HIGHLIGHTS OF A WEB SEMINAR FOR SEI CLIENTS

An SEC Exam Primer: Steps Toward Improving the Outcome

If you are a registered mutual fund adviser, there is sure to be an SEC examination in your future. But with all the changes that have occurred in the SEC's regulations, exam methodologies and priorities, it's hard to know what to expect or where the pitfalls might lie. At a recent SEI Web seminar, compliance experts offered their latest intelligence and updated advice concerning the examination process.

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How concerned should you be?
An SEC exam is unquestionably a crucial matter that demands ample advance thought and preparation. A lack of readiness could well lead to a more extensive and drawn-out SEC investigation entailing an even greater time commitment and business disruption. It might be interpreted by the SEC as a failure to take compliance mandates seriously. It can also pose troubling reputation risks.

These days, anyone seeking an adviser, sub-adviser, or service provider will want unshakable assurance that candidates are in good regulatory standing, and few will take your word for it. The recent Capital Works Investment Partners enforcement matter (http://www.sec.gov/litigation/admin/2006/ia-2520.pdf), only reinforces the growing trend of current and prospective clients to insist on seeing copies of all SEC correspondence as part of the adviser due diligence process. Thus, if a failure to prepare adequately for an SEC exam results in a long deficiency letter detailing a litany of compliance issues, you've got a major perception problem—one that could undermine your reputation for compliance with current and prospective clients.

The SEI Knowledge Partnership is an ongoing source of action-oriented business intelligence and guidance for SEI’s investment manager clients. It helps clients understand the issues that will shape future business conditions, keep abreast of changing best practices, and develop more competitive business strategies.

The Partnership is an initiative of SEI’s Investment Manager Services unit, which delivers operating solutions including fund accounting and administration, hedge fund services, and separate account services.
If you are a registered hedge fund adviser, your situation is different because of the recent successful court challenge to the hedge fund adviser registration rule adopted by the SEC in late 2004 and which became effective in February 2006. As of this writing, the dust hasn’t settled. There are, however, business advantages to being registered, as evidenced by the sizable minority of hedge fund advisers who voluntarily registered even before the SEC rule was adopted. Therefore, many hedge fund advisers likely will choose to remain registered. For registered hedge fund managers, the recommendations below will continue to apply.

What types of SEC exams are you likely to face?
Registered investment advisers are subject to three different types of SEC exams:

The “routine” exam, which simply means your number has come up. In a routine exam, the SEC notifies you by letter or telephone, saying something like, “Good news. We’ll be there in two weeks. We’ll fax you a list of the documents we’d like to see and the questions we’d like answered, and be sure to have it all ready for us when we arrive.”

The “for cause” exam, which means the SEC has become aware of a specific issue or concern regarding your firm and wants to respond with an inspection, which may cover other issues at the same time. For-cause exams can be triggered by various occurrences, including investor or client complaints to the SEC or media reports mentioning your firm.

The “sweep” exam, whereby the SEC conducts an investigation of a particular set of business practices across numerous firms or funds. Sweep exams sound innocuous, but can be quite burdensome. Furthermore, they are more likely than routine exams to result in a serious deficiency or even an enforcement action. That is because sweep exams are usually spurred when a particular business practice of concern has come to the attention of the SEC.

“In a sweep exam, you can’t take any comfort in the idea that you’re simply one of the herd, because enforcement action is more likely to result than with routine exams.”
-SEI Knowledge Partnership

Sweep exams became quite common over the last several years, in part because they could be initiated by any SEC regional office without coordination with SEC headquarters in Washington. More recently, the pace has slowed, and it seems SEC regional offices no longer have quite as much autonomy to initiate sweep exams. This development may be an indication of a more moderate regulatory landscape under the new SEC chairman.

The takeaway messages are clear in any case. First, in a sweep exam, you can’t take any comfort in the idea that you’re one of many advisers who received essentially the same inspection request, because enforcement action is more likely to result from a sweep exam than a routine exam. Secondly, don’t underestimate the burden of responding to any examination request, including a sweep exam.

