



Examinations

What Hedge Fund Managers Need to Know About Getting Through an SEC Examination (Part One of Two)

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The SEC continues to assert its regulatory authority by probing hedge fund managers and other registered investment advisers to private funds. See [“Effects of Expanding SEC Investment Adviser Examinations”](#) (Mar. 24, 2016). Managers must prepare to withstand this increased scrutiny and respond accordingly.

To assist hedge fund managers in this preparation, on June 7, 2016, international recruiting firm Major, Lindsey & Africa (MLA) hosted a panel discussion entitled “A View From the Front: Practical Guidance Learned From Private Fund Exams – What Advisers Need to Know.” Hosted by MLA partners Brian T. Davis and Dimitri G. Mastrocola, the panel featured Ropes & Gray partners Eva Carman, Sarah Davidoff and Joel Wattenbarger.

This article, the first in a two-part series, summarizes the panel’s insights on effectively navigating the SEC examination process. The [second article](#) will highlight key areas of SEC focus, including requests for email; conflicts of interest; allocation of fees, expenses and investment opportunities; valuation; cybersecurity; broker-dealer registration; and attorney-client privilege.

For additional insight from Carman and Wattenbarger, see [“Insights Gleaned From Successfully Navigating Presence Examinations With Hedge Fund Manager Clients”](#) (Mar. 7, 2013). For insight from Davidoff, see [“The Impact on Private Fund Managers of Final Regulations Under the Volcker Rule”](#) (Mar. 13, 2014).

Examination Process

In a recent meeting, said Wattenbarger, senior staff from the SEC Office of Compliance Inspections and Examinations (OCIE), observed that all OCIE exams are “risk-based” and that “there is no such thing as a truly random selection of exam targets.” However, the fact that examinations are “risk-based” does not mean that the SEC believes a firm has done anything wrong; risk can also arise from size or strategy.

One important factor is the adviser’s size. OCIE seeks to examine the largest 48 advisers in the region at least once every three years. On the other hand, about half of advisers in the New York region have not been examined in ten years or more, Wattenbarger noted. Thus, unless an adviser is among the largest advisers, it is hard to predict when it will be examined.

In addition, Wattenbarger explained that the SEC is “actively seeking out **whistleblower tips**.” Exam staff have indicated that about one-quarter of exams are based on tips.

For more on the examination process see “**Usable Lessons and Proven Survival Techniques From the Hedge Fund Examination Trenches**” (Oct. 10, 2014); and “**SEC Staff Provides Roadmap to Middle-Market Private Fund Adviser Examinations**” (May 16, 2014).

Initial Call

According to Wattenbarger, most exams start with a phone call from SEC staff to a firm’s chief compliance officer (CCO), advising when to expect SEC staff on site and that an initial document request letter will follow. Apart from reviewing an adviser’s Form ADV and Form PF, OCIE probably does not engage in substantial diligence prior to initiating an exam, he said. Staff do look carefully at a firm’s prior deficiencies, Carman added.

The panelists explained that, in the last six months, OCIE has been taking a new approach to the introductory phone call, which can now go on for hours. Exam staff will probe deeply into the firm’s business and its assessment of its compliance risks, Wattenbarger said, and incorporate that information into their own risk assessment.

Such calls are becoming the “substantive equivalent to what used to be the first-day presentation,” said Carman. Although some firms are getting caught off guard, Carman considers the call to be a “huge opportunity” to present the firm in the best possible light.

An adviser should prepare for an initial call with outside counsel, but counsel should not be on the call, Davidoff cautioned. Instead, the call should include two or more of the adviser’s personnel.

Document Requests

Document requests are usually extensive, Wattenbarger said, often covering 50 to 70 items. A request may be partially tailored, but there are often a number of items that do not apply. The SEC expects a firm to produce certain “basic compliance and fund documents” within just a few days, with the rest of the documents produced in the next week or so. Preparation for document production is essential.

An adviser should ensure that requested documents are not protected by the attorney-client privilege. This can be a particular issue when the exam staff requests substantial email productions, as has become typical within the last year.

Even if a firm has conducted a privilege review, it should always advise the SEC that the inadvertent production of privileged material is not intended to waive privilege, Carman said. She added that the SEC will usually alert the firm if it believes it has received privileged information.

The SEC respects privilege, Carman said, but it may ask for a waiver if a matter goes to enforcement. She added that the SEC often requests copies of year-end compliance reviews and audits; a claim of privilege with respect to these could be taken as a signal that an issue exists.

The SEC will generally not accept a claim of privilege for an annual compliance review prepared by an outside consultant, even if retained through outside counsel, Wattenbarger added. See

“Six Recommendations for Hedge Fund Managers Seeking to Protect Themselves From Waiver of Attorney-Client Privilege When Faced With SEC Document Requests” (Jan. 17, 2013).

The panelists recommended that all documents turned over to the SEC be “FOIA stamped” – i.e., stamped to request protection from disclosure under the Freedom of Information Act. See **“Repeal of Dodd-Frank Confidentiality Protection for SEC: What Investment Advisers Lost and What Remains”** (Dec. 3, 2010). If the SEC asks for very sensitive information, such as a quantitative trading algorithm, Carman asks the SEC to review such information in the adviser’s office. The panelists also recommended “Bates” stamping documents for ease of identification.

