commissioner Walter emphasized, "Most of these new registrants had never been registered, regulated, or examined and many have complex business models, investment programs and trading strategies."[6] See "SEC Commissioner Walter Explains How an Overworked and Under-Resourced SEC Staff Can Nonetheless Examine Private Fund Advisers Effectively," The Hedge Fund Law Report, Vol. 6, No. 16 (Apr. 18, 2013).

Naturally, this dramatic influx of large and relatively complex new SEC registrants – all now subject to inspection by the OCIE exam staff – required the agency to rethink its approach to exams. The SEC simply does not have the resources to send its staff on routine exams of all (or even most) registered advisers and conduct a thorough review of each registrant's records, policies and practices. Indeed, as Chair White emphasized in her budget request to Congress, over 40% of registered advisers have *never* been examined by the staff, much less subjected to regular periodic inspections. OCIE currently has a staff of about 974 examiners (including both investment adviser and broker-dealer examiners), yet the SEC estimates that by 2014 there will be about 11,000 registered investment advisers alone (including fund managers as well as advisers to individual client accounts) managing $50 trillion in assets.[7] And notwithstanding calls in some quarters for an SRO to oversee investment advisers, comparable to FINRA on the broker-dealer side, for the time being the SEC remains the only regulator with exam authority over this registrant pool.

In order to grapple with the huge imbalance between the number of registered advisers and the number of SEC examiners, the leadership of the National Exam Program (as they have rebranded OCIE) have taken significant steps to reform their approach to examinations. First, as frequently touted by program leaders over the past couple years, the staff has moved to a risk-based approach, rather than the exhaustive checklist-based exams of years past. On a macro level, this means that rather than making a futile attempt

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to put all advisers on some sort of recurring schedule for periodic exams, registrants are selected for examination based on various risk factors assessed by the staff (such as the firm's prior examination history, business model and investment strategy, affiliated relationships, returns relative to the market and additional factors identified from the adviser's Form ADV filings and other public information). See "PLI Panel Provides Regulator and Industry Perspectives on SEC and NFA Examinations, Allocation of Form PF Expenses, Annual Compliance Review Reporting and NFA Bylaw 1101 Compliance," The Hedge Fund Law Report, Vol. 6, No. 24 (Jun. 13, 2013). On a micro-level, each exam is much more likely to be focused on particular areas of concern for the staff, based on agency priorities and particular risks presented by the registrant's profile and investment strategies. While a more thorough analysis of OCIE's current hot-button issues is best addressed separately, in recent years OCIE has taken to issuing both generalized and issue-specific guidance to the market on staff's current concerns and priorities.[8]

Second, and more specifically, the National Exam Program has kicked off its new "Presence Exam" initiative, through which it plans to launch a series of targeted, risk-focused exams of a large number of newly-registered fund advisers. As described by then-OCIE Deputy Director (and now Director of the Division of Investment Management) Norm Champ in May 2012, this initiative would begin with an initial phase of industry outreach and education, followed by "a coordinated series of examinations of a significant percentage of the new registrants that will focus on the highest risk areas of their business and help us to risk rate the new registrants. . . culminating in the publication of a series of 'after action' reports, reporting to the industry on the broad issues, risks, and themes identified during the course of the examinations."[9]

In October 2012, new registrants began receiving letters from their nearest SEC regional office with additional information about the Presence Exam program.[10] See "OCIE Warns Newly-Registered Hedge Fund Advisers to Watch Out for 'Presence Examinations,'" The Hedge Fund Law Report, Vol. 5, No. 39 (Oct. 11, 2012). These letters identified five specific risk areas of interest to the staff, some or all of which would be reviewed in an upcoming examination. These targeted exam areas included:

- Marketing materials used to solicit/retain investors (including how the firm solicited investors, such as through the use of placement agents);see "How Has the New York Pension Fund Kickback Scandal Changed the Landscape for Placement Agents, and for Hedge Fund Managers who Use Them?," The Hedge Fund Law report, Vol. 2, No. 17 (Apr. 30, 2009);
- Portfolio management practices (including allocation of investment opportunities among funds);
- Conflict of interest policies and disclosures (including fee/expense allocations, payments to and transactions with related persons, and personal securities trading);see "Key Legal and Operational Considerations for Hedge Fund Managers in Establishing, Maintaining and Enforcing Effective Personal Trading Policies and Procedures (Part One of Three)," The Hedge Fund Law Report, Vol. 5, No. 3 (Jan. 19, 2012);
- Safety of client assets (including review of independent audits); see "Recently Published SEC Risk Alert Reveals Significant Deficiencies in Custody Practices of Hedge Fund Managers and Other Investment Advisers," The Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013); and

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- Valuation (including valuation policies and procedures as well as fee calculations). See "Hedge Fund Valuation Pitfalls and Best Practices: An Interview with Arthur Tully, Co-Leader of Ernst & Young's Global Hedge Fund Practice," The Hedge Fund Law Report, Vol. 5, No. 2 (Jan. 12, 2012).