How does the SEC determine who will be examined?
Despite the ongoing debate over whether the SEC has “adequate” resources to examine registrants, one thing is clear: demands on the SEC’s inspection resources are increasing. This trend has pushed the SEC to reconsider its methods of identifying which firms will be inspected and with what frequency. Rather than continuing to rely on a combination of random selection and cyclical scheduling, approximately a year ago the SEC began using what it calls a “risk-based approach.”

“SEC staff will not disclose their specific risk criteria...so, figuratively speaking, you may have a flashing red sign that says ‘inspect me’ outside your offices—only you won’t know it.”
-Tim Levin, Morgan Lewis

Based on various public statements by the SEC staff, it appears that, starting with the entire registrant population, the SEC categorizes firms based on information culled from
each firm’s Form ADV. Key criteria considered by the SEC include the disciplinary history of a firm and its principals, assets under management, client base and products sponsored (with alternative investment funds being considered more risky than other products). While advisers are selected for examination from each category, those within categories deemed higher-risk are likely to be examined more frequently. Thus, if you are in a low-risk category, you will still be inspected occasionally, though probably not as frequently as firms with a higher-risk profile.

It’s important to note that the SEC staff has indicated it will not disclose specific risk criteria, or inform firms of their risk ratings. So, figuratively speaking, you may have a flashing red sign that says “inspect me” outside your offices—only you won’t know it.

**What are the best ways to prepare?**

Here are our six key recommendations:

1. **Make sure your compliance program and its implementation are up to par.**

Exam preparation starts long before you receive the request letter. Simplistic as it may sound, the best way to prepare for an SEC exam is to design and implement an adequate compliance program tailored to your business. So CCOs, senior managers, and fund board members alike should not procrastinate in looking critically at all facets of their compliance programs, particularly how conflicts of interest are mitigated.

2. **Use a thorough risk assessment to focus your compliance efforts.**

Mapping your program to the SEC’s requirements will help you identify areas of high, medium, and low compliance risk as well as potential gaps in your program. For example, some gaps that the SEC has recently spotlighted with respect to mutual funds relate to how conflicts of interest are addressed with respect to proxy voting, the monitoring of personal trading by advisory personnel, and sub-adviser oversight. Regarding sub-adviser oversight, we recommend that you consult the sub-adviser oversight questionnaire recently prepared by the Investment Adviser Association and the Investment Company Institute. It can be accessed at: [http://www.icaa.org/public/due_diligence_review_questionnaire.doc](http://www.icaa.org/public/due_diligence_review_questionnaire.doc).

3. **Gauge the strength of your compliance culture and tone at the top.**

The recommendations to create and maintain a strong compliance culture and to establish the right “tone at the top” have been repeated so often, it may seem like overkill to bring them up again. But they’re worth mentioning again, even if only to note that the SEC is actively evaluating those critical factors. The SEC’s exam process now routinely includes interviews with senior management in order to assess how engaged senior management is and how well they understand their firm’s compliance efforts.

The SEC will also take into account how management addresses past compliance issues. If top executives appear to have brushed off past violations or problems as being “no big deal,” it will be a serious red flag for the examiners. If a firm has had compliance problems suggesting disregard of an obvious conflict of interest or some systemic problem, senior management should acknowledge that and, ideally, be prepared to describe how the firm adequately addressed the matter. By the same token, you can benefit if top management has been proactive in addressing a compliance issue without the SEC’s directing the firm to do so. From the SEC’s perspective the issue is not just whether your firm has had any compliance problems, but how you have responded to them.

“The SEC will also consider your reaction to past compliance issues. If top executives appear to have brushed off past problems as ‘no big deal,’ it will be a serious red flag for the examiners.”

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4. **Be disciplined in your recordkeeping.**

Maintaining comprehensive, well-organized documents is a good, basic form of self-protection. Good recordkeeping is both a reflection of your compliance culture and the underpinning of an effective compliance program.

