

**Investment Management
Legal and Compliance Biannual Conference**

Routine SEC Exam Preparation Guidelines

April 26, 2006

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Routine SEC Exam Preparation Guidelines

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INTRODUCTION

- SEC's goals in examinations are to detect
 - Compliance problems and violations
 - Weaknesses in firms' internal control and compliance systems that could lead to violations of the federal securities laws

INTRODUCTION

In its examination program, the SEC seeks to:

- Focus its limited resources on highest risk areas
- Implement a proactive “problem solving” strategy to identify emerging compliance problems so they may be remedied before they can become too severe or systemic
- Help foster strong compliance practices that help prevent problems from occurring in the first place

EXAM STATISTICS

- During its fiscal year ended September 2005, the SEC examined 1,530 investment advisers and 527 investment companies
- Of those exams:
 - 932 were routine
 - 342 were for cause
 - 25 were industry sweeps

EXAM STATISTICS

- In FY 2005, the SEC staff found “significant” deficiencies (i.e., deficiencies that have caused harm to clients, have a high potential to cause harm, or reflect recidivist misconduct) in 37% of exams of advisers and funds
- OCIE referred 399 cases to the Division of Enforcement

REGULATORY AUTHORITY FOR EXAMINATIONS

- **Investment Advisers Act Section 204**
 - All records required to be maintained by registered investment advisers are subject at any time, or from time to time, to reasonable periodic, special or other examinations by the SEC
- **Investment Company Act Section 31(b)**
 - All records required to be maintained by a fund are subject at any time and from time to time to reasonable periodic, special and other examinations by the SEC

TYPES OF EXAMINATIONS

- Routine Exams
 - Scheduled based on the passage of time since a firm has been examined
 - “High risk” firms are on three-year exam cycle
 - “Low risk” firms are selected for exams randomly from year-to-year
- Routine exams are focused in scope.
 - They may focus on areas that have been identified as posing the greatest compliance risk generally, as well as areas that may pose compliance risk for the particular firm being examined

TYPES OF EXAMINATIONS

- Cause Exams

- Cause exams are based on indications, allegations, or tips regarding wrong doing or inappropriate conduct at the firm
- OCIE's goal is to quickly determine whether there is a problem.
- Exams are typically unannounced and conducted on a surprise basis

TYPES OF EXAMINATIONS

- Sweep Exams
 - Sweep or “theme” exams focus on a narrow issue and seek to determine how a sample of the industry is handling that issue
 - Sample sizes can range from hundreds of firms to less than ten, depending on the issue
 - OCIE’s is to gather information in a systematic fashion across the industry

RISK-BASED EXAMS

- For routine exams, the SEC has moved from a “once every five years” schedule to a fully risk-based program
- Firms are divided into two groups: High risk and low risk

RISK-BASED EXAMS – High Risk

- Factors that could lead to a high risk profile include:
 - Large amounts of assets under management
 - Responses in Form ADV
 - Retail client base
 - Having an affiliated broker
 - Having multiple affiliates
 - Employees with disciplinary history
 - Having performance based fees
 - Existence of weak compliance program
 - Severity and significance of problems found during the firm's last examination
- High risk firms are examined every 3 years

RISK-BASED EXAMS – Low Risk

- Firms with low-risk profiles are no longer examined on a cyclical basis
- Low risk firms are selected for examination on a random basis from the population of low risk firms
 - As a result, any such firm is subject to being selected for an exam in any year
 - Random selection is based on statistical sampling techniques and forensic testing methodologies
 - OCIE uses the results of these exams to benchmark its risk assessment procedures and to identify emerging risks or new developments

TOP DEFICIENCIES FOUND IN EXAMS

- Investment Advisers
 - Disclosure
 - Form ADV (e.g., failure to adequately disclose conflicts of interest)
 - Portfolio Management
 - Inadequate controls to ensure client investments track client mandates
 - Weaknesses in managing conflicts of interests
 - Personal Trading and Codes of Ethics
 - Compliance with new Rule 204A-1
- Advertising
 - Overstating performance or AUM, inappropriate index comparisons, omissions of material information on how performance is calculated
 - Use of testimonials
- Brokerage Arrangements and Execution
 - Best execution
 - Conflicts of interest

TOP DEFICIENCIES FOUND IN EXAMS

- Investment Companies
 - Disclosure
 - Inaccuracies in prospectuses and SAIs
 - Corporate Governance
 - Approval and renewal of advisory agreements
 - Portfolio Management
 - Brokerage Arrangements
 - Personal Trading and Codes of Ethics

“HOT TOPICS”

- Areas of current SEC focus include:
 - Fair Valuation
 - Fund Expenses
 - Particularly since directed brokerage has been prohibited and revenue sharing seemingly has slowed due to enforcement actions
 - Anti-Money Laundering
 - Proxy Voting
 - Performance
 - Investment Allocation
 - Personal Training
 - Soft Dollars
 - Compliance Programs
 - Including how the firm tests its program (e.g., forensic testing, transactional testing)

“HOT TOPICS”

- Other areas the SEC may focus on include:
 - Wrap Accounts (suitability and reverse churning)
 - Business Continuity Plans
 - Solicitor Contracts
 - E-mail and Document Retention
 - Reg. S-P (particularly in light of outsourcing initiatives)

WHAT WILL THE SEC BE LOOKING FOR?

- Effective Control and Compliance systems
 - Demonstration, based on documentary evidence, how:
 - Risks are identified, managed and mitigated
 - Problems are found as they occur
 - Problems are resolved promptly
 - If a firm can demonstrate its control and compliance systems are effective, the SEC will “rely” on such systems and reduce some of its analyses
 - If a firm cannot, the SEC will request additional records and conduct more “intensive” analyses and testing

WHAT WILL THE SEC BE LOOKING FOR?

