



Preparing for an SEC Audit & Building a Culture of Compliance

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Introduction

- Proactively preparing for a SEC audit will ensure a smooth-running and less harrowing experience.
- Once you do such a review, you will then want to prepare the resources, tools and information you will be asked to call upon during an audit and make it a regular part of your infrastructure going forward. The implementation of certain tools and expanded compliance infrastructure will contribute to your ability to easily and convincingly demonstrate your commitment to a “culture of compliance” (*i.e.*, doing what it takes to get issues addressed).
- The purpose of this seminar is to provide a summary of several of the areas that are likely to be reviewed during the course of a SEC audit and provide practical guidance on how your firm can build a compliance program that will help you stay prepared for and survive an audit.

A Different SEC?

- Increased resources – ability to hire new examiners/investigators
 - Increased budget in 2010 – reportedly provides ability to hire 60 new investigators
- Taking on challenge to make up for Madoff!
 - Greatly increased training on fraud detection
- Direct inquiries with investors and clients
- Surprise examinations are BACK!

*2009 SEC “Hot” Topics**

- Adequacy of compliance program and procedures
- Hedge Funds
- Protection of Client Information – (e.g. privacy policies)
- Conflicts of Interest
 - Are they being identified? Are they being adequately disclosed?
- Valuation

2009 SEC “Hot” Topics

- Custody
 - A number of enforcement actions have involved the theft or misuse of funds by a hedge fund manager. Therefore, the SEC is going to look at your custody procedures.
 - Proposed amendment – annual surprise custody exams
- Books and Records
 - The SEC has expressed a concern that hedge fund managers may not be keeping the requisite books and records.
- Sales Practices and Marketing Materials
 - Are your marketing documents consistent with your offering documents and Form ADV?

Evaluating your Existing Compliance Infrastructure

- The SEC registration and examination regime are primarily disclosure based. During an examination, the auditors review an adviser's filing with the SEC (*i.e.*, Form ADV Part 1) and other materials provided to clients (*i.e.*, Form ADV Part II, including Schedule F, offering documents and marketing materials) to ensure that the adviser's disclosures are accurate, timely and do not omit material information.

Evaluating your Existing Compliance Infrastructure

- Are there any unique compliance requirements or risks applicable to your firm?
- Are you doing everything that your compliance manual says that you are going to do? **COULD BE A BIG PROBLEM AREA IF YOU ARE NOT!**
 - Are your procedures unique to the operations of your firm?
 - Are you a fund of funds and have procedures on soft dollars or best execution review?
 - Are your best execution review procedures unique to a review of the types of instruments that you trade?
- Are you periodically testing your policies and procedures? Do you document the testing?

Evaluating your Existing Compliance Infrastructure

- Have you performed a gap analysis?
 - Do you maintain all requisite records such as:
 - ALL of your Access Person/Personal Securities Transaction Records? Was proper notice provided? Were pre-clearance requirements followed?
 - Are “no trade” periods followed?
 - Records related to proxy voting?
 - Do you have disclosure statements for all investors and clients that are referred by third party solicitors?
 - Do you have eligibility representations for ALL investors? Especially true for investors in funds that pay incentive-based compensation.
 - Do you retain ALL emails? Are they critically reviewed from a compliance perspective?
 - Are your various marketing materials (including RFPs) critically reviewed from a compliance perspective for consistency?
 - Are trade allocation reviews documented?
 - Do you periodically assess what types of risks your business presents?
 - Do you periodically assess the conflicts of interests that may arise in your business?

Find Your Problems and Fix

- Always better to find and fix your own problems
- Will demonstrate to SEC that you have a strong compliance program
- Unless really serious – problems that you find and fix likely will not make it to the exam letter

Mechanics of an Audit

- Types of Examinations
 - Routine Examinations (by far the most common)
 - High risk – regular
 - Low risk - random
 - Cause Examinations
 - Sweep Examinations
 - RAVE Examinations
- The SEC has adopted a risk based approach to selecting investment advisers for routine examinations.
 - Two levels of the risk based assessment:
 - Disclosures in the Form ADV
 - Risk ranking assigned to that adviser during its previous exam
 - The SEC aims to examine investment advisers that are deemed to be high risk every three years.
 - From the remainder of the SEC registered investment adviser population, the SEC draws a random sample to examine during the year.

