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The International Comparative Legal Guide to:

Alternative Investment Funds 2018

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A practical cross-border insight into Alternative Investment Funds work

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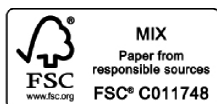
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Adviser Exams: Mitigating Enforcement Risks

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I Introduction

In an evolving securities landscape, examinations of investment advisers remain a key priority for the SEC's Office of Compliance Inspections and Examinations (OCIE). By understanding OCIE's exam priorities, proactively testing policies and procedures, and prudently managing issues as they arise in the course of exams, investment advisers can reduce the risk that an OCIE exam will lead to an investigation by the SEC's Division of Enforcement.

OCIE conducted a record-setting 2,100 investment adviser examinations in FY 2017, a 46% increase over FY 2016, OCIE's previous all-time high.¹ The percentage of advisers examined has similarly increased over time, from 8% in FY 2012, to 11% in FY 2016, to 15% in FY 2017.² The nature of OCIE examinations has also evolved as the SEC seeks to use its limited resources to focus on critical risks impacting market participants and examine registered investment advisers that have never previously been examined.³ OCIE Director Peter B. Driscoll recently stated that examinations have become "targeted, shorter, deep dives into high-risk areas that are published in our priorities."⁴ OCIE has expended substantial time and effort improving its risk assessment and surveillance capabilities to ensure that it spends its time and resources examining "those firms and practices that pose the greatest potential risk of violations that can harm investors and the markets."⁵ These efforts have included developing technological tools that can analyse data provided by all registrants, not just those selected for examination.⁶ In describing their shift in priorities, both OCIE and the SEC as a whole have emphasised the difficulty of monitoring the investment adviser universe, which has grown 15% in terms of the number of advisers and 40% in assets under management in the last five years.⁷ Even with a vastly expanded number of examinations, the technical deficiency rate has remained largely stable. In FY 2017, 72% of examinations identified some deficiency, on par with FY 2016's 72%.⁸ The number of examinations resulting in a "significant finding", however, has declined substantially, from 35% in FY 2013 to 27% in FY 2016, and to 20% in FY 2017.⁹ Similarly, the number of examinations referred to the Division of Enforcement has steadily trickled downward, from 13% in FY 2013, to 9% in FY 2016 and 7% in FY 2017.¹⁰ More frequent, risk-based examinations and industry recognition of the SEC's willingness to take more aggressive Enforcement action when necessary has likely contributed to investment advisers' proactively examining and updating policies and procedures, in turn increasing compliance and reducing the number of serious infractions. As OCIE Director Driscoll has made clear, the SEC hopes that increased transparency of OCIE's priorities have encouraged and enabled firms to focus their internal compliance and "anticipate and preemptively solve compliance issues".¹¹

This article will first explore five key SEC priorities for investment adviser examinations and Enforcement actions. It will next focus on how advisers can proactively identify and address OCIE examination risks *before* those exams are requested. Next, the article will discuss approaches to responding to exam requests given the potential Enforcement backdrop, particularly approaches to responding to requests for documents, emails, and witness interviews that both minimise risk to the adviser and ensure timely, accurate, and complete cooperation with OCIE. Finally, the article will discuss the process for OCIE referrals to the Division of Enforcement, and the circumstances in which an exam deficiency is most likely to lead to a referral.

II Exam Priorities

Exam and Enforcement risk is best minimised by implementing a comprehensive compliance programme covering all aspects of an adviser's operations and proactively addressing any issues of concern prior to the start of an exam. A review of Enforcement actions and settlements and public statements by SEC officials highlights five key areas which may pose particular risks of referral from the exam process to Enforcement, each of which will be discussed briefly below.

Fee, Expense and Trade Allocation

Allocation of fees, expenses, and trades or other investment opportunities has been a perennial focus of OCIE attention and SEC Enforcement actions. Investment advisers' responsibility to allocate expenses between the adviser and managed funds, and to allocate fees, expenses, and trades among clients, create a number of potential conflicts of interest between the adviser and its clients.

