ROAD MAP FOR AN EXAMINATION: SEC EXAMINATION RISK ALERT LAYS OUT SEC EXAMINATION STRATEGY CONSIDERATIONS

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US Asset Management and Investment Funds Alert

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For registered investment advisers, examinations by the Securities and Exchange Commission (SEC) are a part of doing business. While an SEC examination is inevitable, many advisers have often wondered why they were selected for examination and what they could have done to better prepare for their interactions with the SEC staff.

On 6 September 2023, in an all-too-rare insight into its processes, the SEC staff provided some answers. In a Risk Alert from the SEC Division of Examinations (the Division) entitled “Investment Advisers: Assessing Risks, Scoping Examinations, and Requesting Documents” (the Alert), the SEC staff lays out: (i) how they select targets for examination, (ii) how they determine scope of an examination, and (iii) the types of documents they generally request.[1]

With this information, registered investment advisers can assess the likelihood of being selected for a new examination, whether they should change any of their current business practices to minimize the potential for selection, and what foundational steps they should take today to ensure that the inevitable examination goes by quickly and smoothly.

SELECTING FIRMS FOR EXAMINATION

We live in a world of limited resources, and even the SEC has a limited capacity to pursue examinations. As noted in the Alert, there are more than 15,000 registered investment advisers managing over US$115 trillion in assets, and the SEC is able to examine approximately 15% of these advisers annually. Given the relatively small proportion of advisers the SEC is able to examine, the SEC staff employs a risk-based approach to select advisers for examination.

As described in the Alert, this risk-based approach involves the consideration of multiple risk factors related to an investment adviser's business activities (including conflicts of interest relating to those activities) and regulatory history.

In determining whom to examine, the SEC staff is more likely to select firms with deficiencies identified in prior examinations, firms with supervisory concerns (including disciplinary history of the adviser's personnel or its affiliates), and firms with complex business models where the adviser is co-investing with clients. The SEC also considers if a firm has not been examined in a long period of time, is newly registered with the SEC, or is a firm where the SEC staff recently identified issues in compliance programs, disclosure documents, or marketing materials. Firms with material changes in leadership or ownership or firms with access to client assets are also

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more likely to be selected for an examination. In addition, the SEC indicated that they look to adviser disclosures as well as information from third parties, including third-party data, tips, complaints or referrals, and news and media coverage.

In sum, while investment advisers have long assumed an examination is forthcoming when they have not recently been examined, numerous other factors related to the firm's business, risk profile, and compliance history may also draw the SEC's attention.

SCOPE OF EXAMINATIONS

No examination is the same. Even where examinations begin with the same list of requested documents, which is common, the areas SEC staff will focus on evolve based on the business model of the adviser and the adviser's conflicts of interest. As noted in the Alert, the scope of the examination is tailored to test the effectiveness of the adviser's compliance and testing program. As a result, advisers with relatively straightforward business models should expect a more general examination than advisers who invest alongside clients or who advise on more complex investment strategies or charge more complex fees (e.g., performance fees). The Alert lists several specific potential areas of focus, including custody, valuation, portfolio management, fees and expenses, and brokerage and best execution. Any one of these areas could become a central focus of an examination depending on the SEC staff's perception of the conflicts presented by the adviser's business model.

TYPICAL DOCUMENT REQUESTS

The Alert describes the typical examination process, which begins with an initial document request letter. In an appendix to the Alert, the SEC staff discloses the types of documents they typically request. The documents in this initial request are intended to provide the SEC examination staff with a general understanding of the adviser's overall operations, client base, investment products, and conflicts of interest. Advisers subject to an examination should expect that this initial production of documents will be followed by multiple rounds of subsequent production requests, focusing on individual areas the SEC staff believes warrant additional inquiry. These areas of focus will line up with factors specifically related to the adviser's business model, but they are also likely to include requests related to the Division's priorities for the year. Those priorities are announced annually, usually in February or March, and often overlap year to year.

To prepare for a future examination, advisers would be well-advised to review this list (reproduced as Exhibit A to this client alert) and confirm that they can produce all of these documents in short order. A quick and complete production of these initial documents can go far in establishing a cooperative relationship with the SEC examination staff, as well as a reputation of diligence, which is critical if it becomes necessary to provide additional explanation or context around certain business activities.

CONCLUSION

The Alert provides registered investment advisers with key insights into the SEC staff's examination process so that advisers can assess their own risks of being examined, which of their business activities may become a focus item, and how they can better prepare for an inevitable examination. As a result of this public disclosure, the SEC examination staff may come to expect advisers to be even better prepared for examinations than they have been

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in the past. In addition to conducting a mock exam of their own, or engaging a third party to conduct a compliance risk assessment or training, advisers should consider reviewing—and updating as needed—their policies and procedures in light of the Division's priorities for the year. Further, the SEC staff may expect advisers with business models that include more acute conflicts to have developed policies and procedures to mitigate or eliminate these conflicts and disclosures to ensure clients are aware of them.

Exhibit A: Typical Initial Information Examiners Request of Investment Advisers

Described below are the types of initial information, including documents, that SEC staff may request and review during a typical examination of an adviser that does not engage in additional activities or have additional relationships (e.g., manage private funds). These information requests are generally transmitted through secure email, and responses are also typically provided electronically. If certain records are not maintained electronically or cannot be produced electronically, the SEC staff may request that the adviser make such records available for in-person examination.

