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PREPARING FOR AND MANAGING AN SEC EXAMINATION OF A REGISTERED INVESTMENT ADVISER

The examination of investment advisers continues to be an important program for the SEC's Division of Examinations. In this article the author outlines the types of examinations the Division conducts and its 2021 examination priorities. She then provides recommendations how to prepare for an examination, handling the request, and managing the examination. She adds notes on exit interviews and examination summary letters, and concludes with a reminder of the importance of a culture of compliance.

By Kelley A. Howes *

The U.S. Securities and Exchange Commission Division of Examinations ("EXAMS" or the "Division") operates the SEC's National Exam Program ("NEP") out of the SEC's headquarters in Washington, D.C. and each of the SEC's 11 regional offices. The NEP's stated goals are to protect investors, ensure market integrity, and support capital formation through risk-focused strategies that: (i) improve compliance; (ii) prevent fraud; (iii) inform policy; and (iv) monitor firm-wide and systemic risk.¹ The Investment Adviser/Investment Company examination program is one of the two largest program areas (together with the Broker-Dealer and Exchange program).²

As of the end of 2020, the number of registered investment advisers overseen by the Division was approaching 14,000, representing assets under management of approximately \$97 trillion.³ Given those numbers, EXAMS is unable to regularly review all of

the investment advisers registered with the SEC. Nonetheless, EXAMS reported an increased rate of such examinations from 10 percent in 2014 to 15 percent in 2020, despite a mid-year shift to remote examinations in 2020.⁴ Even more importantly, from the point of view of registrants, EXAMS continues to expand its staff training related to investment advisers and, over the last several years, has hired experienced subject matter experts. In short, the examination of investment advisers continues to be an area of emphasis for the EXAMS staff.

This article provides an overview of current examination priorities identified by the EXAMS staff. It then provides practical recommendations related to how an investment adviser and its compliance staff can proactively prepare for an examination and effectively manage an examination once it has begun.

THE NATIONAL EXAM PROGRAM

In general, the NEP conducts three types of examinations:

¹ *About the Division of Examinations*, <https://www.sec.gov/exams/about>.

² *2021 Examination Priorities*, Division of Enforcement (Mar. 3, 2021), <https://www.sec.gov/files/2021-exam-priorities.pdf>.

³ *Id.*

⁴ *Id.*

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- *Risk-Based Examinations* are based either on an adviser’s overall risk profile or specific risks that have been identified by the EXAMS staff. The Division’s risk analysis is data-driven, and considers various risk factors, including: (i) if an adviser offers products with higher risk characteristics; (ii) the nature of an adviser’s compensation and funding arrangements; (iii) the adviser’s disclosures to its clients and potential clients; (iv) the adviser’s prior examination observations and regulatory history; (v) whether a firm has never been examined, is newly registered, or has not been examined in many years; (vi) material changes in firm leadership or other key personnel; and (vii) whether a firm has access to investor assets, i.e., has custody of client assets.⁵
- *Cause Examinations* are based on the staff’s belief that potential violations of federal securities laws have occurred. This can be prompted by press reports, complaints, whistleblowers’ reports, or referrals from other divisions or regulators.
- *Special Purpose Examinations* include risk-targeted sweep exams and often focus on identified emerging risks.

2021 EXAMINATION PRIORITIES

On March 3, 2021, EXAMS published its Examination Priorities for 2021. In many ways, the priorities for 2021 remain consistent with those published in prior years. For example, EXAMS continues to emphasize the protection of retail investors, including seniors, teachers, military personnel, and individuals saving for retirement. As a result, EXAMS will evaluate an adviser’s sales practices regarding more complex products and compliance policies related to the adviser’s recommendations of different kinds of account types for such investors.

EXAMS also reported that it continues to examine investment advisers to “assess whether, as fiduciaries, they have fulfilled their duty of care and duty of

loyalty.”⁶ Among other things, this includes assessing how advisers manage their obligation to consider whether certain types of accounts or products are consistent with the best interests of their clients. This includes, for example, an assessment of whether an investment adviser is either eliminating or making full and fair disclosure of its conflicts of interest when it recommends products and account types to clients. EXAMS will also look at risks associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed compensation arrangements. An investment adviser should expect that this type of review will, among other things, include a careful evaluation of the adviser’s Form ADV and other disclosure documents.

More generally, EXAMS will always assess whether an investment adviser’s compliance program is reasonably designed to ensure that the adviser and its supervised persons will not violate the Investment Advisers Act of 1940 and its related rules. This assessment includes whether such policies are appropriately implemented and maintained. Finally, EXAMS continues to prioritize examinations of newly registered investment advisers and advisers that have never been examined. Examinations of these newly registered or never-before-examined firms are designed to generally evaluate a firm’s compliance program and to educate the firms about best practices.

