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SEC and NFA Examinations: New Registrants, Areas of Regulatory Focus and Compliance Issues

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) eliminated the exemption from registration with the Securities and Exchange Commission (SEC) as investment adviser applicable to the managers of many private funds. The Commodity Futures Trading Commission (CFTC) has also recently modified the CFTC registration exclusion and exemption from registration applicable to the operation of registered investment companies (registered funds) and certain private funds that trade in commodity interests. As a result, many investment managers that were previously unregulated by the SEC and/or CFTC are now subject to examination of their records by the Staff of the SEC and National Futures Association (NFA), the self-regulatory organization that administers the CFTC's registration regime, for the first time.

In addition, many investment managers that traditionally manage private funds have been launching registered funds or establishing advisory relationships with investment advisers to registered funds. This requires registration as an investment adviser and also subjects these investment managers to compliance with the Investment Company Act of 1940 (1940 Act) and the rules thereunder. These types of funds (and their investment managers and boards

of directors) have come under intense regulatory scrutiny in SEC exams as they are viewed as creating potentially heightened levels of risk to registered fund investors.

As a result of these and other developments, it is increasingly important for investment managers to review their compliance programs and be prepared for SEC and NFA exams. As described below, SEC and NFA exams may expose investment managers to risk of disciplinary actions or SEC or CFTC enforcement action. This article (1) reviews recent developments impacting the SEC's and NFA's exam programs, (2) provides an overview of the SEC and NFA exam programs, (3) discusses the typical parts of an SEC or NFA exam, (4) reviews significant "hot button" areas of focus in recent exams and (5) suggests procedures to prepare for and deal efficiently and effectively with those examinations.

I. Background

A. Developments Impacting SEC Exams

Section 204 of the Investment Advisers Act of 1940 (Advisers Act) and Section 31(b) of the 1940 Act authorizes the SEC to conduct examinations of all records maintained by registered investment advisers and registered funds, respectively, as it

deems necessary or appropriate in the public interest or for the protection of investors. The SEC generally conducts thorough examinations of investment advisers and registered funds, and these examinations can lead to enforcement actions.

In that regard, SEC Chair Mary Jo White recently stated that “[t]he more successful we are at being – and being perceived as – the tough cop that everyone rightfully expects, the more confidence in the markets investors will have, the more level the playing field will be and the more wrongdoing that will be deterred.”¹ In her Congressional testimony in support of the SEC’s 2015 budget proposal, Chair White requested funding to hire 316 additional Staff members for the SEC’s Office of Compliance Inspections and Examinations (OCIE) exam program in order help OCIE examine a larger number of advisers.²

Dodd-Frank has resulted in a number of developments that strengthened the SEC’s exam program, including, among other things:

- Dodd-Frank required the SEC’s Division of Investment Management to have its own Staff of examiners. The Division created a new Risk and Examinations Office (REO) in 2012 to implement this requirement. The REO is charged with conducting (1) quantitative analysis of investment management industry data in order to facilitate examinations of suspicious activity and (2) certain examinations of investment management firms in coordination with OCIE. REO’s work has instigated a number of targeted examinations, some of which have led to enforcement actions.³
- Dodd-Frank required the SEC to establish an Office of Investor Advocate in 2011 and SEC Chair Mary Jo White appointed the first Investor Advocate in February 2014. The Investor Advocate’s initial report on objectives for fiscal year 2015 focused on investment adviser examinations. The report identified that the SEC examined only nine percent of registered investment

advisers in fiscal year 2013 (which equates to a frequency of once every 11 years) and recommended that Congress provide additional resources to fund investment adviser examinations.⁴

- Dodd-Frank required the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers. The SEC Staff finalized this study in January 2011.⁵ The SEC report on the study reviews the SEC’s process for examinations and the impact on the SEC of the larger base of registered investment advisers, and makes certain recommendations for Congress to consider relating to exams such as increased funding or delegation of examination authority to self-regulatory organizations.

In the wake of these changes and the recent registration of a large number of investment managers of private funds, the SEC has launched a new exam program, the so-called “presence exam” program. This new program is designed to conduct risk-based exams of newly registered private fund investment advisers to promote engagement, assess risk and establish credibility among these advisers.⁶ The SEC is on track to examine 25 percent of the approximately 1,800 newly registered investment advisers by the end of 2014.⁷ In addition, the SEC established another exam initiative in 2014 to examine the 20 percent of investment advisers that have been registered with the SEC for three or more years, but have never been examined and conduct risk assessment and more focused reviews of these investment advisers.⁸

B. Developments Impacting NFA Exams

In 2012, the CFTC modified the CFTC registration exclusion and exemptions applicable to operation of registered funds and related controlled foreign corporations (CFCs) and private funds that trade in commodity interests to avoid registration with the CFTC as commodity pool operators (CPOs).⁹

As a result of these changes, beginning in 2013, many investment advisers to such registered funds, CFCs and private funds are required to register as CPOs and/or commodity trading advisors (CTAs) and are required to become members of the NFA. Subject to oversight by the CFTC, the NFA monitors CPO and CTA compliance with the commodities laws and rules through its exam program. The NFA views the examination as a collaborative process in which the NFA supports the CPO's or CTA's commitment to meet its regulatory obligations.¹⁰

The NFA has recently strengthened its exam program to accommodate the large number of new member CPOs and CTAs and to respond to recent scandals in the industry. For example, in 2013, the NFA commissioned an independent review of NFA's exam procedures in light of fraudulent activity at Peregrine Financial Group.¹¹ The report of the consulting firm conducting the review included a number of recommendations designed to improve the operations of NFA's examinations in the areas of "hiring, training, supervision, examination process, risk management, and continuing education."¹² As a result of the review, the NFA acted on a number of recommendations to strengthen its examination program, including taking the following actions:

- revising and strengthening its internal exam processes and exam planning;
- implementing staffing changes so that experienced managers and directors spend more time in the field for every exam;
- increasing its recruiting and hiring of more experienced examiners; and
- further improving its examiner training programs.

