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SURVIVING AN SEC REGULATORY EXAM—A GUIDE FOR INVESTMENT ADVISORS

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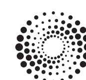
Investment advisers must be cognizant that Securities and Exchange Commission (SEC) regulatory examinations are an inevitable part of their lives. Over the past five years, exams have become more prosecutorial, and examiners have embraced an increasingly adversarial approach when examining investment advisers. To aid advisers in navigating through this regulatory environment, we examine the events that have brought us here and discuss various aspects of the examination process. We conclude with advice for handling examinations in light of the current regulatory environment.

How We Got Here: Recapping Recent History

Over the last 10 years, the convergence of various forces has pushed the SEC into its new and more aggressive regulatory role. Key among these forces are the economic downturn; a series of high-profile frauds, including the Bernie Madoff scandal; and changes in leadership at the SEC.

In the late 2000s, the United States experienced its most significant recession in decades. All three major indices—the S&P 500, NASDAQ, and Dow Jones—dropped by more than 50%.[1] These market declines impacted the American economy as a whole: unemployment hit 10%[2] and the GDP dropped by 3%.[3] The finance industry was a major player in the recession, primarily due to the massive risks associated with mortgage-backed securities. Due to a number of contributing factors, including credit-rating companies failing to identify the high levels of risk among certain credit portfolios, institutional investors purchased enormous quantities of high-risk securities, unaware of the actual level of balance-sheet risk they were taking on. The high-risk securities lost value when the underlying mortgages defaulted, and numerous institutional investors experienced staggering, unanticipated losses.

Much of the public interpreted the market crash and instability as a failure by the SEC to uphold its mission to protect investors and maintain a fair, orderly and efficient market. The SEC's unsuccessful attempt to regulate mortgage-backed securities exacerbated this perception, and soon the SEC found itself in an undesirable spotlight.



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But the financial downturn was not the SEC's only source of vulnerability; it was further compounded by the very public fallout resulting from a series of large fraudulent investment schemes including the Bernie Madoff scandal. In 2008, Madoff was arrested for financial fraud and sentenced to the maximum term of 150 years in prison. He had committed the largest financial fraud in U.S. history, amounting to the mismanagement of tens of billions of dollars. Madoff had run his investment advisory business for decades, and his Ponzi scheme likely lasted for more than 15 years.[4] Although the SEC had examined or investigated Madoff's advisory business five times before 2008, it had never uncovered any violations.[5] Madoff's business and the SEC's unsuccessful examinations prompted the Office of Investigations to conduct a 450-plus-page study investigating how the SEC managed to miss Madoff's financial fraud despite credible red flags and complaints. According to the study, despite the five investigations or examinations, "a thorough and competent investigation or examination was never performed."[6] The study recalled that, even though Madoff contradicted himself during multiple examinations, the examiners either disregarded the contradictions or asked Madoff for clarity and accepted his answers at face value.[7] Teams conducting examinations were criticized as "relatively inexperienced" and conducted the examinations with "insufficient planning."[8] Examiners were described as lacking familiarity with securities laws because their experience was limited to general litigation.[9] As a result, there was "no significant attempt" to analyze the numerous red flags about Madoff's trading and returns that were unearthed through complaints, tips, examinations and investigations while Madoff ran his advisory business.[10]

It quickly became clear that the SEC needed to improve its policies, procedures and personnel to permit it to effectively regulate investment advisers, promote market stabilization and protect investors.

Chasing Broken Windows: The SEC Gets More Aggressive

In 2009, Mary L. Schapiro became the 29th chairman of the SEC, inheriting an economic environment that had just undergone the most significant recession in decades and an organization that failed to identify the largest misappropriation of privately managed financial assets in United States' history. In an effort to improve investor confidence in markets through improved regulatory enforcement, she named Robert S. Khuzami to lead the enforcement division of the SEC later that year.[11]

Khuzami came from a background in litigation, having served for years as a prosecutor at the Manhattan U.S. Attorney's Office. Given his background, Khuzami began his tenure by running the enforcement division like a U.S. Attorney's Office, creating specialized units and reducing layers of management.[12] The examination process picked-up, and the SEC brought a record number of enforcement actions during

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Schapiro's tenure.[13] Quite simply, no regulator wanted to be responsible for missing the next Madoff.

