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# SEC EXAMINATION OF INVESTMENT ADVISERS

*The Securities and Exchange Commission staff conducts various types of compliance examinations of investment advisers, sometimes on a surprise basis, which usually end with a deficiency letter. The authors point out current "hot button issues" and suggest procedures to deal efficiently and effectively with these examinations.*

By Julien Bourgeois, Michael Sherman, and Philip Hinkle *

Section 204 of the Investment Advisers Act of 1940 authorizes the Securities and Exchange Commission to conduct examinations of all records maintained by registered investment advisers as it deems necessary or appropriate in the public interest or for the protection of investors. Under this provision, the Office of Investment Adviser/Investment Company Examinations of the SEC's Office of Compliance Inspections and Examinations ("OCIE") and the SEC's regional and district offices conduct examinations of advisers, including advisers to mutual funds. The SEC's examination process is designed to (1) detect fraud and violations of the securities laws, (2) foster regulatory compliance, and (3) ensure that the SEC is aware of securities industry developments and risks.

In response to the recent financial downturn and the related market disruptions, members of the SEC's staff have focused increased attention, in speeches and writings, on the importance of advisers' compliance obligations under the federal securities laws. The SEC staff has also begun to provide more insight into the examination process, including a number of steps that OCIE is undertaking to improve the process.[1] This increased attention has its likely genesis in the perceived failure of the SEC staff to detect and prevent recent high-profile scandals through the regular examination process including, particularly, those involving registered investment advisers Stanford Capital Management, LLC and Bernard L. Madoff Investment Securities LLC.[2] Already, the industry has seen a more

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1 *See, e.g.*, Lori Richards, Director, OCIE, *Testimony Concerning Examinations by the Securities and Exchange Commission and Issues Raised by the Bernard L. Madoff Investment Securities Matter*, before the US Senate Committee on Banking, Housing and Urban Affairs (January 27, 2009) *available at* http://www.sec.gov/news/testimony/2009/ts012709lar.htm.

2 *SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme*, SEC Press Release (Dec. 11, 2008); *SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme*, SEC Press Release (Feb. 17, 2009). The SEC has acknowledged that "credible and specific allegations regarding Mr. Madoff's wrongdoing,

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thorough and aggressive examination process in the wake of the alleged Stanford and Madoff frauds. We believe that the SEC staff's current examination posture is only the beginning of more aggressive, thorough, and intrusive examinations that are likely to result in more enforcement actions than in the past. On March 5, 2009, Mary L. Schapiro, recently confirmed as Chairman of the SEC, announced the agency's "continu[ing effort] to reinvigorate our enforcement efforts" by specifically noting the importance of "mov[ing] very aggressively to improve the SEC staff's use of tips and complaints from investors and whistleblowers."[3] Additionally, the SEC recently appointed Robert Khuzami, a former federal prosecutor, to head its Division of Enforcement.[4] Upon being appointed Director, Mr. Khuzami noted that the Division "will relentlessly pursue and bring to justice those whose misconduct infects our markets, corrodes investor confidence, and has caused so much financial suffering."

These recent events should reinforce the importance of the requirement that all registered advisers adopt, implement, maintain, annually review, and enforce effective compliance programs, pursuant to Rule 206(4)-(7) under the Advisers Act (the "Compliance Rule"). A compliance program is a set of written policies and procedures designed to prevent violations of the Advisers Act and the rules thereunder. Paying proper attention to the obligations imposed by the Compliance Rule can help an adviser avoid adverse consequences as a result of an SEC examination but, more importantly, can help an adviser to prevent compliance breaches in the first place or, at least, discover and mitigate such breaches before they become a scandal.

Now is an opportune time for advisers to reconsider the effectiveness of their current compliance program. This article is designed to provide advisers with an overview of the SEC staff's examination process and practical tips to help prepare for and manage an examination. It is important to note that this article reflects the current state of the examination process; as noted above, the SEC and its staff have recently faced criticism for perceived failures in the examination program and, as a result, the SEC will likely continue to institute changes to the examination process in the near term to react to recent scandals and, if possible, to prevent future ones. As a result, advisers should continue to keep abreast of developments in this area.

## BACKGROUND

The SEC staff conducts three types of examinations of advisers. The first and most common type is a routine compliance examination in which the SEC staff uses a risk-based approach to test advisers' compliance with applicable federal securities laws and regulations and ensure that advisers have proper compliance systems and procedures in place. Under the risk-based approach, the SEC staff endeavors to examine higher-risk advisers every three years and also to examine a random selection of the remaining lower-risk advisers each year. Generally, the SEC staff deems "higher risk" those firms that present complex compliance issues (*e.g.*, advisers that charge a performance-based management fee, sell products in addition to investment advisory services, engage in principal transactions or cross transactions, hold custody of client assets, or have a disciplinary history) and the largest firms for which a compliance

*footnote continued from previous page…*

going back to at least 1999, were repeatedly brought to the attention of SEC staff, but were never recommended to the Commission for action." *See* Christopher Cox, Chairman, SEC, *Statement Regarding Madoff Investigation* (Dec. 16, 2008), *available at* http://www.sec.gov/news/press/2008/2008-297.htm.

3 *SEC Revamping Process for Reviewing Whistleblower Complaints and Enforcement Tips*, SEC Press Release (Mar. 5, 2009) (stating that the SEC's "comprehensive review [of how it handles tips and complaints] will help . . . identify and improve areas within the agency where gaps or lack of communication may cause breakdowns that prevent us from ensuring swift and vigorous enforcement"). Based on these and other statements from the SEC and the SEC staff, it would be reasonable to assume that there may be increased communications among groups in the SEC charged with examination, enforcement, and functional regulation of various areas of the financial sector.

