



Inspections and Examinations

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Examination Preparation



Preparation

Books and Records and Compliance Controls

- The best way to make a good impression on examination staff is to provide them well maintained and organized records and show them that the investment adviser takes compliance seriously
- The SEC and its staff expects registered investment advisers to:
 - have books and records for past two years (including emails and IMs that are records) at an office of the RIA and for the next three years in a readily accessible location (i.e. retrievable within 48 hours or less)
 - have a compliance program tailored to the risks of the adviser and that is designed to monitor, discover and remedy potential compliance issues on an ongoing basis
- The SEC has higher expectations for controls at larger operations
- RIAs are required to review the effectiveness of their compliance programs and controls at least annually and to report on the effectiveness to senior management



SEC Examination and Staff Focus Areas



Types of Examinations

- Routine Examination—examination because of risk profile
- Cause Examination—examination because of a tip or evidence of wrongdoing
- Sweep Examination—request for information on a certain practice or strategy across a group of advisers
- Begins with a letter, call or visit



Sample of Information Requested in Routine Examination Document Request

- Examination letter typically requests information regarding:
 - the adviser, including insider information, litigation or arbitration, names of officers and directors
 - the advisory relationship, including advisory contracts, ADV Part II
 - clients, including account numbers names and balances, custody, discretion, fees, etc.,
 - names and due diligence relating to service providers,
 - the RIA's compliance program, risk management and internal controls, including compliance reviews, issues logs and tests and findings of those tests
 - trade blotters (in Excel), client portfolios (in Excel), minutes of meetings
 - advertising materials
 - financial records
 - Forms 13D and 13G and Forms 3, 4 and 5
 - select information regarding private funds, including organizational documents, operating agreements, offering documents, financial statements, use of side pockets, list of investors



Recent Focus Areas in Examinations

- Testing for Ponzi schemes
 - Custody arrangements (including verification with custodian and clients)
 - Tying performance and portfolio claims to the underlying data
- Regulation M violations and other trading violations (including insider trading)
- Diligence conducted in fund-of-fund investments and regarding service providers
- Controls and the CCO's review of those controls to ensure that they are properly functioning



Top Deficiencies

- Common deficiencies:
 - Compliance procedure deficiencies, including inadequate controls or failure to follow them
 - Safekeeping of confidential client information
 - Performance advertising and marketing
 - Personal trading and inadequate codes of ethics
 - Brokerage arrangements and soft dollars
 - Lack of annual disclosure or inadequate disclosure
 - Portfolio management and style drift
- Most examinations end in deficiency letters



CCO's Handling of Examinations



Handling of Examination by CCO

CCO or other designated liaison should:

- Reduce the interruption that the inspection causes
 - Keep SEC staff in conference room
 - Schedule times for key individuals to meet with the exam staff
 - Avoid providing unlimited computer access
- Monitor and protect information provided
 - Keep a log of information that is provided to the staff
 - Have a lawyer review any information for privilege and relevance to the question asked
 - Include a FOIA cover letter in information provided to protect from disclosure



Handling of the Examination (Cont'd)

CCO or other designated liaison should:

- Be involved with staff interviews
 - Prepare interviewees
 - Be present in the room when the interviews are conducted
- Try to shape deficiency letter as the examination winds down
- Conduct exit interview to address open concerns
- Be candid and honest with the exam staff
 - Do not try to “pull anything over” on the SEC staff
 - Tell the staff if the policies were just revised
- Take the corrective actions that you promise to take



Summary of Dodd-Frank Enforcement Changes



Summary of Dodd-Frank Enforcement Changes

■ Aiding and Abetting State of Mind Requirement Relaxed in SEC Cases

- Pre-Dodd-Frank, SEC had to establish that a party provided “knowing” substantial assistance to a securities law violator for aiding and abetting liability
- New state of mind standard includes “recklessness”

■ CEA’s Market Manipulation and Antifraud Provisions Amended

- Pre-Dodd-Frank, CFTC had to establish that a party acted with “specific intent” in order to bring a market manipulation case
- New antifraud provision added to the CEA that tracks SEC Rule 10b-5, which has traditionally been interpreted as prohibiting reckless conduct
- Manipulation provisions amended to expressly prohibit the following “disruptive practices”: (a) the violation of bids and offers; (b) conduct that demonstrates an “intentional or reckless disregard for the orderly execution of transactions during the closing period”; and (c) “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution)”
- Recklessness standard also explicitly incorporated into other portions of CEA that address other forms of manipulative and fraudulent conduct



Summary of Dodd-Frank Enforcement Changes

■ **New Whistleblower Provisions**

- Allow whistleblowers to recover 10% to 30% of sanctions over \$1 million for providing “original information” to the SEC or CFTC

■ **SEC may Impose Monetary Penalties in Administrative Cease-and-Desist Proceedings Against Non-Regulated Persons**

■ **Addresses SEC and DOJ Authority to Bring Enforcement Actions in Cases Involving Foreign Securities Transactions**

- Seeks to reverse the Supreme Court’s recent decision in *Morrison v. National Australia Bank Ltd.* for the SEC and DOJ
- Does not impact private securities actions



Summary of Dodd-Frank Enforcement Changes

- **Imposes Deadlines for the Completion of SEC Enforcement Investigations and Compliance Examinations and Inspections**
 - After providing a Wells Notice, the SEC now has 180 days to either bring an enforcement action or provide written notice of intention not to do so
 - After completing an on-site examination, the SEC now has 180 days to inform the entity that the exam has been concluded
 - Both deadlines can be extended if the matter is “sufficiently complex”