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Best Practices for Hedge Fund Managers Preparing for an SEC Examination (Part One of Two)

Examination by the Securities and Exchange Commission is a fact of life for registered investment advisers, including hedge funds, but in recent years, the SEC's Office of Compliance Inspections and Examinations has ramped up its examination efforts, in quantity and scope, so managers today must be as prepared as possible, and at all times, for the inevitable inspection. At a minimum, to ensure the examination process runs as smoothly as it can and firms avoid potential enforcement action, hedge fund managers should continually assess their compliance programs for any deficiencies, review relevant SEC examination priorities and internal compliance policies and procedures for adequacy, and develop an action plan ready for implementation the moment they're notified about an impending exam.

This article, the first in a two-part series, explains the types of examinations the SEC conducts on hedge fund managers, events that trigger exams and pre-exam preparations firms should undertake. The second article in this series continues exploring pre-exam preparations and details best practices for getting through the actual on-site visit.

Types of SEC Exams

Generally, there are three types of examinations of registered investment advisers that the SEC conducts: sweep exams; 'cause' exams triggered by tips, complaints and referrals; and routine exams.

Sweep exams are used to review a compliance issue that the SEC considers a risk across multiple firms, according to Marc Elovitz, a partner and chair of Schulte Roth & Zabel's Investment Management Regulatory and Compliance Group, "A sweep exam is typically a situation where the staff is looking at a particular issue, not a particular manager. There is really no way to prepare for a sweep exam because, by its nature, it goes out broadly. Also, with a sweep exam, the staff doesn't typically go into them with the expectation that they will be visiting your firm." The SEC's recent cybersecurity sweep exams are an example of these types of inspections.

A cause exam occurs when the SEC has a specific reason to examine a manager. Cause exams may be triggered by an individual reporting a securities law violation, a whistleblower complaint or by the SEC's own examiners reporting risky or illegal behavior that requires further investigation.

Routine exams normally take place after the SEC has done a risk-based assessment of an adviser and determines there are sufficient risks within the firm to warrant a more fulsome exam. The SEC notifies managers by letter or telephone that a routine exam is impending and when it will occur.

During Cipperman Compliance Service's recent webinar, "How to Prepare for a Regulatory Exam," Doug Tyre, the consulting firm's assistant compliance director, noted that although the types of exams the SEC conducts have remained consistent over the years, the structure of exams has changed. "Examiners have increasingly conducted a large portion of their examinations remotely—via correspondence and electronic delivery of documents. While the on-site portions of examinations have tended to decrease in length, it is worth noting that even with this increasing use of electronic communications and delivery capabilities, the examination process can still go on for months."

Better examiner preparation, and deeper knowledge about a manager's business before even stepping foot on its premises, has also altered the exam process. According to Tyre, "Regulators invested significantly in technology to analyze data better. Regulators have more tools at their disposal to identify market participants that may exhibit a higher risk profile based on their activities."

Tyre also noted that exams have become more focused in scope, as examiners take deeper dives on more targeted and focused areas of a firm's operations. "We saw this with the cybersecurity sweep exams. These deeper dives in the areas of the examiners' focus present additional opportunities for the examiners to notice underlying issues, which ultimately helps them get their foot in the door and expand the scope of their examination."

In addition, examination of newly-registered managers who have never before been examined will be different than examinations of larger, more established managers, said Elovitz. "The module that's used for new managers or new registrants is more focused than a general module for a firm that has been around longer and may have been examined before."

What Triggers an SEC Exam?

Generally, the SEC performs risk assessments to determine which managers need to be examined soonest or more frequently. The regulator culls through information on firms from various regulatory filings, including Form ADV, and other public information. Examiners assessing the riskiness of particular managers also review the disciplinary history of a firm and its principals, assets under management, client base and products offered.

According to Jason Brown, a partner at Ropes & Gray, "The exams are risk-based, so the larger you are, the more products you offer, the more complex your strategies and the more affiliates you have, the riskier your business could seem to regulators, and that could trigger an exam."

Whistleblowers are also becoming a more common source of tips to regulators, and their complaints often lead to regulatory investigations. Whistleblower tips and/or complaints that originate from employees, former employees, investors and other managers could lead to an exam.

