SEC Examinations of Private Investment Funds

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Since the 2010 passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which required a significant number of previously-exempt fund managers to register as investment advisers with the Securities and Exchange Commission (SEC), the SEC has increasingly focused its regulatory scrutiny on private funds. Among other things, being registered with the agency means the SEC is able to deploy its Office of Compliance Inspections and Examinations (OCIE) to conduct examinations of this new class of registered investment advisers. OCIE examinations have provided the agency with a tremendous window into the operations of advisers which had long been accustomed to operating relatively free from regulatory oversight. These exams have resulted in dramatic changes to the practices of private funds, both through corrective actions urged by OCIE and, in a growing number of matters, referrals to the SEC's Division of Enforcement for investigation and potentially litigation.

The tremendous risks posed to firms examined by the SEC highlight the need for all registered investment advisers, and particularly private fund managers with limited prior experience under SEC oversight, to proactively review their own internal policies and investor disclosures and to be prepared for a potential SEC examination.

OCIE Examination Overview

Since Dodd-Frank, OCIE has made broad efforts to review as many newly-registered funds as possible. An initial "presence exam" project, in which the agency conducted a large number of narrower, risk-focused exams of new registrants, allowed the SEC to review about a quarter of the private funds which registered under Dodd-Frank. In early 2015, the Director of OCIE confirmed that the project would be expanding, with the agency continuing its prioritization of newly-registered fund managers and other advisers who had yet to

be examined.[1] OCIE has also created a Private Funds Unit (PFU) which is dedicated to examining advisers to private funds. Led by a former private equity fund insider and operating out of four SEC regional offices, the PFU has aimed to bring industry expertise into the agency while continuing to develop risk-based approaches to exams. OCIE's Acting Director recently explained that the PFU "plays a critical role" in targeting and selecting exam candidates, scoping risk areas, executing examinations, and analyzing data compiled from those examinations.[2] The unit collaborates closely with the Private Funds Group in the SEC's Division of Investment Management, and thus helps shape policy as well.

The SEC staff conducts examinations out of 11 regional offices, as well as its Home Office in Washington, DC. OCIE is the SEC's second largest division – behind only the Enforcement Division – and possesses significant authority over registrants. Examiners can interview personnel, management and boards (as well as service providers and investors), demand the production of extensive records (including email), make recommendations for remedial action, and refer potential violations of the federal securities laws to the Enforcement Division.

SEC examinations may be commenced for cause, based on investor complaints or other information suggesting possible misconduct. But most examinations are routine, with OCIE identifying potential exam candidates through risk assessments (based on Form ADV filings or other public information). Though resource limitations prevent OCIE from examining most registrants on a regular basis, the agency of late has been particularly focused on new registrants and those who have not been reviewed in many years (or ever), as well as on advisers found to have had significant deficiencies in a prior exam.

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An examination typically commences with a call from the staff scheduling an on-site inspection, coupled with a request for documents and information.[3] With the exception of certain exams focused on a particular issue, most document requests are tremendously broad, seeking extensive information about the adviser—its structure, affiliates, strategies, and compliance policies—as well as documents pertaining to specific risk areas such as asset valuation, conflicts of interest, and fees and expenses. The staff generally expects documents to be produced on a compressed schedule, perhaps two weeks, after which the exam staff will commence a series of on-site meetings. These meetings, which can last from several days to several weeks (depending on the size and complexity of the registrant), will involve extensive interviews of the firm's principals and personnel, including compliance officers, finance personnel, and portfolio managers.

In contrast to witness testimony taken during enforcement investigations, SEC examination interviews tend to be somewhat informal. Outside counsel are typically not expected to participate (though, as discussed below, it is generally good practice for the Chief Compliance Officer, or perhaps General Counsel, to attend all such meetings). While the interviews are not transcribed or recorded, the staff will take careful notes, and the statements of the firm's personnel during interviews can prove problematic for the firm if not handled properly.

Once the on-site portion of the exam is complete, the staff will usually require significant time to complete its analysis, perhaps several months, during which time the staff will typically seek follow-up information—usually additional documents and factual information, but sometimes follow-up interviews as well. The staff will ultimately provide a written report (often accompanied by a verbal exit interview) conveying its findings. The vast majority of examinations identify a number of deficiencies, requiring the adviser to provide responses to the staff. The staff will expect firms to provide a written response detailing its corrective actions, from revised policies and procedures to additional investor disclosures, up to and including reimbursement of fees and expenses which the staff believes to have been improperly assessed. In more complex or problematic exams, there may be multiple rounds of letters and conversations. Depending on

the egregiousness of the deficiencies, and the staff's evaluation of the adviser's remedial actions, the staff may also refer the matter to Enforcement, which can open a lengthy investigation that could ultimately result in enforcement proceedings against the firm and its personnel.[4]

As noted below, advisers will be best served by identifying and beginning to address potential weaknesses before receiving a formal deficiency letter from the staff. Both through the staff's document requests and interviews, as well as a preliminary exit interview on the last day of the onsite fieldwork, the CCO should be able to ascertain at least some of the staff's concerns, and may be able to mitigate some issues before they turn up in a written letter from the SEC. For private funds in particular, sophisticated investors (both current and potential) are increasingly asking for copies of any deficiency letters received by the adviser, as well as any written responses, and heading off potential issues early in the process is critical.

