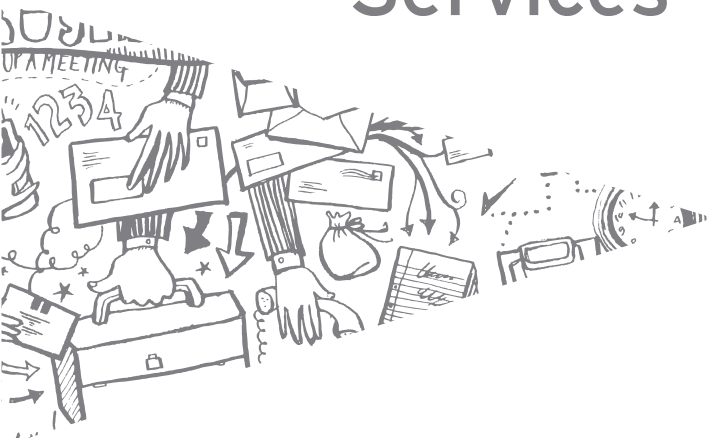


Financial Services



SEC investment adviser examinations

The importance of creating a strategy

by Daniel New and Danielle Ryea

With the continuing implementation of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), many private fund advisers must prepare for a new and more challenging regulatory environment. Along with enhanced regulatory scrutiny comes the inevitable U.S. Securities and Exchange Commission (SEC) examination. In June 2011, the SEC adopted final rules, implementing certain provisions of Dodd-Frank and eliminating the exemption that permitted many advisers to private funds to avoid registering with the SEC. As a result, most hedge fund and private equity advisers with more than US\$150 million in assets under management (AUM) must now register with the SEC no later than 30 March 2012. With the required registration, these private fund advisers will become subject to the SEC's regulatory oversight, rules, and possibly most worrisome, examinations.

It's no secret that examinations almost always turn up deficiencies, even at the most conscientious firms. But being in a position to react in a timely and responsive manner to examiner requests for information, as well as to their critiques, can make the overall process less painful – and perhaps less frequent. This requires planning and preparation and ultimately, an examination strategy.

Create an exam strategy of full compliance

You must be fully aware of your firm's registration and regulatory reporting obligations under the recent amendments to the Investment Advisers Act of 1940. A significant result of registration is the requirement to adhere to the following compliance program rules:

- ▶ Designate a chief compliance officer
- ▶ Establish and maintain a compliance program, including the adoption and implementation of written compliance policies and procedures reasonably designed to prevent violations of federal securities laws
- ▶ Annually assess the adequacy of the compliance program

Although some private fund advisers will not need to register if they qualify for one of the exemptions within the rules, they will still be subject to record-keeping and reporting requirements and to examination of their records by the SEC.

The SEC expects an investment adviser's compliance program to be tailored to its business and designed to prevent, detect and remediate violations of federal securities laws in a timely fashion. In order for a compliance program to be effective, it must be current. Firms should continually revisit their programs to address directly the regulatory and operational risks within the firm and relevant to their client base, investment products and trading strategies – all of which may change over time.

The following is a list of some of the examination review areas and topical questions that private fund advisers should be focused on when creating their examination strategies:

Asset verification

- ▶ Are client and fund assets held with a qualified custodian?
- ▶ Is the qualified custodian independent or affiliated with the adviser?
- ▶ What controls are in place to safeguard client and fund assets?

Valuation

- ▶ Are pricing sources reliable and credible?
- ▶ Does the firm have policies and procedures for fair valuation of assets?
- ▶ What controls are in place to demonstrate that the correct valuations and prices are used to calculate NAV?

Portfolio management

- ▶ Are investment guidelines and restrictions documented?
- ▶ What controls are in place to demonstrate the guidelines and restrictions are not violated?

Performance advertising and marketing

- ▶ Is the performance return data presented to prospective clients and investors accurate?
- ▶ Do the marketing materials comply with the SEC no-action letters?
- ▶ What controls are in place to demonstrate marketing materials are approved before distribution to prospective clients and investors?

Brokerage and trading

- ▶ Is the use of soft dollars or commission-sharing agreements documented?
- ▶ Are trade errors detected and corrected in a timely manner?
- ▶ What controls are in place to facilitate fair allocation of trades and investment opportunities among clients and funds?

Conflicts of interest

- ▶ Has a code of ethics been adopted?
- ▶ How is personal trading of employees monitored?
- ▶ How does the firm mitigate the risk of trading on inside information?

