

## Examinations

# Former SEC Asset Management Unit Co-Chief Robert Kaplan and Former NYS Insurance Superintendent Eric Dinallo, Both Current Debevoise Partners, Discuss the Purpose, Process and Consequences of Presence Examinations of Hedge Fund Managers

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On October 9, 2012, the SEC's Office of Compliance Inspections and Examinations (OCIE) sent a [letter](#) to senior management of newly registered private fund advisers noting that such managers imminently may be subjected to so-called "presence examinations." See "[OCIE Warns Newly Registered Hedge Fund Advisers to Watch Out for 'Presence Examinations,'](#)" *Hedge Fund Law Report*, Vol. 5, No. 39 (Oct. 11, 2012). The letter provided some information on how presence examinations would work and what examiners would be looking for, but the letter also left many important questions unanswered. To fill in the gaps left by the letter and round out the industry's understanding of what presence examinations will mean for registered hedge fund managers, the *Hedge Fund Law Report* recently conducted an interview with Robert Kaplan and Eric Dinallo. Kaplan is the former Co-Chief of the SEC's Asset Management Unit within the Division of Enforcement (Enforcement) and Dinallo is the former New York State Superintendent of Insurance; both are currently partners at Debevoise & Plimpton LLP. Our interview covered, among other things: what presence examinations are; how OCIE evaluates the risk of hedge fund managers when allocating examination resources; the impact of a whistleblower on a manager's risk profile; whether and how managers should approach mock examinations; whether self-reporting of violations found during mock examinations is advisable; how managers should approach senior management interviews with OCIE staff; how managers can ensure consistency across various fund documents and examination interview responses; key conflicts of interest OCIE will focus on during presence examinations; other key focal areas for presence examinations; whether managers must disclose the initiation of routine OCIE examinations to investors; whether managers must disclose unremediated material deficiencies to prospective fund investors; how OCIE approaches referrals of matters to the Division of Enforcement; and steps a manager can take to speed up an OCIE examination.

**HFLR: In its October 9, 2012 letter, OCIE indicated that it would conduct risk-based examinations of newly registered private fund advisers during the next two years, including**

**so-called “presence examinations.” What are presence examinations and what specific areas will OCIE be focusing on during such examinations?**

**Kaplan:** The presence exams are part of a strategy by OCIE to examine a significant percentage of new registrants in a relatively short time horizon. Instead of doing a full-scale routine examination, which can sometimes take months of fieldwork and cover a dozen or so key operational issues as part of a top-to-bottom review, it is sort of a truncated review that may only include three to five days of fieldwork that will focus on a handful of hot issues so that the National Examination Program (exam program) can get a sense of the risk profile of a registrant.

**HFLR: What factors does OCIE take into consideration in assessing the “risk” of a private fund adviser when allocating examination resources? In particular, what role, if any, will an adviser’s Form PF or its “aberrational performance” play in OCIE’s evaluation of the risk posed by the adviser?**

**Kaplan:** Risk is an interesting concept. I think the way the exam program thinks about it is that there are quantifiable risks, and then there are qualitative risks. The quantitative risks are identified as a result of evaluation by the exam program and the Division of Risk, Strategy and Financial Innovation of risk analytics that include everything from performance to other quantitative data from an adviser that may suggest some degree of ongoing risk to investors. It could include information that is included on Form PF when those forms are filed with the SEC. [See “[Lessons Learned by Hedge Fund Managers from the August 2012 Initial Form PF Filing](#),” Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012).]

From a qualitative point of view, risk can involve a look at the regulatory history of a registrant or a look at the kinds of strategies used by an adviser or the practices an adviser uses. For example, if you are an adviser that regularly engages in principal and cross transactions with the hedge funds you manage or if you invest side-by-side with your own special purpose vehicle or proprietary account, that poses a risk for potential conflicts of interest that may elevate your risk profile. [See “[When and How Can Hedge Fund Managers Engage in Transactions with Their Hedge Funds?](#),” Hedge Fund Law Report, Vol. 4, No. 45 (Dec. 15, 2011).]

**HFLR: Can a whistleblower increase a manager’s risk profile, that is, the manager’s likelihood of being examined by OCIE? Along similar lines, how can private fund managers incentivize internal reporting of violations that otherwise would become whistleblower complaints?**

**Kaplan:** First, a whistleblower can absolutely raise a manager’s risk profile. If there is a credible whistleblower complaint about a hedge fund manager, there is a very good chance that registrant will be promptly examined or the SEC might skip the examination and move right toward opening an enforcement matter. That is not a question of whether the complaint tweaks the risk profile of a manager to get caught up in a regular routine exam. It is a cause exam.

**Dinallo:** If regulators see prominent complaints, credible whistleblowers or even news articles, they are not only going to take those as possible paths for examinations or enforcement, but, because they have been under such fire by Congress and the press, I think there is an environment right now where they do not want to be accused of not hunting down every lead that is put before them.