Priority Exam Areas for Investment Advisers

The potential scope of the examination is vast, with examiners authorized to inquire into essentially every area of the firm's compliance policies and business practices. Perennial areas of SEC scrutiny include, among others:

- Portfolio management, including selection and allocation of investment opportunities;
- Disclosures to clients, including account statements and marketing materials;
- Safeguarding of client assets and maintenance of privacy protection;
- Personal trading practices, including safeguards against insider trading and front-running;
- Soft dollars and best execution; and
- Compliance with recordkeeping requirements.[5]

Beyond the generalized recurring issues scrutinized by the SEC, the examiners will typically be focused on a smaller number of emerging, high-priority areas. These are the issues most likely to trigger extensive deficiency letters from OCIE and possible enforcement referrals, and thus the areas where it is most incumbent on advisers to proactively review their own practices and consider remedial actions long before the SEC makes an initial outreach to the firm.

In public statements provided both on the sec.gov website and in speeches made by its senior officials, OCIE has given industry guidance on its current examination priorities, as well as specific topics of concern in the private fund space. For example, while OCIE's published 2015 examination priorities focus primarily on retail investors (particularly the fee practices of dually-registered advisers/brokers), OCIE is also reviewing alternative investment companies and fixed-income investment companies, while continuing to review fees and expenses at private equity firms.[6] The 2015 priorities also identify cybersecurity controls as a significant concern, while emphasizing OCIE's growing use of data analytics to assess potential misconduct.

Similarly, over the past couple years, OCIE officials have identified a number of specific priority areas in their private fund examinations, particularly with respect to private equity firms. Some of issues looming largest include:

Fees and Expenses. In recent years, OCIE has repeatedly noted its concerns regarding the disclosure and allocation of fees and expenses, particularly (but not exclusively) in the private equity industry. Examiners scrutinize the accuracy and thoroughness of firms' fee disclosures, and are particularly sensitive to the assessment of multiple fees beyond the core management fee such as monitoring, transaction, and other "success" fees. Of special note are partnership agreements providing for offsets of management fees, and the manner in which firms determine which fees and expenses are (or, more precisely, are not) used to offset management fees. OCIE has also called out the practice of accelerating monitoring fees in order to charge funds for periods beyond the anticipated life of the fund. The SEC is also acutely focused on how firms allocate various expenses to the advisor, the funds it manages, and the funds' portfolio investments. OCIE seeks to assess both the reasonableness of such expenses and whether they comport with the funds' disclosures and partnership agreements. Related issues include the reimbursement of expenses to affiliated persons or entities, as well as how the firm factors co-investments into expense allocations. OCIE will carefully review a registrant's disclosures and policies around expense allocations, as well as its documentation of its allocation determinations.[7]

Co-Investments. Beyond the above concerns regarding whether expenses are being properly allocated to co-investors, OCIE has been focused more generally on co-investment opportunities and the manner in which special access to investments may be extended to favored or affiliated investors.

Because co-investment opportunities can create material conflicts of interest, it is important to ensure that accurate representations about co-investment rights are made to firm investors. Along similar lines, any side agreements extending more favorable rights to selected fund investors will draw regulatory scrutiny.

Valuation. As OCIE expands its scope well beyond traditional funds and into pooled investment vehicles with complex and illiquid holdings, the manner in which such assets are valued has become a major focus of the agency. Examiners will scrutinize the adequacy of the firm's valuation procedures, whether they comport with the representations made in the registrant's disclosure documents, and the thoroughness of the firm's records documenting its valuation determinations. Incidents of management overrides of independent valuation service providers will be of particular interest. The staff is most likely to raise concerns about valuation where it results in inflated fees paid to fund managers, or where it forms the basis for performance advertising used to raise capital for newer funds.

Performance History. OCIE has for some time taken an interest in advisers' marketing materials, particularly in connection with any representations of an adviser's performance history. OCIE will carefully scrutinize the support for any calculations, whether fees are appropriately considered, and any indications that an adviser is "cherry picking" comparables used in any comparative analysis. Failure to clearly explain whether results are based on actual historical performance or back-tested models is a recurring theme as well.

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Notably, as the SEC has gotten its arms around the private equity industry in the years since Dodd-Frank, the Private Funds Unit has recently expressed its interest in and intent to examine advisers in sub-industries and related areas, including real estate private equity advisers, credit advisers, and infrastructure and timber advisers.

