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On an Island With the SEC (Aka Diary of an SEC Exam)

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With a new season of the reality show “Survivor” airing, it occurred to me that an SEC exam might have been thought of in the past like those challenges between tribes on deserted islands in the Pacific. Unfortunately, it was always one tribe, the SEC, winning immunity from being voted off the island. But today, the environment is different and while no investment advisory firm will ever win “immunity” it seems that inter-tribal teamwork might prove more beneficial these days. The days of putting the SEC Staff in the coldest (or hottest) smallest room in the office with no windows while feeding them local delicacies reminiscent of Survivor food challenges are gone. Making them feel comfy seems more the norm, but certainly you don’t want to make their island shelter too plush.

So what goes on these days during an SEC exam and perhaps, more importantly, what should you, as the potential examinee, be doing to make the proverbial lemonade? Drawing from some real life examples, this article will explore the diary of an SEC exam from initial contact to final comment letter. While the experiences that will be noted were real, obviously, others will experience different ones.

Your first surprise will of course be the initial contact from the SEC that may come in the form of an e-mail announcing the intention to begin an exam and requesting an initial conference call. The time from the initial contact until the tribe shows up may be anywhere from a few days to two weeks. And they will expect a significant amount of information to have already been gathered. The initial request letter is relatively standard and available. It will typically request information relating to a recent quarter or year. It is encouraged that you obtain the standard letter in case you have not seen a recent one. Knowing in advance what will likely be requested will give you an opportunity to prepare for an eventual exam. While it may not be as high a priority as finding water on a deserted island, it can prove useful.

Getting Organized

Just like building a shelter on a deserted island using only leaves and branches from available trees, getting organized for an SEC appearance takes a lot of effort and teamwork. The first step should be to assign a point person for logging the requested information as it is gathered (a spreadsheet works well for this purpose). Also, assigning who is to gather what will be required. All information should be reviewed and approved before being submitted to the SEC to make sure it

has the requested information and meets the standards that the SEC is looking for. Several points to consider:

- Create a shared drive on your network which permits access by all those involved in gathering and reviewing requested information. The shared drive should be organized in the identical order and use the same naming conventions as the SEC request letter. For example, if Part I, item 7. of the SEC Letter requests the current Form ADV Part 2, then name the file that is loaded into the shared drive: “Part I, Item 7-Form ADV Part 2.” Of course you can abbreviate with “I7-Form ADV Part 2” if you like as long as you are consistent. It should be decided up front how the files will be named so that everyone names their files consistently as they are input into the shared drive.
- Enter into the log each item and its status. For example, statuses could include, “submitted for review,” “reviewed,” “approved,” “submitted to SEC,” etc. as deemed appropriate.
- Make sure it is very clear who is to answer each item. Certain items may be split among several personnel to address. You want to avoid duplication of effort, but also make sure all items are addressed appropriately.
- As items are addressed and circulated for review, make sure only those responsible for the review receive the item. You don’t want people getting an e-mail noting that an item is ready for review and have someone review it when it is not necessary for that person to review it. Also, decide how the shared drive will be used. Will items be loaded to the shared drive that are the first draft and are ready for review, or should the shared drive be saved for only approved and ready for submission to the SEC items? This is a style question, but make sure you are consistent, so the logger of the requested information knows whether an item is final and ready for submission or is a draft response. This can spin out of control quickly if different statuses of information are submitted without clarity as to the status. Perhaps it will make sense to create a “draft” file for each item and a “final” file for each item.
- You may be tempted to give more information than is requested. You may think that the SEC may look at your process and how robust it is and how you gave them even more than they requested, and then they will pat you on the back...NOT! If there is anything in the additional information you provide that they do not understand or is unusual, you may get additional inquiries that make additional unnecessary work for you and your staff. If the SEC requests your most recent annual compliance review and there are some compliance violations, but the year before you were perfect, only give them the most recent one regardless. You will not get an immunity idol for a perfect annual compliance report, but if there is something that tweaks their curiosity from the prior year, you will have more work on your hands.
- If there is missing or incomplete information in response to a request, under no circumstances should you create and backdate data. This is a major no-no that seems innocuous and hard to detect. But the SEC has sanctioned firms for backfilling information and making it appear that it was created in the past when in fact it was created at the time of the exam. You may have to create a memo or describe a situation in order to respond to the SEC’s information request. It is not an issue to create such a memo, but if they ask for personal trading certifications and you failed to obtain one or more from employees, do not have them submit the certification with a date other than the date they signed/submitted it. It is a comment in your deficiency letter from the SEC that your files were not complete and you failed to obtain certain certifications (or perform a certain procedure). But if you are caught backdating, it will raise red flags and will likely lead to a much more in depth look at the execution of your policies and procedures; and could possibly lead to an enforcement action.

- Have one person (perhaps the logger of the status of the requests) review all requests for consistency of format, typos, etc. The SEC will appreciate the consistency and while they will again, not pat you on the back, they will look upon you more kindly than if things were inconsistent or contained typos everywhere.

Delivery of the Information

The SEC will be looking for a substantial amount of the information requested when they walk in the door. It is not practical to expect that all the information will have been gathered, and they will not expect all of it. It will be wise to gather things that are easy to obtain and that will give them lots to do. Lengthy documents (prospectuses, PPMs, advisory agreements and the like) will soak up a lot of their time initially and give you a chance to obtain the “harder to find” items.