In addition, the CFTC has recently taken a number of steps to strengthen its oversight of the NFA exam program. In response to a mandate under Dodd-Frank, the CFTC established the Division of Swap Dealer and Intermediary Oversight (DSIO) to oversee CPOs and CTAs. DSIO employs highly

specialized auditors that perform a broad array of duties, including evaluating the NFA's methodologies and processes for monitoring CPO and CTA compliance with Commodity Exchange Act and CFTC regulations.¹³ The CFTC examines the NFA's performance of its exam program on a quarterly basis.

II. Overview of Exam Programs and Selection for Exam

A. SEC Exams

The Office of Investment Adviser/Investment Company Examinations of OCIE and the SEC's regional and district offices conduct examinations of investment advisers and registered funds. SEC exams are designed to: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform regulatory policy.¹⁴

SEC examiners conduct three types of exams. In a routine exam (including presence and never-before examined adviser exams), the examiners test investment advisers' compliance with applicable federal securities laws and regulations and ensure that investment advisers have proper compliance systems and procedures in place. The SEC conducts "cause exams" in response to tips or complaints about an investment adviser's conduct or otherwise becomes aware of a potential compliance concern. The SEC also conducts "sweep exams" of specific risk areas across a sample of investment advisers.

The SEC uses a risk-based approach to select investment advisers for routine exams. The SEC uses qualitative analysis to identify firms it deems "higher risk," such as those firms that present complex compliance issues, such as conflicts of interest, portfolio management, valuation, performance, advertising and asset verification issues. The SEC tends to examine the largest firms for which a compliance issue would affect a very large number of investors.¹⁵ The SEC also now uses algorithms to analyze available quantitative data to identify higher risk investment advisers.¹⁶

The SEC Staff also runs a routine on-site exam program specifically tailored to examining the largest mutual fund firms. Under this program, teams of two to four examiners work on-site with the investment adviser to settle compliance issues in lieu of the standard routine exam process.¹⁷ There is only very limited public information about the mutual fund exam program and the SEC has not made a practice of revealing what its Staff finds during these special on-site exams.¹⁸

In 2013 the SEC Staff conducted exams of 964 investment advisers and 99 investment company complexes.¹⁹

B. NFA Exams

As noted above, pursuant to CFTC-delegated authority, the NFA is the self-regulatory organization that administers the CFTC's registration regime and oversees the activities of registered CPOs and CTAs. The NFA's Compliance Department conducts audits and exams of NFA members. Like the SEC, the NFA also conducts both routine and for cause exams.

The NFA Staff has stated that the NFA also utilizes a risk-based approach to identify CPOs and CTAs for exam based on their advertising and promotional materials, financial statements, assets under management, use of leverage, customer complaints, and referrals from other agencies, among other factors.²⁰ The NFA Staff has stated that, generally, each registered CPO and CTA is subject to exam at least once every three to five years or more frequently if the registered CPO/CTA is identified by the NFA as higher risk under the NFA's risk-based audit selection process.²¹ The NFA Staff generally will examine such new registrants within one year of the CPO's registration (although this period has been longer in some cases).

The NFA does not examine exempt CPOs and CTAs. Registered CPOs and CTAs that maintained active registrations with the NFA, but were not subject to exam (due to a no-longer-available exemption or exclusion from registration), are likely to be treated as newly registered CPOs and examined

within one year of their new status taking effect or soon thereafter.

III. The Exam Process

A. SEC and NFA Initial Contact and Document Request List

The Staff of each of the SEC and NFA typically provide an investment manager that is designated as the subject of a routine on-site exam one to two weeks' advance notice of an upcoming exam by telephone. The Staff typically conducts a planning interview with the investment manager during the initial telephone call.

Prior to the on-site portion of an exam, the SEC or NFA Exam Staff generally will send a document and information request list so that the investment manager may gather requested books and records for the SEC's or NFA's review prior to the on-site portion of the exam. These request lists generally are based on form request lists and may be tailored to reflect the Staff's understanding of the investment manager's business and specialized compliance issues based on the Exam Staff's review of the investment manager's registration forms and reports submitted to the SEC or NFA (as applicable) and discussions on the initial call.

SEC and NFA document request lists typically ask for:

- general information on the investment manager and its business such as lists of officers and directors (of the manager and registered funds), principals and associated persons (for CPOs/CTAs), affiliates, fund investors and separate account clients, disclosure documents, customer complaints, and records of internal disciplinary actions;
- information regarding the investment manager's compliance program, risk management, and internal controls, such as compliance policies and procedures, documentation of internal risk analysis, and outside audit records;

- information to facilitate testing with respect to trading activities (for example, trade blotter, list of investments held, description of brokerage arrangements, future commission merchants, swap dealers and other trading counterparts and other persons with whom the investment manager does business); and
- information to perform testing for compliance in various other areas such as performance advertising and financial records.²²

More specific information may be required depending on the investment manager's client base and the specific types of financial products or instruments traded and lists of sub-advisers and service providers. Information requests also generally require investment managers to provide a detailed narrative discussion and other evidence of how the investment manager's compliance program operates in practice. The SEC Staff may also request documentation of proxy voting records, custodial information, proof of assets, and other information.

Providing complete and responsive documentation in response to the initial document request list is one of the first steps an investment manager can take to assure the SEC or NFA Staff that the investment manager has a solid compliance culture, is conducting business properly, and has nothing to hide.²³

As noted above, the SEC Staff also regularly conducts exams that are more limited in scope of certain newly registered investment advisers to private funds through the presence exams initiative. Once the initiative is complete, OCIE plans to report its observations to the public as guidance to registrants.²⁴ The reporting is meant to inform registrants of what they observed during the examinations and to help advisers make improvements to their compliance programs.