Mechanics of an Audit

- Surprise exams are back.
- If not a surprise exam- the SEC likely will only give you the weekend to prepare.
 - Prior to Madoff, the SEC has been providing more notice. We had seen as much as two weeks notice.
- Auditors will stay as long as it takes to conduct the audit.
 - According to the associate director of examination for the SEC's northeast region, the rule of thumb is four to six weeks.
- SEC will provide the document request list prior to its arrival and will expect you to have hard and electronic copies of requested documents ready for the auditors to review.
 - *Note: Only provide the auditors with documents or access to documents that are requested.*

Mechanics of an Audit

- The auditors are trying to gain an understanding of the “story” behind your firm. GIVE THEM WHAT THEY ARE LOOKING FOR AND TAKE CONTROL OF TELLING YOUR STORY!
 - Remember: The smoother the audit goes, the faster you can get back to focusing on the business!!
- SEC has specifically noted that the following persons will need to be available for interviews during the on-site audit:
 - At least one member of senior management
 - Chief Compliance Officer
 - Reps from portfolio management, trading, back office, IT, AML and marketing
 - The SEC has stated that going forward it intends to interview more analysts and operations staff at firms.
 - *Note:* There may be significant overlap of positions at small firms.

Responding to the SEC Request List

- Have you reviewed a sample list?
- In the past couple of years, the Request List has been expanded to request information and detail on the development of compliance infrastructure and internal monitoring, reporting and review of compliance issues.
- A recent version of the Request List specifically states that **“failure to provide information that documents how your compliance program operates in practice may result in our concluding that Registrant has weak or ineffective risk management and control processes and is not in compliance with Rule 206(4)-7 [of the Advisers Act].”**

Responding to the SEC Request List

- Your Compliance Manual is only the beginning of demonstrating your “culture of compliance.”
- The Request List states that advisers should be prepared to produce documents that contain “output” from the application of such compliance policies and procedures to the daily work flows of the adviser.
 - Some examples of “output” include:
 - Exception reports together with documentation of follow-up work
 - Completed compliance checklists
 - Reconciliations
 - Management reports
 - Documents containing supervisory approval of overrides
 - Warnings or sanction notices to employees that violate procedures
 - Results or related analyses of forensic testing
 - Internal audit reports

Responding to the SEC Request List

- Thoughtful preparation of a response memo and exhibit files allow you to take the time to tell your story in the proper light.
 - This can originally be done as part of an infrastructure evaluation (rather than during the stress of an actual audit).
 - *Note: Only provide the auditors with documents or access to documents that are requested.*
- Carefully review and craft a response/reaction to each request.
- If you are forced to react to items on the Request List during the course of the actual audit your “story” may appear disjointed and disorganized. It may also create the impression that your firm does NOT have a strong “culture of compliance.”

Get Ready

- You will be expected to be prepared for a SEC exam!
- *“Many, many times, firms act surprised when examiners arrive onsite or when they receive a document request letter... They act surprised that they are subject to examination by the SEC. And they sometimes act surprised that they have compliance obligations under the law. That’s got to stop and there’s no excuse for that.”*

– Lori Richards, Director of the SEC’s Office of Compliance Inspections and Examinations – Source: SEC’s Schapiro Wants Power to Make Hedge-Fund Rules, Bloomberg.com, May 2, 2009

Practical Advice for Staying Prepared for the Inevitable Audit

- Use Request Lists previously distributed by the SEC to become familiar with the types of records and information that the auditors are likely to request.
- In managing your record-keeping, organize required documents in an audit-prep bin (or other form of temporary files). If you commit to updating these records on a regular basis – actual work in preparing for audit will be much smoother.
- When reviewing the Request List, identify and address which areas are not applicable to your firm.
 - For example, if you manage a fund of funds, requests relating to selecting broker-dealers do not relate to you.

Demonstrate Review of Compliance Procedures

- Investors & Prospective Investors
 - Copies of all fund related reports, marketing materials, presentations, offering documents, etc.
 - Relationship history (how you met, where you met, why you met, when you solicited an investment, communication traffic since inception)
 - Qualifications (qualification of client, AML check, investor type, etc.)
 - Account transaction history (balance, fees, performance, etc.)

Demonstrate Review of Compliance Procedures

- Management Company & Fund
 - 3(c)(1), 3(c)(7) slots management
 - ERISA management (what is your current capacity by class?)
 - Performance attribution and NAV calculation (YTD, QTD, arbitrary months)
 - Third party consultant relationships (who you have paid, how much, and why?)
 - Current “standard” RIA documentation (ADV II, Code of Ethics, RFP’s, etc.)

Demonstrate Review of Compliance Procedures

- Access Person Reporting and review of reports
 - Ability to demonstrate tracking and reminder emails – “culture of compliance”
- Pre-Clearance Review Report
- Conflicts of Interest Review Report
- Evidence of regular review of conflicts of interest unique to your firm
- Soft Dollar Activities Review Report
- AML/Patriot Act Review Report

Questions & Answers

- Thank you for your interest.

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