As discussed at length in our June 2017 and 2016 article, *Allocating Fees and Expenses: The SEC Is Paying Close Attention*,¹² the SEC has settled nearly two dozen cases with investment adviser firms regarding fee and expense allocation. Many of these scenarios involved allocations among advisers, client funds, and co-investment vehicles. In its April 2018 Compliance Outreach Program, and accompanying Risk Alert,¹³ the SEC distilled the findings of over 1,500 adviser examinations into several categories of violations. In broad overview, three key lessons follow:

First, the SEC expects that potential conflicts of interest will be disclosed at the time the investor makes an investment decision. Once an investment decision has been made, the SEC appears to believe that disclosures describing how an adviser will act are far less effective in protecting even the most sophisticated investors, unless investors are able to act on such disclosure by consenting or by redeeming.¹⁴

Second, the SEC expects that disclosures regarding fee, expense, and trade allocations must precisely describe the mechanics of allocation and specify both the types of fees, expenses, and trades that will be allocated and how the adviser will allocate them in specific circumstances. The SEC has refused to allow advisers to point to “catch-all” provisions that permit discretionary allocations of expenses to avoid liability.¹⁵

Third, the SEC will require advisers to comply with their established and disclosed allocation procedures. The SEC may bring Enforcement actions against advisers that do not comply with established procedures even in the absence of significant investor harm.¹⁶ OCIE’s 2018 Risk Alert highlighted a number of categories of deviation from established procedures. Some, such as charging fees based on improper valuations, charging fees at rates or according to a time schedule different from that disclosed to investors, highlight the importance of careful recordkeeping and operations. Others, such as failing to aggregate holdings that would comply for volume discounts, failing to disclose fee sharing practices, or improperly charging fund expenses, highlight the importance of a well-resourced compliance function that can effectively monitor all aspects of an advisers’ operations.

Advisers can expect OCIE to review the sufficiency of adviser’s allocation disclosures and compliance from multiple perspectives. OCIE routinely asks advisers to provide and identify disclosures made to investors at the time they are committing capital and in the course of a fund’s life cycle. OCIE will also request the adviser’s compliance policies and procedures governing allocations and documentation demonstrating compliance with these policies and procedures.

To test the adviser’s compliance with its disclosures and policies, OCIE may request financial records showing how the adviser has allocated fees, expenses, and trades for a lengthy period of time. In the event an adviser lacks the necessary records, the SEC may ask the adviser to create charts showing the allocated amounts. Finally, the exam team may ask advisers to explain the rationale behind allocations of particular interest, either by written explanations, by providing contemporaneous documentation, such as email, or potentially in interviews.

Insider Trading and the Treatment of Material Nonpublic Information

Insider trading and the treatment of material nonpublic information remain a top priority for both OCIE and the SEC’s Enforcement Division, and likely will always occupy an important position on the SEC’s exam priority list. Both substantive insider trading issues and the advisers’ insider trading compliance programme are likely areas of scrutiny during an OCIE exam.

OCIE exam teams are likely to request general information regarding a firm’s research and investment decision-making process, both through requests for documents and through written questions. The exam team will then drill down into specific relationships and communications that a firm’s portfolio managers and research analysts have with corporate insiders and other market participants. In recent years, this inquiry has included a particular focus on how firms control and monitor one-on-one and small-group communications with corporate insiders.

Second, the exam team will likely identify particular transactions for closer review where either there is unusually positive performance or the transaction is outside the scope of the adviser’s ordinary areas of investment focus. The exam team can be expected to review sample investment files and emails relevant to those flagged transactions. Portfolio managers and analysts identified through

that review may be interviewed. OCIE often requests significant background information to understand the sources of information used by the adviser and to confirm that there was no improper use of material nonpublic information.

Third, OCIE exam teams will likely scrutinise the compliance department’s control and oversight over the use of nonpublic information. Materials analysed will include written policies and procedures, logs of contacts with industry consultants and with personnel of publicly-traded issuers, and records of trainings regarding insider trading. Recent settlements have demonstrated the SEC’s close attention to alleged failures in sufficiently tailoring policies regarding the misuse of material nonpublic information.

Valuation

Valuation methodologies and disclosures are consistently identified as an examination focus in the SEC’s annual publication of national exam programme examination priorities. Kristin Snyder, OCIE’s Co-Head of the SEC’s Investment Adviser/Investment Company Examination Program, reaffirmed the focus on valuation for private fund advisers at a Q&A panel following the SEC’s 2018 examination priority announcement. Investors and the SEC demand reliable calculations of a fund’s value. Advisers can expect to face continued scrutiny of both valuation policies and procedures and the oversight of those policies.