Both the SEC and NFA also may conduct surprise exams, in which case the Staff would conduct the planning interview and present the initial documents request list when the Staff first arrives at the investment manager's offices.

B. SEC and NFA On-Site Exam

After reviewing the initial documents provided by the investment manager, both the SEC and NFA Exam Staff will typically visit the investment manager's offices to carry out the next steps of the exam.

At the outset of the on-site portion, the Exam Staff conducts an initial interview with the investment manager's management and internal legal counsel during which the Staff will (1) describe the expected exam process, (2) review any questions the Staff may have based on the information that the investment manager provided, (3) inquire about the investment manager's business and organizational structure, and (4) request certain additional materials to help the Exam Staff define the scope of the exam. The Exam Staff may also request a tour of the investment manager's premises to provide the Staff with a general understanding of the investment manager's organization, flow of work and control environment. Some entities deliver presentations to the Staff during the initial interview explaining the investment manager's business, operational and compliance structure.

After the initial interview, the Exam Staff will conduct a detailed review of the investment manager's business and investment activities, and its corresponding records, compliance policies and procedures and other information. During this stage, the Exam Staff likely will ask follow-up questions, request additional documents and records, request meetings with certain of the investment manager's employees and request relevant information from service providers and other third parties.

The length of the on-site exam varies depending on such factors as the experience the SEC or NFA Exam Staff has had with the investment manager, the size and complexity of the investment manager's business and assets managed, the speed at which the investment manager is able to provide the Staff with requested documents and information and whether the Staff is satisfied that it has acquired a good understanding of the investment manager's operations and compliance procedures.

Typically, the Staff requests an exit interview with the exam subject's management at or shortly after the close of the on-site portion of an exam to discuss specific issues discovered during the exam, the status of the exam, any potential concerns the Staff may have and any additional information the investment manager would like to provide.

After the on-site portion of the exam, the SEC or NFA Exam Staff will review and analyze the information the investment manager and other relevant parties have provided. The Exam Staff may consult with other SEC divisions or the Staff of the NFA Compliance Department or CFTC, as applicable, for guidance on particular issues. In the course of its analysis, the Exam Staff will examine whether: the investment manager's books and records are properly maintained; the investment manager has implemented and enforced compliance procedures that effectively address relevant compliance risks; and the investment manager's business is compliant with applicable law and rules. The Staff will likely pay particular attention to the current focus areas described below.

C. Sweep Exams

In a sweep exam, the SEC Staff does not always conduct on-site inspections and may instead review the investment manager's response and subsequently may engage in a series of correspondence or telephone calls with the investment manager to discuss the information provided in response to the sweep exam document and information request.

The SEC Exam Staff has recently also requested meetings with registered fund board members in the context of various sweep exams. The SEC Staff has stated that it is requesting these meetings to discuss certain topics of interest to the Staff and also apparently to assess the funds' corporate governance structure.²⁵ Prior to any such meeting, the investment manager should inquire as to the subjects that the SEC Staff wishes to discuss and ensure that the Staff is slated to discuss the issues with the appropriate board members. In addition, counsel to the

independent board members should refresh the relevant board members on the board materials from the last few years relevant to the subject matter being considered by the SEC Staff.

D. Closing the Exam

SEC Exam Close-Out. Once the SEC Staff is satisfied with its analysis, normally within 180 days after the conclusion of the on-site exam, it will typically: (1) close the exam without further action and issue the adviser a letter indicating that no deficiencies were identified; (2) issue an examination findings letter to the adviser describing certain deficiencies and requesting that the investment manager take 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 an examination findings letter and recommend enforcement proceedings.

The SEC Staff traditionally has considered the following non-exclusive factors in deciding whether to refer a matter to the Division of Enforcement:

- whether it appears that fraud has occurred;
- whether investors were harmed;
- if there was not fraud, whether the misconduct was serious, ongoing, repetitive, systemic, or severe;
- whether the investment manager alerted the SEC and took meaningful corrective action to address the misconduct prior to or during the exam;
- whether the matter is one traditionally addressed by the SEC, as opposed to another agency (for example, the CFTC or the Department of Labor if the violation involves ERISA plan assets);
- whether an activity noted is a particular area of SEC focus;
- whether an actor profited from any prohibited actions;
- whether the prohibited actions appear to have been intentional;

- whether the conduct appeared recidivist in nature; and
- whether the investment manager's supervisory procedures were inadequate.²⁶

In practice, the SEC Staff concludes most exams with an examination findings letter.²⁷ After the SEC Staff issues an examination findings letter, the investment manager is typically required to respond, in writing, to the SEC Staff outlining any corrective actions identified by the SEC Staff within 30 days. Such a response should reproduce or summarize the SEC Staff's comments, provide explanations about the investment manager's practices, and detail any steps the investment manager has taken or will take in response to the noted deficiencies.

It is important that the investment manager responds carefully and promptly to violations noted in the examination findings letter. In addition, the investment manager should implement remedial measures quickly and be prepared for the SEC to revisit and test whether these problem areas have been fixed. The SEC Staff will often return to the offices of the investment manager to verify that the significant issues have been corrected.

NFA Exam Close-Out. After the NFA Staff completes an exam of an investment manager, if there are no deficiencies identified that warrant corrective action, the NFA Staff will request a letter from the investment manager containing representations (among other things) that:

- the investment manager has responded fully to all inquiries by the NFA Staff during the exam and made available to the NFA Staff all information and documentation requested;
- the investment manager has not received any communications from other regulatory agencies concerning non-compliance or deficiencies regarding the CPO's/CTA's compliance program; and
- if applicable, the investment manager has taken necessary corrective actions (as discussed with

the NFA Staff) to resolve any deficiencies identified during the exam.

