Compliance Corner

The SEC's Never-Before Examined Initiative: Are You Ready?

By K. Susan Grafton, Partner, K&L Gates LLP*

On January 9, 2014, the Securities and Exchange Commission's (the "SEC's") Office of Compliance Inspections and Examinations ("OCIE") published its 2014 National Exam Program ("NEP") priorities, available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf, which included never-before examined investment advisers. Subsequently, on February 20, 2014, OCIE announced details regarding its initiative to conduct risk-based and focused examinations of these advisers (the "NBE Initiative"), available at http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf. The NBE Initiative is separate from OCIE's "Presence Exam" initiative, which is directed at private fund advisers that were required to register following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The NBE Initiative will particularly focus on advisers that have been registered three or more years without being subject to an exam. In a letter sent to registered investment advisers that the SEC has identified as having never been examined, **Jane Jarcho,** the National Associate Director IAIC Examinations, explained that the NBE Initiative will include (1) risk assessment exams and (2) focused reviews.

Risk Assessment Exams

Risk assessment exams are intended to provide the SEC staff with a better understanding of registrants. These types of examinations will consist of high level reviews of an adviser's compliance program and other essential documents so that the examiners can assess the representations made in the adviser's disclosure documents.

Focused Reviews

Focused reviews will involve more comprehensive, risk-based examinations of areas identified by the exam staff as posing higher risks for the adviser's business and operations. The five higher risk areas OCIE identified are:

1. The Adviser's Compliance Program

Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") requires registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to prevent, detect, and promptly address any violations of the Advisers Act by the adviser and any of its "supervised persons," as defined in section 202(a)(25) of the Advisers Act. Rule 206(4)-7 also requires investment advisers to undertake an annual review to determine the adequacy and effectiveness of their procedures in light of internal and external developments affecting the firm.

OCIE's examiners are expected to evaluate the effectiveness of the adviser's compliance program, including reviewing whether conflicts of interest and compliance-related risks are properly identified, mitigated, and disclosed. Examiners will also review whether a competent Chief Compliance Officer ("CCO") has been empowered to administer the compliance program, as the SEC has said is required by Rule 206(4)-7.

2. Filings and Disclosures

As fiduciaries, investment advisers have duties of care and loyalty to their clients, which require disclosure of all material facts regarding conflicts of interest. This obligation is intended to allow clients and potential clients to make informed decisions before entering into or continuing a relationship with an adviser. OCIE has identified certain conflicts of interest that may be inherent in investment advisory business models, including:

- Compensation arrangements, particularly undisclosed compensation arrangements and their effect on recommendations;
- The allocation of investment opportunities;

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- Controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts;
- Risk controls and disclosures; and
- Higher risk products or strategies targeted to retail investors.

Examiners are also likely to review an adviser's filings, marketing materials, and other disclosure documents for the content, accuracy, and completeness of disclosures, particularly regarding the full scope of the adviser's business, investment activities, and conflicts of interest.

3. Marketing

OCIE identified marketing and performance advertising as a 2014 exam priority generally for investment advisers, and specifically as part of the NBE Initiative. During focused reviews, examiners are expected to evaluate the accuracy and completeness of the adviser's claims about their business, investment objectives, and performance record.

Among other things, OCIE will likely review and test hypothetical and back-tested performance, the use and disclosure of composite performance figures, and performance record keeping. Examiners are also likely to review the adviser's compliance oversight of its marketing activities and, if applicable, marketing efforts related to securities offered and sold pursuant to exemptions afforded by the Jumpstart Our Business Startups (JOBS) Act.

4. Portfolio Management

OCIE has noted that examiners will review and evaluate the portfolio decision-making practices of the adviser, including the allocation of investment opportunities and whether the adviser's practices are consistent with its disclosures to clients.

5. Safety of Client Assets

During focused reviews, OCIE is expected to utilize a risk-based asset verification process to confirm the existence of assets, and test for the adviser's compliance with the Custody Rule, Rule 206(4)-2 under the Advisers Act, and other provisions designed to prevent the loss or theft of client assets. OCIE's March 2013 Risk Alert, available at http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf, discusses some of the most common Custody Rule violations that examiners have identified.

Using the Risk Assessment Program to Prepare for Exams

As noted above, Rule 206(4)-7(b) requires an adviser to undertake a review of the adequacy and effectiveness of its compliance program at least annually, or more often if appropriate due to internal and external developments. An adviser's risk assessment program can provide a useful tool for preparing for risk assessment and focused reviews.

Step One: Establish the Review Protocol

1. Identify Responsible Personnel

The size and complexity of an investment adviser and its business will inform who should conduct the review. Smaller firms may well determine that it is appropriate for the compliance department, under the direction of the CCO, to conduct the review. Larger advisers may find it beneficial to establish a standing risk committee that is responsible for directing the performance of the annual review and for meeting periodically to consider and address business, compliance, operational, financial, and reputational risks. If the adviser has never-before been examined, significant compliance issues have been identified, or significant changes in the adviser's organization or activities have occurred, it may be appropriate for the adviser to have the review conducted under the direction of outside counsel.