Meanwhile, in 2010, Congress attempted to help the SEC further its mission by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). To address the SEC's past examination failings, Section 914 of Title IX of Dodd Frank required the SEC to review and analyze its own examination of investment advisers. The SEC's Division of Investment Management was tasked with conducting this study. In 2011, the Division released a report finding that the SEC's Office of Compliance Inspections and Examinations (OCIE) "[would] not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency."[14] In light of this assessment of the OCIE—which functions as the eyes and ears of the SEC[15]—it became clear that the changes under Schapiro and Khuzami were not enough and the SEC had more work to do to improve the examination process.

In April 2013, Mary Jo White replaced Schapiro as the chairman of the SEC. Like Khuzami, White came from a background in federal prosecution, with a career built on a tough-on-crime reputation. She ran with Schapiro's aggressive style and pursued the broken window theory, in which no violation was too small to punish. In her own words, "Minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions."[16] Accordingly, the SEC made an intentional effort to pursue smaller cases, such as control failures and negligence-based offenses.[17] Andrew J. Ceresney, co-director of the SEC's Division of Enforcement, embraced this motto, and stated, "[t]he benchmark of an effective enforcement program is zero tolerance for any securities law violations, including violations that do not require manipulative intent."[18]

The new approach quickly manifested. Enforcement of Rule 105, which is a strict liability offense prohibiting short selling and participating in a secondary offering within a prohibited window of time, is an archetypal example.[19] In September 2013, the SEC announced charges against 23 firms for Rule 105 violations[20] and in September 2014, the SEC announced 19 different cases[21] in which firms were sanctioned for Rule 105 violations. In 2015, the SEC sanctioned one firm for $7.2 million to settle charges related to Rule 105 violations—the largest monetary sanction ever obtained for a Rule 105 violation.[22]

The SEC's leaner and more aggressive approach has been buttressed by enhanced enforcement mechanisms created by legislative changes, including both Dodd-Frank and the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which have given the SEC's enforcement arm significantly more power. For instance, when the SEC was created by Congress, it did not have the ability to obtain monetary penalties from violators.[23] Instead, it had to obtain a court order to stop ongoing or future violations in the form of an injunction—ranging from disgorgement of illegally-obtained profits to prohibiting violators from participation in the securities industry.[24] This contrasts our current regulatory landscape, where the SEC can hold its own administrative hearings that impose mon-

etary penalties on violators. This has provided the SEC with significantly more power over the enforcement process as well as more discretion in determining the level of monetary penalties imposed on perceived violators.

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As a result of new leaders, aggressive policies, and the SEC's ability to levy large fines, examinations have become a more nerve-racking experience whereby regulators are commonly skeptical that an adviser is compliant with regulations.

SEC's Enforcement Priorities

The SEC's exam process differs depending on numerous factors, including which of the 11 regional offices conducts the exam, which examiners take part in the exam, and what initiated the exam in the first place. The SEC's exams fit into two general categories: presence and non-presence examinations. Both of these examinations can be triggered from several factors, such as a higher-risk business model, a for-cause exam generally involving a tip or complaint, or a sweep examination involving a compliance issue that impacts multiple firms. The common theme among these triggers is perceived regulatory risk. (*Note*: routine examinations—as opposed to risk-based exams—used to take place on a regular basis, but due to lack of resources, they occur much less frequently.[25])

On an annual basis, the SEC publishes "Examination Priorities," or topics and issues of focus for examinations.[26] These provide an opportunity to triple-check that your firm is compliant with regulations as well as educate firm personnel on the high-priority regulatory topics. In 2015, the topics of focus fit into four themes: (*i*) retail investors and investors saving for retirement; (*ii*) market-wide risks; (*iii*) using data to examine practices such as excessive trading and pump-and-dump schemes; and (*iv*) other initiatives (which functions similar to a "miscellaneous" category).[27] Within these themes, the SEC provides examples of specific topics that will be the focus of examinations, which are a good predictor of what enforcement actions will materialize during that year. For instance, in 2015, one of the topics is examining the fees and expenses of private equity funds. In June 2015, Kohlberg Kravis Roberts & Co. LP (KKR) paid approximately $30 million for allegedly failing to properly allocate broken deal expenses among its private funds and co-investors.[28] Shortly thereafter in October, Blackstone Management Partners LLC, Blackstone Management Partners III LLC, and Blackstone Management Partners IV LLC (collectively, "Blackstone") agreed to pay a $39 million settlement involving claims that the firm did not fully disclose information about fees and business discounts that benefited the firm.[29] And most recently in November, Fenway Partners, LLC and certain owners of the firm paid approximately $10.2 million for failing to disclose conflicts of interests related to charging fees to

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portfolio companies of private funds managed by the firm.[30]