The NFA Staff is often willing to modify these representation letters as needed, and it is important for the investment manager to work with the NFA Staff to ensure that all representations are accurate and true.

If the NFA Staff determines that the investment manager is not violating NFA rules and has addressed any concerns, the NFA Staff then generally will issue a written report to the CPO/CTA restating the findings of the NFA Staff and closing the exam.

In the event that the NFA Staff determines that the investment manager is violating NFA rules, the NFA Compliance Department will submit a written report to the NFA's Business Conduct Committee (BCC) regarding the results and any potential violations of NFA rules.²⁸ The BCC will then assess whether a violation has occurred that warrants enforcement action. In some cases, such as when serious wrongdoing is detected, NFA Staff will refer the matter to the CFTC and work with the CFTC (and possibly other federal agencies where there is criminal conduct), in bringing an enforcement action.

IV. Areas of Focus During Exams

The scope of an SEC or NFA exam may be extremely broad and may cover numerous topics. This section provides an overview of certain current SEC and NFA Staff focus areas and other areas of current or perennial interest that investment managers should consider in evaluating whether they are prepared for a routine or sweep exam.

A. SEC Exam Focus Areas

The OCIE Staff typically announces its examination priorities for the coming year in a guidance update to registered investment advisers. In January 2014 the OCIE Staff announced that it was concentrating on the following areas, among others:

- *Fraud detection and prevention*, using quantitative and qualitative tools and techniques to

- seek to identify investment advisers engaged in fraudulent or unethical behavior;
- *Corporate governance, conflicts of interest, and enterprise risk management*, including discussions with senior management and boards of mutual funds;
 - *Technology*, examining governance and supervision of information technology systems, operational capability, market access, information security, and preparedness to respond to sudden malfunctions and system outages;
 - *Dually registered investment advisers and broker-dealers*;
 - *Compliance with recently-adopted laws and rules*;
 - *Retirement vehicles and rollovers*;
 - *Compliance with Rule 206(4)-2 under the Advisers Act*, the rule relating to safety and custody of clients' assets;
 - *Conflicts of interest inherent in certain investment adviser business models*, with a focus on compensation arrangements, allocation of investment opportunities, controls and disclosure associated with side-by-side management of performance-based and asset-based fee accounts (for example, concurrent management of hedge funds and mutual funds) and higher risk products or strategies targeted to retail investors;
 - *Marketing and performance*, reviewing and testing hypothetical and back-tested performance, disclosure of composite performance figures, performance record keeping, and compliance oversight of marketing, in addition to marketing efforts newly permitted under the Jumpstart Our Business Startups (JOBS) Act;
 - *Never-before examined advisers*;
 - *Wrap fee programs*;
 - *Quantitative trading models*;
 - *Presence exams*;
 - *Payment for distribution in guise* (recent sweep exam topic);
 - *Fixed income funds* (recent sweep exam topic), focusing on risks associated with a changing

interest rate environment and related disclosures to fixed income fund investors;

- *Money market funds* (recent sweep exam topic), monitoring the management of stress events and funds showing outlier behavior;
- *Alternative mutual funds* (recent sweep exam topic), focusing on (1) leverage, liquidity and valuation policies and practices, (2) the staffing, funding and empowerment of boards, compliance personnel and back-offices and (3) marketing to investors; and
- *Securities lending arrangements* (recent sweep exam topic).²⁹

As noted above, the OCIE Staff has initiated broad sweep exams of investment advisers and the registered funds they manage in 2014, focusing on certain previously-announced topics of OCIE Staff focus. Recent sweep exam topics are highlighted as “recent sweep exam topics” in the above list.

B. NFA Exam Focus Areas

Generally, the scope of an NFA examination can be very broad. Based on our experience, the NFA Staff typically will focus on, among other things, compliance with:

- *NFA Bylaw 1101*, which prohibits NFA members from doing business with most non-members that are required to be registered with the CFTC as a CPO/CTA.³⁰ Under CFTC guidance, CPOs to registered funds must review and keep records of the status of brokers, counterparties and sub-advisers to the registered funds they advise to comply with Bylaw 1101.³¹
- The CFTC “*harmonization rules*” with respect to registered funds implicating CPO/CTA registration for purposes of disclosure, reporting and recordkeeping.
- The requirement that any CPO/CTA’s *principals, associated persons, branch offices and relevant affiliates must be properly registered or listed* as such with the NFA.

- The requirement that CPOs/CTAs conduct an *annual review of their business operations and policies and procedures* to ensure they are in compliance with a number of CFTC and NFA rules and regulations through completing a questionnaire published by the NFA.³²
- Compliance with the CPO/CTA's *compliance policies and procedures* required under applicable CFTC and NFA rules (for example, disaster recovery plan, privacy policy and ethics training policy) and internal distribution of these documents, and with any other commodity-related compliance policies and procedures.

C. Additional and More Detail on Focus Areas

Following is a more detailed discussion of certain topics investment managers should consider in assessing their compliance programs generally.

- **Alternative Mutual Funds.** In August 2014 the SEC began a sweep exam that reviewed alternative mutual funds. These types of registered funds typically are managed utilizing the same or a similar alternative strategy as used for comparable private funds, such as nontraditional bond funds, long/short equity funds, multi-alternative funds and market-neutral funds. In connection with the launch of the sweep exam, OCIE Staff stated that the Exam Staff would initially review around 30 firms by April 2015 and may cover more firms thereafter, if deemed necessary. It has been reported that, in addition to covering established mutual fund companies, the sweep covered a number of investment advisers that until recently had not offered mutual funds as part of their lineup, and that the OCIE Staff members have delivered request letters asking to speak with members of the boards of certain mutual funds.