Pre-Exam Preparations

Though it may seem obvious, the first step managers preparing for the inevitable SEC exam should take is to ensure their compliance programs pass muster. The often-touted culture of compliance must be instilled throughout the firm, and examiners should be able to perceive and document a "tone at the top" that managers have established and which permeates the firm.

"Firms should have a compliance manual that is tailored to their businesses and that people follow," said Brown. "There should be adequate resources devoted to compliance to get the job done. Compliance should be integrated into the activities of the firm. There needs to be a 'tone at the top,' and buy-in by management, and evidence that they participate in the compliance program. Having these things will be the first step to making sure your exam goes smoothly."

According to Richard Marshall, a partner at Katten Muchin Rosenman, "Probably the single best thing you can do to prepare for an inspection is to have a good compliance program. If you don't have problems, then there is nothing for the SEC to find. You want to identify issues within your firm, address and correct them."

The SEC also reviews how management has addressed past compliance issues. Examiners view failure to adopt a culture of compliance and pervasive "tone from the top" as a red flag that something has gone wrong at a firm, and the omissions could lead to longer examinations, lengthy deficiency letters and/or a referral to enforcement.

More generally, managers that are ill-prepared for an exam could face greater scrutiny or other issues during and after the exam. "Issues come up because people aren't prepared, such as having the basic documents ready to go to the SEC," noted Elovitz. "If you don't have those ready in a couple of days, the staff is going to question why you don't have them, because they are basic documents, and they are things managers know or should know the SEC likes to review."

Brian Daly, a partner at Schulte, Roth & Zabel, highlighted that preparation for new managers comes from "running a very tight ship on the compliance side every day. There are so many things compliance officers have to do today, and it can be wearing on a compliance officer, but you need to have all of the proper records and a really tight annual review process as a place to start. You can supplement that with exam request lists and making sure those documents are ready to go. You need to be just as thoughtful about that process as you are about the annual review process."

Daly added that even if a manager has already been examined, preparations for a new exam may deviate substantially from the prior exam's process, because no two examinations—even of the same manager—are the same. "First of all, the exam team coming in will probably be different, and their areas of focus or the particular risk profiles they are looking at has changed since the last time the manager was examined. There are also different exam teams, such as exam teams from the regional offices or teams from the Asset Management Unit, and these teams tend to be focused on different issues."

Brown observed that the managers who've previously been examined may have a sense about how the exam will work, but even that could be different the next time around. "The structures of exams change from time to time. For example, years ago the SEC might come on-site for a large firm and be there for a month or longer. Now, it's pretty much a week that they're going to be in your office. It could be less. The exam could be done remotely. Since the structure can change, you never really know what you can expect."

Brown also noted that previous exam experiences may not be a reliable litmus test for what to expect during future exams since the SEC's exam priorities change, at least on an annual basis. "What the SEC was looking at five years ago might not be what they're digging into today."

Focus on Compliance

As registered investment advisers, under Advisers Act Rule 206(4)-7, also known as the "Compliance Rule," hedge fund managers are required to establish and maintain a written policies and procedures manual reasonably designed to prevent violations of the Advisers Act and conduct annual compliance reviews to test the effectiveness of their compliance programs.

Managers also need to develop a compliance manual that outlines the firm's best practices, allowable behavior and ethics program because managers will invariably want to review it. According to Jay Haas, compliance director and CCO at Cipperman, "The compliance manual is often one of the first documents requested for review by examiners. Your compliance manual should be a living document and should be updated frequently and customized to your business. Make sure the policies and procedures described within the manual adequately describe how you supervise your business."

Firms should also make sure to conduct robust annual compliance reviews, said Marshall, because these reviews are "the best way to always be prepared and to ensure that your compliance program is robust. You have to do the annual review anyway but if there are problems you are going to be able to identify them through this process."

Conduct a Risk Assessment

A risk assessment is a systematic process of identifying and prioritizing risk factors—such as conflicts of interest, failure to seek best execution and trading on material nonpublic information—within a firm that have the potential to cause legal, financial, operational or regulatory damage. Managers can use risk assessments to identify areas of high, medium, and low compliance risk as well as potential gaps in the compliance program.

Tyre said Cipperman recommends firms have a robust risk-assessment process that "identifies and outlines any policies and procedures that you have designed to mitigate the key risks inherent with your business. It's also important to ensure you have the appropriate documentation to evidence that the processes that you've enacted are being carried out and are designed to specifically mitigate those key risks."