The SEC has made clear that particular attention will be paid to advisers’ valuations used to calculate management fees. Examiners will also review whether assets are valued in accordance with investor agreements, disclosures, and the firm’s policies and procedures and whether there have been breakdowns in compliance controls. Difficult-to-value or illiquid instruments will face enhanced scrutiny. Advisers can also expect that OCIE exam staff will devote particular attention to any instances in which the valuation process described to clients is not ultimately followed or the valuation methodologies are modified without being communicated to investors.

SEC examiners will expect firms to have a clearly defined, step-by-step valuation procedure which is memorialised in written policies and procedures. Any alternative methods for valuation should be similarly memorialised. OCIE staff will examine whether detailed pricing methodologies exist and are consistently applied. Examiners will also look for documentation of pricing errors, if and when they occur, and a record of how such errors were corrected.

With the need for accurate valuation information comes the need for a well-defined and substantial oversight of the valuation process. OCIE will look for a valuation committee that routinely reviews valuation methodologies and, where applicable, pricing decisions and will expect to see clearly defined roles for all those involved in the valuation process, as well as policies and procedures that address monitoring and controls for such individuals.

Advertising

Consistent with the SEC’s focus on investor protection, advertising has been a priority since the SEC launched its advertising review initiative in 2016, which the SEC described as a response to having frequently identified deficiencies in adviser advertising practices. Indeed, many of the “most frequent advertising rule compliance issues” are directly relevant to the kinds of marketing communication that frequently occur between funds and their investors.¹⁷ The Advertising Rule prohibits an adviser from publishing or distributing any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading, and the

definition of what constitutes an advertisement is quite broad.¹⁸ The most common and problematic deficiencies involve the sharing of misleading performance results, misleading claims of compliance with voluntary performance standards, cherry-picked profitable stock selections, and misleading one-on-one presentations.¹⁹

In a sweep investigation of potential violations of the Advertising Rule, the SEC demonstrated its willingness to bring significant charges against investment advisers when it found 13 investment advisory firms had repeated F-Squared Investments' false performance data, which had been substantially inflated.²⁰ The 13 firms did not sufficiently substantiate the information that F-Squared Investments had provided, and the then SEC Enforcement Director emphasised that advisers "must verify the information first rather than accept it as fact".²¹

Over the course of an exam, OCIE can be expected to scrutinise presentation decks used when meeting with investors, standard due diligence questionnaire responses, investor letters, and other routine marketing communications. Because in-person or telephonic meetings can be just as important as printed disclosures and marketing material, OCIE will also scrutinise compliance manuals and policies and procedures governing these kinds of oral marketing communications. OCIE's review of advertising materials is, of course, not only targeted at advertising compliance: many of the other exam priorities, such as fee, expense, and trade allocation turn on how an adviser describes its practices to investors in disclosures and advertising material.

Cybersecurity

OCIE first identified cybersecurity as an exam priority in 2014 and, recognising the growing threat of cyber intrusion and the increasing reliance of investors on the internet for account access and securities transactions, the SEC has since placed greater emphasis on evaluating and addressing cybersecurity risk. The SEC has noted the increasing frequency and complexity of cyber-related misconduct affecting the securities markets.²² In August 2017, the SEC described cybersecurity as "one of the top compliance risks for financial firms."²³ OCIE's cybersecurity concerns have grown as the market becomes increasingly entangled with cyberspace, creating heightened risks for targeted firms, market participants, and retail investors alike. The SEC has noted that the rapid growth of distributed ledger technologies and the cryptocurrency markets present challenges to the staff, requiring additional expertise and a continuously improving programme.²⁴ Accordingly, in its FY 2019 budget request, the SEC has specifically sought additional staff to monitor critical securities market infrastructure for significant cyber events and outages.²⁵

In August 2017, the SEC issued an alert detailing observations from 75 examinations conducted in connection with OCIE's cybersecurity initiative. The findings were troubling: while nearly all investment advisers had written policies and procedures addressing cybersecurity issues and corresponding protections, those policies were often too general, not tailored to the firm's business model, or simply not reflective of actual practices at the firm.²⁶

In preparing for an OCIE exam, investment advisers should first ensure that it has in place sufficient written cybersecurity policies and procedures. OCIE's August 2017 cybersecurity observations have a detailed list of the kinds of policies that OCIE says firms may "wish to consider". OCIE expects mandatory cybersecurity awareness training for employees and contractors.