It is our understanding that the OCIE Staff has requested information relating to sub-advisers and the funds' board governance structures and oversight processes. The SEC Staff is also reviewing sub-adviser compliance policies

and procedures, with a focus on cover of senior securities and derivatives investment monitoring and risk management (in addition to the previously-announced focus areas noted above). In addition, the SEC Staff has requested that funds provide the Staff copies of all trade documentation, including ISDA agreements and trade confirmations.

- **Marketing and Performance Claims.** The SEC Staff has stated that marketing and performance advertising is an inherently high-risk area "due to the highly competitive nature of the investment management industry."³³ The Staff will review "the accuracy and completeness of advisers' claims about their investment objectives and performance."³⁴ The Staff will "review and test hypothetical and back-tested performance, the use and disclosure of composite performance figures, performance record keeping, and compliance oversight in marketing."³⁵ As noted above, the Staff will also review marketing efforts in connection with the newly effective rules under the JOBS Act.³⁶ The SEC Staff has stated that an adviser should have procedures in place to ensure that all published performance information is accurate.

NFA Compliance Rule 2-29 and related NFA interpretations subject promotional materials to general anti-fraud requirements. CPO/CTA promotional materials, including sales materials and other advertisements are similarly a high risk area that the NFA Staff scrutinizes carefully because of the strong incentive for market participants to exaggerate or mischaracterize their performance figures in order to promote their business.

- **Valuation of Client and Fund Assets.** The 1940 Act 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 to valuation to comply with Rule 38a-1 under the 1940 Act. During exams, the SEC Staff often reviews investment managers' controls on securities valuations, focusing on

whether the adviser has appropriate controls in place and whether it implements them in pricing structured products, illiquid securities, and difficult-to-price securities.³⁷ The NFA Staff as well has indicated that valuation is a key focus area during examinations.

In the mutual fund context, valuation policies and procedures are viewed as increasingly important and sensitive after the enforcement actions brought against the boards of directors of funds sponsored by Morgan Keegan Asset Management and Northern Lights Compliance Services.³⁸

- **Conflicts of Interest in Certain Investment Adviser Business Models.** As noted above, the OCIE Staff identified in 2014 that conflicts of interest in certain investment adviser business models will be a key area of focus going forward.³⁹ The SEC conducts examinations focused on conflicts of interest in the business model such as: (1) compensation arrangements for the adviser, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients; (2) the allocation of investment opportunities; (3) controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts; (4) risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies; and (5) higher risk products and strategies targeted to retail (particularly retired and elderly) investors.⁴⁰ Investment advisers must be cognizant of the areas of their business in which conflicts of interest may arise and should create policies and procedures designed to mitigate or eliminate the harm such conflicts may cause to their clients.
- **Social Media.** During a recent sweep exam, OCIE Staff requested all documents sufficient to identify a particular adviser's involvement with or usage of social media websites, including Facebook, LinkedIn and others. They also requested any communications made through a

social media utility and all of the adviser's policies and procedures on social media use. The SEC Staff has described social media as converting "the traditional two-party, adviser-to-client communication into an interactive, multi-party dialogue among advisers, clients, and prospects, within an open architecture accessible to third-party observers."⁴¹ Under Advisers Act Rule 206(4)-7, firms who take advantage of social media "should adopt, and periodically review the effectiveness of, policies and procedures regarding social media in the face of rapidly changing technology."⁴²

In 2010, the NFA took a number of steps to address the issue of CPO/CTA use of social networking by amending Compliance Rule 2-29(h) and providing an interpretive notice on the topic.⁴³ These changes were designed to ensure CPOs/CTAs have policies and procedures in place designed to mitigate the risk associated with employees making unauthorized or misleading communications to potential customers through social media that could be construed as advertisements.

A firm's use of social media must comply with the federal securities and commodities laws and regulations, including provisions on antifraud, compliance and recordkeeping, among others. In order to mitigate risk in this area, firms should have in place policies and procedures designed to monitor the types of things that are communicated to clients, prospective clients and others through social media. Usage guidelines may be appropriate as a means to inform employees of the types of communications that are acceptable to make through social media utilities. Firms should maintain content standards for such communications and may even want to consider pre-approval requirements.

- **Compliance and Supervision.** In light of the London Whale trading scandal, the SEC Staff issued a risk alert describing the steps that should be taken to ensure the risk of unauthorized

trading is mitigated to the greatest degree possible.⁴⁴ The SEC Staff suggested that firms consider “actively engaging such control functions as operational risk, audit, legal and compliance to work closely with management in performing an independent identification of risks and practices that could permit unauthorized trading.” In addition, the SEC Staff suggested reviewing and testing internal controls on a regular basis and assessing their adequacy in light of changing business and market conditions.

- ***Business Continuity Plans.*** The SEC Staff has stated that 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.⁴⁵ The NFA, under Rule 2-38, similarly requires a registered CPO/CTA to adopt and maintain a disaster recovery plan reasonably designed to enable a CPO/CTA to continue operations in the event of a disaster.

This requirement has been given renewed attention after Hurricane Sandy caused significant and wide-ranging damage across the northeast coast in 2012, shutting down equities and options markets.⁴⁶ The storm prompted the SEC’s Exam Staff to review the business continuity plans of around 40 investment advisers in areas the storm impacted, assessing their compliance with applicable laws, rules and regulations relating to business continuity plans.

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.⁴⁷

V. Being Prepared for the Exam

A. Compliance Program

Maintaining compliance policies and procedures that accurately reflect the investment manager’s business and operations and are responsive to SEC, CFTC and NFA requirements (as applicable) is the most significant part of being prepared for an exam.