4 *Robert Khuzami Named SEC Director of Enforcement*, SEC Press Release (Feb. 19, 2009).

issue would affect a very large number of investors.[5] In 2008, OCIE's director, Lori Richards, noted that about 1,000 of the approximately 11,300 registered investment advisers are deemed to pose a high risk.[6] The SEC staff also routinely conducts more limited examinations of certain newly registered advisers, through telephonic or short, in-person visits, accompanied by an abbreviated document request. In 2006, OCIE also began an on-site examination program tailored to examining the largest mutual fund firms. Under this program, the SEC staff, in teams of two to four examiners, works on-site with the advisory firm to settle compliance issues in lieu of the standard routine examination process.[7] There is only very limited public information about the mutual fund examination program and the SEC has not made a practice of revealing what its staff finds during these special on-site examinations.[8]

In addition to routine examinations, the SEC also conducts (1) "cause examinations" when it receives tips or client complaints that an adviser may be involved in questionable conduct or otherwise becomes aware of a potential compliance concern, and (2) "sweep examinations" in which the SEC staff examines a specific risk area across a sample of advisers. Recent examples of specific risk areas the SEC staff has examined through sweep examinations include: adviser practices relating to the malicious creation, spread, or use of false or misleading rumors with the intent to manipulate securities prices; money market fund holdings; practices with regard to fair valuation; safekeeping of client assets; and proxy voting on behalf of mutual funds.

## THE EXAMINATION PROCESS

### *The Examination*

To prepare for an upcoming examination, the SEC staff generally will first review the adviser's Form ADV, any complaints against the adviser, past reports filed with the SEC, and records of prior inspections. This preparation allows the SEC staff to focus its attention on particular areas that are perceived to present compliance risks. Once the SEC staff is prepared to start the examination, it will typically give the adviser advance notice of its on-site visit, although the SEC staff may not provide notice before the inspection of a newly registered adviser or before a cause or sweep examination.

Prior to or at the beginning of the on-site portion of an examination, the SEC staff generally will provide the adviser with a document and information request list so that the adviser may gather any necessary books and records for the SEC staff to review.[9] Although these request lists are often tailored to the SEC staff's understanding (based on its preliminary review, as described above) of the adviser, in November 2008 OCIE published a sample "Core Initial Request for Information," which sets forth the basic information that the SEC staff will request during a routine examination (the "Sample Request"). Included in the Sample Request and in nearly all actual request letters that we have seen are requests for: (1) general information on the adviser (*e.g.*, lists of the adviser's officers and directors, disclosure documents, customer complaints, records of internal disciplinary actions); (2) information regarding the adviser's compliance program, risk management, and internal controls (*e.g.*, compliance policies and procedures, documentation of internal risk

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[5] The SEC deems the 20 largest advisers by assets under management to pose a high risk for systemic reasons. GAO, REPORT TO CONGRESSIONAL REQUESTERS, SECURITIES AND EXCHANGE COMMISSION: STEPS BEING TAKEN TO MAKE EXAMINATION PROGRAM MORE RISK-BASED AND TRANSPARENT 12 (Aug. 2007). Lori Richards, Director of OCIE, described the relevant factors the SEC uses in determining how often OCIE conducts routine compliance examinations in a 2008 speech. She indicated that OCIE focuses on (1) large firms where non-compliance will affect a large number of investors; (2) firms and areas within firms where compliance controls appear weak; and (3) firms involved in increased-risk activities. *See* Lori Richards, Director, OCIE, *Address at the IA Compliance Best Practices Summit 2008: Focus Areas in SEC Examination of Investment Advisers: the Top 10* (March 20, 2008) (hereinafter "*Top 10 Speech")*, *available at* http://www.sec.gov/news/speech/2008/spch032008lar.htm.

[6] Lori Richards, Director, OCIE, *Speech to the National Society of Compliance Professionals, Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals* (Oct. 21, 2008) (hereinafter "*Focus Areas Speech*"), *available at* http://www.sec.gov/news/speech/2008/spch102108lar.htm.

[7] GAO, *supra* note 5, at 10.

[8] *See Big Firms Work with SEC in New Oversight Program*, Fund Action (April 2, 2008).

[9] SEC, *Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers, and Investment Companies 2* (Nov. 2007) *available at* http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf. When conducting an unannounced examination, the SEC staff will typically provide a document and information request list upon arrival.

analysis, outside audit records); (3) information to facilitate testing with respect to advisory trading activities (*e.g.*, trade blotter, list of securities held, description of brokerage arrangements); and (4) information to perform testing for compliance in various other areas (*e.g.*, performance advertising, financial records).[10] Additionally, more specific information is generally required when an adviser manages mutual funds or hedge funds, or provides advice with regard to specific types of financial products or instruments. Information requests also generally require an adviser to provide a detailed narrative discussion and other evidence of how the adviser's compliance program operates in practice, in addition to requesting a review of all of the adviser's compliance policies and procedures that have been adopted pursuant to the Compliance Rule. The SEC staff may also request documentation of proxy voting records, custodial information, proof of assets, and other information. A more detailed description of the types of information the SEC reviews during examinations is provided below in "Recent Areas of Focus During Examinations."

At the beginning of the on-site portion of an examination, the SEC staff usually conducts an initial interview with the adviser's management during which the SEC staff will describe the expected examination process, review with the adviser's management the information that the SEC staff has requested, inquire about the adviser's business and organizational structure, and request certain additional materials to help the SEC staff examiners define the scope of the examination. The SEC staff may conclude the initial interview by requesting a tour of the adviser's premises to provide the SEC staff with a general understanding of the adviser's organization, flow of work, and control environment. For the adviser, the initial interview is one of the first occasions to assure the SEC staff that the adviser has a solid compliance culture, is conducting business properly, and has nothing to hide. Some advisers deliver presentations to the SEC staff during the initial interview explaining the adviser's business, operational, and compliance structure. As further discussed below, it is important that the adviser make an appropriate workspace in its offices available to the SEC staff for the on-site examination.