After examination of the contents of the firm's policies and procedures, OCIE will consider whether these policies are followed. For example, if there is a policy that states employees cannot use

home computers in their professional capacity or must use secure mobile devices, OCIE will seek evidence that, in fact, employees are not using home computers in a professional capacity and cannot accept firm emails on an unsecured personal mobile device.

OCIE will also look for risk assessments, such as tests of cyber vulnerabilities or documented understandings of where sensitive data resides and whether it is adequately protected. OCIE will similarly expect advisers to have in place an incident response plan, which should address potential cybersecurity incidents. Because vendors are entrusted with sensitive data, OCIE expects firms to also consider whether to perform due diligence on third parties with access to investor information. If an adviser's internal review identified cybersecurity deficiencies, OCIE will scrutinise the efforts made to mitigate the issue and expect policies and procedures to have been revised to prevent the same future deficiency.

III The Exam Process

A. Before OCIE Arrives: Exam Preparation

The first step in the OCIE exam process is preparing for an exam – which should begin before an exam is on the horizon. By knowing the areas OCIE likely will focus on during an examination, advisers can identify potential issues and take corrective action, if necessary, before OCIE arrives. The SEC's focus on transparency, continued effort to effectively allocate its limited resources through risk-based analytics, and advocacy of strong adviser compliance programmes provide an encouraging environment for investment advisers to address potential issues before they develop into an Enforcement action. Cooperation, proactive remediation, and, where appropriate, self-reporting benefit investment advisers, investors, and the SEC alike.

There are several key measures advisers should consider taking on a routine basis to best prepare for OCIE exams and prevent subsequent SEC Enforcement actions:

- **Evaluate written policies and procedures to ensure they are in place, properly tailored to your firm's circumstances, and up to date.** As noted above, a key area of OCIE focus is evaluating whether written policies and procedures are in place, sufficiently tailored to the specific firm, up to date, and followed. Advisers should thus regularly review their policies and procedures, with particular attention given to those relevant to the SEC's priorities. Where applicable, policies should be updated to reflect current best practices. Advisers should also ensure that policies are followed and that steps taken pursuant to policies are documented.
- **Ensure any deficiencies noted in prior OCIE exams have been addressed.** Because OCIE is focused on addressing repeated deficiencies, firms should closely examine any issues that have been addressed in prior examinations. All deficiencies previously identified by OCIE should have been fully resolved in a timely manner. Firms should expect OCIE to follow up on those earlier issues, and advisers should be prepared to explain changes made to policies or implementation practices to address those deficiencies, and demonstrate that past deficiencies have not been repeated.
- **Determine if any further action is needed to remedy past deficiencies or to proactively address potential deficiencies.** Once risk areas have been identified, the adviser must also determine whether any proactive remedial action is needed. Some remedial steps will be straightforward – updating out-of-date policies or implementing new procedures to follow an emerging best practice. Judgments around other potential remediations may be more complex and nuanced and involve a balancing of considerations, particularly in areas where

OCIE and Enforcement priorities appear to be evolving. Whether or not a decision is made to remediate, it is essential to be prepared to explain to OCIE the firm's decision and decision-making process.

- **Develop a regularised procedure for OCIE exams, including a process to manage interactions with examiners, document production, and responses to requests.** Advisers should designate a coordinator to serve as a primary point of contact for the OCIE staff in order to maintain clear communication and ensure that requests are dealt with promptly. This also facilitates proper recordkeeping and improves the ability to efficiently produce documents upon request.

Perhaps the best way to ensure that the above exam preparation steps occur on a routine and regularised basis is to make them part of an adviser's regular compliance procedures. By integrating this prospective review into a regular compliance review, advisers can ensure that steps are taken regularly, systematically, and with ample time to assess and implement any remedial action. This is only possible, of course, if advisers ensure that their compliance function has sufficient resources to proactively address potential exam issues, allowing the firm to substantially lessen resource expenditure, disruption and risk later on.