In addition to these perennial areas of focus, EXAMS stated that firms that claim to be investing in a manner that is consistent with environmental, social, and governance (“ESG”) criteria will be examined for compliance with these stated investment goals. Among other things, EXAMS considers whether a firm’s policies and procedures are consistent with the ESG criteria contained in a firm’s disclosure documents, such as its Form ADV, marketing materials, and fund-offering documents. The Division will also review an adviser’s proxy voting policies and procedures to ensure that they align with the firm’s disclosure and investment strategies.

⁵ *Id.*

⁶ *Id.*

The Division clearly signaled that these ESG-focused examinations remain an area of focus when, on April 9, 2021, it published a risk alert highlighting staff observations of deficiencies gleaned from examinations of investment managers that offer ESG products and services.⁷ The risk alert also identified best practices related to how investment advisers can ensure compliance with their stated ESG investment guidelines. Investment advisers that claim to follow an ESG investment framework should evaluate and, as necessary, revise their compliance programs in light of the information contained in this risk alert.

While an investment adviser should pay close attention to the examination priorities and consider if it is operating consistent with best practices identified in EXAMS' published risk alerts, other data may push a particular adviser to the top of the Division's risk-based list of examination candidates. Accordingly, investment advisers should seek to ensure that they are and remain adequately prepared for the possibility of an examination and take steps to regularly assess their readiness.

HOW TO PREPARE FOR AN EXAMINATION – EVEN WHEN YOU DON'T KNOW IT'S COMING

Investment advisers should strive to maintain a constant state of readiness for a potential examination. The single best way to do so is to ensure that an adviser's compliance program is in good order. This sounds relatively simple, but it can be time consuming and labor intensive, and can involve a number of issues, including:

- Ensuring that any compliance deficiencies previously identified by EXAMS staff are addressed in a manner consistent with representations made to the staff. Advisers should document how and when deficiencies identified in prior examinations were resolved and maintain that record in an easily accessible place in anticipation of their next examination.
- Monitoring new regulations and ensuring that compliance policies and procedures are amended in a timely manner to reflect new rules adopted by the SEC or other regulators that are applicable to a particular investment adviser. One of the easiest ways to ensure timely notification of new and pending regulations, or relevant public statements of SEC commissioners or staff, is to subscribe to SEC

website feeds that will deliver information directly to a compliance officer's e-mail inbox. Additionally, EXAMS has established a compliance outreach program designed to provide a forum for compliance officers and SEC staff to discuss timely compliance issues and best practices.⁸

- Keeping up with the business conducted by the investment adviser, including understanding whether the adviser uses any unusual or high-risk investment strategies, valuation techniques, compensation structures, allocation procedures, or other business policies. If so, compliance and business personnel should be prepared to explain the strategies and techniques to EXAMS staff and address how conflicts of interest and other risks related to such strategies and structures are mitigated and disclosed.
- Create and have ready an introductory presentation that can be used to ensure that the EXAMS staff understands the structure and business of the investment adviser, its key personnel, and any unusual business practices. From time to time, the compliance officer should review that presentation with senior management, sales staff, and portfolio management to ensure that it doesn't get stale and that it captures not only the compliance view of the organization but is consistent with how the business represents itself elsewhere.
- Monitor EXAMS' published risk alerts and other guidance. Make sure that the adviser maintains and can easily access any records identified in such publications and consider if changes need to be made to the firm's compliance policies and procedures to address identified best practices.
- Review sample SEC document request lists.⁹ Among other things, these lists can help an adviser identify any potential challenges that it might encounter in producing requested records before an examination occurs.

HANDLING THE EXAMINATION REQUEST

In the case of a routine examination, EXAMS staff will usually call the chief compliance officer ("CCO")

⁸ *Compliance Outreach Program for Investment Adviser and Investment Company Chief Compliance Officers*, https://www.sec.gov/info/complianceoutreach_ia-funds.htm.

⁹ *Office of Compliance Inspections and Examinations Investment Adviser Examinations: Core Initial Request for Information*, <https://www.sec.gov/info/cco/requestlistcore1108.htm>.

⁷ *The Division of Examinations' Review of ESG Investing* (Apr. 9, 2021), <https://www.sec.gov/files/esg-risk-alert.pdf>.

disclosed on an investment adviser's Form ADV to apprise him or her that the EXAMS staff intends to conduct an examination.¹⁰ That phone call will be followed in short order by an e-mail that includes a cover letter (identifying the staff personnel managing the examination and explaining how documents and other requested records should be provided to the EXAMS staff), and a document request list.