Conduct a Mock Audit

One of the most effective and practical ways managers can prepare for an SEC exam is to conduct a mock examination. Since managers do not want to first learn of issues or potential violations during the course of an exam, they should prioritize uncovering any potential deficiencies before the SEC shows up, and preferably before they receive a letter from the SEC announcing an exam will take place.

A mock examination is essentially a run through of an actual SEC examination. During mock exams, stand-in or mock examiners typically guide the hedge funds compliance staff through an SEC examination, and identify and document potential gaps in the firm's compliance program. Much like SEC examiners, mock examiners review documents, interview investment personnel and review the results of the exam with the firms' compliance staff.

Marshall said when conducting mock exams, managers sometimes take a recent inspection request, and have the firm pull all of the documents in the request, gather key personnel and interview them the way the SEC would, and then use that audit to critique the firm. "I think there is value to this process but it is limited in that your actual exam could go very differently from what you experience with the mock audit. However, these mock audits are useful in that they perform the function of a compliance review, and by doing that you ferret out and identify issues. They are also a valuable way of making sure the firm is doing things right and focusing people on the process of an inspection."

Recordkeeping

Hedge fund managers should also ensure they keep proper records supporting the compliance work done throughout the year so that they can more readily organize a response to a potential exam notification. Managers should also review public lists of document requests to obtain a firmer grasp on what the SEC typically looks for and to make sure relevant documents are ready for submission.

Maintaining comprehensive, well-organized documents can go a long way toward ensuring a smoother exam process, particularly because the effort speeds up the response time to documents requests and shows dedication to compliance and an effective compliance program. In fact, though, seemingly small details like proper recordkeeping are often overlooked by firms as they prepare for a regulatory examination. According to Marshall, "People tend to focus on the big issues like fraud. You should be focusing most of your resources on the most important issues but it's also important to pay attention to recordkeeping. If you don't keep complete, orderly records then that creates a very bad impression for the examiners. Recordkeeping is not the biggest issue but it does create a negative impression if examiners find gaps in your records during the examination."

Marshall added that because it is difficult to guess the documents the SEC wants managers to produce during an exam, maintaining proper records is important, because "at the very least, the examiners are going to want to see the records that you are required to keep."

Managers should also focus on sensitive compliance documents, such as those pertaining to any compliance errors uncovered and how they were addressed, and any trade error logs and how the firm responded to those errors. Managers should be reviewing these records for accuracy and to make sure issues that were identified were addressed.

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Best Practices for Hedge Fund Managers Preparing for an SEC Examination (Part Two of Two)

Examination by the Securities and Exchange Commission is a fact of life for registered investment advisers, including hedge funds. In recent years, however, what was already a nerve-wracking process has become grueling, according to some experts, because the SEC has ramped up its examination efforts—in quantity and scope—shortened its deadlines and become more aggressive, all while the specter of enforcement action looms over firms. Preparation is key for managers today, who should at all times be prepared for the inevitable inspection and have an action plan at the ready for implementation the moment they're notified about an impending exam.

This article, the second in a two-part series, continues exploring specific steps managers should take leading up to the SEC's onsite visit, including reviewing prior examination results, designating an examination point person and preparing an introductory presentation on the firm to the SEC staff. The first article in this series explained the types of examinations the SEC conducts on hedge fund managers, events that trigger exams and pre-exam preparations such as conducting a risk assessment and recordkeeping reviews.

Pre-Exam Preparations

In addition to focusing on compliance, conducting a risk assessment, conducting a mock examination and reviewing recordkeeping practices (discussed in Part One of this series), managers preparing for an onsite SEC exam should ensure they know the SEC's current annual priorities and review the results of any prior exams the firm has undergone and how any deficiencies were resolved.

Know the SEC's Exam Priorities

The annual priorities letters put out by both the SEC and FINRA can help managers identify current hot-button issues so that they can review their internal policies and procedures with an eye toward conforming them to the SEC's latest statement of its expectations. "You should read these priorities letters and assess any areas that may be applicable to your line of business. Any overlap between regulatory priorities and your business will very likely be areas of focus during your regulatory exam," Doug Tyre, assistant compliance director at Cipperman Compliance Services, advised.