In addition to the Examination Priorities publication, the OCIE issues periodic "Risk Alerts" that outline the OCIE's observations during recent exams, as well as specific topics of focus for future examinations.[31] For instance, in both February and September 2015, the OCIE issued Risk Alerts related to cybersecurity.[32] Soon after, in late-September, R.T. Jones Capital Equity Management, Inc. was sanctioned $75,000 for failing to adopt written policies and procedures reasonably designed to protect its investors' private information.[33] R.T. Jones had previously been a victim of a cyberattack compromising the personal information of more than 100,000 investors, and the SEC determined R.T. Jones' policies and procedures during that attack were not sufficient to protect investors' personal information.[34]

In short, both Examination Priorities and Risk Alerts are helpful tools in keeping up-to-date with the SEC's target areas of inquiry. This knowledge will allow you to better evaluate the strength of your own firm's compliance program and determine whether it should be modified or enhanced.

The Examination Process[35]

The presence examination process typically begins with a phone call to the targeted firm's Chief Compliance Officer (CCO). The examiner will let the CCO know a presence examination will take place and ask basic questions about the firm's Form ADV and other topics. (The adviser's Form ADV is the primary public disclosure document providing information on the adviser and its business.) The detail and topic of these conversations fluctuates depending on which regional office is conducting the examination.

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Next, the CCO will receive a letter with a documentation request. (Registered investment advisers are required to comply with the books and recordkeeping requirements of Section 275.204-2 of the Advisers Act, which generally requires retention of business records for a period of five years. However, due to reasonable business practices, many firms retain documentation for an even longer period of time.) The timeframe for producing the documentation varies from exam to exam, but expect a time period that is around one week. The SEC may request that the documents are delivered to the regional office or that they are available for review at the adviser's office. Additionally, examiners may request information and documents held by third-party service providers that work in conjunction with the adviser.

Next, the SEC will provide a date that the presence exam will take place. This can range from one to several weeks from the initial SEC contact. (A week may sound short, but many state securities regulators conduct "surprise exams" or, in other words, they examine firms without providing any notice. The SEC reserves the right to conduct surprise examinations, but they are unusual.)

Once the SEC arrives, the examiners will review the materials produced from the docu-

ment request. The examiners will also have a conversation with the CCO and conduct introductory interviews with partners of the firm. Once again, depending on the office and the examiner, the intensity of these conversations will vary: some examiners have a reputation for being highly aggressive and critical, while others have a more collegial tone. These interviews are very important since they often set the tone for the remainder of the examination. In addition to conducting interviews, examiners will likely tour the office to obtain a better understanding of how it is organized and the workflow of the adviser's business.

The remaining portions of the examination generally depend on the issues, if any, identified by the examiner during the documentation request and initial interviews. Examiners tend to focus on specific areas, such as custody and allocation of expenses. While they investigate perceived potential issues, the examiners typically interview additional employees.

The examination will conclude with an exit interview. This conversation provides insight into any potential regulatory deficiencies that may be addressed in the upcoming deficiency letter. The deficiency letter generally arrives within six months of the end of the presence exam. However, when serious deficiencies are detected, the examiner may immediately refer the deficiencies to the Commission's Division of Enforcement, or another organization, which may commence a separate process.

Next Steps: What You Can Do to Prepare

There are proactive steps firms can take to make SEC examinations a more efficient and less disruptive process.

First, keep the firm's books and records organized. Prior to any examination, review the recordkeeping requirements under the Advisers Act and ensure that documents can be promptly produced. Your goal should be producing the documents within 24 hours, and it is much easier to achieve that goal if records are maintained in a clear, deliberate and systematic manner.

Second, respond to regulators in a clear, but concise manner. Make sure that firm partners and executives understand that the examination will run more smoothly if responses to questions are targeted and deliberate. The last thing you want is to waste an examiner's time by failing to answer a question and create an irrelevant rabbit hole for the examiner to go down.

Additionally, make sure that the firm is well-versed in its own compliance program. Prior to the initiation of any examination, all employees should be knowledgeable about what their compliance responsibilities entail. When an examination is initiated, it is a good time to have employees review policies and procedures. Make sure employees feel comfortable asking questions about the program and that there is a knowledgeable source to answer these questions—most likely the adviser's CCO. Furthermore, the adviser's CCO typically receives the majority of questions during the examination and must be prepared to discuss the firm's compliance program in detail.

Third, know what topics the SEC is focusing on during examinations. As mentioned above, the SEC periodically publishes an updated list of topics and issues of focus for examinations on the SEC's website.[36] Make sure your firm is not only compliant with changing regulations, but also aware of the SEC's focus areas so that employ-

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ees can engage in productive and efficient conversations with examiners.