5. **Stage a mock exam or similar exercise.**

One of the most effective and practical ways you can prepare is to conduct a mock examination or similar
exercise using a recent SEC examination checklist. Not only will it give you the opportunity to prepare your responses and identify any gaps in your compliance program, a mock examination or similar exercise also will help you identify who has the information you will need to produce for an actual exam. Especially in a large or complex organization, the CCO may not always readily know which employees are responsible for maintaining the pertinent data. A mock exam or similar exercise can help you establish those contacts and relationships in advance, so you’re not wasting precious time while under the pressure of an actual exam.

"Not only is a mock exam or similar exercise a good way to prepare your responses and identify gaps in your compliance program, it can also be a useful tool for engaging senior management and reinforcing your culture of compliance."
- SEI Knowledge Partnership

Preparing solid answers to potential SEC questions is more important than it used to be because the SEC’s methods have changed. These days, SEC examiners are increasingly inclined to ask that you commit your responses to writing. Rather than simply asking you to show up for a meeting where they pose questions about your program and take notes, they now say “write it all down for us then we’ll talk with you and see how the discussion squares with your written responses and the documentation of your practices.”

Finally, a mock exam or similar exercise can be a useful tool for engaging senior management and reinforcing your culture of compliance.

6. Address any previously noted deficiencies.

Last, but not least, make sure you have fully resolved all deficiencies the SEC has noted in prior exams. That is sure to be the first thing the examiners will review.

Exam Do’s and Don’ts

Be sure to:

Ask whether the exam is routine or for cause. If it’s a “for cause” examination, get your counsel involved immediately.

Notify your staff. You should always notify your staff that the SEC will be on site.

Assign a liaison to the SEC examiners for the entire examination period. The CCO is the natural point person to assist the examiners and help coordinate your firm’s response. The CCO should be the SEC’s facilitator for the entire exam and be able to provide senior management with a status of the exam’s progress at all times.

Prepare your people for discussions with SEC examiners. Again, the CCO is the logical person to play an active role in preparing senior managers for their interviews. In-house or external counsel also can provide valuable assistance in preparing senior management for an exam. “Prepping” doesn’t mean coaching employees or putting words in their mouths, but rather helping them understand the process and the types of questions they will be asked. Furthermore, we recommend that when senior management is interviewed, the CCO be present to help interpret and clarify questions, if necessary. The CCO’s presence is especially helpful if he or she has a legal or regulatory background. That way, senior managers can get the benefit of a legal or regulatory perspective without bringing the general counsel into it, which might give the wrong impression. You don’t want to appear to be treating the interview like a deposition.

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Seek clarification of any requests you don’t understand. An exam question or request may be unclear or appear not to apply to your business. Some firms are often reluctant to engage the SEC, for fear that it will come back to haunt them in some way. However, you can save yourself a lot of headaches by simply picking up the phone and asking for clarification or elaboration regarding a question or request, rather than struggling to come up with an answer that may be unresponsive or unnecessarily beg additional questions. It is also an opportunity to proactively engage the SEC and help them better understand your particular business. They may find that issues they viewed
as industry-wide don’t really apply to your business, and they will likely appreciate clarifications that help them avoid wasting time and resources.

One caution, however, is that you should seek clarification sparingly. Rather than coming back with an overly lengthy list of questions about the exam request letter, which might lead them to think your organization is totally unprepared, you should limit yourself to a handful of questions and preferably pose them all at one time.

**Provide the SEC with comprehensive, well-organized materials.** Clear labeling of materials is critical, as is cross-referencing your materials to the SEC’s exam request letter. Also, be absolutely sure to keep a copy of everything you provide.

**Designate a workspace for the examiners’ use.** Preferably, the designated space should be a conference room.

**Be prepared for additional questions during the exam.** For example, a CCO should be ready to discuss whether or not in the CCO’s opinion the firm has dedicated adequate compliance resources. The SEC appears to no longer be asking that question in writing, but may well ask it in person during the examination. You don’t want to equivocate, and you certainly don’t want to blind-side management or use the exam as an opportunity to air grievances.