**Kaplan:** In regards to whether managers can incentivize internal reporting, that is an interesting question because when the whistleblower rules were being considered by the SEC, a lot of people in the industry were concerned that it gave an incentive for employees to circumvent their ordinary reporting lines. The SEC tried to address that through some very specific provisions in the whistleblower rules, but this remains a concern for the registrant community. In terms of what you can do to enhance reporting internally instead of externally, there are good

sound practices that include creating an environment in your firm that allows people to feel comfortable reporting misconduct without threat of retaliation. [See also “[How Can Hedge Fund Managers Incentivize Employees to Report Compliance Issues Internally in Light of the SEC’s Whistleblower Bounty Program?](#),” Hedge Fund Law Report, Vol. 5, No. 20 (May 17, 2012).]

**HFLR: Should private fund managers conduct mock OCIE examinations, and, if so, should the results of any such mock examination be documented in written form or only communicated orally?**

**Kaplan:** I think advisers should do mock exams. You need to perform a top-to-bottom review of your readiness to be a registrant. I can tell you from personal experience that when you get the notification from the exam program that they are going to be visiting your offices, that is not the time to prepare for an SEC examination. You really need to prepare internally by making sure that your compliance program is sufficient and that you are complying with your own policies and procedures. You also need to accurately report your policies and procedures to your investor base.

There are a lot of pitfalls for an adviser, and the SEC is keenly interested in the extent to which registrants are really operating their firms with a culture of compliance and in a way that is consistent with being a registrant.

**Dinallo:** It is entirely appropriate to take some serious time to consider what documents OCIE will ask for and who they will want to speak with. I would not call it practice, but rather, anticipation and creating comfort with the examination process. That will only be a benefit to the firm and make the examination not as stressful an experience. Possibly the most important issue, as a legal matter, is whatever the policies and procedures say is actually being done with investors and the outside world. The SEC wants to see that there is a following of the policies and procedures.

**Kaplan:** The one week before the exam staff shows up in your offices is a bad time to figure out for the first time that you are not following your written policies and procedures. If you ask me if a mock audit is worth it to prepare for an examination, I think the answer is yes. It is as much to figure out what shape you are in from a compliance point of view as it is to simply be prepared for the time when the SEC staff comes. [See also “[Legal and Practical Considerations in Connection with Mock Examinations of Hedge Fund Managers](#),” Hedge Fund Law Report, Vol. 4, No. 26 (Aug. 4, 2011).]

**HFLR: Are there circumstances in which it makes sense to self-report legal or regulatory violations discovered in the course of a mock examination? If so, can you describe such a circumstance and how a manager can maximize credit for self-reporting?**

**Kaplan:** I think reporting out decisions are very complicated. There are times where it does make sense to report out to the SEC, but, to me, the most important takeaway is that if you are going to report a matter out, you should do it promptly once you have gotten your arms around an issue.

If you are going to report it out, the SEC evaluates credit in a number of different ways, including how promptly the issue was reported; what steps you took to remediate the issue; the extent to which any investors were harmed; that you took prompt corrective action; and, if there were employees involved in improper conduct, that you took action to appropriately discipline that employee. I think those are important factors for the SEC to consider.

**Dinallo:** It is inevitably going to be a case-by-case question. You are certainly going to want to consult with outside counsel to make sure they are in agreement that you have uncovered a reportable event. One also has to get into a serious discussion about what is reportable. In this

new environment where people are really trying to get things right, there may be some acceptable areas where the SEC expects self-correction in anticipation of examinations without necessarily reporting everything.

**HFLR: In the course of actual examinations, is OCIE interested in interviewing senior management of a private fund manager? If so, who (by title) are senior managers for this purpose and what concrete steps can senior managers take to prepare for such interviews?**

**Dinallo:** They will initially accept first interviews with legal and compliance. I think the first engagement would be with the General Counsel and/or the Chief Compliance Officer. It can not end there because the examiners are going to want to sit with the business people that are listed on the various committees, such as the **valuation committee** or the allocation committee. They are going to want to meet with principals, particularly those that have a higher public profile.

With that in mind, I think the first thing that you do is to sit with predictable people and make some decisions internally about the best representatives of your firm for the SEC to interview. I do not think that the representatives have to be the smoothest or the most comfortable, but they should be the most knowledgeable. I think the SEC will respond well to you putting in front of them true experts in the areas the examiners are asking about. Because not all of the examiners that come to your firm will be completely knowledgeable about the industry, I think it would be helpful to put people in front of them who are comfortable teaching and can communicate well to help the examiners really understand what your firm is doing and how you make decisions.

