

## REGULATORY MONITOR

SEC Update  
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### The SEC's New "Presence Exams"

More than 1500 private fund managers registered as investment advisers with the Securities and Exchange Commission (SEC) in 2012, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. For many fund managers, the registration process was daunting. In addition to the compliance policies and programs required by SEC Rule 206(4)-7, and the Codes of Ethics required by SEC Rule 204A-1, managers needed to complete the newly expanded Form ADV required of all SEC registered investment advisers. In the past two years Form ADV has been overhauled, with newly-detailed "private fund" disclosures in Part 1 of the form, and a detailed narrative describing the business (including risk factors, conflicts of interest and other topics) in Part 2. In addition to filing the ADV, the newly-registered advisers had to implement all of their new policies. From recordkeeping to the annual review requirement, there has been plenty to keep managers busy. New filing requirements – such as Form PF for systemic risk reporting – are taxing new registrants as well. Added to this already long list is a new examination program being rolled out by the SEC's Office of Compliance Inspections and Examinations (OCIE).

On the morning of Oct. 9, 2012, the regional offices of the SEC emailed letters to newly-registered private fund managers announcing OCIE's new National Exam Program (NEP) initiative to conduct "Presence Exams" of newly-registered investment advisers (the October Letter). Under Section 204 of the Investment Advisers Act of 1940, the SEC has broad authority to examine the books and records of registered investment advisers. Over the past several years the

percentage of registered advisers examined by the SEC has fallen below 10 percent each year, with many advisers going numerous years without examination. The new Presence Exams give the SEC the ability to reach a much larger percentage of the new registrants, by focusing on a limited number of issues and taking a risk-based approach. OCIE has explained that the NEP is a two-year initiative that will include (1) an Engagement Phase—involving outreach to newly registered advisers, (2) an Examination Phase—during which the exams will occur and (3) a Reporting Phase—during which the NEP will report to the SEC and the public its observations from the examinations (including common practices identified in the higher-risk areas, industry trends and significant issues).

Many registered advisers and their counsel welcome the Engagement Phase and the Reporting Phase, looking forward to the opportunity to learn what the SEC identifies as compliance concerns. The Examination Phase creates more of a concern. OCIE's history with examinations has included many that have been straightforward and manageable, but others that have lasted for months or even years. While most SEC examinations lead to a deficiency letter, some matters are referred to the SEC's Enforcement Division for further investigation and potential charges. With this experience in mind, the new NEP examinations have been the subject of much anticipation and speculation since OCIE officials began talking about them earlier this year.

Based on the October Letter and what we have seen in recent examinations, the new "Presence Exams" appear to be a reasonable and workable approach to the SEC's task of examining so many new registrants. One of the benefits of the Presence Exams is brevity. By focusing on a limited number of topics, the SEC can establish its presence with a large percentage of new registrants. New registrants will get the experience of undergoing an examination, and presumably improving upon any deficiencies noted in their compliance programs. These briefer exams will give OCIE the opportunity to "risk-rate" many of the new registrants, targeting those that will be reviewed in a more in-depth manner sooner rather than later. The Presence Exams also will give OCIE data on some

common compliance issues at firms, which may form the basis for further SEC Staff guidance to registrants.

OCIE identified the following focus areas for the Presence Exams in the October Letter.

*Marketing.* NEP Staff will look for false and misleading statements in marketing materials used to solicit new investors or retain existing investors. Several points are important here. First, the SEC's view of marketing materials may be much broader than the fund manager's view – quarterly investor letters, requests for proposal (RFP) and due diligence questionnaire (DDQ) responses and other communications all may be viewed in certain circumstances as marketing materials subject to the SEC's Advertising Rule 206(4)-1, the antifraud prohibitions of Rule 206(4)-8 and other antifraud rules. Second, these rules apply to both new and existing investors. And third, the SEC's Enforcement Division has been actively investigating and pursuing charges with respect to alleged misrepresentations about the manager's performance history (track-record), the amount of the manager's personal capital invested in the funds, the amount and timing of investments in the fund by other investors and the results of prior SEC examinations.

*Portfolio Management.* The NEP Staff will review and evaluate the adviser's portfolio decision-making practices and whether they are consistent with disclosures to investors. While many funds have broad investment mandates—and broadly-worded investment programs in their offering documents—the examination Staff may look to the more granular discussions in pitchbooks and investor letters to see whether they are consistent with what is actually happening in terms of investment decision-making. The NEP also will look at the manager's allocation of investment opportunities among different accounts, an issue that has led to investigations and enforcement actions.

*Conflicts of Interest.* Potential conflicts of interest continue to be a focal point for the SEC and critical for advisers to consider carefully. Conflicts of interest can arise in allocating investment opportunities among clients, allocating expenses between the adviser and clients, payments made by private funds to the adviser or its affiliates and transactions by the adviser with affiliated parties. There appears to be a particular OCIE focus on expenses charged to funds—both in terms of the appropriateness of the manager charging an expense as opposed to paying for it out of management fees, and with respect to

the allocation of expenses among various client funds and accounts. Outside business activities and personal securities trading are also conflicts issues that will be addressed. The SEC's Enforcement Division has brought a series of charges against private fund managers relating to conflicts of interest, including loans between the manager and client funds.

*Safety of Client Assets.* It should go without saying that in the post-Madoff era, the SEC will continue to focus on the safety of client assets. NEP Staff will review advisers' compliance with the custody requirements under Rule 206(4)-2, such as maintaining most securities with a qualified custodian (typically a bank, broker dealer or trust company) and delivering GAAP financial statements to a private fund's investors within 120 days of the end of the fund's fiscal year.

*Valuation.* NEP Staff will review the adviser's policies and procedures regarding the valuation of client assets and assessment of fees based on those valuations. Obviously, illiquid or difficult to value investments present more valuation concerns. Managers should review both their valuation processes and their disclosures related to those processes. Recent enforcement actions have alleged violations by managers in both the underlying valuations and in the disclosures to investors and prospective investors with respect to these valuations. The calculation of management and performance fees is an issue noted in the October Letter, and it is also an issue that has been a more regular examination area during the past year.

While Presence Exams are not meant to be lengthy, there is always the risk that the examination Staff identifies what it believes to be a significant issue that is worthy of further evaluation. There is also the risk that the examination Staff questions the firm's commitment to compliance. Once the examination Staff doubts the firm's commitment, it can be an uphill battle to change that perception. The new Presence Exam program means that newly-registered fund managers should expect to be examined within the next two years and should prepare accordingly. Managers and their counsel should thoroughly review the “focus areas” identified in the October Letter and managers also should prepare for the mechanics of the exam (that is, being able to gather and produce the requested documents accurately and efficiently). Additionally, managers should be prepared to explain their firm and their business to the exam Staff in a way that demonstrates the firm's commitment to compliance.