Fourth, stay aware of the SEC's mindset by keeping abreast of recent SEC cases. For example, recent cases illustrate the SEC's changed approach in addressing issues identified by compliance programs. Traditionally, the SEC has considered a compliance program to be effective as long as it adequately identifies potential issues and promptly corrects those issues moving forward. This year, however, KKR was sanctioned approximately $30 million dollars—including a $10 million penalty—for doing just that: it identified potentially problematic expense allocations during a 2011 internal review and corrected those expense allocations going forward.[37] In light of that case, it appears the SEC's view of a strong compliance program has shifted: simply having a compliance program identify problems and correct such problems moving forward is insufficient to avoid violations of fiduciary duty and significant SEC sanctions.

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As another example, the settlement order in the KKR case and the settlement order four months later in the Blackstone case suggest another SEC mindset: cooperating with the SEC is a significant factor when the SEC is determining whether to settle a case against an adviser and how favorable the terms of the settlement will be. In the KKR case, KKR identified and corrected potentially problematic expense allocations pursuant to its internal review in 2011, and hired an outside compliance consultant to rebuild aspects of its program. In the end, instead of pursuing further enforcement actions, the SEC chose to settle the case with KKR. In the Blackstone case, Blackstone took steps to stop problematic legal fee arrangements and also increased disclosures to investors after identifying regulatory compliance issues during a 2011 internal audit. Additionally, Blackstone personnel voluntarily provided documents and information to examiners, and responded to the SEC's inquiries in an "extremely prompt and responsive" manner.[38] Again, the SEC elected to settle with Blackstone, rather than pursue further enforcement action.[39]

The SEC's successive settlement orders for KKR and Blackstone specifically reference the advisers' respective remediation efforts as a consideration when determining whether to settle the cases.[40] Furthermore, in the press release for the Blackstone case, the SEC publicly encourages advisers to self-report regulatory issues, and emphasizes that self-reporting is one factor used to determine whether, and to what extent, a settlement will take place.[41] Considering the SEC's enforcement manual lists both remediation and self-reporting as two-out-of-four measurements to determine if an adviser cooperated with the SEC, cooperation—as a whole—is likely a significant factor in determining whether to settle a case and how favorable the terms of the settlement will be.[42] As a result, it would be wise to become familiar with the SEC's publicly stated measurements used to determine whether an adviser is deemed cooperative and take steps to ensure your firm acts in a cooperative manner.

Fifth, be patient. The SEC tends to hire exam-

iners who are either attorneys with backgrounds in general litigation[43] or accountants, which oftentimes means that fund managers and CCOs will need to explain their business models and compliance programs multiple times. In our experience, regulators will assume a violation exists until you have persuaded them that the violation did not take place. If the regulator does not understand what you are saying, it is very difficult to persuade them. As a result, have an extra cup of coffee on the day of your exam and be prepared to spend a significant period of time explaining your business.

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Conclusion

The SEC has responded to tough criticism and failure to maintain market stability by making leadership and policy changes that have resulted in an aggressive regulatory environment. As a result, advisers must anticipate and prepare themselves for the current environment by maintaining a strong compliance program and actively preparing for SEC examinations.

ENDNOTES:

[1]*Historical Prices*, YAHOO FINANCE, http://finance.yahoo.com/q/hp?s=``IXIC (set date range to Oct. 9, 2007 to Mar. 9, 2009); *Historical Prices*, YAHOO FINANCE, http://finance.yahoo.com/q/hp?s=``GSPC (set date range to Oct. 9, 2007 to Mar. 9, 2009); *Historical Prices*, YAHOO FINANCE, http://finance.yahoo.com/q/hp?s=``DJI (set date range to Oct. 9, 2007 to Mar. 9, 2009).

[2]*Databases, Tables & Calculators by Subject*, BUREAU LAB. STAT., http://data.bls.gov/timeseries/LNS14000000 (last visited Nov. 10, 2015).

[3]*National Economic Accounts: Gross Domestic Product (GDP): Percent Change from Preceding Period*, BUREAU ECON. ANALYSIS, http://www.bea.gov/national (last visited Nov. 10, 2015) (follow "Percent change from preceding period" hyperlink).

[4]"The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading." SEC OFF. INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME: PUBLIC VERSION 21 (2009), https://www.sec.gov/news/studies/2009/oig-509.pdf.

[5]*Id.* at 20-21.

[6]*Id.* at 21.

[7]*Id.* at 23.

[8]*Id.*

[9]*Id.* at 29.

[10]*Id.* at 23.