After the initial interview, the SEC staff will review an adviser's business and investment activities, and its corresponding records, compliance policies and procedures, and other information that the adviser has prepared, generally at the adviser's offices. During this stage, the SEC staff may ask follow-up questions, request additional records and make copies, request meetings with certain of the adviser's employees, and request relevant information from service providers and other third parties. The length of the on-site examination varies depending on such factors as the experience the SEC staff has had with the adviser, the complexity of the adviser's business, the size of the adviser's organization and assets managed, the speed at which the adviser is able to provide the SEC staff with requested documents and information, and whether the SEC staff is satisfied that it has acquired a good understanding of the adviser's operations and compliance procedures. Typically, the SEC staff requests an exit interview with the adviser's management at or shortly after the close of the on-site portion of an examination to inquire about specific issues discovered during the visit, to discuss the status of the examination, to inform the adviser about any concerns the SEC staff may have, and to allow management to provide the SEC staff with any additional necessary information.

After the on-site portion of the examination, the SEC staff will review and analyze the information the adviser has provided and may consult with other SEC divisions for guidance on particular issues. In the course of its analysis, the SEC staff will examine whether: the adviser's books and records are properly maintained; the adviser has implemented and enforced compliance procedures that effectively address relevant compliance risks; and the adviser's business is compliant with applicable law and rules. The SEC staff will pay particular attention to the current "focus areas" described below.

Once the SEC staff is satisfied with its analysis, normally within 120 days after the conclusion of the on-site examination, it will typically: (1) close the examination without further action, satisfied that the adviser is in compliance with the securities laws and regulations, and send the adviser a "no-further-action letter"; (2) issue a deficiency letter to the adviser requesting that it take corrective actions and provide a response that outlines those corrective actions; or (3) refer the matter to the SEC's Division of Enforcement for further investigation and potential enforcement proceedings. The SEC staff may also concurrently issue a deficiency letter and recommend enforcement proceedings.

The SEC staff generally considers the following non-exclusive factors in deciding whether to refer a matter to

[10] Office of Compliance Inspections and Examinations, *Investment Adviser Examinations: Core Initial Request for Information* (Nov. 2008), *available at* http://www.sec.gov/info/cco/requestlistcore1108.htm.

the Division of Enforcement: (1) whether it appears that fraud has occurred; (2) whether investors were harmed; (3) if there was not fraud, whether the misconduct was serious, ongoing, repetitive, systemic, or severe; (4) whether the adviser alerted the SEC and took meaningful corrective action to address the misconduct prior to or during the examination; (5) whether the matter is one traditionally addressed by the SEC, as opposed to another agency (*e.g.*, the Department of Labor if the violation involves ERISA plan assets); (6) whether an activity noted is a particular area of SEC focus; (7) whether an actor profited from any prohibited actions; (8) whether the prohibited actions appear to have been intentional; (9) whether the conduct appeared recidivist in nature; and (10) whether the advisory firm's supervisory procedures were inadequate.[11]

In practice, the SEC staff concludes most examinations with a deficiency letter.[12] After the SEC staff issues a deficiency letter, the adviser is required to respond, in writing, within 30 days. Such a response should reproduce or summarize the SEC staff's comments, provide explanations about the adviser's practices, and detail any steps the adviser has taken or will take in response to the noted deficiencies. In some cases, advisers may be subject to further SEC staff attention as a result.

### *Being Prepared for the Examination — The Compliance Program*

Advisers should seek to remain prepared for a possible examination at any time. As noted above, the Compliance Rule requires any investment adviser that is, or is required to be, registered with the SEC to have adopted and implemented a compliance program – written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. In addition, the Compliance Rule requires advisers to designate a CCO to administer the compliance program and to review its adequacy and effectiveness on an annual basis. An investment adviser serving an investment company registered under the Investment Company Act of 1940 must also ensure that the fund group has established and maintains a set of written compliance procedures and has appointed a CCO pursuant to Rule 38a-1 under that act.

Further, the adviser must ensure that its CCO is effective. The SEC staff has highlighted certain qualities that advisers should consider when evaluating whether a CCO and its compliance staff are effective.[13] The CCO should be knowledgeable regarding the Advisers Act and empowered enough within the adviser's organization to enforce compliance with that act.[14] The CCO must be a supervised person of the adviser but should have a sufficient degree of independence from the adviser's management and sufficient standing within the adviser's organization to identify and prevent conflicts of interest – a central focus of the CCO's role. Also, the adviser's CCO and compliance staff should have sufficient resources and incentives to exercise diligence in identifying and following up on any compliance issues, and the adviser's staff should be trained to bring any potential compliance issues to the attention of the CCO.

In addition, the adviser's compliance program should effectively take into consideration the characteristics of the adviser's business, proactively addressing potential risk areas. An adviser should consider internal audit or testing mechanisms to monitor compliance with the adviser's policies and procedures and applicable law. Among other things, this internal review process should allow the adviser to amend its procedures in response to new legal, regulatory, and business developments. OCIE has developed a "CCOutreach Program" to help advisers and investment companies keep abreast of developments regarding compliance issues by providing a means of communication between CCOs and the SEC staff.[15] The CCOutreach Program provides advisers anonymous access to members of the SEC staff to discuss compliance questions and concerns about industry practice. At the same time, however, advisers

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11 Lori Richards, Director, OCIE, *Address at the SIFMA Compliance and Legal Division January General Luncheon Meeting, Frequently-Asked Questions About SEC Examinations* (January 17, 2008), (hereinafter "*FAQs Speech*"), *available at* http://www.sec.gov/news/speech/2008/spch011708lar.htm.