Marc Elovitz, a partner at Schulte Roth & Zabel who oversees the firm's investment management regulatory and compliance practice, noted, however, that the annual letters cover the SEC's priorities related to supervision of the entire securities industry, so in any given year, some or much of their content may not be relevant to hedge fund managers. "With those exam priorities that come out, it's very hard for hedge fund managers to find useful information in them, because the vast majority of issues do not relate to hedge fund managers but focus on retail products."

Review the Results of Prior Exams

Managers who have previously been examined should review the results of their prior exams and how the firm addressed any issues the SEC uncovered. Prior exams and any resulting deficiencies are "low-hanging fruit" for new examiners, Tyre said. "If your firm has previously undergone an exam and received a deficiency letter, you need to ensure that appropriate documentation and procedures exist to substantiate your firm's remediation of any issues found. Failure to remediate any previous examination findings will, more likely than not, lead to enhanced scrutiny, potential fines and referrals to enforcement by the new examination team."

Ropes & Gray partner Jason Brown added, "If you were previously examined and you received a deficiency letter you really want to make sure you have addressed everything in the letter and that you've done what you told the SEC you would do. If the SEC comes in, and you haven't fixed something they found the first time around, you might have a very serious problem on your hands. The SEC has brought enforcement actions on relatively minor issues because there was recidivism. It's not exam prep per se, but just something you should do."

Preparing for the Onsite Visit

Examiners generally call a manager targeted for examination in advance to alert the firm and schedule the SEC's onsite visit. According to Jon Wowak, chief operating officer at Cipperman, "The lead examiner may call the CCO or other executive at your firm to introduce themselves and learn more about your firm. This call will usually be followed by a letter requesting a list of documents pertinent to the firm's business."

Managers should also ask how many SEC staff will be visiting so that the firm can provide adequate and appropriate space for the examiners to conduct their review. Wowak noted that onsite visits are not as long now as they were in the past, in part because examiners today have done a significant amount of homework on a manager before they arrive at its offices. "You should assume the examiners have reviewed all public disclosures about your firm. These items may include the Form ADV, the website and all documentation provided to the examiners prior to their visit. They will develop an understanding of your business based on what information they have reviewed."

Firms should also have a "clean desk" policy in place which requires employees to put away sensitive documents and lock computers prior to leaving workspaces. Since examiners may walk around the office, employees should also clear their spaces of any notes that contain usernames and/or passwords, so that examiners do not find sensitive firm or client data lying around in plain sight.

Designate a Contact Person

According to Richard Marshall, a partner at Katten Muchin Rosenman, "There should be a person that is the point of contact for the SEC examiners and all document requests should go through that person. All information is produced by that person to the SEC. Any interviews of firm personnel that are conducted, the point of contact will sit in on these and takes notes. It doesn't have to be the chief compliance officer, but that is the most common person designated to do this."

In his experience, offered Brown, the CCO often serves as the primary point of contact for examiners, and in that capacity, all communications flow through the compliance function, and the CCO is present for the initial interview and also educates the SEC about the firm, its products and services. The CCO is also responsible for gathering and organizing documents for production. "This allows firms to keep an accurate record of what was requested and what was provided and to really help ensure there are few or no misunderstandings," he added.

Wowak agreed and advised managers to have the CCO attend all meetings. "The examiners do not object to this. Having the CCO there will give a consistent presence during the meetings. The CCO should take notes of questions asked and responses given, and then have an internal briefing after these meetings to ensure consistent messaging is being given."

Preparing Staff

Once a manager knows an exam is imminent, firm staff need to be informed. As a preliminary step, managers should instruct staff to review the firm's compliance manual, with particular focus on the sections most relevant to their respective job functions, and remind staff to clear their desks of deal information and to refrain from either discussing deals in public areas or offering unsolicited information to the examiners.

Second, the firm should conduct—or hire outside counsel to conduct—mock examination exercises with, at a minimum, said Brown, the managing partners, the CCO and the CFO, because the SEC will always want to meet with them onsite. "After that," he noted, "It really depends on the issues the SEC is focusing on. They could also, for example, talk to the controller, someone in investor relations or the head of trading."