General Information	
Organizational Information	▪ Organizational structure, affiliations, and control persons. ▪ Remote offices and branch locations. ▪ Joint ventures or other businesses (including those with respect to the firm or any officer, director, portfolio manager, or trader). ▪ Current and former supervised persons, officers, or directors.
Business and Operations	▪ Committees (e.g., responsibilities, members, meeting frequency, meeting minutes). ▪ Client advisory contracts or agreements. ▪ Agreements and arrangements with third parties associated with the management of client accounts (e.g., sub-advisers, third-party managers, referrals, wrap fee programs, and third-party investment platforms used for clients). ▪ Fees and payments for services rendered. ▪ Power of attorney obtained from clients. ▪ Service providers and the services they perform.
Disclosures and Filings	▪ Disclosure documents and filings with regulators (e.g., Form ADV, including the brochure, and Form CRS).
Legal and	▪ Threatened, pending, and settled litigation, arbitration, or administrative

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Disciplinary	proceedings involving the adviser or any supervised person. ▪ Remedial actions taken against supervised persons.
Information Regarding the Compliance Program, Risk Management, and Internal Controls	
Compliance Program and Oversight Process	▪ Compliance policies and procedures in effect during the examination period. ▪ Tests performed (e.g., compliance reviews, quality control analyses, surveillance, or forensic or transactional tests performed by the firm). ▪ Compliance consultant reports resulting from a review of compliance policies and procedures, operations, or books and records. ▪ Annual or interim reviews of policies and procedures, including any reports prepared. ▪ Record of compliance exceptions. ▪ Remote office or independent advisory contractor oversight process. ▪ Client complaints and correspondence and the process for monitoring such communications, including electronic communications. ▪ Inventory of compliance risks and conflicts of interest that form the basis for policies and procedures and notations regarding changes made to the inventory. ▪ Written guidance and training provided to employees regarding compliance program and documentation of attendance.
Valuation	▪ Valuation process. ▪ Pricing services, quotation services, and externally acquired portfolio accounting systems used in the valuation process and payment information. ▪ Fair-valued and illiquid securities held by clients. ▪ Advisory fee calculations. ▪ Pricing overrides.
Information Processing, Reporting, and Protection	▪ Safeguards for the protection of customer records and information. ▪ Electronic access controls. ▪ Business continuity plan. ▪ Cybersecurity incidents or breaches (e.g., incident description, impact, and

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	remediation).
Information to Facilitate Testing With Respect to Advisory Trading Activities	
Information About Advisory Clients and Accounts	▪ Current advisory client account information regarding: account inception, type, balance, and management discretion; client demographic information; client affiliation with the firm; custodial arrangements; firm authority with respect to the account (e.g., trading authority, custody, and trustee); services provided; investment strategy and investment objectives; portfolio manager; fee computation; fee payment arrangements; and consultant related to obtaining the client, if any. ▪ Advisory clients lost during review period.
Portfolio Management	▪ Securities held in all client portfolios, including information identifying each client holding an interest, the amount owned by each client, the aggregate number of shares or principal or notional amount held, and the total market value of the position. ▪ Information about certain types of client investments (e.g., private investments and initial public offerings). ▪ Publicly traded companies for which employees of the adviser or its affiliates serve as officers or directors. ▪ Companies for which employees of the adviser or its affiliates serve on creditors' committees. ▪ Outside compensation to supervised persons, including compensation related to client's transactions or investments. ▪ Client portfolio profile information (e.g., investment objectives, investment strategy, risk tolerance, suitability, and mandates).
Brokerage and Trading	▪ Trade blotter. ▪ Brokerage arrangements and best execution evaluation documentation. ▪ Soft-dollar budget and products and services obtained using clients' brokerage commissions. ▪ Commission-sharing arrangements. ▪ Affiliated broker-dealers. ▪ Principal trades and cross transactions.

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	▪ Wrap fee programs. ▪ Trade errors and related information. ▪ Trade allocation information regarding initial public offerings and secondary offerings in which clients, proprietary accounts, or access persons participated.
Conflicts of Interest and Insider Trading	▪ Code of ethics and insider trading policies and procedures for the firm and its affiliates. ▪ Code of ethics attestations. ▪ Exemptions from code of ethics for supervised persons. ▪ Reports of securities transactions reported by access persons. ▪ Fee splitting or revenue sharing arrangements.
Information to Perform Testing for Compliance in Various Areas	
Marketing and Advertising	▪ Advertisements and marketing materials disseminated, including newsletters, public audio and video programs, pitch books, pamphlets, brochures, websites, blogs, social media, and other promotional or marketing materials used. ▪ Client or investor meeting materials and presentations. ▪ Sponsored and attended seminars or events. ▪ Client performance information. ▪ Composite performance information, including current and terminated composites and composite returns. ▪ Requests for proposal, due diligence questionnaires, and any other questionnaires (e.g., third-party consultant database or other performance database). ▪ Testimonials and endorsements, including payments made and compensation received. ▪ Third-party ratings and rankings.
Financial Records	▪ Balance sheets, trial balances, income statements, and cash flow statements. ▪ Cash receipts and disbursements journal. ▪ General ledger and chart of accounts.

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	▪ Loans and sales of firm or affiliate's stock.
Custody	▪ Custodian identification and contact information for entities that maintain custody of client assets. ▪ Surprise examination documentation, such as engagement letters, client account lists, and reports, results, and recommendations. ▪ Auditor engagement letters, opinions, and findings. ▪ Custodial confirmation of positions for specific clients.

FOOTNOTES

[1] SEC Division of Examinations Staff Risk Alert, OBSERVATIONS FROM EXAMINATIONS OF NEW-REGISTERED ADVISERS (Sept 6, 2023), *available at* https://www.sec.gov/files/risk-alert-newly-registered-ias-032723.pdf.

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