12 At the Practicing Law Institute's "SEC Speaks in 2009" program, the OCIE staff noted that in 2008, approximately 68% of the advisers and 71% of the mutual funds that were examined were issued deficiency letters.

13 SEC, *Questions Advisers Should Ask While Establishing or Reviewing their Compliance Programs* (May 2006), *available at* http://www.sec.gov/info/cco/adviser_compliance_questions.htm; *see also* Thomas M. Majewski, *Conflicts of Interest Chief Compliance Officers Face in Implementing Compliance Programs for Investment Funds and Investment Advisers*, 7 J. Investment Compliance 23 (2006).

14 *See* Compliance Programs of Investment Companies and Investment Advisers, Adv. Act Rel. No. 2204 (2003).

15 More information on the CCOutreach Program is *available at* http://www.sec.gov/info/iaicccoutreach.htm.

should not tailor their compliance programs exclusively around the regulatory process. According to Lori Richards, advisers should "proactively identify and address areas of risk . . . on an ongoing basis, not just those areas where you know regulators have an interest and not just right before an exam. You will get caught dealing with yesterday's problems and the 'just-in-time' approach will be obvious to the examiners anyway."[16]

As an important part of the compliance program, advisers should place particular emphasis on maintaining required books and records. Section 204 of the Advisers Act and Rule 204-2 (the "Books and Records Rule") require advisers to maintain and preserve certain records generally for not less than five years, and the first two years in an appropriate office of the adviser.[17] Those records must be made available to the SEC staff during an examination. In this regard, the SEC staff generally will request copies of, or access to, the adviser's books and records during an examination. In order to provide requested records while minimizing disruption of the adviser's business, the adviser should speak with the SEC staff about which documents are available and how easy or difficult it is to retrieve those documents. Among other things, the SEC staff will seek to review and reconcile the books and records to confirm their accuracy, detect any omissions, and identify possible conflicts of interest and internal control weaknesses. An adviser may be found deficient if its books and records are incomplete, inaccurate, or otherwise inadequate, inaccessible, or not maintained or preserved as required.[18] The SEC staff is also likely to presume that improper maintenance of books and records indicates other misconduct. We also understand that the SEC staff is increasingly reaching out to service providers and clients to verify information provided by an adviser in the course of an examination and that this outreach has assisted the SEC staff in exposing recent frauds.

### *Managing the Examination Process Appropriately*

Advisers should continually seek to anticipate the questions that the SEC staff is likely to raise during an examination. If the adviser has been subject to examination in the past, the adviser should review its records of prior examinations to anticipate questions and incorporate modifications to its compliance procedures accordingly during each annual review of its compliance program, as recidivism is of special concern to the SEC staff. Similarly, advisers should consider SEC staff interpretive and no-action guidance and settled enforcement actions in ensuring that their compliance and investment processes comply with applicable law and relevant disclosures.[19] When the examination starts, the adviser should make all reasonable attempts to cooperate with the SEC staff. To that end, the adviser should designate a senior officer within the legal or compliance department who is knowledgeable about the adviser's business, operations, and compliance program to serve as an "exam coordinator," the SEC staff's point of contact during the examination.[20] The adviser should request that the SEC staff direct all questions and information requests through the exam coordinator, and should also request that the exam coordinator be present for all interviews with the adviser's personnel.

The adviser should consult with counsel who is familiar with the examination process and able to provide detailed guidance on how to deal with the legal aspects of the examination as soon as the adviser receives the initial request for information or becomes aware of the SEC staff's visit. Counsel should be permitted to review any information before it is produced to the SEC staff and should review e-mails and other communications for privilege before those materials are provided to the SEC staff. The exam coordinator should also contact the adviser's outside auditor (and/or the outside auditor for any pooled vehicles advised by the adviser), as accounting issues frequently arise in examinations. Finally, the adviser should advise its personnel about the SEC staff's visit and advise them that the exam coordinator will coordinate the responses to the SEC staff.

The exam coordinator should produce requested information quickly and maintain a courteous and sincere demeanor towards the SEC staff.[21] The exam coordinator should facilitate the SEC staff visit by making proper arrangements for workspace, an adequate means of communication, and a power source. To avoid

[16] *See FAQs Speech, supra* note 11.

[17] Time, place, and manner requirements may vary depending on the nature of the record.

[18] *See CCOutreach 2007 Regional Seminars, available at* http://www.sec.gov/info/cco/information2007.pdf.

[19] For example, advisers who aggregate trades should assure that their practices comply with SMC Capital, Inc. (pub. avail. Sept. 5, 1995) and Pretzel & Stouffer (pub. avail. Dec. 31, 1995) while advisers who accept client-directed brokerage instructions should consider the SEC enforcement actions against Mark Bailey, Adv. Act Rel. No. 1105 (1988), and Jamison, Eaton & Wood, Adv. Act Rel. No. 2129 (2003).

[20] Ideally, the CCO would fill this role.

[21] See *FAQs Speech*, *supra* note 11.

unnecessary disruption to the adviser's day-to-day operations, the workspace should be separated from the adviser's general workspace. It is not advisable to provide the SEC staff free access to a copy machine, but instead the adviser should provide for the SEC staff's copy needs by copying any non-privileged documents at the SEC staff's request.