The Role of Enforcement

For a registered investment adviser, the most damaging outcome of an exam is a referral to the SEC's Enforcement Division. Once Enforcement opens an inquiry, the registrant will be subject to a potentially protracted investigation, with extensive document productions and witness testimony. At the conclusion of the investigation, which can last upwards of one or two years (on top of the time already spent undergoing OCIE's examination), the SEC may determine to pursue civil proceedings against the registrant and its principals, either in federal court or, more likely, before the SEC's own administrative forum.

The SEC has the ability to seek monetary sanctions, as well as suspensions or bars from the securities industry. The costs of defending such an action can also be significant. Of course, for many advisers, the mere accusation of a legal violation by the SEC may be enough to damage or destroy the adviser's business, regardless of the outcome of any ensuing litigation.

Although enforcement referrals are made in only a minority of examinations, the Enforcement Division has over the past few years demonstrated a growing appetite for actions against investment advisers. Indeed, in fiscal 2013, investment adviser cases represented the single largest category of SEC enforcement actions (outstripping public company reporting cases and insider trading cases combined).[8] Investment adviser cases slipped to a close second in 2014, just behind broker-dealer matters, but given the trends of recent years, it seems likely that investment advisers will remain at the forefront of the Enforcement docket for the foreseeable future.

While the historical scenario, as described above, is for an examination identifying serious deficiencies to result in a formal referral to the Enforcement Division, OCIE and Enforcement work far more collaboratively these days. It is not unusual for the respective staffs of the two divisions to be in communication during the course of an exam, particularly where potentially significant issues are identified early in the process, or where the exam was triggered by a complaint or other indicia of potential problems. For this reason as well, it is paramount for the CCO and other officials of the firm to be attuned to developments during the exam and to move quickly

toward potential remediation; waiting until the receipt of a deficiency letter may be too late to turn back the tide of Enforcement interest.

Given the working relationship between OCIE and Enforcement, it is unsurprising that Enforcement's 2015 investment adviser priorities mirror those of the exam program. The Enforcement Division's Asset Management Unit (AMU), which specializes in investigations of investment advisers (and, in particular, private funds with complex investment strategies), has been regularly investigating matters involving fees and expenses, valuation, and performance advertising, In the past year, the SEC obtained significant sanctions against fund managers based on their disclosures and practices around the allocation of advisory expenses to the funds they manage. As a general matter, Enforcement is particularly concerned with conflicts of interest, and any indicia of self-dealing or self-interested decision-making will be considered a breach of the adviser's fiduciary duties to its clients. In a speech earlier this year (significantly entitled "Conflicts, Conflicts Everywhere"), the co-head of the AMU expanded on the unit's consideration of a firm's failure to mitigate or disclose conflicts of interest.[9]

In the same speech, the AMU identified other priorities as well. For example, Enforcement is focusing on registered investment companies, particularly around issues of valuation and performance advertising, deviations from a fund's investment guidelines, fund governance, and fund distribution. The AMU is also pursuing matters involving separately managed accounts, particularly involving conflicts, fee arrangements, and repeated compliance failures.

Certain factors may make an examination a more likely candidate for an enforcement referral. Misappropriation of client assets will obviously be escalated, as will any exam where registrants are believed to be have misled the SEC staff or provided false information or altered documents. (Such cases may also result in SEC referrals to the Justice Department for potential criminal prosecution.) But even far less egregious matters may pique Enforcement's interest where there is evidence of recidivism, either because the registrant failed to correct deficiencies identified in prior exams or was otherwise on notice of the violation but failed to take appropriate measures. And, as a general matter, any cases that support the priority areas of OCIE – again, fees and expenses being at the top of the list – are more likely to be pursued by Enforcement.

For example, in 2015 alone, the SEC has filed enforcement actions against private fund managers alleging, among other things:

- Conflicts of interest created by undisclosed loans between funds;
- Inadequate disclosure of advisory expenses charged to funds;
- Misallocation of broken deal expenses among funds and co-investors; and
- Valuation practices inconsistent with firm disclosures.[10]

Preparing For and Managing the SEC Examination

With OCIE moving aggressively to visit a growing number of registrants, it is essential for registered advisers to be prepared for the eventuality of an SEC examination. Obviously, the most important preventative measure is for registrants to review – and, where needed, remediate – their policies, procedures and investor disclosures before the SEC arrives on the scene. Compliance officers need to keep apprised of current SEC priorities, as well as traditional areas of SEC concern, and assess their own compliance practices.