**Request an exit interview.** This practice is always helpful, because it will either be comforting or give you advance notice as to the seriousness of the matters that will be cited in your deficiency letter. We suggest you make the exit interview request the first day the SEC comes into your shop, which allows the examiners to budget time at the end of the examination to summarize and present their findings to you. During the exit interview itself, it’s important to ask directly whether any potential deficiencies have been identified. If you disagree with a deficiency finding and are prepared to substantiate your position, you should respectfully express your disagreement and succinctly explain your position. You may be successful in eliminating the deficiency from the letter.

“During the exit interview, ask straight out whether any potential deficiencies have been identified….If you disagree with a finding and can substantiate your position, you may even be able to get it eliminated from the letter.”

- SEI Knowledge Partnership

**Ask that all subsequent information requests be in writing.** As a general principle, you want to be sure to maintain a record of everything that you have sent to the SEC and everything that they have requested of you. When you request that the SEC put its follow-up questions in writing, you may also find that the examiners reword some questions, and perhaps even omit certain queries upon further consideration. In our experience, SEC staff is amenable to requests for written follow-up questions.

**Be polite and courteous throughout.** As obvious as this point may be, it is sometimes forgotten, particularly when some members of the SEC examination staff prove to be inexperienced. Still, SEC staffers are professionals who take their jobs seriously. You can only benefit by treating them as such. Remember, friction will never help you through the examination process. It can also erode the examiners’ inclination to give you the benefit of the doubt, which may turn out to be a critical factor (albeit one that is hard to quantify).

**Take the exam process seriously.** Although this may seem to be another obvious recommendation, it is one that still underscores a central point: there are many simple, basic things you can do to help stay on the right side of the SEC. Taking the exam seriously is an opportunity for you to demonstrate that your firm has the right kind of compliance culture.

**What not to do:**

**Don’t be uncooperative or untruthful.** You have nothing to gain by resisting, and everything to lose by misleading or lying to the SEC examiners. You are obliged to be absolutely truthful, even if that means you end up disclosing something you would have preferred not to disclose. You should certainly be prepared to disclose all material compliance matters that you identified throughout the year, and ideally how you proactively addressed those matters.
Don't provide more information than the SEC has requested. You don't get bonus points for providing extra information.

Don't speculate or ruminate. Litigators think in terms of three simple steps: listen to the question, answer the question, and then stop. If you don't know the answer, you should say so and provide the correct information at a later time, but as soon as possible. The worst thing you can do is say, "I'm not sure, but I think . . . ." It's also a bad idea to ramble on about your job responsibilities. You may pique curiosity about something that wasn't on the examiners' radar until you mentioned it. Before you know it, you could end up answering numerous questions sparked by a comment that was simply a "throwaway" remark.

Don't fail to anticipate requests for e-mail records. Having a workable framework for retaining e-mails and then producing them during exams remains a difficult challenge. Some advisers do not keep every single e-mail, based on the justification that not all e-mails contain required records. However, the SEC has developed a tactic that tests this hypothesis. Lately, examiners have been asking for all e-mails to and from a certain individual over a specified period. They will then pore over those e-mails to see if they include some required records. Bear in mind that you will be responsible for delivering whatever e-mails the SEC requests, and delivering them promptly. While the SEC staff has acknowledged that firms are not required to retain e-mails that do not include required information, you must be able to demonstrate that procedures reasonably designed to ensure that required information are being maintained.

What deficiencies do examiners most commonly find?