- The SEC is looking for more than just:
 - Compliance manuals
 - Samples of blank report formats and checklists
- Rather, the SEC wants to see how control and compliance systems work in practice
 - “You can demonstrate the effectiveness of your compliance processes only by providing documents that contain ‘output’ from the application of [your] compliance policies and procedures to the daily flows of the Registrant.” -- Recent SEC Document Request to an Investment Adviser

WHAT WILL THE SEC BE LOOKING FOR?

- SEC is looking for:
 - Exception reports with documentation of follow-ups
 - Compliance check lists (completed)
 - Reconciliations
 - Documentation of supervisory approval of overrides
 - Compliance work papers (including results and analysis of transactional and forensic testing)
 - Documentation of problems and follow-up resolutions
 - Periodic assessments of control and compliance processes
 - Warning or sanction notices
 - Internal audit reports

DOCUMENT REQUESTS

- Specifies time period for which information is requested
- Requests that senior managers discuss the firm's organization, businesses, control environment and compliance culture
- Requests access to CCO and risk manager (if any) for in-depth discussion of the firm's compliance program and specific, identified compliance risks
- States that the SEC may want to interview persons responsible for portfolio management, trade execution pricing, back office/administration, IT, AML, and marketing

DOCUMENT REQUESTS

- Following that general introduction, the document request is typically broken into two components:
 1. Request for narrative discussion of risk management and internal controls
 2. Request for specific records and information

DOCUMENT REQUESTS

- Request for written narratives focuses on:
 - Overall process for and commitment to establishing and maintaining an effective compliance culture (“tone at the top”)
 - Consistency of portfolio management decisions with clients’ mandates, regulatory requirements, disclosures and fiduciary duties
 - Allocation of block trades and IPO shares
 - Brokerage/order placement practices – and consistency with seeking best execution and disclosures
 - Securities pricing
 - Protection of assets from theft, misappropriation, misuse and loss
 - Personal trading
 - Performance calculations
 - AML
 - Reconciliation of client transactions

DOCUMENT REQUESTS

- Request for specific records and information includes:
 - Compliance breach log:
 - Nature of the breach or issue
 - How the breach or issue was initially detected or found
 - Date or period of occurrence
 - Persons involved
 - Monetary impact, if any, on clients
 - Description of relevant documentation available for review
 - SEC may agree to limit to material breaches or issues

DOCUMENT REQUESTS

- Request for specific records and information includes:
 - Information about the firm's risk assessment process, including current inventory of risks and inventory for other dates during the inspection period
 - Annual reports on the review of the compliance program
 - Records that provide:
 - Insight to broad operations areas and to relationships that may create material conflicts of interest
 - Comfort that by focusing on control systems the SEC is not missing significant problems

DOCUMENT REQUESTS

- Request for specific records and information includes:
 - Client lists
 - Complaint files
 - Fund board meeting minutes
 - Financial statements
 - Management letters from independent auditors
 - Clients' portfolio transactions files
 - Information on litigation
 - Information on soft dollar arrangements
 - Information on proprietary accounts
 - Information on third-party consultants

INTERVIEWS

- SEC will discuss with management and employees how the firm organizes its risk management process – how risk management is actually practiced
- SEC will discuss, as well, how control procedures at both business and compliance unit levels are performed in critical areas

E-MAIL

- SEC generally is not asking for e-mail in initial document requests for routine exams
- SEC may ask for e-mail in secondary, follow-up requests
- E-mails are being requested in sweep and cause exams

EXAM OUTCOMES

- What happens if SEC finds control and compliance processes are weak?
 - Range of remedies depending on severity of violation and the nature of the violation
 - Remedies can include:
 - Deficiency Letter – resulting in a quicker next inspection than may otherwise be the case
 - Referral to Enforcement for having non-existent or insufficient compliance and control procedures – e.g., Rule 206 anti-fraud charge
 - No Findings Letter (sometimes)

KEYS TO PREPARING FOR AN EXAM

- Keys to Preparation – Areas of Inquiry
 1. Be aware of current regulatory rules and initiatives by SEC
 2. Review compliance procedures systematically – Ask yourself this question – “Do my firm’s policies and procedures take into consideration the nature of my firm’s operations?”
 - Are our procedures designed to detect and prevent violations of the securities laws?
 - Are our procedures designed to correct promptly any material violations?
 - What are all of the material conflicts of interest my firm must identify and address?
 - Do my procedures adequately provide for exception reports & follow-up procedures? Do I have the documents to show we have followed these?
 3. Practice Makes Perfect – Conduct periodic mock exams
 - “Produce” the documents the SEC would request
 - Prepare senior management and employees for interviews
 - Observe the same time constraints the SEC will put you under

EXAM TIPS

- Before the SEC arrives
 - Review the SEC exam request list
 - Chart out each item and who is responsible
 - Ask the SEC staff for clarification as needed
 - Flag tentative areas of concern or documents that may be hard to produce
 - Review past deficiency letters
 - Prepare presentation to the SEC staff on Control and Compliance

EXAM TIPS

- When the SEC staff arrives
 - Provide the SEC examiners with appropriate workspace
 - Designate a liaison to work with the SEC staff
 - Be courteous
 - Establish an understanding with the SEC staff about how they will get information and their access to your offices and employees
 - Maintain logs of requests received and documents produced
 - Bates stamp documents produced
 - Request Confidential Treatment under FOIA for documents produced
 - Have CCO sit in on interviews, but don't interject
 - Be precise in oral & written responses
 - Correct miscommunications
 - Request an exit interview if it does not appear the SEC staff intends to conduct one
 - If appropriate, ask to address concerns or misunderstandings before the SEC staff issues a deficiency letter

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