The Deal
BYLINE

INVESTMENT ADVISORS GET PREPARED: THE SEC IS KNOCKING

BY BERT F. LACATIVO AND JOHN R. STANLEY

When Mary Jo White took over as Chair of the Securities and Exchange Commission (SEC) in April 2013, she vowed that the SEC was going to be more active in fulfilling its role to protect the investing community. One of the SEC's many initiatives has been the examination of investment advisors who are required to register with the SEC under the Investment Advisors Act of 1940. Section 402 of the Dodd-Frank Act expanded the definition of advisors required to register under the Investment Advisors Act. In addition to its on-going Investment Adviser/Investment Company (IA-IC) Program, the SEC's Office of Compliance Inspections and Examinations (OCIE) has undertaken a risk-based "Never Before Examined Advisers" program and "Presence Exams" of advisors newly required to register under Section 402. These three exam programs, combined with the SEC's active solicitation of whistle blower tips and its on-going routine examinations of previously registered advisors, represent the SEC's concerted effort to address what it perceives to be heightened risks and issues associated with registered investment advisors.

The Exam Process

The SEC has undertaken various efforts to enhance understanding and transparency of its examination programs. In various public comments and publication of the OCIE's National Examination Program (NEP) priorities for 2014, the SEC has indicated that its exams are focused on marketing, portfolio management, conflicts of interest, safety of client assets, and valuation procedures.

While the OCIE can show up unannounced to conduct an exam, the process typically begins with a notification letter indicating that the OCIE intends to conduct an exam beginning at a certain date. The letter will be accompanied by an information request focusing on the areas mentioned above and will include a deadline to provide information and/or have the information available upon the examiners' arrival.

Depending on the size of the advisor and the areas to be examined, the examiners could be on site for one to six weeks. During the on-site visit, expect the examiners to conduct interviews and review the documentation provided.

Following the completion of an exam, the SEC will provide the advisor with an "exam summary letter" summarizing any deficiencies identified during the exam. Advisors are generally required to provide the SEC with a written response within 30 days detailing corrective actions. If serious deficiencies or potential violations of securities laws are found, OCIE staff may also refer findings to the SEC's Division of Enforcement, self-regulatory organizations (e.g., FINRA), or state securities regulators.

Why Should You Care?

As indicated above, the SEC has undertaken an admirable and extensive effort to educate the advisor community about the requirements for an SEC-registered advisor by publishing a number of guides and updates on its Website. Among this information, the OCIE and the SEC's Division of Investment Management published "Information for Newly-Registered Investment Advisers" (http://www.sec.gov/divisions/investment/advoverview.htm), highlighting 14 areas of requirements for advisors per the Investment Advisors Act. From these 14 areas, we note the following:

• Investment advisors are fiduciaries to their clients. Beyond the obvious obligation to act in the best interests of their clients and to not withhold any material information, the SEC goes on to state that advisors must disclose all conflicts of interest that might cause them to render biased advice.

• Investment advisors are required to have a designated chief compliance officer (CCO) and a compliance program reasonably designed to prevent, deter, and detect violations of the Investment Advisors Act. The SEC states that the compliance program should be designed to address the risks presented by an advisor's specific operations and that related policies and procedures should be evaluated at least annually for adequacy (are they designed to mitigate the underlying risk?) and effective implementation (are they working as designed?). In other words, a generic or "off the shelf" compliance program will likely not be deemed sufficient. To the extent that they are relevant to an advisor's business, policies and procedures must address the following at a minimum:

- Portfolio management procedures including investment allocation, consistency of portfolio objectives with the investors' objectives, and disclosures;
- Accurate disclosures to investors, clients, and regulators, including account statements and advertising/marketing materials;
- Personal trading activities for members of the advisor's staff;
- Safeguarding of client assets from inappropriate use or conversion;
- Creation and safeguarding of required records and documents;
- Trading practices including best execution, "soft dollar" arrangements, and allocations of aggregated trades;

- Marketing of advisory services and the use of solicitors;
- Valuation procedures and the assessment of fees based on asset values; and,
- Business continuity plans.

• Investment advisors must have a code of ethics governing their employees and enforce certain insider trading procedures, such as quarterly reports of personal securities transactions and annual reports of personal securities holdings. An advisor is also required to establish, maintain, and enforce policies and procedures reasonably designed to prohibit misuse of material non-public information (MNPI).

• Rounding out the SEC's additional requirements, advisors are required to:

- Prepare and file certain reports with the SEC;
- Provide specified disclosures to their clients;
- Maintain certain books and records (generally for five years from the end of the year in which they were created) and make them available for periodic review by the SEC;
- Obtain best price and execution for their clients' securities transactions;
- Include certain elements in contracts with their clients;
- Represent their clients' best interests in any proxy votes;
- Adhere to certain requirements for advertisements and the use of solicitors;
- Utilize "qualified custodians" if the advisor has custody of client assets; and,
- Disclose certain financial, disciplinary, criminal, and/or legal actions that may be material to an investor's evaluation of the advisor's integrity or ability to meet its financial commitments to its clients.

What Should You Do?

At a minimum, prior to the receipt of an examination notice, you should examine the areas identified by the OCIE as priorities to ensure you are meeting the regulatory requirements and have auditable policies, processes, and procedures in place that demonstrate compliance. This can be done with in-house compliance and/or internal audit personnel.

If your organization is new to the regulatory examination process, you may want to consider having a "mock examination" conducted by a third party. This gives you the opportunity to experience a live examination process performed by an independent party working with you to identify areas of weakness that can be corrected prior to a real examination.

Whether you conduct a mock examination in-house or utilize an independent third party, consider the following to help you prepare:

• Is the information likely to be requested by the SEC easily attainable? The OCIE has published "Investment Adviser Examinations: Core Initial Request for Information" detailing the type of information likely to be requested in an exam. Exam preparation efforts should consider whether information such as accounting records, compliance policies and procedures, contracts, personal trading records, and even e-mails can be efficiently collected and provided to SEC examiners.

• Can your organization efficiently provide the information to SEC examiners? In other words, can you provide the information in the manner requested by the SEC (hard copy versus soft copy) in a well-organized, easy to understand package? While this may sound trivial, providing examiners with poorly organized, incomplete, or non-responsive information only serves to frustrate them and creates the impression of a poorly managed compliance function. Examiners may not be obliged to give the organization a second chance to make a good first impression.

• Are your employees prepared to be interviewed by SEC examiners? As part of their on-site work, SEC examiners will likely request interviews with key employees beyond just those overseeing compliance functions. For example, SEC examiners will likely want to speak with the head of the firm to understand the "tone at the top" within the organization. They may also wish to speak with individuals involved with identifying either new investments or new investors to understand how their activities reconcile with the documented policies and procedures related to such activities. SEC examiners will also speak with employees regarding actual valuation procedures versus documented procedures and communications with investors.

• Even a cursory fresh look may identify gaps or deficiencies in the compliance program that can be quickly and easily remediated. For example, are there policies and procedures in your compliance manual that are no longer applicable due to changes in your business? Have roles and responsibilities changed due to routine staffing changes? Are organization and investment structure charts up-to-date? Have all employees signed and acknowledged the annual ethics statement confirmation? These are basic, yet important, items that are certain to be reviewed in any SEC exam and can easily be prevented from becoming exam findings.

The SEC has made no secret of its increased scrutiny of the investment advisor community. Advisors should understand the SEC's expectations of them and duly prepare for compliance examinations that are certain to be coming. It's only a question of 'when.'

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