2. Gather Relevant Documents

To prepare for the review, the responsible personnel will want to compile a file of relevant information, such as:

- The current Form ADV, brochure, and polices and procedures, including its Code of Ethics;
- The last annual review, including any planned remediation;
- Communications with the SEC;
- Employee or client complaints;
- Internal reports or documentation relating to a compliance event and its resolution;
- Relevant supervisory or compliance logs, deficiency reports, or similar other documentation;
- Management reports;
- A checklist of relevant legal or regulatory developments that are required to be reflected in the adviser's policies and procedures;
- Copies of current disclosures and marketing materials; and
- Negative news articles or publicity.

3. Determine Who Should Be Interviewed

A list of personnel to be interviewed should be developed. The list should not be limited to compliance professionals, but should include relevant business, operations, technology, and financial personnel who are knowledgeable about changes in the adviser's activities as well as events that should be factored into the review. Business personnel should include portfolio managers, investment committee members, trading personnel, and research analysts.

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Identifying Risks and Conducting the Review

Advisers should use the annual review to test the effectiveness of its compliance policies and procedures since the last review, consider internal and external developments over the past year, evaluate the compliance risks that they pose for the adviser, and confirm the implementation of appropriate controls for managing and mitigating these risks. *See, e.g.,* the SEC staff's "Risk Inventory Guide," available at http://www.sec.gov/info/cco/red_flag_legend_2007.pdf, which identifies 12 of the risks that investment advisers typically experience as part of their day-to-day operations. New developments that advisers will want to consider are:

1. Organizational and Personnel Changes

An investment adviser should regularly confirm that it has addressed organizational and personnel changes, if needed. Among other things, an adviser will want to review its Form ADV, organizational chart, and policies and procedures to ensure that new ownership or affiliate relationships and key personnel changes are reflected, and that any gaps in management or supervision resulting from new business lines or employee departures are addressed. Disclosures should be reviewed and revised as necessary to reflect any additional conflicts of interest as a result of organizational and personnel changes.

2. Changes in Business Activities or Clients

The review should consider whether the adviser needs to update its disclosures, policies, or internal controls to address conflicts of interest, or compliance and other risks arising from changes in its activities—or its affiliates' activities—or changes in its clients or their circumstances. Care should be taken to be sure that any new strategies or activities are consistent with stated objectives or restrictions, and any inconsistencies should be reconciled promptly. New developments that may need to be reflected include new lines of business and products, new compensation practices, changes in executing brokers, new soft dollar practices, new types of clients, and changes in client and counterparty ownership or credit risks.

3. Operational and Financial Issues

The adequacy of the adviser's operational systems, infrastructure, and financial controls should be reviewed and tested at least annually to make sure that they remain effective and keep pace with overall developments. Among other things, the adviser may wish to:

- Test information security and privacy controls;
- Review whether any restructuring of the trading floor or office moves creates actual or apparent risks of insider trading or misappropriation of client information; and
- Test the performance of execution and order management systems, information systems, and trade allocation systems.

4. Regulatory Developments

The adviser's review should take into account legal and regulatory developments applicable to the adviser's business, confirm that its policies and procedures have been updated to reflect those developments, and verify that appropriate training was provided to relevant personnel. In addition to new rules, the assessment should take into account relevant SEC enforcement cases and private litigation as well as informal SEC guidance, such as staff interpretations, statements about examination priorities, and commissioners' speeches.

5. Compliance Issues

The risk assessment review should confirm that any compliance issues identified since the last review were addressed, and that all regulatory deadlines were met. Supervisory logs should be checked to determine the resolution of any identified red flags.

Post Review Follow-Up

Following completion of the risk assessment review, advisers will need to consider:

1. Documentation

Advisers Act Rule 204-2 requires a registered investment adviser to make and keep records documenting its annual review of policies and procedures conducted pursuant to Rule 206(4)-7(b). Although the adviser will want to create a record of its review and document the remediation of any identified compliance issues, careful consideration should be given to the detail included in the written report because the SEC staff and potentially some clients will request a copy of the report. Accordingly, careful consideration should be given to whether the report should be prepared under the direction of legal counsel, and the final report should be distributed internally only to responsible persons with a need to know. An exit interview can provide a useful forum for discussing any complicated issues identified in the review.

2. Disclosures and Consents

The adviser will want to update any disclosures that are found to be inaccurate or incomplete, including the adviser's Form ADV, marketing materials, and

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disclosures of conflicts of interest, fees, or soft dollar practices. Consideration should be given if any client consents are required to be obtained.

3. Policies and Procedures

The adviser's compliance policies and procedures should be updated if they are determined to be outdated, incomplete, inaccurate, or insufficient. Prior to discarding any outdated policies and procedures, registered advisers should consider that Advisers Act Rule 204-2 requires advisers to make and keep copies of all policies and procedures that are in effect or were in effect at any time during the last five years.

4. Training

As part of the adviser's regular compliance protocol, personnel should routinely receive training in the event of material changes in business, procedures, or operations. If the adviser's procedures are updated as a result of review findings, or if compliance issues are discovered, compliance training should be provided to relevant personnel.

5. Mitigation and Self-Reporting

If any deficiencies are uncovered during the review, responsibility for remediation should be assigned, and remedial action should promptly be taken and documented. If the deficiency is material, the adviser, in consultation with counsel, should determine whether to self-report the issue to the SEC.

**K. Susan Grafton is a partner in the Washington, DC and New York offices of K&L Gates LLP. Ms. Grafton may be reached at (202) 778-9498 or susan.grafton@klgates.com. This article is intended to provide general information on the matters discussed herein. It should not be relied upon for legal advice on any matter.* ■

K. Susan Grafton, Partner, K&L Gates LLP