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2014 SEC EXAMINATION PRIORITIES FOR INVESTMENT ADVISERS

The SEC recently announced its priorities when examining registered investment advisers in 2014.

Background

- The SEC operates the "National Examination Program" ("NEP"), which reviews activities of all registered market-participants (broker-dealers, exchanges, etc.).
- The NEP includes a significant component – with its own agenda, budget and staffing – that focuses only on investment managers.
- In general, examinations may take several forms: they may follow a program generally applicable to all investment advisers, regardless of the nature of the adviser's clients or business; an examination focused on risks or issues that the SEC has concluded are particular to a specific investment manager; or they may seek to obtain information regarding developing marketing practices which the SEC seeks to learn more about.

2014 Examination Topics

The examination topics below include the priorities identified in the SEC's recent public release, as well as the topics which the SEC communicated in 2013 would continue to be of importance when conducting future examinations.

NEP-Wide Topics

- Fraud detection and prevention. The agency's examination staff will ask managers to provide evidence that the registrant has developed and implemented appropriate policies and procedures to detect and prevent insider trading and other categories of fraud, and that the manager's procedures are supported by appropriate training and surveillance / testing.
- Governance and enterprise risk management. The agency's examination staff will request at least one meeting with the senior managers of the adviser, including the chief executive officer (or equivalent), as well as the board of any entities registered with the SEC. An investment adviser should expect that the meetings will focus on the manager's representatives' ability to articulate how the firm identifies and mitigates regulatory, legal, financial and operational risks, as well as how the firm identifies and addresses conflicts of interest arising from how the manager conducts its business. Advisers must be prepared to provide evidence of an appropriate "control environment" and a strong "tone at the top," particularly through demonstrating an understanding of the risks and controls referenced above. Specifically with respect to an adviser's regulatory risk management staff, SEC examiners will look for evidence of the chief compliance officer's "presence, access and empowerment."
- Technology. Managers will be expected to discuss their "information security" policies, procedures, training and technology, including those employed to prevent and detect

misappropriation of "personal information." In addition, managers should be prepared to provide the examination staff with a written business continuity and disaster recovery plan, supported by evidence that the plan has been tested and is expected to function in the event of a triggering event. The SEC is quite unlikely to accept incomplete or untested business continuity / disaster recovery plans: through a joint 2013 "risk report" with the CFTC and FINRA regarding this topic, the SEC placed the industry on notice regarding the importance for registrants to conduct, complete and document appropriate business continuity / disaster recovery planning.

- New laws / regulations. Of the categories of information identified by the SEC in this category, the topic most likely to be relevant to private fund advisers is compliance with Rule 506(c), which imposes new requirements to collect information regarding "accredited investors." Through this line of inquiry, an investment manager should expect to respond to an unprecedented level of questioning regarding the manager's due diligence efforts respecting investors in the funds managed by the adviser, including greatly increased scrutiny of investor account agreements and related documentation.

"Specific Initiatives"

- Custody. Compliance with the Custody Rule remains central to the SEC's concerns about fraud and abusive practices among investment managers. The SEC's 2013 report regarding "deficient" custody practices, as well as the enforcement cases brought by the agency against numerous investment advisers, highlight the continuing importance of sound custody practices. Examination topics in this area are likely to focus on (i) identifying instances in which the manager has inadvertent custody and (ii) confirming the existence of client assets and their location(s) with "qualified custodians."

- Conflicts of interest inherent in the investment manager's operational model. In general, the issues that arise in this area relate to conduct in which the manager arguably places its, or an employee's, interest(s) ahead of a client's interest(s). The primary topics in this area are likely to be the following:

    - Satisfactory disclosure of compensation arrangements to clients, with a particular focus on identifying compensation arrangements that have not been disclosed to clients (including the undisclosed payment by clients of operational or other costs incurred in the management of the adviser's business).

    - Allocation practices or transactions that are not consistent with the manager's policies or procedures, or applicable law.

    - Appropriate controls and disclosures associated with side-by-side management of performance-based and asset-based fee arrangements / relationships (e.g., differences in disclosures to (i) investors in a fund and (ii) investors invested in a fund AND who have title to separately managed accounts or tracking vehicles managed by the same adviser that may provide those investors with a greater level of information regarding the fund's holdings and activities).

  - Satisfactory disclosure to clients of risks associated with the manager's investment strategies and trading (and trade-financing) processes.

  - Valuation documentation and processes. The examination staff will review the manager's internal policies and procedures applicable to the valuation of investments, and the manager's disclosures to clients regarding those policies and procedures. Particular areas of focus for the examination staff are expected to be how the manager addresses investments that are "difficult to value," the role and responsibility of any third-parties involved in the valuation process (e.g., pricing services, dealers who conduct other business with the manager, board of directors), and how the manager's valuation processes are supervised.