Create an exam strategy with the right people

Investment advisers should not wait until the arrival of an SEC phone call or request letter to begin creating an examination strategy. Taking the time to identify a response team consisting of key executives with the appropriate seniority and skills is a necessary step toward a successful strategy. Examinations can take anywhere from several weeks to several months or more, so appointing competent compliance personnel to be the main point of contact is crucial for continuity and makes a good first impression.

SEC examiners expect access to advisers' C-level executives in order to get a feel for the firm's investment philosophy and compliance culture. Such insights will help the examiners scope their examinations. This means senior executives should be fully briefed on the compliance program and all relevant issues. Their personal liability for failures in compliance matters – being fined and/or barred from the business for egregious transgressions – should motivate them to shine in the meetings. These encounters also present executives with an opportunity to explain their often-complex strategies and organizational structures to the regulators, which could result in less invasive or lengthy reviews. Firms where C-level executives have insufficient involvement in, or understanding of, compliance matters could face more in-depth probes. SEC examiners are likely to approach an adviser's board if its chief executive, chief financial officer or chief compliance officer is unable to provide satisfactory responses to their queries.

Once the firm is notified of the impending exam, senior executives should brief the firm's staff. Examiners usually interview all levels of employees, often holding open-ended and informal talks with portfolio managers, traders, client service representatives and fund accountants. Therefore, it is important to have a firmwide understanding and consensus on both compliance philosophy and logistics so employees can communicate them accurately. Employees should also be conversant with the basic facts about the firm – its AUM, how long it has been registered and so forth. The response team should ask the examiners what specific topics they plan to discuss and should sit in on the interviews. Expect the examination staff to identify and inquire on targeted risk areas and industry practices that warrant a more in-depth interview. And post Dodd-Frank, examination staff are likely to be highly skilled examiners with

expertise in accounting, quantitative trading, valuation and complex financial instruments.

On the first day of examination fieldwork, the response team should be prepared to conduct an initial briefing with the SEC examiners, which should ideally consist of straightforward and concise presentations on top-line issues, such as due diligence policies, marketing efforts, compliance, custody, corporate governance, risk management and fund accounting.

Create an exam strategy for books and records

Maintaining true and accurate books and records in an easily accessible location is not only a rule requirement; it is an essential element of a successful examination strategy (and an overall compliance program). Private fund advisers with no regulatory reporting experience may not be familiar with the nature and scope of SEC requests for documents and may not have the infrastructure to gather the required information. It is critical for a firm to be able to respond to examination document requests in the format requested, with the specificity expected by examiners and in a timely manner. Firms should:

- ▶ Facilitate the hand over of all trading, valuation and client records to the SEC upon request
- ▶ Have key employment-related documents for all staff at hand
- ▶ Be prepared to produce documentation on compliance education programs
- ▶ Keep service-provider records – e.g., custody agreements and audit records – up to date and accessible

Be aware of current record-keeping requirements for all aspects of the advisory business as retention obligations will vary. Deficiencies will quickly become apparent when a firm has difficulty producing the information requested by the SEC before the onsite examination commences. The commission typically wants this information within a matter of weeks, and it is not in the habit of granting extensions.

Test the exam strategy with a mock examination

How do you know if your exam strategy is on point? To confirm they can meet the SEC's reporting demands and respond to examinations in an effective manner, all RIAs should regularly test their exam strategy – information- and data-gathering and the efficiency of their compliance procedures – via mock examinations or similar exercises.

The scope and depth of the examinations make it difficult to uncover beforehand all the problems that could possibly arise. This is why

it is often smart to hire a service provider to conduct a mock exam. Finding such an entity is not as easy as it sounds. There are a number of factors to be considered when choosing one to play this role, such as whether the entity fully understands compliance and has the expertise to assess the firm's procedures, processes and controls.

The SEC is likely to ask to see the results of any mock exams. There are several ways in which the industry deals with this: some investment advisers request verbal reports and have nothing to provide to regulators, while others prefer to receive written reports with the idea that mock exam results should be shared with regulators. In this "we're all on the same team" mindset, showing how a firm identified an issue, escalated it appropriately, corrected it and documented the amelioration can give regulators comfort rather than consternation.

Relax

It may be difficult to relax in today's economic environment, with the market's ups and downs, but having an examination strategy and feeling confident of your firm's ability to successfully navigate an SEC examination should help you sleep a little bit better at night.

How Ernst & Young can help

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