



Examinations

Steps Advisers Can Take to Minimize the Risk That a Routine SEC Examination Ends With a Referral to Enforcement: Five Key Priorities for OCIE (Part One of Two)

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By Vincent Pitaro, *Hedge Fund Law Report*

Although there has been much talk of deregulation under the Trump administration, investment advisers remain subject to close SEC scrutiny. A recent program presented by Davis Polk discussed the current SEC examination and enforcement climate affecting advisers, including an overview of five key examination priorities, and offered guidance on preparing for and handling routine examinations conducted by the SEC's Office of Compliance Inspections and Examinations (OCIE), all with a view toward minimizing the risk of a referral to the SEC's Division of Enforcement (Enforcement Division). The program, entitled "How to Reduce the Risk That Your OCIE Exam Becomes an Enforcement Investigation," featured Davis Polk partners [Leor Landa](#), [Amelia T.R. Starr](#) and [James H.R. Windels](#), along with associate [Marc J. Tobak](#).

This two-part series summarizes the panel's insights. This first article discusses five areas identified by the panelists on which OCIE frequently focuses during the examination of investment advisers. The [second article](#) will provide guidance on the steps that advisers can take to minimize the likelihood that OCIE will refer certain issues to the Enforcement Division.

For more on the current regulatory environment, see our two-part series providing commentary from former senior SEC attorneys: "[Chair Clayton's Priorities and the Current Enforcement Climate](#)" (Dec. 7, 2017); and "[Current Regulatory Climate, Adviser Examinations and the Enforcement Referral Process](#)" (Dec. 21, 2017).

For coverage of prior Davis Polk programs, see our two-part series on activist hedge funds: "[Filing Obligations and Other Operational Considerations](#)" (May 5, 2016); and "[Settlement, Prospects, Shareholder Engagement and Proxy Access Considerations](#)" (May 12, 2016).

The Current SEC Examination Environment

In 2012, OCIE announced its [presence examination initiative](#), which led to an increase in the number of investment adviser examinations and enforcement actions, Landa explained. Under the Trump administration, senior officials are seen as being less interested in pursuing a "[broken windows](#)" approach to enforcement. Statistics indicate that the SEC brought fewer enforcement actions in its most recent fiscal year than during the prior year.

Nevertheless, all indications point to an increase in the examinations of investment advisers, Starr said. This is consistent with recent trends. In 2012, only 8 percent of advisers were examined, while in the most recent fiscal year, that statistic increased to 15 percent. The number for 2018 is expected to be higher still, with SEC Chair Clayton requesting an increased budget for adviser exams.

Not only is the SEC seeking to expand its examination regime, it is also trying to be more focused. The Director of OCIE, [Peter Driscoll](#), has called for “targeted, shorter, deep dives into high-risk areas that are published in [OCIE’s] priorities,” Starr continued. Thus, not only will there be more exams, but they are likely to be better and more challenging.

See [“OCIE 2017 Examination Priorities Illustrate Continued Focus on Conflicts of Interest; Branch Offices; Advisers Employing Bad Actors; Oversight of FINRA; Use of Data Analytics; and Cybersecurity”](#) (Jan. 26, 2017).

In fiscal year 2016, 72 percent of exams resulted in at least “some deficiency.” Some of those deficiencies may have been technical in nature and easy to remedy, while others may have resulted in a referral to the Enforcement Division. More than one-quarter resulted in a “significant finding” that went to the “core of the investment adviser’s work,” Starr said. Nine percent of exams resulted in an enforcement referral.

OCIE’s focus on investment adviser exams is one reason that the SEC brought a record number of 159 enforcement actions against advisers in fiscal year 2016. It is too early to say whether the recent record number of examinations will carry over into enforcement, but it is clear that the SEC is using the OCIE examination process to ensure that advisers to private funds adhere to best practices when it comes to priority areas for the SEC, she said.

See [“SEC Signals Aggressive Stance on Individual Responsibility, Including Potential CCO Liability, in FY 2017 Annual Report”](#) (Dec. 14, 2017); and [“What the SEC’s Enforcement Statistics Reveal About the Regulator’s Focus on Hedge Funds and Investment Advisers”](#) (Oct. 20, 2016).

Five Substantive SEC Examination Priorities

In developing the program, the panelists reviewed various communications from the SEC, including releases and speeches by members of OCIE and the Enforcement Division, and considered how those pronouncements were reflected in enforcement activity, Starr said. After conducting this research, they identified five areas of significant risk and how those issues arise in compliance exams.

See [“How Studying SEC Enforcement Trends Can Help Hedge Fund Managers Prepare for SEC Examinations and Investigations”](#) (Sep. 8, 2016).

Priority 1: Fee, Expense and Trade Allocations

Fee, expense and trade allocations have been a high priority of the SEC for several years, Windels said. Allocations will be closely scrutinized. For example, there have been about two dozen recent enforcement actions against private equity firms over their fee- and expense-allocation practices. See [“SEC Enforcement Director Highlights Increased Focus on Undisclosed Private Equity Fees and Expenses”](#) (May 19, 2016).

Allocation issues arise during exams in several ways. OCIE looks primarily at disclosures made to investors before they commit capital, but it will look at subsequent disclosures as well. It reviews

policies and procedures governing allocations and documentation of how the adviser complies with those policies.

OCIE also reviews financial records documenting actual allocations. If these documents are not available, OCIE may ask the adviser to create detailed charts showing the allocations. It may then conduct what amounts to a “line-item audit” of the materials provided and ask the adviser to track a particular fee back to the relevant disclosure, Windels stated. If a fee or expense is even on the “borderline” of falling within the adviser’s disclosures, OCIE will want an explanation. This could be the most onerous part of the process. If OCIE has questions about specific allocations, it may later ask for written explanations and documentation – including, potentially, internal emails – of the rationale for those allocations.