- SEC Rule 206(4)-7 under the Advisers Act requires any investment adviser that is, or is required to be, registered with the SEC to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder and to designate a chief compliance officer (CCO) to administer the compliance program. An investment adviser must also review its adequacy and effectiveness on an annual basis.
- Rule 38a-1 under the 1940 Act requires registered funds to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by the investment adviser (among other service providers). Registered funds also must appoint a CCO and conduct annual reviews of the funds’ and advisers’ policies and procedures.
- Certain CFTC and NFA requirements require a CPO or CTA to maintain certain compliance policies and procedures. Registered CPOs and CTAs typically adopt CFTC/NFA compliance policies and procedures designed to address applicable CFTC and NFA rules.

In addition, an investment manager’s compliance program should effectively take into consideration the characteristics of the adviser’s business, proactively addressing potential risk areas.

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.⁴⁸ 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, investment managers 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.”⁴⁹ The NFA likewise often issues notices relating to changes in rules and policies and current issues.

B. Recordkeeping

Investment managers should place particular emphasis on maintaining required books and records for purposes of SEC and NFA exams.⁵⁰ Those records must be made available to the SEC or NFA Staff during an exam, and the Staff generally will request copies of, or access to, books and records during an exam. Among other things, Staff members 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 investment manager’s books and records may be found deficient if its books and records are incomplete, inaccurate, or otherwise inadequate, inaccessible, or not maintained or preserved as required. The SEC and NFA 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 investment manager in the course of an exam and that this outreach has assisted the SEC Staff in exposing recent frauds.

C. Role of CCO

An investment manager must ensure that its CCO is effective.⁵¹ The CCO should be knowledgeable regarding the securities and commodities laws

and rules (as applicable) and sufficiently empowered within the investment manager’s organization to enforce compliance with those laws and rules.⁵² The CCO must be a supervised person of the investment manager, but should have a sufficient degree of independence from the investment manager’s management and sufficient standing within the investment manager’s organization to identify and prevent conflicts of interest – a central focus of the CCO’s role. Also, the investment manager’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 investment manager’s staff should be trained to bring any potential compliance issues to the attention of the CCO.

D. Mock Audits

Investment managers should consider implementing internal periodic audits and/or engage compliance service providers to conduct mock SEC/NFA exams to monitor compliance with compliance policies and procedures and applicable law and rules. Among other things, this review process should allow the investment manager to amend its procedures in response to new legal, regulatory, and business developments.

CPOs and CTAs are also required to conduct an annual “self-examination” by the NFA, which is vital to being prepared for an NFA exam. In addition, the NFA allows new members to request an educational examination, in which the NFA will review the CPO/CTA’s procedures, registration of personnel, promotional materials, account statements, customer recordkeeping, and disclosure documents (among other things).

E. Prior Exam Results and Current Regulatory Guidance

Investment managers should continuously seek to anticipate the questions that the SEC or NFA Staff is likely to raise during an exam. If the investment manager has been subject to an exam in the past, it should review its records of prior exams to

anticipate questions and incorporate modifications to its compliance procedures accordingly during its periodic review of its compliance program, as recidivism is of special concern to the SEC and NFA Staff. Similarly, investment managers should consider SEC, CFTC and NFA and their Staffs' interpretive, no-action and other guidance and settled enforcement actions in ensuring that their compliance and investment processes comply with applicable law and relevant disclosures.⁵³

VI. Managing the Exam Process

Exam Coordinator. When the exam starts, the investment manager should make all reasonable attempts to cooperate with the SEC or NFA Staff. To that end, the investment manager should designate a senior officer within the legal or compliance department who is knowledgeable about its business, operations, and compliance program to serve as an exam coordinator and will be the Staff's point of contact during the exam.⁵⁴ The investment manager should request that the 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 investment manager personnel.

Involvement of Outside Counsel. The investment manager should consult with counsel who is familiar with the exam process and able to provide detailed guidance on how to deal with the legal aspects of the exam as soon as the investment manager receives the initial request for information or becomes aware of the exam. Depending on the circumstances, counsel may need to review information before it is produced to the SEC or NFA Staff and review e-mails and other communications for privilege before those materials are provided to the SEC or NFA Staff. The exam coordinator should also contact the investment manager outside auditor (and/or the outside auditor for any pooled vehicles advised by the investment manager), as accounting issues frequently arise in exams. Finally, the investment manager should inform its personnel about the

on-site portion of the exam and notify them that the exam coordinator will coordinate the responses to the SEC or NFA Staff.

Timely Production and Separate Workspace. The exam coordinator should produce requested information quickly. The exam coordinator should facilitate the Exam Staff visit by making proper arrangements for workspace, an adequate means of communication, and a power source. To avoid unnecessary disruption to the investment manager's day-to-day operations, the workspace should be separated from the investment manager's general workspace.

Information to Produce. The exam coordinator should produce for the SEC or NFA Staff all information that is responsive to its request unless that information is privileged, but should not produce non-responsive documents. The exam coordinator should maintain a log of documents reviewed by and produced to the Exam Staff. If certain of the investment manager's records are electronic, the exam coordinator may arrange for the Exam Staff to have controlled access to relevant sections of the investment manager's systems or provide relevant information in a searchable format, if requested by the Staff.

Impact of Production on Privilege. Certain materials that the SEC or NFA Staff requests may be protected by the attorney-client privilege. Disclosure of privileged information to the Staff likely may result in the loss of the attorney-client privilege. However, resisting Staff requests for information may raise concerns. As a result, whether to disclose such documents is a case-by-case business decision that an investment manager should make with its counsel. In some cases, it may be helpful to disclose redacted versions of certain documents which are responsive to requests so that certain privileged information contained within the document can be hidden, while still providing the SEC or NFA with information the Exam Staff may be seeking. If the exam coordinator identifies that certain requested information is privileged and should be withheld, he or she should request a meeting with the Exam Staff

to explain the reasons for withholding the privileged information.