As noted above, Section 204 of the Act and the Books and Records Rule permits the SEC staff to seek access to certain books and records of an adviser. The exam coordinator should produce for the SEC staff all information that is responsive to its request unless that information is privileged, but should not produce non-responsive documents, and should maintain a log of documents reviewed by and produced to the SEC staff. If certain of the adviser's records are electronic, the exam coordinator may arrange for the SEC staff to have controlled access to relevant sections of the adviser's systems or provide relevant information in a searchable format, if requested by the SEC staff.

As noted, certain materials that the SEC staff requests may be protected by the attorney-client privilege. Disclosure of privileged information to the SEC staff likely may result in the loss of the attorney-client privilege, but resisting the SEC staff's requests may raise suspicions. As a result, whether to disclose such documents is a case-by-case business decision that an adviser should make with its counsel. If the exam coordinator identifies that certain requested information is privileged and should be withheld, he or she should request a meeting with the SEC staff to explain the reasons for withholding the privileged information. If the on-site SEC staff presses for a waiver of privilege, the adviser may wish to raise the issue with more senior SEC staff members. The SEC staff may request that a privilege log be produced when an adviser claims attorney-client privilege.

The adviser should also protect the commercial and financial information that it provides the SEC from disclosure to the public under the Freedom of Information Act ("FOIA"). The SEC has implemented procedures with regard to FOIA requests for confidential treatment.[22] Any materials and response letters provided to the SEC staff during an examination should be treated as communications (1) in the course of an examination and (2) that are entitled to confidential treatment for reasons of personal privacy and/or business confidentiality.[23] Such materials are generally, therefore, considered non-public for FOIA purposes.[24] Even so, during an examination the exam coordinator should ensure that, when it provides confidential information to the SEC staff, the information is segregated from non-confidential information, conspicuously marked on each page "Confidential Treatment Requested by [Adviser]," sequentially numbered, and accompanied by a written request for confidential treatment. The confidential treatment request must also be submitted to the SEC's FOIA office as soon as possible (preferably contemporaneously and in any event at least within 30 days of production). Although the FOIA request process provides a measure of protection from disclosure to the public, there remains some possibility that such documents might be turned over to a third party. Upon a third-party's request for the relevant information, the FOIA office will send a notice to the adviser and ask that the adviser substantiate its confidentiality claim. The adviser must then show that the information falls within one of the categories protected under the FOIA to prevent disclosure.

## RECENT AREAS OF FOCUS DURING EXAMINATIONS

The scope of an examination may be extremely broad. The SEC staff recently announced that it was concentrating on the following areas, among others: (1) valuation controls; (2) controls over non-public information and personal trading by adviser employees; (3) senior investor relations; (4) compliance and

22 17 CFR 200.80; 17 CFR 200.83.

23 *See* 17 CFR 200.80(b)(4)(iii), which states that "information contained in reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of or in connection with an examination or inspection of the books and records of any person or any other investigation" is generally considered to be non-public for purposes of FOIA; and 17 CFR 200.80(b)(3), which states that, generally, "matters that are specifically exempted from disclosure by statute" are considered to be non-public for purposes of FOIA. Additionally, Section 210 of the Advisers Act provides, generally, that the SEC and its staff "shall not make public the fact that any examination or investigation under this title is being conducted, or the results of or any facts ascertained during any such examination or investigation; and no member, officer or employee of the [SEC] shall disclose to any person . . . any information obtained as a result of any such examination or investigation except with the approval of the [SEC]." Similarly, Section 210(c) of the Advisers Act generally protects advisers from "disclos[ing] the identity, investments, or affairs of any client," subject to certain exceptions.

24 17 CFR 200.83.

supervision; (5) portfolio management and trading strategies; (6) brokerage arrangements and best execution; (7) allocation of trades; (8) performance advertising, marketing, and fund distribution; (9) safety of clients' and funds' assets; and (10) books and records, disclosures and filings.[25] Other areas the SEC staff has recently identified as presenting recurring compliance issues include: (11) proxy voting and funds' use of proxy voting services; (12) valuation and liquidity issues; (13) business continuity plans; and (14) soft dollar practices.[26] The following discussion provides an overview of certain SEC staff focus areas (and other areas of current or perennial interest) that advisers should consider in evaluating whether they are prepared for a routine or sweep examination.

### *Controls Over Non-Public Information and Personal Trading*

Under Section 204A of the Advisers Act, advisers must establish, maintain, and enforce written procedures reasonably designed to prevent the misuse of material, non-public information by the adviser or associated persons in client, proprietary, or employee accounts. Rule 204A-1 under the Advisers Act (the "Code of Ethics Rule") requires that an adviser that is registered or required to be registered must establish, maintain, and enforce a written code of ethics, and requires that advisers collect holdings and transaction reports from all access persons (supervised persons with access to information on clients' holdings or that provide investment advice, among others). The Code of Ethics Rule requires that each adviser access person submit to the adviser's CCO periodic personal trading transaction reports, which must include: a description and amount of the securities transactions; the date and nature of the transactions; the price at which the transactions were effected; and the names of the brokers, dealers, or banks that effected the transactions. Currently, the SEC staff prioritizes the review of controls and procedures designed to prevent improper personal trading, focusing on whether the adviser "has identified the source and type of non-public information that they and employees may be privy to," and whether the adviser has established and is implementing adequate controls and procedures to maintain the confidentiality of that information.[27]

During a recent sweep examination in which the SEC staff reviewed the implementation and effectiveness of several advisers' controls over insider trading, the SEC staff emphasized the importance of internal monitoring and review of personal trading by adviser access persons.[28] Permitting personal securities trades to be executed concurrently with client trades without imposing adequate safeguards may be inconsistent with the adviser's fiduciary duty. The SEC staff has noted that common deficiencies in this area include incomplete codes of ethics that do not sufficiently address all regulatory requirements, failure to enforce procedures designed to prevent insider trading violations, failure to require reporting and monitoring of personal trading, and inadequacies in Form ADV disclosures. Examples of abusive personal trading activities include trading in securities for personal accounts shortly before trading the same securities for clients (*i.e.,* "front-running") or directing clients to trade in securities in which the adviser has an undisclosed interest and causing the value of those securities to increase to the adviser's benefit. Risks of abuse are especially high when the adviser is dealing with thinly traded securities or securities of limited availability, such as initial public offerings or private placements.[29] During an examination, the SEC staff is also likely to consider whether the adviser obtains and reviews personal holdings and transactions reports, and maintains those reports as records consistent with Rule 204-2.