In preparing his clients for an SEC exam, Elovitz said, "For people we know will be meeting with the SEC examiners, we will do individual sessions so they can understand the types of things the staff might be interested in, including certain hot issues the exam staff might be focusing on. You want these individuals to be able to discuss how these issues relate to their firm and how their own processes address these issues."

Marshall noted that, strategically, preparing employees to be interviewed by SEC examiners is similar to preparing a witness for testimony. "You don't want to over-prepare. But, you want to make sure these individuals know what to expect, and they are all on the same page about what the firm does."

Employees should also understand that they don't need to know the answer to every question the SEC may pose, added Brown. In fact, sometimes it's better for an employee to respond that they don't know an answer than it is to guess. "People need to understand that if they say something, and the SEC discovers that the answer was wrong, that person and the firm take a major credibility hit. Even just guessing, but turning out to be wrong, can cause a major issue with your exam. So, it's important for people to understand it's okay to tell the examiners they are not sure about something, but that they will look into it and get back to them with the correct information."

Preparing staff in advance can also help the firm maintain a consistent message to the SEC about its practices and the importance of its culture of compliance. Key person interviews, for example, can be an important medium through which firms can communicate the importance of a culture of compliance, added Brian Daly, a partner at Schulte Roth & Zabel. "The CIO and other executives should meet with the exam staff and explain how important compliance is. Making key personnel available for interview during the exam sets the tone for the exam and can really get the exam off on the right foot. You want key people within the firm to be able to discuss the role of compliance within the firm and to demonstrate the culture of compliance within the firm. This should be a consistent message."

Finally, if there are any known disgruntled employees within the firm, managers should meet with them before the exam. "Address any personnel issues before the SEC comes in. If you have someone who is unhappy with the firm, they're going to have a bad interview," said Marshall.

Responding to Document Requests

Once managers receive document requests from the SEC, they should analyze them to determine the examiners' areas of focus and which types of documents will be responsive to the SEC's concerns. "The initial request can be a general listing of five to 10 documents or a more comprehensive listing of 40-50 items," explained Wowak. "You should review the letter and assess it for themes or consistent topics that will help you understand if the exam is targeting a specific area of your business." Managers should also pay close attention to the exam period, he said, so that the information provided is limited to the time period under review.

Although it may seem like it should go without saying, managers should make every effort to meet all SEC deadlines for production of documents. If meeting a deadline is impossible, the firm's point of contact should reach out to the SEC staff as soon as possible to discuss potential delays and request an extension.

In addition to timely producing documents, Wowak advised, "Prior to submitting any information to examiners, a consistency review should take place. This may include triangulating your public disclosures, your regulatory filings and any internal compliance manuals or policies you've written. Catching discrepancies in your documents prior to providing them to examiners helps."

Prepare a Presentation

Any registered adviser being examined should prepare an introductory presentation to give to the SEC when they arrive onsite for the exam. The presentation can give examiners insight into the firm's operations and frame the subsequent examination, and the exercise of preparing it can be useful for managers to ensure consistent messaging in how they explain the firm to the SEC. These presentations used to be optional, said Brown, but examiners have come to expect them. “Nowadays, in most first-day request letters, the SEC will ask for a slide deck presentation on the firm. Some firms do prepare these presentations in advance but many don’t.”

Wowak advised managers to develop a presentation that provides an overview of the firm, its organizational structure, compliance review process, controls, and investment strategy. “Preparing and sharing an overview of your business that clearly articulates what your firm does and how the investment strategy is executed may be a way to ensure that you and the exam team are on the same page when it comes to your business.”

Elovitz agreed that “first day” presentations are helpful to examiners. “These PowerPoint slide decks walk through the firm and present it to the exam staff. This is a way of affirmatively telling your firm’s story to the exam staff instead of sitting back and letting the examiners just cross-examine you. We consistently see this as a way to get exams off on the right foot, so that the staff can get the most information about your firm in an easily digestible format early on.”

Marshall also agreed introductory presentations can be a helpful tool. “I think preparing a slideshow is helpful to give examiners an overview of your business and how you execute your investment strategy. However, these are presentations the manager usually prepares for marketing purposes, and I don’t think it’s a valuable use of time to perpetually update one of these presentations just in case the SEC starts an inspection.”

Instead, the presentations should be updated once the SEC announces its examination, and managers should tailor the presentation to the examiners’ areas of focus.