FOIA Confidential Treatment Requests. The investment manager should also protect the commercial and financial information that it provides during SEC or NFA exams from disclosure to the public under the Freedom of Information Act (FOIA). The SEC and CFTC (with respect to materials provided to the NFA or CFTC) have implemented procedures with regard to FOIA requests for confidential treatment.

Conclusion

SEC and NFA examinations of investment managers are significant and often unpredictable, and the Staffs have the authority to inquire about almost any aspect of an investment manager's business. Exams can lead to enforcement or disciplinary action if the investment manager is not adequately prepared for an examination or does not have a sufficient compliance program in place.

Accordingly, investment managers must be familiar with the exam process and have in place strong compliance programs and internal control procedures to ensure compliance with relevant laws, rules and regulatory guidance. Investment managers 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 investment manager will escape serious deficiencies or enforcement action as a result of an examination.

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NOTES

- ¹ Mary Jo White, Chairman, SEC, Speech to the Council of Institutional Investors, Deploying the Full Enforcement Arsenal (Sept. 26, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.UksV_dLkvnH (last visited Oct. 13, 2014).
- ² Mary Jo White, Chairman, SEC, Testimony on SEC Budget (May. 7, 2013), available at <http://www.sec.gov/News/Testimony/Detail/Testimony/1365171516034> (last visited Oct. 13, 2014).
- ³ The SEC is increasingly using data analysis as a basis for allocating their examination resources to uncover illegal conduct. For example, in November 2013, OCIE examined Ambassador Capital Management after REO informed OCIE that it has identified the performance of Ambassador Money Market Fund as being consistently different from the rest of the market. REO's work triggered a targeted, "cause" examination that ultimately uncovered fraudulent conduct on the part of the adviser, which led to an enforcement action. "SEC Announces Fraud Charges Against Detroit-Based Money Market Fund Manager," SEC Press Release (July 11, 2011), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540414950> (last visited Oct. 13, 2014).
- ⁴ See SEC Office of the Investor Advocate, "Report on Objectives Fiscal Year 2015" (June 30, 2014), available at <http://www.sec.gov/investorad#.VD0mnRaGc0g> (last visited Oct. 13, 2014).
- ⁵ See Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011), available at <http://sec.gov/news/studies/2011/914studyfinal.pdf> (last visited Oct. 13, 2014) (2011 IA Exam Study) (Staff study required by section 914 of Dodd-Frank, which directed the SEC to review and analyze the need for enhanced examination and enforcement resources relating to investment advisers).
- ⁶ See SEC OCIE, Letter to Senior Executives or Principals of Newly Registered Investment Advisers, Oct. 9, 2012, available at www.sec.gov/about/offices/ocie/letter-presence-exams.pdf (last visited Oct. 13, 2014).

- ⁷ See Mary Jo White, Chairman, SEC, “Oversight of the SEC’s Agenda, Operations and FY 2015 Budget Request”, testimony before the Committee on Financial Services, United States House of Representatives, (Apr. 29, 2014), available at <http://www.sec.gov/News/Testimony/Detail/Testimony/1370541674457#.VDrO6haGc0g> (last visited Oct. 13, 2014) (*Mary Jo White 2014 Testimony*).
- ⁸ SEC OCIE, Letter to Never-Before Examined Investment Advisers, Feb. 20, 2014, available at <http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf> (last visited Oct. 13, 2014).
- ⁹ Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 FR 11252 (Feb. 24, 2012) (amending CFTC Reg. 4.5 (registered funds) and rescinding CFTC Reg. 4.13(a) (4) (CFCs and private funds)).
- ¹⁰ Matt Pendell and Lauren Golm, NFA Compliance Department, “Preparing for an NFA Audit,” audio podcast (June 29, 2009), (*NFA Podcast*), available at <http://www.nfa.futures.org/NFA-compliance/NFA-education-training/NFA-podcasts/preparing-for-an-NFA-audit.HTML> (last visited Oct. 13, 2014).
- ¹¹ Daniel J. Roth, President and CEO, NFA, Testimony Before the Committee on Agriculture of the U.S. House of Representatives (Oct. 2, 2013), available at <http://www.nfa.futures.org/news/newsTestimony.asp?ArticleID=4311> (last visited Oct. 13, 2014). Peregrine is a futures commission merchant, but the review covered all categories of NFA members.
- ¹² *Id.*
- ¹³ CFTC Fiscal Year 2014 President’s Budget And Performance Plan, Divisions, Swap Dealer and Intermediary Oversight, available at <http://www.cftc.gov/reports/presbudget/2014/2014presidentsbudget020309.html> (last visited Oct. 13, 2014); Gary Gensler, Chairman, CFTC, Testimony on Before the U.S. Senate Committee on Agriculture (Aug. 1, 2012), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-120> (last visited Oct. 13, 2014).
- ¹⁴ *2011 IA Exam Study*.
- ¹⁵ The SEC deems the 20 largest advisers by assets under management to pose a high risk for systemic reasons. See Government Accountability Office, Report to Congressional Requesters, SEC: Steps Being Taken to Make Examination Program More Risk-Based and Transparent 12 (Aug. 2007) (*GAO Report*); see also 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) (*Top 10 Speech*), available at <http://www.sec.gov/news/speech/2008/spch032008lar.htm> (last visited Oct. 13, 2014).
- ¹⁶ Elisse B. Walter, Speech to the NASAA Public Policy Conference, Examining Investment Advisers: The Challenge Continues (Apr. 16, 2013), available at <https://www.sec.gov/News/Speech/Detail/Speech/1365171515276> (last visited Oct. 13, 2014).
- ¹⁷ GAO Report, at 10.
- ¹⁸ See “Big Firms Work with SEC in New Oversight Program,” *Fund Action* (April 2, 2008).
- ¹⁹ See Mary Jo White 2014 Testimony.
- ²⁰ See, e.g., NFA Compliance Department, Session 6: NFA Audits, slide deck prepared for September 27, 2012 New York NFA CPO Workshop, available at <http://www.nfa.futures.org/nfa-compliance/NFA-education-training/NFA-member-workshops/CPO-exempt/materials.HTML> (last visited Oct. 13, 2013); and NFA Compliance Rule 3-1.
- ²¹ See *id.*
- ²² OCIE and the NFA have published sample document request lists. See SEC OCIE, “Investment Adviser Examinations: Core Initial Request for Information” (Nov. 2008), available at <http://www.sec.gov/info/ccol/requestlistcore1108.htm> (last visited Oct. 13, 2014); and NFA Compliance Department, CPO/CTA Regulatory Seminar Materials (Mar. 2, 2010), available at http://www.nfa.futures.org/nfa-compliance/NFA-education-training/NFA-member-workshops/doc_req_list.pdf (last visited Oct. 13, 2014).
- ²³ For example, the NFA Staff has publicly stated that appropriate information allows the NFA Staff to gain a comfort level with the CPO’s compliance, reduces follow-up document requests, and makes the on-site