Promptly upon receipt of this phone call, a firm's CCO should take certain steps, including:

- Promptly notifying the firm's executives and other employees that the firm is under examination. The CCO should summarize the examination process, including whether it is likely to involve any onsite visits by EXAMS staff, and notify employees that they may be asked to help identify, create, or produce requested records.
- Instituting a freeze on all document destruction.
- Notifying those individuals who will likely be interviewed by the EXAMS staff and starting to prepare them for the interview process.

MANAGING THE EXAMINATION

No matter how prepared an investment adviser is for a regulatory exam, the examination itself can be stressful and labor intensive. The firm's CCO or their designee should be prepared to manage all facets of the examination and ensure that all staff requests are addressed in a timely and complete manner.

There are two primary portions of an examination: (i) preparing and producing the records and (ii) completing staff interviews. It is not necessary to accumulate all of the required records and produce them to the SEC staff at the same time. Rather, documents should be produced on a "rolling basis." In other words, easily accessible information, such as organizational charts and employee lists generally, can and should be produced within days of receiving an examination request (after the documents have been reviewed for accuracy and completeness).

The CCO or their designee should maintain a list of all requested information and when and how each

request is addressed. The CCO or their designee should keep copies of all of the documents produced to the staff and any supplemental written responses to questions raised by the examiners. Additionally, best practice is to request confidential treatment of documents produced under the Freedom of Information Act ("FOIA") and to number (i.e., with a BATES stamp) all documents submitted to the staff.¹¹ This will facilitate discussions about particular documents if the staff has specific questions.

An investment adviser should expect that the EXAMS staff will request to interview certain staff members. In general, this is likely to include senior executives, the CCO, and members of the sales and portfolio management teams.¹² The CCO should ensure that all employees who are interviewed understand how the examination has proceeded up to the date of their interviews. This includes, for example, understanding conversations that have occurred with the staff prior to the interviews. The CCO should also ensure that each interviewee has copies of the documents that have been produced to the staff and that are relevant to their area of expertise.

Best practice is to have a compliance representative attend all interviews to document the questions asked and determine whether any particular follow-up interviews are necessary.

EXIT INTERVIEWS AND EXAMINATION SUMMARY LETTERS

When the staff has completed their document requests and interviews, the CCO should request an exit interview with the EXAMS staff to discuss the preliminary findings. This will not reflect final findings of any deficiencies, but provides an opportunity for the CCO and compliance team to learn about any identified deficiencies in advance of the summary letter. It also provides the compliance team with an opportunity to

¹¹ If an adviser requests FOIA treatment, it will be notified if a third party requests access to any of the documents submitted and can seek protection of those documents under SEC procedures.

¹² The CCO should expect that they will be asked questions related to their qualifications and experience, as well as their understanding of the firm, its business, and the regulations applicable to the firm in light of its structure and business. The staff will likely also try to assess if a CCO has the authority necessary to implement and enforce the investment adviser's written compliance program.

¹⁰ As a result, it is important to ensure that any change in the firm's appointment of its chief compliance officer are promptly disclosed in an update to an adviser's Form ADV.

address any misunderstandings that may have occurred during the course of the examination, or to determine if any additional documentation could resolve such misunderstandings. It is also an opportunity to confirm that the Division staff believes that they have received all of the documents that they requested.

After the EXAMS staff has completed its review of the produced documents and the information generated through its interviews, it will issue a letter summarizing its examination findings. The letter may include any compliance deficiencies identified by the staff, and will ask the investment adviser to respond in writing. The response should acknowledge any identified deficiencies, and address how the adviser has or will correct those deficiencies and amend its compliance policies to ensure that similar deficiencies do not occur in the future. As noted above, this communication is also

one of the starting points for maintaining the adviser's preparedness for its next examination.

CULTURE OF COMPLIANCE

The SEC and its staff have consistently suggested that maintaining a culture of compliance is a critical component of a strong compliance program.¹³ In other words, from the top down, an investment advisory firm should work to establish and maintain strong organizational ethics that recognize the fiduciary nature of an adviser's role and that value regulatory compliance. Every person within the organization should know that their first priority is to do the right thing. A regulatory examination is certainly an opportunity to demonstrate to the SEC staff that the firm has a solid culture of compliance, but that is not the time to put a compliance culture in place. ■

¹³ *Working Towards a Culture of Compliance: Some Obstacles in the Path*, speech by Lori Richards, Director, Office of Compliance Inspections and Examinations (Oct. 18, 2007), available at <https://www.sec.gov/news/speech/2007/spch101807lar.htm>; *Observations on Culture at Financial Institutions and the SEC*, speech by Jay Clayton, Chairman (June 18, 2018).