### *Senior Investors*

The SEC staff has recently emphasized the importance of protecting the increasing number of senior investors (*i.e.,* investors who are retired or are near retirement age) through investor education programs, sweep examinations, and enforcement actions.[30] In

[25] *See Focus Areas Speech*, *supra* note 6.

[26] *See* SEC, *ComplianceAlert* (June 2007), *available at* http://www.sec.gov/about/offices/ocie/complialert.htm, and SEC, *ComplianceAlert* (July 2008), *available at* www.sec.gov/about/offices/ocie/complialert0708.htm.

[27] *See FAQs Speech*, *supra* note 11.

[28] *See* SEC, *ComplianceAlert* (July 2008).

[29] Consequently, the Code of Ethics Rule requires pre-clearance by the adviser of employee purchases of IPOs and private placements.

[30] Section 206(1) and (2) of the Advisers Act provides the SEC with statutory mechanisms to punish senior-targeted frauds or deceits. Of particular concern are advertisements and "free lunch" programs that induce seniors into buying securities from the sponsoring adviser. *See* OCIE, NASAA, and FINRA, *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars*

2008, the SEC announced that it had conducted a sweep examination of broker-dealers and investment advisers that offer "free lunch" sales seminars that target senior investors and noted compliance problems in the marketing, sales, and supervisory processes in this area.[31] The SEC staff has also undertaken a joint ongoing effort to protect senior investors with the North American Securities Administrators Association and the Financial Industry Regulatory Authority, and has published a report on common practices of financial services firms in interacting with senior investors.[32] In addition, the SEC recently filed a number of cases relating to fraudulent behavior involving senior citizens, for example, actions against a formerly registered adviser for fraudulent behavior involving a senior citizen suffering from Alzheimer's disease,[33] and against an unregistered investment adviser for fraudulently obtaining cash from an elderly widow by falsely representing that he would put her money in certain bond investments.[34]

Advisers who service senior investors should assess whether their compliance programs adequately capture and manage the unique risks presented. Most importantly, an adviser's compliance program should be able to demonstrate that it has considered the special risks presented by senior investors and has put in place compliance procedures specifically designed to manage these risks. For example, an adviser could have controls in place to flag unusual trading activity in senior investor accounts and require a determination of whether an investor may have diminished mental capacity or could be a target of financial abuse, and could implement mandatory training for its access persons regarding the proper handling of aging investors. The SEC staff has reported that some advisory firms restrict high-risk trading for investors over a certain age without pre-approval as an element of their compliance programs. In addition, advisers should always consider whether products promoted as "near-retirement" investment options are actually appropriate for senior investors.

*footnote continued from previous page…*

(Sept. 2007), *available at* http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

[31] SEC, *ComplianceAlert* (July 2008).

[32] *Protecting Senior Investors: Compliance, Supervisory, and Other Practices Used by Financial Services Firms in Servicing Senior Investors* (Joint report of OCIE, NASAA and FINRA), September 22, 2008.

[33] Lit. Rel. No. 20609 (2008).

[34] Lit. Rel. No. 20591 (2008).

### *Compliance and Supervision*

Compliance and supervision are "key areas" of the SEC staff's focus in examinations, and the SEC staff examinations tend to focus on whether the adviser's compliance program "is designed to capture and manage" the adviser's compliance risks and conflicts of interest.[35] As noted above, the Compliance Rule requires advisers to implement and maintain compliance programs, and assessing the adequacy of these programs on an organization-wide basis has become a central function of the examination process.

The SEC staff generally will also review the manner in which an adviser supervises its employees. Section 203(e) authorizes the SEC to sanction an adviser that has failed to reasonably supervise another person subject to the adviser's supervision who commits a violation of the federal securities laws. Section 203(e)(6) of the Advisers Act, however, provides a defense to charges that an adviser has failed to supervise if the adviser: (1) has established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect violations; (2) has reasonably discharged its duties under such procedures and system; and (3) has no reasonable cause to believe the procedures and system were not being followed. The SEC staff has indicated that it is concerned with advisers' supervision of portfolio managers and/or traders and contracted entities, and that it is focusing on advisers' policies and procedures adopted to supervise personnel. An adviser should give particular attention to controls in those areas of its activities that pose the greatest potential for creating conflicts of interest or that may harm clients.[36] In the past, the SEC staff has stated that it pays particular attention to supervision with regard to advisers with multiple offices and advisers that have "star" portfolio managers or traders, whose performance record may create reluctance to supervise their activities closely.

### *Portfolio Management*

Client accounts must be invested in a manner consistent with the advisers' disclosures and the client's investment objectives and restrictions. Advisers should constantly consider whether their compliance programs provide for, and whether they are conducting, adequate monitoring of their activities to assure and verify conformity with such investment objectives and restrictions.

[35] *See Top 10 Speech*, *supra* note 5.