Onsite Review

OCIE expects a first day presentation that explains the history of the firm, its business, its compliance program and its operations, said Wattenbarger. The presentation, which should be given by the CCO and appropriate senior investment and operations personnel, should generally run from 60 to 90 minutes.

In Wattenbarger’s view, it is helpful for the CCO to indicate that the firm has conducted a risk assessment, summarize its key risks and explain how the firm is addressing them. OCIE often asks to see a copy of internal risk assessments.

Staff may ask the CCO to give an example of a recently discovered risk and how it has been addressed, Carman added. They also like to ask “what keeps you awake at night,” she said. Other questions are aimed at whether there is a strong tone at the top and whether appropriate legal and compliance personnel have a “seat at the table.”

The onsite portion of recent exams has typically run about one to two weeks in total, Wattenbarger said. Staff will occupy a conference room, review documents and interview key personnel. The questions being asked may signal concern about a particular area of the firm’s operations or that the firm is being examined because of a whistleblower tip, he added.

Likely candidates for interviews should be prepared in advance. The CCO or another compliance representative should sit in on interviews to ensure that the firm is responding appropriately and consistently. The days when the SEC “camped out” in a firm’s offices for weeks on end are a thing of the past, Wattenbarger added.

Follow-Up Requests, Exit Interview and Deficiency Letter

After the exam staff leaves, said Wattenbarger, “the process is far from over.” On the contrary, it may continue for many months. OCIE will request additional documents on a rolling basis. A firm should have a process in place for promptly responding to those requests and should be thinking about what specific issues the SEC is concerned about.

At the end of the exam there will be an exit interview at which the staff will inform the firm of OCIE’s findings. The exit interview is followed by a deficiency letter. In some cases, a firm may be able to push back on the letter and provide additional information and influence the outcome. In Wattenbarger’s experience, virtually all exams end in a deficiency letter; staff see this as a “natural conclusion” to exams. The goal is to limit the letter as much as possible.

A firm usually has 30 days to respond to a deficiency letter. See **“Three Steps in Responding to an SEC Examination Deficiency Letter and Other Practical Guidance for Hedge Fund Managers**

From [SEC Veteran and Sutherland Partner John Walsh](#) (Feb. 13, 2014). The response must address the SEC's concerns, but it should also be drafted with the understanding that investors may also request the letter. See ["Is a Hedge Fund Manager Required to Disclose the Existence or Substance of SEC Examination Deficiency Letters to Investors or Potential Investors?"](#) (Jun. 1, 2011).

Wattenbarger emphasized the importance of following through on any commitments that a firm makes in its response letter. OCIE may follow up in several months and ask for documentation to show that the firm has done so.

General Observations Regarding Examinations

Many firms use outside counsel or compliance consultants to assist with compliance, Wattenbarger observed. He cautioned that those service providers should remain behind the scenes during an actual exam. Having outside counsel present could be taken as a sign that there is an issue that the firm is concerned about.

A firm is expected to be able to "run its own shop," so counsel should never be present, except in a crisis, Carman added. The same is true in regard to investor perceptions, Davidoff added. Even responses to deficiency letters should avoid reference to outside counsel or consultants when possible.

The panelists offered several other tips and highlighted several important general trends concerning examinations:

- Identifying OCIE concerns early and offering advocacy on issues as they arise is better than waiting for them to be noted in a deficiency letter, Carman said. The further into an exam, the less control the firm has, Davidoff added.
- Because the SEC can process much larger volumes of data, requests for emails and trading records are now much more extensive. See, e.g., ["Current and Former Regulators Advise Hedge Fund Managers on How to Prepare for SEC Exams"](#) (Feb. 18, 2016).
- OCIE's Private Funds Unit is devoted to finding issues in private funds. Wattenbarger has seen a higher level of sophistication among examiners and a better understanding of how private funds operate. That is helpful, but it also means that such examiners have a better understanding of "where some of the bodies may be buried." See ["SEC's Rozenblit Offers Perspectives From the Private Funds Unit"](#) (Feb. 11, 2016).
- The SEC may ask to speak with third parties, such as fund accountants. In theory, this is voluntary but, "in practice, it is impossible to say no," Wattenbarger said. Carman cautioned that communications with accountants are not privileged.
- When the SEC challenges the adequacy of a disclosure and a firm replies that investors know about a particular practice, the SEC's next question will be to ask to speak with the investors. Carman added that investor "gatekeepers" are usually reluctant to admit that they knew about a particular practice.
- There is increased collaboration between exam and enforcement staff, he said. There are more lawyers on the exam staff, and more enforcement personnel appear at exams. See ["SEC Division Heads Enumerate OCIE Priorities, Including Cybersecurity, Fees, Bad Actors and Never-Before Examined Hedge Fund Managers \(Part One of Two\)"](#) (Apr. 28, 2016).

- Over the past few years there has been an intense focus on private equity and real estate funds. In the past six months, focus on hedge funds has increased. The SEC has been using the knowledge it gained from its focus on private equity firms in its examinations of hedge funds, Davidoff added.
- Preparation is key, said Carman. The SEC expects private funds to be cognizant of recent decisions and enforcement actions. It is no longer focused only on insider trading and fraud in hedge funds.

See also “SEC’s Rozenblit and Law Firm Partners Explain the SEC’s Enforcement Priorities and Offer Tips on How Hedge Fund and Private Equity Managers Can Avoid Enforcement Actions (Part Three of Four)” (Jan. 15, 2015).

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