We found the best way to deliver the information was to use discs. Each disc was loaded with the information that was ready, labeled and given by hand to the SEC. The master log of items requested should note that the item was given to the SEC on disc #X on Y date. Color coding the items on the spreadsheet is an efficient way of doing this for easy reference. You should obtain some form of acknowledgement from the SEC that the disc was received (perhaps an e-mail).

As additional information is provided to the SEC, the same process should be followed.

Let's Play 2

Just when you think you have things under control, the SEC will decide it wants to play a doubleheader. As early as two weeks after they walk in the door, and well before you have provided them everything from their first information request letter, they may begin to request additional information based on what they have reviewed to date. This is where it is very easy to lose control. The SEC may want

additional information for several reasons (this is not all inclusive):

- To supplement what they originally received in order to clarify the original information;
- To answer questions that arose in their original review (they are unlikely to ask you orally for anything);
- Anything that is unusual or new to them, they are likely to ask for additional information. In our example, the adviser used a unique investment strategy with which the SEC staff was unfamiliar. They ask to interview the portfolio managers and also requested additional information about the strategy.
- If issues arise, or there is missing documentation, that will also trigger a request for additional information.

The second game of the doubleheader may actually end up being more tedious and time consuming than the first game. The reason for this is that the information in the original request letter is relatively standard and should be relatively easy to gather for the most part. The second game consists of unusual items, issues and the need for more in depth information. This might not be as easily accumulated and may require the creation of documents to explain items and the bringing in of personnel to assist that were not part of the first phase. Care needs to be taken with respect to who responds to the second battery of requests to make sure the right person with the right knowledge is responding, and also keeping in mind the need for continued consistency in responses and to not include information not requested. This is where it becomes more of an art form.

And this is where you can lose control. As you continue to gather the originally requested information, which of course you organized impeccably, you are now asked for more and different information that has to be gathered, reviewed and approved while the first set is also in progress. And you likely have more people involved in the process. And then you realize that you are really playing a tripleheader as an

additional request comes in, and so on, and so on...

No fewer than 28 additional requests for information came in from the SEC after the initial information request. Now, none of the additional requests were nearly as lengthy as the first, but they came in rapid succession after the first couple of weeks of the exam. Each one required additional logging of the request, assignment to gather the information, review of the information and submission to the SEC. The logging process can become a nightmare if not properly organized at the outset. It needs to be logical and consistent, otherwise information may get lost or misfiled and time wasted trying to retrieve it or duplicate it.

Another caution in the additional information request phase is to be careful who is assigned the gathering of the information. In many instances, a response to a question was required which had to be created. Care needs to be taken in terms of any original thought that goes into a formal SEC response that is created. It should be reviewed carefully for content and responsiveness to the question. Make sure it answers the question but does not provide additional information. And if you can't answer a question or did not comply with a policy, the response should be "mea culpa" and it will be fixed immediately.

At times both initially and during the process, the SEC will ask to interview certain personnel. It may be the CEO and CCO initially to get to know the organization, but then it may be portfolio managers, analysts or financial personnel later to answer follow up questions. It is suggested that one member of upper management participate in all SEC interviews of your staff. This can guide your staff in answering the questions as well as being a witness to what is said. I would suggest you take notes of what was discussed and memorialize and confirm them with the other attendees. There can be misinterpretation or misunderstanding of verbal information exchanged.

A final note on the second game of the doubleheader is that the SEC may request the same information more than once. Different SEC staff members may be working on different areas that overlap and require review of the same information. This is where a good logging system will prove valuable. You will be able to specifically reference exactly where that information is on a disc already submitted, so you don't have to duplicate the work.

Final Tribal Council

Before extinguishing the flame on its torch and departing your offices for good (which in this instance was about three months) you will have an exit interview with the SEC where they will lay out the items they expect to be in the deficiency letter. I think we all know that 95% of all exams conclude with some form of deficiency letter so there is no alarm to the fact of the letter. You will not be asked to respond to any of the items at this point, but it will prepare you for the matters to be discussed in the letter. While it was nice to find out there were no "smoking guns" as we were told (all items were minor), the actual letter may provide a couple of surprises that were not discussed at the exit interview.

The time between the exit interview and receipt of the actual letter (in this case, five months) provides time to actually correct some of the deficiencies noted in the exit interview which will facilitate your response to the SEC letter which will be required within 30 days of its date. Once received, the SEC letter response should be treated very similarly to the way the original request for information was handled. Each comment should be assigned to the appropriate individual to prepare a response. Such response should be reviewed by the designated reviewer. One person should be responsible for assembly of the letter and circulation of drafts for comments. As the entire letter is an original creation (versus many of the responses to information requests which were already created documents), senior management should review all responses to ensure consistency and propriety of the information included. The same tenets should be

followed in the responses to the SEC letter that were used during the actual exam. “Mea culpa” when appropriate, no backdating, provide only requested information, etc.

It may be that some of the items that are in the letter require significant work that cannot be completed within the 30 day time frame. This may be acceptable providing that you acknowledge the reasons therefore and commit to a follow up response when the item is fully resolved.

Survival

To survive an SEC exam you will have to demonstrate that your policies and procedures are appropriate and executed effectively. But to make an SEC exam as bearable as possible, you should abide by the following concepts: be honest, be cordial, be organized, have appropriate resources available, and be responsive.

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