**HFLR: How can private fund managers ensure the consistency of representations across fund documents and oral representations? For example, how can a manager ensure that its PPM, Form PF and compliance manual, as well as its Chief Risk Officer and Chief Compliance Officer in the course of interviews during an examination, all describe the manager's approach to risk management in the same way?**

**Kaplan:** That is not something that can be done just in preparation for an examination. That is something a registrant really has to do in its day-to-day operations. It means making sure you are scrubbing investor-facing communications (whether it is the PPM, due diligence questionnaires or pitch books) and make sure the staff stays on message. There is no easy way to do that. Someone needs to be on top of those issues, in some ways testing by a mock audit or working with a compliance consultant or law firm to make sure everything is consistent.

**Dinallo:** What also needs to be consistent is the documentation of your culture of compliance. The SEC wants to see that you document that frequently. Being able to show, not just say, that on a periodic basis the compliance officer or other executive is sending out clear guidance on what the firm's policies and procedures are will be the best way to protect the firm. You want to show that you laboriously, consistently and frequently gave compliance training, e-mails and guidance in order to demonstrate to the regulators the firm's culture of compliance, not just to describe it.

**HFLR: What are the primary conflicts of interest that OCIE is focusing on during examinations of private fund managers, and how can managers mitigate those conflicts in anticipation of examinations?**

**Kaplan:** I think the key conflicts the staff is looking at right now include related party transactions – any transactions involving the adviser and its affiliates and any of their advised hedge funds – which certainly include **loans to principals** or affiliates of principals or **investments with affiliates of a principal**.



I think the staff views fee and expense allocations between the adviser and the fund as a key conflict as well as the **allocation of expenses** and investment opportunities among an adviser's funds.

**HFLR: Are you seeing examination themes develop with respect to valuation, side letters and fees?**

**Kaplan:** Yes. What has surprised me is how granular those reviews can become, particularly in an evaluation of fees and expenses allocated between the manager and its funds and among commonly managed accounts and vehicles.

**HFLR: Is a fund manager required to disclose the commencement of an SEC examination to its investors?**

**Kaplan:** I am not so sure that an adviser's fiduciary obligations require it to disclose the commencement of a routine examination.

**HFLR: If a private fund manager receives a deficiency letter following an examination, is the manager required to disclose to all fund investors the fact or content of the letter or to disclose the existence of any unremediated compliance issues to prospective investors?**

**Dinallo:** It gets tricky if the staff uncovers material deficiencies. At some point a manager who is actively marketing a fund has to think seriously about whether to disclose unremediated material deficiencies to prospective investors. It certainly depends on the facts and circumstances. [See "**Are Hedge Fund Managers Required to Disclose the Existence or Outcome of Regulatory Examinations to Current or Potential Investors?**," Hedge Fund Law Report, Vol. 4, No. 32 (Sep. 16, 2011).]

**HFLR: Can you describe the analysis undertaken by OCIE in determining whether to refer a manager under examination to the SEC's Division of Enforcement or the U.S. Department of Justice (DOJ) for further action?**

**Kaplan:** Referrals to Enforcement are quite common, and the Enforcement staff is taking those referrals in record numbers. Enforcement scrutinizes referrals carefully, but gravitates towards matters that (1) reflect serious misconduct and risk of investor losses; (2) reflect an industry practice about which the SEC has concerns, even if that conduct was the result of negligence or was inadvertent; or (3) vindicate important interests of the exam program (including, for example, the books and records or compliance provisions of the Investment Advisers Act of 1940).

As a practical matter, OCIE will only refer a matter to DOJ in consultation with the Division of Enforcement. A referral to criminal authorities will typically involve egregious conduct with a high degree of intentional misconduct and real investor losses.

**Dinallo:** It is not unusual that the exam staff will reach a decision point on whether to handle a problem with the adviser through the deficiency process or whether they will make a referral to the Division of Enforcement. Actions taken by the adviser throughout this process can help reach a favorable outcome.

The beginning of the analysis is definitely a reference to general comportment and feelings the examiners got during the examination. Interpersonal reactions, cooperativeness, friendliness, openness, the desire to teach and the desire to be frank matter in the regulatory relationship, and I think it can set the tone from the very beginning. That tone will carry through to determine whether something is a mere deficiency or whether it will be referred for enforcement. If the examiners come away feeling that they just do not trust the personnel, it can bias them.

**HFLR: Are there specific steps that a private fund manager can take to increase the speed with which an examination is completed?**

**Dinallo:** I do think that preparedness matters. If you take some significant time now predicting what documents are going to be requested and checking for privilege (i.e., all of the stuff that really should not be happening live), you should try to do it because it will help you get through a portion of the exam process a lot faster. If you are prepared for interviews and think about who will speak to examiners about the operations and investments, law and compliance, and policies and procedures, that will also speed things up. Obviously, much of the exam will happen in real time, but it is not performance art. Effort expended in anticipation of the inevitable exam is well-spent.

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