The staff has begun following up on these letters, initiating exams of new registrants. As with most exams, the process typically begins with an introductory phone call from the staff to the Chief Compliance Officer (CCO), followed by a document request. Though still potentially arduous, the requests have, consistent with the SEC's earlier pronouncements, been fairly targeted, seeking some general background information as well as documents relating to one or more of the focus areas identified in the October letter. (In contrast, notwithstanding OCIE's promises of more risk-focused examinations, some initial document requests sent to registrants outside the Presence Exam initiative continue to seek dozens of categories of records.)

The staff has been proposing a surprisingly quick turnaround time, requesting that documents be produced in just a few business days so that the on-site examination can begin as soon as a week after the document request goes out to the registrant. As with the document requests themselves, the on-site phase of the Presence Exam is relatively abbreviated, typically lasting less than a week.

Of course, as with any risk-focused exam, the scope of the examination can (and often does) expand based on the staff's initial review of the documents and on-site interviews with registrant personnel. It is not unusual for the registrant to receive follow-up document requests, either seeking additional information relating to the initial areas of inquiry or potentially delving into new areas entirely.

Registrants both old and new should be aware that the exam program has been casting a much wider net than had historically been the case when seeking information about a registrant. As the Madoff matter made clear, relying primarily on the registrant, and particularly on a single point of contact within the registrant, could lead to some dire results. In addition to the CCO, the staff will expect to speak to relevant employees and senior officers of the registrant. The staff will also almost invariably seek some form of third-party verification of the firm's assets. See "How Does the SEC Approach Custody Issues in the Course of Examinations of Hedge Fund Managers?," The Hedge Fund Law Report, Vol. 5, No. 18 (May 3, 2012). In addition, reaching out to an adviser's clients for information about the firm's representations and disclosures, and to affiliates of the firm about potential conflicts, has become far more routine.

Once the staff has obtained the necessary documents and completed its fieldwork, the staff will conduct its analysis and assessment of the adviser back at the SEC office. It is not unusual for this process to take several months, and while the purpose of the Presence Exams is, in part, to take a quick look at as many firms as the agency's resources permit, any narrowing of the scope of the exams is likely to be offset by the size and complexity of the new registrants. In any event, the exam will typically conclude with the staff reporting its findings to the registrant. In most cases, the staff will set up an exit interview with the firm to highlight the staff's findings and tie up loose ends. In some cases, particularly where major issues have been identified, the staff will seek to include not just the CCO, but other senior personnel in these

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discussions. An exit interview is typically accompanied by or followed by a closing letter reporting no deficiencies, or, far more frequently, a deficiency letter identifying significant issues. In the case of a deficiency letter, the staff will generally ask the registrant to take remedial steps and to report back on those steps within 60 days. In a less frequent, but trending scenario, the exam staff will make a referral to Enforcement for further investigation.

The Enforcement Focus on Private Fund Managers

The refocusing of SEC exam resources in the wake of Dodd-Frank has been accompanied by a parallel shift in the priorities of Enforcement. As a proportion of Enforcement's overall cases (which also include public company financial reporting fraud, insider trading, securities offering fraud, and so forth), the share of cases brought against investment advisers has essentially doubled in the past couple of years. In the fiscal year ended September 30, 2012, the SEC filed 147 cases, against 230 individuals and entities, in the investment adviser/investment company space. This represented nearly 25% of the SEC enforcement actions filed that year.[11] These figures were essentially identical in fiscal year 2011.[12] But look back just five years, to FY 2007, and a very different picture emerges. Back then, the SEC filed only 79 investment adviser/investment company cases, or about 13% of the Division's docket.[13] That had been much more the norm until just recently.

Some of the evolving Enforcement focus toward investment advisers and other regulated entities has been driven by a notable decline in other types of investigations (particularly public company financial fraud, historically a major focus of Enforcement, but far less prevalent following the reforms of the Sarbanes-Oxley Act of 2002 as well as the economic downturn), which has freed up Enforcement to direct more resources at regulated entity cases. However, the shift has also been by design, with Enforcement specifically seeking out more actions in the investment adviser arena.

One signifier of this shift has been the creation of the Division's specialized Asset Management Unit, in which dedicated staff pursue investigations solely of investment advisers (and, in particular, managers to hedge funds and private equity funds). The formation of specialized units was one of several reforms implemented in the post-Madoff environment, designed to bring greater levels of expertise to emerging areas of emphasis for the SEC. As part of its strategy of developing particularized expertise in these areas, the Division has also hired a number of industry insiders hailing from private equity firms, hedge funds, and mutual funds. See "OCIE Director Carlo di Florio and Asset Management Unit Chief Bruce Karpati Address Examination and Enforcement Priorities for Hedge Fund Managers at the RCA's Compliance, Risk & Enforcement 2012 Symposium," The Hedge Fund Law Report, Vol. 6, No. 4 (Jan. 24, 2013).