- <u>Marketing presentations</u>. The examination staff will review the accuracy and completeness of the manager's representations / statements to clients and prospective clients regarding its investment objectives and performance. This review will almost certainly include the staff conducting and completing its own analysis and testing of the performance information claimed by the manager (rather than simply reviewing the manager's analysis and / or testing of the performance information). Hypothetical and derived performance presentations will receive very close scrutiny, in particular. Additionally, the staff will seek evidence that the manager has retained appropriate records to substantiate the performance claimed by the firm, and that there has been appropriate review by supervisory personnel and the adviser's compliance staff of the performance presentations before those documents are communicated to clients. In all cases, managers should be prepared to timely provide the examination staff with copies of performance reports and actual trade data for the period(s) of time under review by the staff.

- <u>Inadvertent broker-dealer registration issues</u>. In 2013, the SEC communicated its concerns regarding whether marketing by a private fund adviser's internal personnel (and the receipt by such personnel of transaction-based compensation in connection with the sale of securities by a private fund) could give rise to the requirements that (i) the adviser register as a broker-dealer and (ii) certain personnel of the adviser register as representatives of the broker-dealer. Despite requests for clarification from the industry, no rule-making or other interpretive guidance on this issue was provided. Accordingly, in an examination, investment managers should be prepared to explain, and provide documentary evidence to support, their employee compensation practices, particularly in respect of employees who could be characterized by the SEC as receiving transaction-based compensation from "soliciting securities transactions."

- "<u>Disguised" payments for distribution</u>. The examination staff is expected to ask managers to identify all direct and indirect payments made by the manager and any client account to distributors and "intermediaries" that could be interpreted as being distributors. The staff will review the scope and nature of disclosure to clients regarding these payments, as well as the process by which the payments are made and the payments processes are supervised. The staff's objective is to determine whether the payments are undisclosed payments for distribution.

- Rule 105. The SEC emphasized on several occasions in 2013 its view that there was widespread non-compliance with Rule 105 in the investment management community. Those statements resulted in the SEC adopting a specific examination component focused on determining whether a manager has adopted and implemented appropriate policies and procedures to comply with Rule 105, and whether the manager has conducted periodic testing to determine its compliance with the rule over time.

- AML. Given the recent high-profile enforcement matters that resulted in significant fines / penalties and criminal convictions resulting from violations of the Bank Secrecy Act and other legislation, the SEC is expected to ask managers to produce evidence that they have implemented satisfactory policies and procedures respecting compliance with applicable anti-money laundering laws and regulations, and that they have periodically trained their relevant personnel regarding the application of those policies and procedures.

- "Gatekeepers." At various times in 2013, the SEC's senior staff publicly communicated that the SEC intended to continue to target "gatekeepers" (e.g., accounting and auditing staff, compliance staff, in-house counsel) for evidence that the employees occupying those roles continue to satisfy their "special duties to ensure that the interests of investors are safeguarded." The chairman of the SEC has continued to specifically reinforce this point, as recently as December 2013. Accordingly, the registered investment adviser, and its executive management, should be prepared to produce and explain documentation that supports the conclusion that the "gatekeepers" in the organization have the support and resources they require, and are in fact discharging their respective responsibilities.

Firms Targeted in Examinations

- Advisers who have never been examined. The SEC launched a specific initiative under the NEP to examine investment managers who have been operating for at least three years and who have never been examined. Although not confirmed in writing by the agency, it is expected that investment managers who have less than a three-year operating history, but which are owned and / or managed by individuals with prior ownership / management experience with SEC-registered investment managers, may be subject to prompt examination under this category.

- Presence exams. The SEC itself has acknowledged that the component of the NEP focused on investment managers commits the agency to reviewing approximately 11,000 registered investment advisers. To fulfill this requirement, the SEC will continue its 2012 initiative of completing "presence exams" of new registrants. The five "key focus areas" in SEC presence examinations are the following:

    - Marketing (see above)

    - Portfolio management practices. The examination staff will seek information regarding the adviser's portfolio decision-making processes and practices, including how the manager determines allocations among advisory client accounts, and whether the decision-making processes and practices are consistent with the adviser's disclosures to clients.

    - ➢ Conflicts of interest (see above)
    - ➢ Custody / safety of client assets (see above)
    - ➢ Valuation (see above)

- "Alternative investment companies." Some time ago, as part of the agency's efforts to learn more about market-participants, the SEC introduced a practice of periodically reviewing "funds offering alternative investment strategies," with a focus on (i) leverage, liquidity and valuation policies and procedures; (ii) staffing and funding of several risk-management functions, including the accounting, operations, and compliance groups; and (iii) marketing practices. Hence the SEC could target a manager to an "alternative investment company" (i.e., a private, unregistered fund) for examination solely as a means of acquiring information regarding the manager and its clients, and not because the manager is viewed as operating a particularly risky product or vehicle, or because the manager has engaged in questionable conduct.

- Risk-based assessment. Regardless of the outlined points above, the SEC continues to apply a risk-based calculus to determine which investment advisers the agency will examine: the higher the perceived risk, the greater priority the SEC places on examining the firm, irrespective of whether the adviser has been operating for sixth months or five years.

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