B. Responding to Written Requests

OCIE exams ordinarily commence with a series of written requests for documentation and information. Before responding to written requests from OCIE, investment advisers should consider the full context of each request and the potential Enforcement implications. Although responding to such requests can seem like a rote exercise, initial requests offer critical insight into what OCIE may have identified through its pre-exam risk assessment as issues for enhanced scrutiny. OCIE inquiries should not be viewed through the adversarial lens of civil litigation, however. Rather, written requests should be approached as an opportune time to begin building a cooperative relationship with OCIE examiners through timely and accurate responses:

- **Consider the aim of written requests and evaluate whether additional information should be provided.** An adviser's goal in responding to a request should be both to fulfil the request and to ensure that the adviser has provided a complete and accurate response to OCIE. When a written request is received, an investment adviser should first consider the aim of that request. Does the request relate to the examination and Enforcement priorities identified above? How does the request relate to the firm's business and strategies? What would someone in an Enforcement capacity be looking for in the responses? By reflecting on these questions, an adviser can better determine whether there is information outside the scope of the request that might be provided to ensure that OCIE has a complete and accurate picture of the adviser's practices.
- **Evaluate follow-up requests with particular care to identify potential target areas.** Follow-up requests offer even more refined insight into OCIE's thinking. These requests enable advisers to determine whether the OCIE inquiry is, in fact, aimed at the issues initially believed to be the focus. By their nature, follow-up requests suggest OCIE's interest has been piqued: a follow-up request for fee allocation data for the past X years, for example, is a strong indication that OCIE has flagged this area as high-risk for the firm and is taking careful look at the issue. Follow-up requests should also prompt advisers to more closely consider whether there exists additional information that, while not directly responsive to the request, would be relevant to the general line of inquiry and may be beneficial to proactively share.

It is important to maintain thorough records of all materials provided to OCIE. Even though information requests often arrive on short notice with tight deadlines, firms should keep a detailed log of every document or item provided to OCIE, as well as a copy of all materials produced.

C. Responding to Email Requests

OCIE exams frequently include requests for the production of email. Recent practice indicates that OCIE increasingly seeks all emails from selected senior personnel (including portfolio managers and analysts) over extended time periods, resulting in extensive initial email production. Email collection, review, and production can become expensive and time intensive and are fraught with pitfalls, from inadvertent production of privileged material to technical issues in search or production. In contrast to document review in the civil litigation context, the timeline for most OCIE exams typically makes it impossible and unduly expensive to review, before producing, every email of multiple employees sent or received over a broad time period. It is essential, however, to have steps in place to protect privileged information and obtain a general understanding of what information is being produced and what the exam team may focus on. The essential parts of a review strategy include the following:

- **Identify potentially privileged material before production.** Producing privileged materials to the SEC without taking reasonable steps to avoid production risks waiving the privilege with respect to the documents or potentially over the entire subject matter of the communications. Advisers should therefore take reasonable efforts to remove privileged material from the production before the documents are produced to OCIE. Among other search approaches, advisors should consider identifying relevant attorneys, and documents or communications sent to or from those attorneys, or created by or for counsel, should be searched for and analysed. This narrowing of criteria can help identify the documents that most require review so that privileged material is not inadvertently produced.
- **Develop a search strategy to identify highly relevant documents, ideally before production.** An additional search strategy will be needed to identify the key non-privileged documents in the production. This search, which will likely feature search terms and may be narrowed to particularly significant document custodians over a particular time period, will depend on the relevant exam priorities and the factual context of the exam. Ideally, the search strategy employed will yield a small document set that is manageable to review before production or before follow-up communications are required with OCIE.

D. Requests for Interviews

OCIE frequently requests one or more interviews with an adviser's personnel in the course of an exam. Initial interviews routinely cover general questions about the entity and the activities to be examined, which allows the exam staff to develop a preliminary understanding of the firm's compliance practices and its adherence to policies and procedures. To the extent that the exam staff has identified particular areas of focus, they may request supplemental interviews. The topics of such interviews may suggest that the exam team is giving increased scrutiny particular aspect of the adviser's business or a particular transaction. Such targeted interviews require a shift in thought process and preparation, with witness preparation demanding careful attention.

- **Treat OCIE interviews with the same care you would afford to an interview or deposition in an Enforcement investigation.** While there should be no lessening of

cooperation and transparency with OCIE, preparation for interviews should be thorough and comprehensive. The interviewee's statements about what occurred and why will become part of the permanent record of the matter and will follow the adviser to any Enforcement action that may arise out of the exam. If the interviewee's statements are inaccurate for any reason, it may be difficult to correct them at a later stage or dispel any misunderstandings they may have caused. Advisers must therefore carefully consider the background of an interview request, understand the intended scope of the interview, gather documents and emails relating to the relevant transactions or events, and determine a preparation approach with the interviewee.