Beyond regular internal review as well as more risk-focused periodic assessments, advisers should give careful consideration to retaining an outside consultant to provide a thorough assessment of the firm. Such consultants can conduct a mock examination, akin to an actual SEC exam, identifying the sorts of deficiencies that are likely to draw SEC scrutiny. If an adviser chooses to go down this path, however, there are some important caveats. First, such consultants should be hired through counsel to ensure their work product is protected by the attorney-client privilege. SEC examiners invariably request information about these external reviews, and while the firm will want to have some record of its findings (and any related corrective actions), care needs to be taken to limit the exposure caused by such documentation. Second, the adviser must be prepared to remediate any deficiencies identified through the mock exam process. Once an adviser is put on notice of potential issues, failing to correct them can present significant legal risk to the firm.

In the event that the registrant is in fact contacted by SEC staff members seeking to initiate an examination, the firm will need to be ready to move quickly. There are numerous

steps a private fund adviser can take to both prepare for and deal effectively with the examination. A well-prepared Chief Compliance Officer can reduce the burdens imposed by an examination and, more importantly, mitigate the risk that the examination will result in significant findings or, worse, an Enforcement referral. Steps to be taken both in anticipation of a potential exam and during the course of the exam include the following:

- *Prepare in Advance:* As noted above, the staff's request for documents will likely have a short response time. The CCO should make sure he or she has a good handle on where key documents will be found so that they can be collected and produced on a timely basis. This is an early opportunity to provide the staff with a good first impression of the firm's culture of compliance by showing the firm and its compliance personnel are diligent, organized, and prepared. In addition, examiners will typically expect to begin their on-site inspection with an introduction to the firm's structure, investment strategies, and compliance policies. Advisers will want to have a background presentation prepared for the staff when they arrive at the office. Particularly for private fund advisers who may have particularly complex strategies and interrelationships among affiliated parties, it will make the exam go much more smoothly if the registrant is able to help the SEC staff get an early understanding of the firm.
- *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 SEC staff, and responses given by firm personnel, are carefully tracked so that issues can be spotted right away. If the CCO perceives weaknesses, it is most 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 their business practices, familiarity with compliance policies, and other matters within their purview. 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 corrective action, whether it means policy changes or even fee reimbursements, is feasible, it should be strongly considered. If the registrant strongly believes the SEC is in error, 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 deterrence purposes, even if the practice has been corrected.

- *Follow Through:* Finally, the registrant must ensure that it follows through with implementing any changes promised to the staff, and that sufficient testing and monitoring is done to prevent recurrence of the same issues. OCIE has repeatedly emphasized its focus on recidivist violators, and it is not unusual for examiners to return to an adviser after the exam is complete to assess whether the registrant has lived up to its promises to correct deficiencies. 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 bad faith 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) – even for lesser, non-fraud regulatory infractions.

ENDNOTES

* Before joining the firm, Marc J. Fagel spent nearly 16 years at the SEC, most recently as the Regional Director of the SEC's San Francisco Regional Office from 2008-2013, and before that as the office's Head of Enforcement. During his tenure at the SEC he conducted and supervised hundreds of investigations involving allegations of accounting fraud, FCPA violations, insider trading, and misconduct by investment firms and financial institutions. Mr. Fagel is a graduate of Princeton University and the University of Chicago Law School.

1 SEC to Conduct 'Presence Exams' on Never-Examined Advisers, ThinkAdvisor (Jan. 7, 2015), *available at* www.thinkadvisor.com/2015/01/07/sec-to-conduct-presence-exams-on-never-examined-ad.

2 Marc Wyatt, Acting Director, OCIE, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), *available at* www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

3 A general overview of the OCIE exam process can be found in the official OCIE Brochure, *available at* www.sec.gov/about/offices/ocie/ocie_exam-brochure.pdf.

4 In fiscal 2014, 76% of SEC examinations identified deficiencies; 30% of all exams resulted in "significant findings," defined as deficiencies which could cause harm to a firm or its clients or reflected recidivist misconduct. OCIE referred 12% of its examinations to enforcement. *See* SEC FY 2014 Annual Performance Report, *available at* www.sec.gov/about/reports/sec-fy2014-fy2016-annua-performance.pdf.

5 *See, e.g.,* Staff of the Division of Investment Management and OCIE, Information for Newly-Registered Investment Advisers, *available at* www.sec.gov/divisions/investment/advoverview.htm.

6 National Examination Program Examination Priorities for 2015 (Jan. 13, 2015), *available at* www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

7 *See generally* supra note 2.

8 Select SEC and Market Data, Fiscal 2013, *available* at www.sec.gov/about/secstats2013.pdf.

9 Julie Riewe, Speech, Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015, *available at* www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

10 For a review of these and other recent cases, *see* Gibson Dunn, 2015 Mid-Year Securities Enforcement Update (Jul. 13, 2015), *available at* www.gibsondunn.com/publications/Pages/2015-Mid-Year-Securities-Enforcement-Update.aspx.