According to a speech given earlier this year by Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), the deficiencies most often cited with respect to investment advisers and mutual funds include:

- **Personal trading**, which includes inadequate policies and procedures in your code of ethics.
- **Performance matters**, such as using prohibited testimonials or comparing your performance to an inappropriate index.
- **Brokerage arrangements and disclosure**. Typical problems here include a lack of adequate controls regarding the allocation of brokerage and soft dollars. The SEC is paying particular attention to use of client brokerage to pay for client referrals and whether such arrangements are subject to the Adviser Act's cash compensation rule. Under Rule 12b-1(h), mutual funds are flatly prohibited from using fund brokerage to pay for distribution. The overarching principle here is that brokerage is a client asset, which means you have a fiduciary duty to ensure that it's used for clients' benefit.
- **Inadequate controls over portfolio management**. Advisers must take steps, preferably using pre-trade controls, to ensure that portfolios are managed in a manner consistent with investment mandates. Portfolio management training is helpful, if not essential, particularly with respect to limitations that can't be tested on a pre-trade basis.
- **Disclosure deficiencies or inaccuracies**. Inadequate disclosure in Form ADV is the single most frequently cited adviser deficiency. In fact, half of all deficiencies relate to inadequate disclosure of business practices and fees charged to clients. A natural question is, "What's the standard with respect to Form ADV disclosure?" The standard is full, accurate, and complete disclosure in plain English. In essence, that means no material omissions or misstatements. Having said that, Form ADV disclosure is the area the SEC is most likely to nitpick. Even the slightest inaccuracy or inconsistency among documents will be written up as a deficiency, so you'll want to make sure that (1) you periodically review your Form ADV to ensure that it reflects your current business operations, and (2) you disclose all material conflicts, even if you are taking steps to mitigate the conflict.
- **Insufficient Board due diligence**. SEC staff has indicated that twenty percent of their mutual fund exams result in a deficiency comment in this area. Fundamentally, the problems revolve around some Boards not getting enough materials and not asking...
the right questions when it comes to issues such as advisory contracts and soft dollar arrangements. In deficiency cases, the staff believes that Boards do not get enough information to make good judgments and their meeting minutes do not adequately reflect their deliberations. We all know there is good reason to keep minutes at a general, high level, but the SEC considers some to be so general that they lose all value as a record of Board diligence.

What are the hottest exam topics?

**Business continuity** plans are garnering increasing attention.

**Compliance programs** are an obvious focus, in light of the new compliance rules.

**Conflicts of interest** with respect to personal trading, soft dollars, proxy voting, trade allocation, and brokerage allocation remain areas of keen interest to the SEC.

**Hedge fund side letters**, wherein advisers provide selected investors with preferential terms concerning such matters as fees, portfolio transparency, liquidity or redemption rights, and notice of a portfolio manager departure (often referred to as a “key man” clause). The SEC is concerned whether the terms of a side letter (1) raise conflicts of interest, and (2) are consistent with the adviser’s fiduciary duty. Remember that advisers owe an equal fiduciary duty to all clients. Some side letter terms are higher-risk than others. Liquidity and transparency terms, for example, are more likely to be controversial, especially when combined with a key-man clause. Our instant poll during the web seminar found that of the attending SEI clients who sponsor hedge funds, more than eighty percent grant side letters, confirming that this issue is of broad interest.

**The gamut of other hedge fund practices.** The SEC is using a new, comprehensive examination request list for hedge fund advisers, covering areas such as personal trading, trade allocation, performance advertising, and custody of client assets. Available at the SEI Knowledge Partnership website in the archive materials (link provided on next page), this list would be a good basis for a mock exam or similar exercise. You should also be aware of issues the SEC is focusing on, including:

- **Compensation of solicitors**—that is, how hedge fund managers compensate third parties for bringing in investors and whether those arrangements comply with the Advisers Act’s solicitation rule. The SEC is particularly focused on directed brokerage arrangements and those in which the solicitor receives an interest in the fund as a reward for bringing in investors.