Stepped-up attention from Enforcement in general, and from the Asset Management Unit in particular, has already resulted in a significant number of complex and relatively novel cases involving hedge fund and private equity fund managers, raising myriad issues including inflated asset valuation, improper conflicts of interest, misrepresentations about fund performance, and preferential treatment given to a favored investor. And, as has been much publicized, the SEC (along with the Department of Justice) continues to level charges against hedge fund managers and personnel for their alleged roles in far-reaching insider trading schemes.[14]

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The Asset Management Unit leadership has also spoken publicly about emerging areas of interest in the private equity field. In a speech earlier this year, then-Chief of the Asset Management Unit Bruce Karpati identified several high-priority issues in the private equity industry, including, among other things: valuation of illiquid securities; shifting of expenses from the management company to a fund; fees and expenses that are poorly disclosed or improperly allocated among portfolio companies, funds and clients; various related-party transactions; and various risks surrounding "zombie funds," or investment vehicles that continue past their stated term.[15] See "SEC Asset Management Unit Chief Bruce Karpati Addresses Private Equity Enforcement Trends, Initiatives and Priorities," The Hedge Fund Law Report, Vol. 6, No. 6 (Feb. 7, 2013).

No less important than Enforcement's focus on private fund cases is the Division's evolving approach in coordinating with the exam program. The historic model of OCIE and Enforcement as relatively independent organizations has undergone a significant shift. As noted above, one outcome of an SEC exam may be a referral to Enforcement, but the reality is no longer that simple. While there are still situations where the exam staff will complete their exam and hand a written referral to the Enforcement staff for consideration, it is far more typical these days for staff from the two programs to closely coordinate their efforts. Enforcement staff are frequently consulted early in an exam as issues are identified in order to gauge the level of Enforcement interest and assess what further information may help build a potential enforcement action. For a discussion of heightened coordination among the SEC's offices and units, see "SEC Commissioner Aguilar Discusses Insider Trading by Hedge Fund Managers, Valuation and Other Examination and Enforcement Pressure Points," The Hedge Fund Law Report, Vol. 6, No. 18 (May 2, 2013). Likewise, regular meetings are held among the managers in an office's exam and enforcement programs to discuss trends, emerging issues, and possible referrals. Instances where an Enforcement staff attorney may join the examiners during the field work are becoming more frequent.

By communicating with Enforcement staff earlier in an exam, and more frequently throughout, examiners are better able to focus their attention on issues more likely to attract the interest of Enforcement attorneys, and Enforcement staff are able to direct the examiners towards inquiries more useful in generating information that will aid a determination whether to pursue an investigation.

Preparing for the SEC

There are numerous steps a private fund adviser can take to both prepare for and deal effectively with an SEC examination. If handled properly, an adviser can greatly reduce the risk that their examination will result in significant findings, or worse, an Enforcement referral. A few common "best practices" for advisers who are facing the prospect of an SEC examination would include:

- Prepare in Advance: Particularly in the case of Presence Exams, examiners are moving at a much quicker pace. Even before an exam begins, the CCO should make sure he or she has a good handle on where key documents will be found. Consider having a background presentation on the firm prepared for the staff when they come on-site. Particularly for private fund advisers who may have complex strategies and interrelationships among affiliated parties, it

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will make the exam go much more smoothly if the registrant is able to help the staff get a handle on the firm. This is also an opportunity to provide the staff with a good first impression by showing them that you are diligent, organized, and prepared. As an additional consideration, where resources permit, advisers should give careful consideration to retaining an outside consultant, in conjunction with outside counsel, to assist with a "mock exam," which can help identify gaps in the firm's compliance program, suggest potential improvements, and prepare personnel for an actual SEC inspection. See "Legal and Practical Considerations in Connection with Mock Examinations of Hedge Fund Managers," The Hedge Fund Law Report, Vol. 4, No. 26 (Aug. 4, 2011).

