
How to Reduce the Risk That Your OCIE Exam Becomes an Enforcement Investigation

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December 5, 2017

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Adviser Exams Remain a High Priority for the SEC

SEC Chairman Jay Clayton has strengthened the commitment to investment adviser examination and oversight in 2017

Increased Investment Adviser Oversight

- Chairman Clayton requested additional staff and budget for investment adviser oversight
 - In 2016 100+ staff reassigned to the investment adviser examination unit
 - Plans to increase examinations by 20% in FY 2017 and 5% in FY 2018

Increased Investment Advisor Firm Examinations

- SEC examined 15% of investment adviser firms in FY 2017
 - 8% in FY 2012
 - 11% in FY 2016

Targeting High-Risk Areas

- OCIE director Peter Driscoll stated that examiners are taking more “targeted, shorter, deep dives into high-risk areas that are published in our priorities”

Investment Advisers Face the Risk of Enforcement Investigations Arising from OCIE Exams



In FY 2016, many OCIE exams resulted in negative findings

Investment Adviser Exams

72% Resulted in **deficiencies**

27% Resulted in a **“significant finding”**

9% Resulted in a **referral to Enforcement**

FY 2016

The SEC brought a record

159 **cases** against investment advisers



Topics Overview

1

What are the SEC's exam priorities for investment advisers, and how do they create Enforcement risk?

2

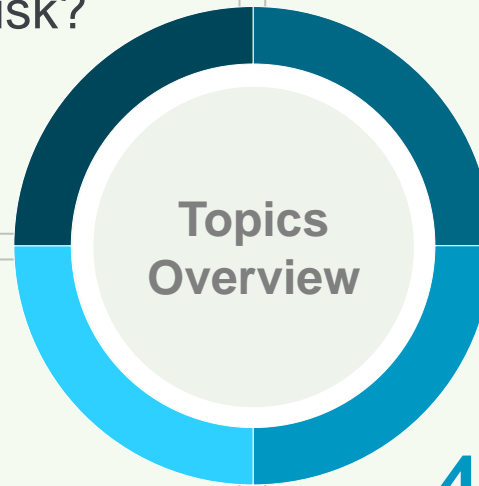
How should advisers identify risks for an OCIE exam?

3

How should an adviser respond to exam requests which raise Enforcement risk?

4

Which exam issues are most likely to generate referrals to Enforcement?



Exam and Enforcement Priorities

SEC Priorities for Investment Advisers

SEC releases, speeches by senior officials, and prior Enforcement actions identify five priorities for exams and Enforcement actions:



1

Fee, Expense
and Trade
Allocation



2

Insider
Trading /
Treatment of
Material
Non-Public
Information



3

Valuation



4

Advertising



5

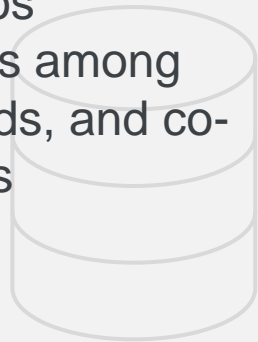
Cybersecurity

1. Fee, Expense and Trade Allocation

■ Fee, expense and trade allocation

is a top priority for both OCIE and the Enforcement Division

- Trade allocation has been a focus for many years
- Nearly two dozen Enforcement settlements with private equity firms regarding fee and expense allocation
- Numerous scenarios involving allocations among advisers, client funds, and co-investment vehicles



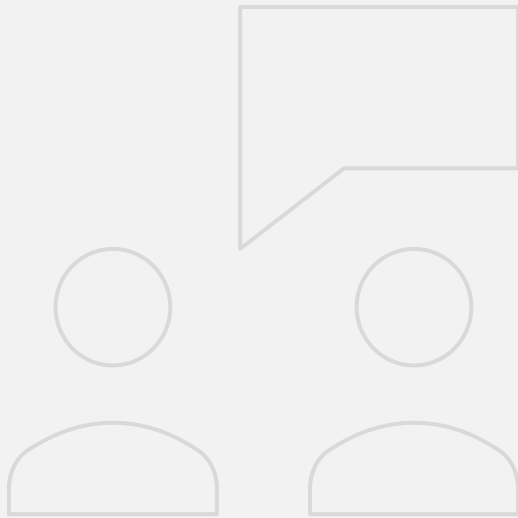
■ Key areas of scrutiny during examinations:

- **Disclosures:** What investors are told before committing capital and in the course of a fund's life cycle
- **Compliance:** What policies and procedures exist (whether written or unwritten) to ensure allocations are consistent with fund agreements and disclosures
- **Allocations:** How are different types of fees, expenses and trades allocated; OCIE may require preparation of detailed charts reflecting and explaining allocations
- Written questions/interviews regarding areas of interest

2. Insider Trading and Treatment of Material Non-Public Information

■ Insider trading

remains a top Enforcement priority, and in the course of exams OCIE will scrutinize how firms obtain and treat material non-public information



- Key areas of scrutiny during examinations:
 - Research and investment decision processes and how firms acquire and use information
 - Relationships and communications with insiders and other market participants
 - Review of sample investment files and emails relevant to transactions
 - Interviews with portfolio managers and analysts
 - Transactions with aberrant performance or outside of adviser's ordinary scope
 - Written policies and procedures, compliance logs, and training

3. Valuation

■ Valuation

will remain a high OCIE priority given the importance of valuation to investors



- Key areas of scrutiny during examinations:
 - Difficult-to-value securities
 - Development of a clear pricing methodology
 - Documentation of pricing errors
 - Appropriate disclosure of the risks of illiquid securities
 - Clear policies and procedures for a valuation committee that routinely reviews valuation methodologies and pricing decisions

“It is essential that the accurate pricing of the portfolio holdings and NAV calculations are carefully considered.... I, along with your investors, expect that you will get it right.”

Mary Jo White, Former SEC Chairman

4. Advertising

■ Advertising

is an exam priority following OCIE's 2016 launch of an initiative in response to observed deficiencies in adviser advertising



■ Key areas of scrutiny during examinations:

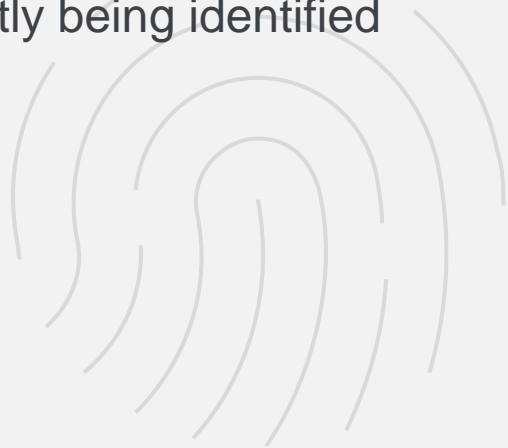
- Advertising materials, whether in the form of performance results, one-on-one presentations, or claims of compliance with voluntary performance standards
- Performance information, including cherry-picked profitable trades
- Compliance policies and procedures designed to prevent advertising violations, and evidence that such policies are enforced

5. Cybersecurity

■ Cybersecurity

identified as top exam priority annually since 2014.

- OCIE has observed that “cybersecurity remains one of the top compliance risks for financial firms”
- Rapidly evolving area, as new risks and best practices are constantly being identified

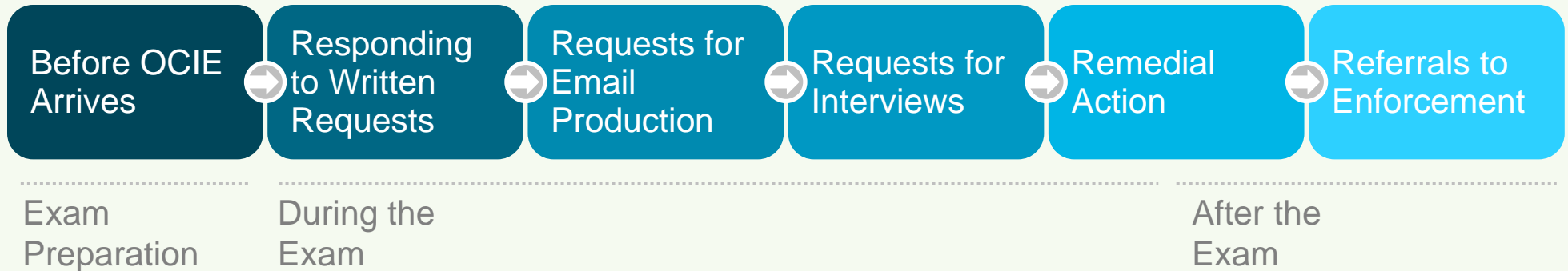


■ Key areas of scrutiny during examinations:

- Written policies and procedures
- Firms’ actual practices in context of written policies and procedures
- Risk assessments
- Remediation efforts

The OCIE Exam Process

The OCIE Exam Process



Exam Preparation Before OCIE Arrives

Before OCIE Arrives



Responding to Written Requests



Requests for Email Production



Requests for Interviews



Remedial Action



Referrals to Enforcement

Review OCIE and Enforcement priorities and take necessary corrective action before an exam

- Identify potential risk areas in the specific context of your firm's operations that may arise in exam process
- Review and update policies and procedures
- Ensure any deficiencies noted in prior exams or compliance reviews have been resolved
- Determine if remedial action needs to be taken
- Annual compliance review is a great way to accomplish this
 - Need proactive, properly resourced compliance function

During the Exam

Responding to Written Requests



Consider the full context and potential Enforcement risks when responding to written requests

- What is the request aimed at? What is OCIE—and what would Enforcement be—looking for?
- Is there information outside the four corners of the request that should be provided to ensure that the response presents a complete picture?
- What do any follow-up requests reveal about areas of interest and the likely path of the exam?
- Build a cooperative relationship with OCIE examiners through timely, accurate, and complete responses to written requests

During the Exam

Requests for Email Production



Broad email productions are becoming more frequent in exams; they can be expensive and fraught with pitfalls so consultation with advisors experienced in Enforcement matters may be beneficial

- OCIE may request all emails for identified employees over particular time periods
- Timing and cost concerns preclude a full review of emails before production.
- Obtain advice to develop a strategy even if the production will be handled internally or by email vendor
- Key issues:
 - Remove privileged material from production
 - Design a search strategy to identify relevant documents before production
 - Consider whether additional review is appropriate after production—particularly if an email custodian will be interviewed

During the Exam

Requests for Interviews



Interviews are an important part of the exam process and can require careful preparation

- Who is likely to be interviewed?
 - Compliance, portfolio managers, analysts, supervisors
 - OCIE may or may not identify a particular interviewee
 - Consider who would be best situated to respond based on personal knowledge, involvement in relevant issues, and level of responsibility
- If the request suggests OCIE has specific issues in mind, consider what documents and information have been provided to OCIE and how best to prepare interviewee for interview
- Keep accurate notes of interviews as part of your exam file
- Interviews can turn somewhat adversarial; consider appropriate interview preparation

During and After the Exam

Remedial Action



Taking remedial action during an exam may help avoid a referral to Enforcement or lessen an Enforcement charge

- If OCIE identifies a deficiency, thoroughly assess the nature and cause of the deficiency
 - What are the relevant fund agreements and client disclosures?
 - Were clients harmed? Did the adviser benefit?
 - Was the deficiency caused by a good faith error or technological failure?
- Develop a plan to remedy the deficiency during the exam process
 - Remediation may involve financial redress, enhancements to policies and procedures, and revised disclosures
- Even if OCIE does refer to Enforcement, a record of proactive remedial measures will benefit the adviser in an Enforcement investigation

After the Exam

Referrals to Enforcement



Referrals to Enforcement are most likely where deficiencies harmed investors, benefited the adviser or resulted from bad faith conduct

- Enforcement is more likely when the deficiency involves:
 - Injury to investors, such as through inadequate disclosures or conflicts of interest
 - Injury to markets, such as through insider trading or other misconduct regarding material non-public information
 - “Fraud,” in the broadest sense: allegedly deceptive advertisement, valuation, etc.
- In response to a deficiency letter, an adviser will have an opportunity to make a submission to OCIE and address areas of concern
 - Advisers should take full advantage of this opportunity and submit any relevant factual information and legal arguments
 - The adviser’s submission will be closely considered by OCIE and Enforcement in determining whether a referral to Enforcement should occur
 - Additional calls and meetings may be requested, but advisers should assume that their written submission is the principal basis to advocate their positions

Questions?