[36] *See Top 10 Speech, supra* note 5.

In this regard, the SEC staff is interested in whether the overall manner in which an adviser is running its advisory business, including procedures related to risk management, valuation, and accounting, is consistent with the adviser's disclosures to its clients.[37] For example, in 2008, the SEC won a preliminary injunction temporarily freezing the assets of an adviser to certain private funds for a failure to comply with the funds' disclosed investment strategies, among other things.[38] The adviser allegedly informed potential investors that the funds' investment strategy would focus solely on the buying and selling of covered calls, but instead transferred $10 million from the funds to a holding company and used much of the remaining fund assets to engage in short-sale transactions involving Treasury bonds.

The SEC staff is also interested in identifying whether advisers claiming to comply with special restrictions on investment strategies, such as "socially responsible investing" ("SRI") restrictions, adequately comply with those restrictions and adhere to related components of their compliance programs. For example, the SEC recently issued an order imposing sanctions and a cease-and-desist remedy against an adviser to socially responsible funds for fraud under Section 206(2) of the Advisers Act and for related violations of the Investment Company Act of 1940 because the adviser failed to adhere to disclosed SRI restrictions.[39] Designed and promoted as SRI investment products, the funds disclosed certain investment policies and restrictions prohibiting them from investing in issuers that derived revenue from specified "non-SRI" activities. The SEC found that the adviser had failed to satisfy its corresponding duties to screen issuers and ensure the funds' compliance with the SRI restrictions.

### *Performance Claims*

The SEC staff has indicated in the past that it is concerned about the accuracy of the representations made in an adviser's marketing materials in relation to investment performance, because performance may be an important factor in determining whether to engage or retain an adviser.[40] The SEC staff recently reiterated that it focuses on reviewing performance numbers during all inspections, where relevant, and that an adviser should have procedures in place to ensure that all published performance information is accurate. In this regard, the SEC staff has noted that it has found that many advisers have failed to make disclosures in advertisements to prevent these communications regarding performance from being misleading and to put in place adequate compliance policies and procedures relating to marketing and performance advertising.[41]

Inaccurate and false performance claims violate the general antifraud provisions of the Advisers Act, as well as Rule 206(4)-1 thereunder, which provides that certain types of advertising by an investment adviser may constitute a fraudulent, deceptive, or manipulative act. The SEC staff has given several examples of performance claims that may be fraudulent, and advisers should closely scrutinize any performance presentations, advertisements or claims to ensure they are not misleading. Examples of situations that may lead to fraudulent or misleading performance claims include: (1) creating distorted performance results by constructing composites that include only selected profitable accounts or that include only selected profitable periods; (2) comparing an adviser's performance to inappropriate indices (*e.g.*, stating or implying that a dissimilar index is comparable to the adviser's investment strategy); (3) representing or implying that model or back-tested performance is actual performance; (4) failing to deduct an adviser's fees from performance calculations, without disclosure; (5) representing falsely the adviser's total assets under management, credentials, or length of time in business; (6) incorporating a predecessor adviser's performance into the adviser's advertised performance returns in a misleading manner, or when it is otherwise inappropriate; and (7) making false claims of compliance with voluntary standards, such as the Global Investment Performance Standards. Advisers should consider SEC and SEC staff guidance with regard to advertising in the form of no-action letters and settled enforcement actions before publishing any performance data.[42]

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37 *See Top 10 Speech, supra* note 5.

38 *Securities and Exchange Commission v. Plus Money, Inc. and Matthew La Madrid, et al.,* Lit. Rel. No. 20587 (2008).

39 *See In the Matter of Pax World Management Corp.*, Adv. Act Rel. No. 2761 (2008).

40 Rel. No. 33-7965 (2001).

41 SEC, *ComplianceAlert* (June 2007).

42 For example, advisers who rely on performance statistics derived from other client accounts under management should comply with the SEC staff's position set forth in Clover Capital Management (pub. avail. Oct. 28, 1986) and Investment Company Institute (pub. avail. Sept. 23, 1988) and should consider the SEC enforcement action against Reservoir Capital Management, Inc., Adv. Act. Rel. No. 1717 (1998).

The SEC's recent action against Bernard Madoff and his investment adviser/broker-dealer business is an example of potential action for egregious claims of false performance, and the revelation of Mr. Madoff's alleged $50 billion Ponzi scheme will likely cause the SEC staff to scrutinize performance claims more closely. Other enforcement actions brought against investment advisers also demonstrate that false performance claims draw SEC attention. In *In re Lancaster*,[43] for example, the SEC filed an enforcement action against the control person of an adviser, alleging that he knowingly or recklessly had made materially false and misleading statements regarding investment performance, thus violating Sections 206(1) and (2) of the Advisers Act. Similarly, in *In re Trabulse*,[44] the SEC filed a complaint against an investment adviser to a private investment fund, alleging that the adviser falsified investor account statements in order to make the fund look more profitable, solicit new investors, and convince existing investors to make further investments.