- Designate a Primary Contact: The adviser should have a primary point of contact, typically the CCO, who participates in all interviews. It is essential that questions being posed by the staff, and responses given by firm personnel, are carefully tracked so that issues can be spotted right away. If the CCO perceives weaknesses, it could be effective to begin addressing them with the SEC staff even before the exam is completed.
- Be Respectful and Cooperative: Treating the exam as an adversarial proceeding is almost certain to get things off on the wrong foot. Examiners who perceive that the registrant is not cooperating may assume that the firm has something to hide and are much more likely to expand the scope of the exam or involve the Enforcement staff. This does not mean that the registrant cannot push back on information requests that are unclear or seem overbroad, but it should do so in a way that helps the staff more quickly get the answers it is seeking.
- Prepare Key Staff for Interviews: Make sure senior personnel are prepared to answer questions pertaining to the key risks presented by the adviser's strategies and business model and understand how those risks are being monitored and minimized by the firm's policies and practices. Particularly for new post-Dodd-Frank registrants unaccustomed to regulatory oversight, there is a tendency to assume that as long as the fund is performing well and investors or limited partners are not complaining, the SEC will have few concerns. The SEC staff does not see it that way. Examiners are focused on regulatory compliance, and the likelihood of the exam staff identifying deficiencies necessitating remediation – or even making a referral to Enforcement for further investigation – does not turn on the profitability of the fund or investor dissatisfaction. (Of course, unhappy investors certainly make for a more attractive enforcement action in the eyes of the Enforcement staff.)
- Assess Risk During the Examination: Although anticipating whether the staff is contemplating an Enforcement referral can be difficult, one can at least assess the potential for a referral if the staff demonstrates a heightened interest in a particular issue during the exam. The staff rarely discloses that it is contemplating an Enforcement referral, so being attuned to the issues drawing their attention while the process is unfolding may be the only opportunity to engage the staff and address their concerns before a final decision is made.
- Remediate Deficiencies Promptly: It is essential for registrants to take the exam staff seriously and make their best effort to allay the staff's concerns. Where

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corrective action, whether it means policy changes or even fee reimbursements, is feasible, it should be taken. Where the registrant strongly believes the SEC has it wrong, the registrant should respectfully say so, and support its position with whatever information may be helpful to the staff. Even if the examiners are not entirely satisfied, the Enforcement staff will be cautious about moving forward with an investigation if the adviser has acted in good faith in responding to the staff's concerns. (Of course, even prompt remediation is not always a guarantee that no enforcement action will follow: The staff may view the violation as sufficiently severe to warrant sanctions, or may view it as programmatically important to file an action (and publicize the issue) for deterrent purposes.)

- Follow Through: Finally, if remediation is undertaken, make sure any changes you pledge to make are implemented, and that sufficient testing and monitoring is done to prevent recurrence of the same issues. OCIE has articulated a strategy whereby it intends to conduct follow-up exams shortly after an exam concludes, and if the registrant has failed to follow through on the promised improvements, an Enforcement referral is much more likely to result. Moreover, a repeated compliance failure after the registrant has been put on notice of the problem by the exam staff may be viewed as evidence of recklessness on the part of the registrant and its principals, leading not just to a potential enforcement action, but to more severe sanctions (including monetary penalties and industry bars).

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[1] Mary Jo White, Chair, SEC, *Testimony on SEC Budget Before The Subcommittee on Financial Services and General Government* before the Committee on Appropriations, U.S. House of Representatives (May 7, 2013).

[2] SEC FY 2014 Congressional Budget Justification, at 14.

[3] See Press Release, SEC, *SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act* (June 22, 2011).

[4] See Press Release, SEC, more than 1,500 Private Fund Advisers Registered with the SEC Since Passage of the Financial Reform Law (Oct. 19, 2012).

[5] *See* North American Securities Administrators Association, *NASAA IA Switch Report* (May 20, 2013); Mark Schoeff Jr., InvestmentNews, *Fewer Advisers Than Expected Switch to State Oversight* (May 17, 2013).

[6] Elisse B. Walter, Chair, SEC, *Testimony on "Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections"* before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Feb. 14, 2013).

[7] SEC FY 2014 Congressional Budget Justification, at 73.

[8] *See* National Exam Program (OCIE), SEC, *Examination Priorities for 2013* (Feb. 21, 2013); *see also this link* compiling industry risk alerts.

[9] Norm Champ, Speech by SEC Staff: *What SEC Registration Means for Hedge Fund Advisers* (May 11, 2012).

[10] Letter from OCIE staff (Oct. 9, 2012).

[11] Select SEC and Market Data, Fiscal 2012 (Note that this calculation excludes administrative proceedings against issuers with delinquent filings, a relatively compressed procedure not necessarily indicative of Enforcement's allocation of investigative resources and priorities).

[12] Select SEC and Market Data, Fiscal 2011.

[13] Select SEC and Market Data, Fiscal 2007.

[14] *See, e.g.*, Press Release, SEC, *SEC Charges Whittier Trust and Fund Manager in Insider Trading Investigation into Expert Networks* (June 7, 2013); SEC Press Release, *SEC Charges California-Based Hedge Fund Analyst and Two Others with Insider Trading* (March 26, 2013).

[15] Bruce Karpati, Speech by SEC Staff: *Private Equity Enforcement Concerns* (Jan. 23, 2013).

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