[11]Press Release, SEC, *Robert Khuzami Names SEC Director of Enforcement* (Feb. 19, 2009), https://www.sec.gov/news/press/2009/2009-31.htm.

[12]Aruna Viswanatha & Christopher Matthews, *Regulators Tap Prosecutors for Key Jobs*, WALL ST. J. (Apr. 6, 2015), http://www.wsj.com/articles/regulators-tap-prosecutors-for-key-jobs-1428361038.

[13]*SEC Biography: Chairman Mary L. Schapiro*, SEC, https://www.sec.gov/about/commissioner/schapiro.htm (last visited Nov. 10, 2015).

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[14]SEC Division Inv. Mgmt., Study on Enhancing Investment Adviser Examinations 3-4 (2011), http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

[15]Andrew Donohue, Chief of Staff, SEC, Remarks at NRS 30th Annual Fall Investment Adviser and Broker-Dealer Compliance Conference (Oct. 14, 2015), http://www.sec.gov/news/speech/donohue-nrs-30th-annual.html.

[16]Mary Jo White, Chair, SEC, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539872100.

[17]*Id.*

[18]Press Release, SEC, *SEC Charges 23 Firms with Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings* (Sept. 17, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376.

[19]Short selling in connection with a public offering, 17 C.F.R. § 242.105 (2007).

[20]Press Release, SEC, *supra* note 18.

[21]Press Release, SEC, *SEC Sanctions 19 Firms and Individual Trader for Short Selling Violations in Advance of Stock Offerings* (Sept. 16, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542963767.

[22]Press Release, SEC, *SEC Announces Largest Monetary Sanction for Rule 105 Short Selling Violations* (Mar. 5, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540883326.

[23]Jon Eisenberg, *Brother Can You Spare $8.9 Billion? Making Sense of the SEC Civil Money Penalties*, LEGAL INSIGHT, Feb. 11, 2014, at 1, http://www.klgates.com/files/Publication/7b9cf03a-e90d-4bba-a373-bb494b063f9b/Presentation/PublicationAttachment/e5d51e6b-f798-4bf7-80be-ebeb853f0ad9/SEC__alert__021114.pdf.

[24]*Id.* at 2.

[25]Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations, Strengthening Examination Oversight: Changes to Regulatory Examinations (June 17, 2009), https://www.sec.gov/news/speech/2009/spch061709lar.htm.

[26]*Office of Compliance Inspections and Examinations*, SEC, http://www.sec.gov/ocie (last visited Nov. 10, 2015).

[27]SEC OFF. COMPLIANCE INSPECTIONS AND EXAMINATIONS, EXAMINATION PRIORITIES FOR 2015 (2015), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

[28]*In re Kohlberg Kravis Roberts & Co. LP*, Investment Advisers Act Release No. 4131 (June 29, 2015).

[29]*In re Blackstone Mgmt. Partners LLC*, Investment Advisers Act Release No. 4219 (Oct. 7, 2015).

[30]*In re Fenway Partners, LLC*, Investment Advisers Act Release No. 4253 (Nov. 3, 2015).

[31]Office of Compliance Inspections and Examinations, SEC, supra note 26.

[32]*See generally* SEC Off. Compliance Inspections and Examinations, *Cybersecurity Examination Sweep Summary*, NAT'L EXAM PROGRAM RISK ALERT, Feb. 3, 2015, http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf; SEC Off. Compliance Inspections and Examinations, *OCIE's Cybersecurity Examination Initiative*, NAT'L EXAM PROGRAM RISK ALERT, Sept. 15, 2015, https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

[33]*In re R.T. Jones Capital Equities Mgmt., Inc.*, Investment Advisers Act Release No. 4204 (Sept. 22, 2015).

[34]*Id.*

[35]This section will focus on presence examinations.

[36]Office of Compliance Inspections and Examinations, SEC, supra note 26.

[37]*In re Kohlberg Kravis Roberts & Co. LP*, supra note 28.

[38]*In re Blackstone Mgmt. Partners LLC*, supra note 29.

[39] *Id*.

[40] *Id*.; *In re Kohlberg Kravis Roberts & Co. LP*, supra note 28.

[41] Press Release, SEC, *Blackstone Charged with Disclosure Failures* (Oct. 7, 2015), http://www.sec.gov/news/pressrelease/2015-235.html.

[42] SEC DIVISION ENFORCEMENT, ENFORCEMENT MANUAL 94-97, http://www.sec.gov/divisions/enforce/enforcementmanual.pdf (detailing the framework with which the SEC evaluates cooperation by individuals and companies).

[43] Viswanatha, *supra* note 12.

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