- portion of the exam as efficient as possible. *See NFA Podcast.*
- ²⁴ *See* Norm Champ, Director, Division of Investment Management, SEC Remarks the Practicing Law Institute, Hedge Fund Management Seminar 2014 (Sept. 11, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370542916156#.VDraTBaGc0g> (last visited Oct. 13, 2014).
- ²⁵ *See* SEC OCIE, Examination Priorities for 2014 (January 9, 2014) (2014 Exam Priorities), available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf> (last visited Oct. 13, 2014).
- ²⁶ 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) (*FAQs Speech*), available at <http://www.sec.gov/news/speech/2008/spch011708lar.htm> (last visited Oct. 13, 2014).
- ²⁷ 2011 IA Exam Study.
- ²⁸ *See* NFA Compliance Rules 3-2 and 3-3 and NFA Bylaws 704.
- ²⁹ *See* 2014 Exam Priorities.
- ³⁰ *See* NFA Bylaw 1101, Doing Business with Non-Members.
- ³¹ *See* “Guidance on Obligations Under NFA Bylaw 1101 for Commodity Pool Operator Members Advising Pools that are Registered Investment Companies,” NFA Notice to Members I-12-34 (Dec. 19, 2012).
- ³² *See* NFA Self-Examination Questionnaire, available at <http://www.nfa.futures.org/nfa-compliance/publication-library/self-exam-questionnaire.HTML> (last visited Oct. 13, 2014). After the questionnaire is complete, an employee with supervisory experience must sign and date a written attestation stating they have reviewed the organization’s operations in connection with the matters covered by the questionnaire.
- ³³ SEC OCIE, Examination Priorities for 2013 (2013 Exam Priorities), available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf> (last visited Oct. 13, 2014).
- ³⁴ 2014 Exam Priorities.
- ³⁵ *Id.*
- ³⁶ *Id.*
- ³⁷ *See* FAQs Speech; and Top 10 Speech.
- ³⁸ *See In the Matter of Morgan Asset Management, Inc., et al.*, Rel. No. 34-64720 (June 22, 2011); *In the Matter of Northern Lights Compliance Services LLC, et al.*, Rel. No. IC-30502 (May 2, 2013).
- ³⁹ 2014 Exam Priorities.
- ⁴⁰ *Id.*
- ⁴¹ SEC, Risk Alert (January 2012).
- ⁴² *Id.* It is important to note that third party postings through social media may be considered a testimonial for purposes of Rule 206(4)-1(a)(1). While it depends on the facts and circumstances surrounding the post, the SEC “believes that ... the use of ‘social plug-ins’ such as the ‘like’ button could be a testimonial under the Advisers Act,” given the right set of facts. According to the SEC, if members of the public are invited to “like” an advisers biography posted through social media, for example, that “like” could constitute a type of testimonial prohibited by rule 206(4)-1(a)(1). Under the recordkeeping requirements of the Advisers Act, a firm must keep records of social media communications “if they contain information that satisfies an investment adviser’s recordkeeping obligations under the Advisers Act.” *Id.*; Rule 204-2 under the Advisers Act.
- ⁴³ NFA Newsletter, “NFA addresses the issue of Member use of online social networking with rule amendment and interpretive notice” (2010), available at <https://www.nfa.futures.org/news/member-newsletter-2010/newsletterWinter2010.HTML#Rule2-29> (last visited Oct. 13, 2014).
- ⁴⁴ SEC, Risk Alert (February 2012).
- ⁴⁵ *See* Adv. Act Rel. No. 2204 (2003).
- ⁴⁶ SEC Risk Alert (August 2013).
- ⁴⁷ SEC, Compliance Alert (June 2007).
- ⁴⁸ More information on the CCO Outreach Program is available at http://www.sec.gov/info/compliance/outreach_ia-funds.htm (last visited Oct. 13, 2014).
- ⁴⁹ *See* FAQs Speech.

- ⁵⁰ 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. NFA Rule 2-10 requires each NFA member to maintain adequate books and records necessary and appropriate to conduct its business including records required under CFTC Regulations 1.18, 1.32–1.37, 1.68, and 1.71 for not less than five years and for the first two years in a readily accessible place pursuant to CFTC Regulation 1.31. Time, place, and manner requirements may vary depending on the nature of the record.
- ⁵¹ The SEC Staff has highlighted certain qualities that advisers should consider when evaluating whether a CCO and its compliance staff are effective. 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 (last visited Oct. 13, 2014).
- ⁵² See e.g., Compliance Programs of Investment Companies and Investment Advisers, Adv. Act Rel. No. 2204 (2003).
- ⁵³ 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).
- ⁵⁴ Ideally, the CCO would fill this role.

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