

# What to do When the SEC Examiner Calls

Tuesday, May 25, 2010

Moderated by Evan Cooper and Frederick P. Gabriel, Jr.

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## Frank Ortner, III, CPA, PFS

Vice President

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- Frank Ortner, III, CPA, PFS is Vice President of the Ortner, O'Brien & Ortner Advisory Group, Inc. and is the Chief Planner with the firm.
- A graduate of Villanova University, he spent the early part of his career in a public accounting firm specializing in small business and personal income taxes.
- Working as a financial and tax adviser, Mr. Ortner attained the Personal Financial

Specialist (PFS) designation from the AICPA, a designation available only to CPAs who demonstrate a complete knowledge and understanding of all areas of financial planning.

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## Steven Stone

Partner

Morgan, Lewis & Bockius LLP



- Steven W. Stone is the leader of Morgan Lewis's Investment Management Practice Group. He is also a member of the firm's Advisory Board.

- Mr. Stone's practice focuses on broker-dealer and investment manager regulation and enforcement defense and regulation of the capital securities markets.

- Mr. Stone has a broad background in broker-dealer and investment management regulation, representing major investment banks, broker-dealers and investment managers in a wide range of matters. He frequently advises trading desks of both broker-dealers and investment managers on a range of issues.

- Mr. Stone counsels clients on a wide variety of regulatory and transactional matters, including development of new innovative products and services; regulation and operation of separately managed account (or wrap fee) programs and hedge funds; trading issues affecting both broker-dealers and investment advisers; soft dollar arrangements; federal and state registration and compliance issues; SEC, NASD FINRA and state investigations; and enforcement actions; mergers and acquisitions; and more.

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## SEC's approach post-Madoff

- Greater insistence in document requests
  - What they want
  - When they want it
- Greater Coordination with Enforcement
  - Enforcement referrals based on conduct *in exams*
- Increased Use of Third-Party Verification
  - Valuation of assets
  - Asset verification



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## OCIE's new approach

1. Greater focus on key issues and forensics, less focus on the routine
2. Greater attentiveness to tips, complaints and referrals,
  - Including from the Division of Enforcement's new Office of Market Intelligence
3. Less compartmentalization, broader "looking around the corner" focus (including affiliates and related activities)
4. Greater substantive expertise and pre-exam preparation
5. Tighter integration with Divisions of Enforcement, Investment Management, Trading and Markets, and Risk, Strategy, and Financial Innovation



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## Enforcement changes

- Reorganization into specialized units
  - Asset Management Unit – 60 enforcement lawyers
- Focus on
  - Emerging issues
  - Risk/forensic approach
  - "Bread & butter" cases too



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## 6 top exam mistakes

1. Stiff arm or be discourteous to examiners
2. Think examiners are your new best friends
3. Let the examiners rove and question employees without a Compliance chaperone
4. Be sloppy in answering questions or producing information
5. Wait too late to escalate concerns and call in outside help
6. Be un-strategic in dealing with issues



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## 5 key steps in exams

1. Prepare and be organized
  - Review past deficiency letters
  - Consult legal counsel
  - Identify points of concern
2. Be clear in communication with the exam staff
3. Keep records of what they ask for and what you provide (and what you still owe them)
4. Be direct and proactive in addressing issues
5. Bring in legal counsel to help address and defuse problems



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## Gary Watkins

Partner

ACA Compliance Group



- Gary Watkins is a founding partner of ACA and his primary responsibilities include conducting mock inspections of investment advisers and hedge funds.
- Mr. Watkins also assists ACA clients in responding to SEC deficiency letters, reviewing best execution and trading practices, preparing advertisements that comply with the federal securities laws and developing customized policies and procedures.
- In addition, he has liaised with the SEC on behalf of his clients during regulatory inspections.
- A frequent speaker at industry seminars, he also writes articles related to compliance issues. Prior to joining ACA, Mr. Watkins owned his own consulting firm servicing investment advisors. He was responsible for consulting on a variety of compliance issues related to federal and state registered investment advisors.
- Mr. Watkins was also active in lobbying the Virginia General Assembly and the Virginia State Corporation Commission to promote and protect the interests of investment advisers located in Virginia.