See our three-part series on fee and expense allocation practices: “[Practices Fund Managers Should Avoid](#)” (Aug. 25, 2016); “[Flawed Disclosures to Avoid](#)” (Sep. 8, 2016); and “[Preventing and Remedying Improper Allocations](#)” (Sep. 15, 2016).

Priority 2: Insider Trading and Material Nonpublic Information

Insider trading is expected to remain a top priority for all SEC divisions, Windels said. At the outset of an exam, the OCIE team will ask general questions about the adviser’s research and investment process. It will look at specific relationships and communications with corporate insiders and other sources of information, as well as how that flow of information is governed. The exam team may derive questions from the adviser’s Form ADV.

OCIE scrutinizes compliance controls and oversight of the use of material nonpublic information (MNPI). It reviews policies and procedures, compliance logs, training records and personal trading procedures. For example, OCIE looks at an adviser’s controls and monitoring of one-on-one and small-group meetings with corporate insiders. It reviews relevant compliance policies and procedures, and it considers how compliance conducts monitoring as well as whether it has sufficient information to carry out its specified monitoring duties. OCIE will “undoubtedly” ask questions about this during an exam, he said.

The exam team will also review sample investment files and emails regarding specific transactions, Windels continued. It will communicate with portfolio managers and analysts about them. In virtually every recent exam, OCIE has focused on at least a half dozen specific transactions involving [aberrant performance](#) or transactions outside the adviser’s usual investment focus and has taken a deep dive into them. It asked for “significant” information about those transactions to confirm that they were not based on MNPI.

See our two-part series on what fund managers can learn from “Tipper X”: “[Best Practices for Preventing and Detecting Insider Trading](#)” (Jul. 13, 2017); and “[Best Practices for Navigating the Evolving Insider Trading Landscape](#)” (Jul. 20, 2017).

See also “[Hedge Fund Manager Deerfield Fined \\$4.7 Million for Failing to Adopt Insider Trading Compliance Policies Tailored to the Firm’s Specific Risks](#)” (Sep. 21, 2017).

Priority 3: Valuation

Valuation is a critical issue to both investors and the SEC. There have been “numerous enforcement actions and really significant settlements, all relating to either improper or inaccurate valuation data being released to the public,” Starr said.

OCIE scrutinizes controls over hard to value assets. It looks for:

- a clear pricing policy that is applied consistently;
- documentation as to pricing errors and how the adviser corrected them;
- disclosures to investors on illiquid investments and related valuation risks; and
- clear policies and procedures for a **valuation committee**, which should be charged with reviewing valuation methodology, policies and specific transactions.

In valuing illiquid assets, there is always room for honest mistakes and differences of opinion, Starr remarked. OCIE, however, reviews valuations with the benefit of hindsight. Thus, an adviser should be able to point to its policies, to its consistent application of those policies and to the review of valuations by appropriate senior personnel. This makes the adviser more credible. Documentation of the valuation process is critical.

See “**Unreasonable Assumptions When Valuing Fund Assets May Lead to Charges of GAAP Non-Compliance, Fraud and Compliance Violations**” (Aug. 24, 2017); “**Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations**” (May 11, 2017); and “**SEC Settlement With PIMCO Highlights the Importance of Proper Valuation and Performance Disclosures**” (Dec. 8, 2016).

Priority 4: Marketing

Investor protection is now of “paramount interest” to the SEC, Starr said. See “**Co-Director of SEC Enforcement Division Champions New Retail Strategy Task Force and Cyber Unit**” (Nov. 16, 2017). In 2016, OCIE launched a review of investment adviser marketing practices, culminating in the issuance of a **Risk Alert** on September 14, 2017, Tobak explained. See “**Risk Alert Highlights Six Most Frequent Advertising Rule Compliance Issues**” (Oct. 19, 2017).

During an exam, OCIE can be expected to scrutinize presentation decks, responses to due diligence questionnaires, investor letters, marketing communications and the performance information contained in them, Tobak said. It will also look at compliance manuals and policies and procedures relating to verbal marketing communications. It looks for clear, well-documented policies and evidence that the firm has a process for monitoring and enforcing them.

See our three-part advertising compliance series: “**Ten Best Practices for a Fund Manager to Streamline Its Compliance Review**” (Sep. 14, 2017); “**Five High-Risk Areas for a Fund Manager to Focus on When Reviewing Marketing Materials**” (Sep. 21, 2017); and “**Six Methods for a Fund Manager to Test Its Advertising Review Procedures**” (Sep. 28, 2017).

Priority 5: Cybersecurity

Cybersecurity has come up “over and over and over again” in exams and risk alerts, Landa cautioned. An exam priority since 2014, it has been described by OCIE as “one of the top compliance risks for financial firms.” OCIE’s August 7, 2017, **Risk Alert** detailed both improvements and shortcomings in advisers’ cybersecurity preparedness.

See “**SEC Review of Cybersecurity Finds Gains Since 2014, but Cites Gaps in Training and Compliance**” (Aug. 24, 2017).

During an exam, OCIE looks for best practices with respect to policies and procedures and how those policies are enforced, Landa continued. It also looks at whether the adviser has conducted any risk assessments, its breach response plans and whether the adviser has remediated any identified issues.

See our two-part series on the SEC's expectations with respect to cybersecurity: "**Enforcement and Examination Priorities**" (May 11, 2017); and "**Examination Priorities and Guidance on When to Disclose Cyber Events**" (May 18, 2017).

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