- **Valuation.** Regulators, including the SEC and the UK’s Financial Services Authority, are keenly interested in how hedge funds value their assets and the potential for a conflict of interest related to performance fees, which are directly impacted by the valuation of a fund’s assets. We recommend that you evaluate whether your valuation procedures are adequate to, among other things, address conflicts of interest. In addition, we recommend that you review the Financial Accounting Standards Board’s fair value proposal, “Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133,” which has potentially significant ramifications for hedge funds in light of their ability to hold a significant percentage of their assets in illiquid positions. For more information, please see [http://www.fasb.org/project/fv_measurement.shtml](http://www.fasb.org/project/fv_measurement.shtml).

- **“Deals not done.”** The SEC has been known to ask for a description of business arrangements that were considered, but not pursued, and the reasons for that decision. For example, with respect to side letters, the SEC seeks information regarding any side letter or side letter term that was rejected by the adviser, the reasons why the proposal was rejected and who made the proposal. There is a question as to the SEC’s basis for seeking this kind of information, as it would not seem to fall within parameters of the record keeping rule.

If you get a deficiency letter....

Sooner or later, every adviser will be subject to an exam. Recent experience suggests that nine out of ten exams will result in a deficiency letter, so you should expect to receive one. At that point, the good news will be that the exam itself is over. In addition, John Walsh, Chief Counsel of OCIE, has acknowledged some of the recent criticisms of the
deficiency letter process noted by the Investment Advisers Association and others, so we may see some improvement on that front.

Still, given the odds that there will be an SEC deficiency letter in your future, it only makes sense to do some advance thinking on how to respond. Our advice regarding responses is:

- **Take your time in responding.** You won’t score points for replying quickly, so take the full amount of time allotted to respond with a well-crafted letter that details how you are going to address the identified deficiencies.

- **Don’t be afraid to respectfully disagree with a specific deficiency,** as long as you can substantiate your position. It is not at all uncommon to begin a response letter with the words, “We respectfully disagree…..”

- **Have the letter come from senior management.** In years past, it was common to see deficiency letter responses issued by law firms. You may still want to have outside counsel help with the letter, and to the extent applicable, you should certainly have your fund or independent trustees’ counsel review the letter before it is sent. Given the emphasis now placed on “tone at the top,” however, it is vital that the response letter bear senior management’s signature.

- **Think of your response as an opportunity.** Strange as it may sound, replying to a deficiency letter gives you one more chance to burnish your image with a thoughtful, well-reasoned response. In effect, the way you discuss a deficiency can help to mitigate it.

> “It is not at all uncommon to begin a response letter with the words, ‘We respectfully disagree…..’”
> - Tim Levin, Morgan Lewis

**What can an exam request letter do for you?**

As a final thought, don’t forget that the SEC’s exam request letter gives you an excellent starting place for your annual compliance review. To a large extent, the issues covered in a request letter overlap with the things you will want to cover in your annual review. While neither the request letter nor a mock exam or similar exercise based on it will alone provide a sufficient framework for an annual review, they can be a major component. So rather than thinking of a mock audit or similar exercise as something that takes time and resources away from your annual review, think of it as doing double duty. Not only will it help you prepare for your SEC exam, it will take you a long way in structuring your annual compliance review.

**Information Resources**

- **Sample SEC examination request letter:** SEI Knowledge Partnership/ComplianceAdvantage archives

- **On oversight of sub-adviser compliance:** Questionnaire recently prepared by the Investment Adviser Association and the Investment Company Institute
  [http://www.icaa.org/public/due_diligence_review_questionnaire.doc](http://www.icaa.org/public/due_diligence_review_questionnaire.doc)

- **On valuation issues:** The Financial Accounting Standards Board’s fair value proposal
  [http://www.fasb.org/project/fv_measurement.shtml](http://www.fasb.org/project/fv_measurement.shtml)

- **General compliance advice/updates on regulatory developments:** SEI Knowledge Partnership/ComplianceAdvantage archives (for SEI clients only; login and password required)
ISSUES FOR 2006

- Legal and regulatory change
- Business operations and outsourcing
- Marketing, sales, distribution
- Business strategy

For more information, please contact: your SEI Relationship Manager or email the SEI Knowledge Partnership at SEI-KnowledgePartnership@seic.com.