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## Drivers of risk-based and TCR examinations

- Risk-based Examinations: Firms selected based on
  - Risk ratings based on Form ADV Part 1, prior examinations, and RAVES
  - Industry experts hired by the SEC in specialized areas, including new “Senior Specialized Examiners”
  - Focused examination sweeps on specific issues, e.g., custody
- TCR (“Tip, Complaint, and Referral”) Examinations: Firms selected based on
  - “Leads” from the SEC’s new Office of Market Intelligence
  - Referrals from other divisions or offices, including the new Division of Risk, Strategy, and Financial Innovation
  - Public complaints and whistleblowers
  - Expect examiners to ask questions in other areas as well
- The SEC’s goal had been to examine 1/3 of high risk advisers every year, but it examined only 22% in 2009. As Associate Director Gohlke has acknowledged, shifts in examination focus and procedures will mean even fewer examinations
- Fewer examinations = longer examinations

## Make the most of any advance notice received

- The potential scope may be broad, but examiners are likely to be focused on specific areas, given the SEC's risk-based approach.
- Ask about the scope and any focus areas – the examiners may just tell you!
- Carefully review the request letter (with counsel or consultant, as available)
  - Many of the items in the SEC request letter are ambiguous or overbroad. Clarify what you do not understand and narrow overbroad requests before the on-site examination.
- Consider whether past deficiency letters, recent outlier performance (either positive or negative), client complaints, problem counterparties, or publicized SEC Enforcement focus areas (e.g., insider trading) may have spurred the examination. Be prepared to address the issues!



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## ACA's general observations on recent SEC activities

- Focus on custody
- SEC intolerant of delayed document production
- SEC intolerant of firms that have not conducted a documented control risk assessment
- Two year window for document requests
- Copies of all versions of disclosure documents in place during the review period rather than the most recent copy
- Surprise exams are back!!!!!!
- Emails sent/received from the date of the announcement of the SEC examination to present



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## SEC exam requests are focused on risk management and internal controls

- SEC initial request list includes information regarding the Adviser's risk management and internal controls.
  - Be prepared to Identify and document compliance risks and conflicts of interest
  - Map risks to policies and procedures




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In developing these policies and procedures, XYZ considered the material risks associated with administering the Code of Ethics. This analysis includes risks such as:

- Employees and/or XYZ fail to identify and comply with all applicable Federal Securities Laws;
- Employees do not report personal securities transactions;
- Employees trade personal accounts ahead of Client accounts;
- Employees allocate profitable trades to personal accounts or unprofitable trades to Client accounts;
- Violations of the Federal Securities Laws, the Code of Ethics, or the policies and procedures set forth in this Manual, are not reported to the CCO and/or appropriate supervisory personnel;
- XYZ does not provide its code of ethics and any amendments to all Employees; and
- XYZ does not retain Employees' written acknowledgements that they received the code and any amendments.

XYZ has established the following guidelines to mitigate these risks.



Topic	Compliance Risk	Control Policy	Control Process	Testing Procedures
<b>Adherence to Client Investment Objectives, Guidelines, and Restrictions</b>	Advisory client accounts may not be managed in accordance with disclosures and management agreements.	Trading and Portfolio Management Policy	Compliance Performs Quarterly Account Reviews	<u>Primary Test</u> 1. Select a sample of advisory client accounts. 2. For each advisory client account, review the trading history, contract, documentation of objectives, and correspondence with the IAR.
<b>Trade Errors</b>	Trade errors may not be identified in a timely manner.	Trade Error Policy	Quarterly Trade Blotter Review	<u>Primary Test</u> 1. Obtain the trade blotter for advisory client accounts. 2. Sort the blotter by client then by trade date. 3. Look for transactions in which a client bought and sold the same security on the same day. 4. Follow up to determine if any of the transactions represent undisclosed trade errors.

## Top 5 deficiencies found during exams

1. Information disclosure, reporting, and filings;
2. Adequacy of procedures under the compliance rule;
3. Personal trading;
4. Performance advertising and marketing; and
5. Portfolio management internal controls.

Source: ACA Insight, *Compliance Panel Highlights Developments in OCIE*, March 29, 2010.



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## Top 10 focus areas

- Custody arrangements and the safekeeping of assets
- Money market funds
- Complex structured products
- Valuation smoothing
- Use of non-public information to make investment decisions
- Firms in financial distress
- Firms controlled by a dominant individual
- Information security
- Performance advertising
- Quantitative algorithmic trading practices

Source: ACA Insight, *Compliance Panel Highlights Developments in OCIE*, March 29, 2010.0



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## Compliance resources

- Networking with other compliance officers
- Regulators' websites
- Membership organizations, e.g. NSCP, IAA, CFA Institute,
- Compliance newsletters
- Updates from law firms
- Conferences



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