### *Books and Records*

Pursuant to the Books and Records Rule, advisers must maintain adequate and complete records and must establish certain procedures relating to the maintenance of such records. The SEC staff has noted that it focuses on whether an adviser's compliance program captures, compiles, maintains, and reports relevant and timely information in its books and records and in its reports to clients and regulators. The SEC staff also inspects whether the adviser has controls in place to protect the information from theft and destruction in a disaster. It should be noted that the general record retention rules apply equally to e-mails and other electronic documents, in addition to the special requirements that relate to the protection of such records. Also, although advisers must maintain detailed information relating to their clients, the Books and Records Rule permits advisers to indicate the identity of any client in its records by numerical, alphabetical, or another code, which allows advisers to protect their clients' identities during an examination.[45]

Advisers must maintain copies of all written materials produced, distributed, or received by the adviser. The basic three groups of such records are: written materials regarding recommendations and advice given or proposed; transaction reports for the receipt, disbursement, or delivery of client funds and securities; and reports relating to the placement or execution of orders. Other records that advisers must maintain include: documents supporting performance claims; a list of discretionary accounts; powers of attorney; written contracts; codes of ethics; personal securities transactions; disclosure documents; client solicitation agreements; and written policies and procedures. Consequently, advisers should ensure that their accounting records are current, and should be constantly creating and maintaining records of transactions, such as invoices, payments, vouchers, and confirmations. Advisers may also update secondary records as necessary for their business needs and should maintain accounting records in a manner that suits their business; however, advisers should be mindful that in an examination the SEC staff may determine that an accounting recordkeeping system is inadequate, given the nature of the adviser's business.[46]

The Books and Records Rule also requires that, and the SEC staff will also examine whether, an adviser with proxy voting authority maintains: copies of the proxy voting procedures required by Rule 206(4)-6 under the Advisers Act; proxy materials received on behalf of its clients; records of votes cast; documents material to the adviser's proxy vote decision-making process; and copies of any client requests and related responses relating to the proxy voting process. Advisers should be mindful that the SEC staff recently conducted a sweep examination related to retention of e-mail relating to proxy voting and that the Books and Records Rule applies equally to e-mail relating to such matters.

### *Valuation of Client Assets*

The SEC staff has indicated that, in order to comply with the Compliance Rule, advisers must put in place processes to value client holdings and assess fees based on those valuations.[47] In addition, the Investment Company Act of 1940 requires mutual funds to sell and redeem fund shares at the fund's current net asset value, and mutual funds must adopt certain procedures related

43 Adv. Act Rel. No. 2726 (2008).

44 Adv. Act Rel. No. 2728 (2008).

45 Section 210(c) of the Advisers Act restricts the SEC from requiring advisers to disclose the identity, investments, or affairs of their clients except as "necessary or appropriate in a particular proceeding or investigation having as its object the enforcement of a provision or provisions of [the Advisers Act]."

46 W. John McGuire, *Adviser Recordkeeping Requirements,* 7 J. Investment Compliance 43 (2006).

47 *See* Adv. Act Rel. No. 2204 (2003).

to valuation to comply with Rule 38a-1.[48] In examinations, the SEC staff reviews advisers' controls on securities valuations, focusing on whether the adviser has put such controls in place and whether it implements them in pricing structured products, illiquid securities, and difficult-to-price securities.[49] In this regard, the SEC staff will consider whether (1) the adviser is complying with its valuation procedures, (2) the adviser applies adequate diligence in pricing, and (3) the adviser's procedures would ensure that valuations reflect prices comparable to that obtainable in a current sale. The SEC staff may also consider the qualifications of the adviser's staff that is involved in the valuation process. As a result of recent market events, the SEC staff has stated that it will also look for an adviser's reluctance to fair value or mark down prices in compliance with the adviser's valuation procedures and will closely examine compliance with the guidance regarding valuation of hard-to-value securities in Statement of Financial Accounting Standards No. 157, "Fair Value Measurement."[50]

### *Business Continuity Plans*

The SEC staff has stated that, under the Compliance Rule, an adviser generally must put in place a "business continuity plan" designed to facilitate the adviser's ability to provide uninterrupted advisory services to clients as soon as is practicable after an emergency, natural disaster, or other event that would cause a significant business disruption.[51] During a routine examination, the SEC staff will often request copies of advisers' business continuity plans and ask questions regarding its contingency plans for alternative physical facilities, back-up records storage, and alternative communications systems. The SEC staff may focus on the adviser's routine testing and internal evaluation of contingency preparedness. The SEC staff has noted that the following provisions of an adviser's business continuity plan, among others, are particularly effective after a disaster: a pre-arranged remote location for operations; alternative communication protocols for contact with the adviser's staff and clients; remote access to the adviser's books and records; succession or coverage plans in the event that key personnel are temporarily or permanently unable to provide services; periodic testing, evaluation, and review of the disaster recovery plan; and sufficient insurance coverage.[52] For a large advisory organization, it may be helpful to hire a consultant to assist in developing the plan. An adviser should ensure that senior management contributes to developing the plan, that routine periodic testing of the plan is conducted, and that the plan provides for any necessary staff training and for an annual review in order to reflect any changes in regulatory guidance and within the adviser's business. Smaller advisers should also consider succession matters and other provisions should key personnel become unexpectedly unavailable to provide necessary services.

## CONCLUSION

SEC examinations of investment advisers are often unpredictable, and the SEC staff has the authority to inquire about almost any aspect of an adviser's business. Investment advisers must be familiar with the examination process and have in place strong compliance programs and internal control procedures to ensure compliance with the Advisers Act and other applicable securities laws. Investment advisers should not overlook any compliance areas, but should pay particular attention to areas that have recently been the subject of particular scrutiny or which present increased risk to the firm. Proper preparation greatly increases the chance that an adviser will escape serious deficiencies or enforcement action as a result of an examination.■

[48] At the Practicing Law Institute's "SEC Speaks in 2009" program, the OCIE staff noted that pricing and calculation of net asset value, and the related internal controls, were one of the top deficiency areas identified during mutual fund examinations in 2008.

[49] *See FAQs Speech*, *supra* note 11; *Top 10 Speech*, *supra* note 5.

[50] *See Focus Areas Speech*, *supra* note 6.

[51] *See* Adv. Act Rel. No. 2204 (2003).

[52] SEC, *ComplianceAlert* (June 2007).