- **Carefully consider which adviser personnel can best serve as interview subjects.** OCIE may request to conduct an interview on a particular subject or transaction rather than to interview a specific person. Advisers and their counsel should consider who among the adviser's personnel with knowledge of the subject would best present a complete and accurate account of the relevant facts, and have sufficient "big picture" perspective to situate a transaction or occurrence in the adviser's overall business. For example, junior employees may have had direct "hands-on" involvement in a particular transaction but may lack the perspective or experience to provide a complete report to OCIE. Conversely, a senior employee may be able to present the best overview of a subject but may lack detailed firsthand knowledge of a relevant occurrence. Advisers and their counsel should carefully balance these considerations when selecting interview subjects.
- **Prepare for OCIE interviews just as you would prepare for a deposition.** Ideally, advisers would provide interview subjects with relevant documents and conduct preparation meetings in advance of the interview. The purpose is to understand fully what the witness recalls and what the witness would state in response to questions. Mock Q&A sessions are also an indispensable part of preparation, as an investigative interview – like a deposition – is very different from an ordinary conversation. While the short timetable for OCIE interviews may limit the ability to conduct as extensive preparation as for a litigation deposition, advisers and their counsel should develop a preparation process that ensures the witness will be prepared in the fundamentals of the interview process and relevant facts.

E. Remedial Action

Whether to take remedial action in the course of an exam can be one of the most important and difficult decisions to be made in the context of managing the risks of subsequent Enforcement action. Where it is feasible to take corrective action before the conclusion of an exam, advisers should weigh the following considerations in making this judgment:

- **Carefully assess the merits of the underlying deficiency.** If OCIE identifies a deficiency, investment advisers should thoroughly assess the nature and cause of that deficiency. Advisers should first examine relevant fund agreements and client disclosures with the goal of identifying opposing arguments on whether there was a violation of those agreements and disclosure. Recognising that the SEC may expect increased levels of detail in agreements and disclosures, advisers should consider the strength of the firm's position on the merits.
- **Consider whether adviser clients may have been harmed by any deficiencies, and if so, how clients may be made whole.** In situations where there is a close question on the merits and financial remediation is contemplated, firms need look closely at whether clients were harmed, whether the

adviser benefited, and whether the deficiency was caused by a good faith error or technological glitch or whether it resulted from mal-intent or compliance programme shortcomings. The particular facts and circumstances will drive every judgment, but if a firm is faced with an ambiguous or borderline position on the merits of an issue, which resulted in determinable financial costs to investors to the benefit of the adviser, prompt remedial action should be strongly considered.

- **Consider the form of potential remedial action.** Remediation can take many forms: enhancing policies and procedures, making additional client disclosures, amending fund agreements, and making financial payments. Determining how to handle possible remediation begins with fully understanding the relevant facts and applicable laws and regulations and how they might apply to the circumstances. There is often ambiguity about this, as applicable laws and regulations frequently do not address the situations that arise and OCIE's expectations may be based on industry best practices which are evolving. Given the complex judgments required to reach a remediation decision, investment advisers should begin considering remediation options as soon as issues arise. Waiting for OCIE to raise a concern and then appearing to remediate only because OCIE has focused on the issue does not put the firm in the most favourable position.
- **Consider how remediation may be perceived as OCIE evaluates whether to refer the matter to Enforcement.** When corrective action is undertaken appropriately, the risk of an issue being referred to Enforcement may be reduced. Alternatively, the decision not to remediate an issue which OCIE clearly believes should be remediated can substantially increase the risk of a referral to Enforcement, which in turn could lead to substantially greater financial and reputational costs for the adviser. Remediation itself does not, however, create a "safe harbour" to avoid Enforcement, and there are many situations where OCIE will refer an issue to Enforcement even when an adviser remediates in the course of an exam.
- **Remedial action should generally not be seen as an admission of noncompliance.** Advisers may focus unduly on whether taking remedial action will constitute a concession, thereby increasing the likelihood of an issue going to Enforcement, or whether, if there is an Enforcement investigation, the firm will not receive credit for taking remedial action in a settlement, resulting in an additional sanction by Enforcement. While every set of circumstances is different and should be evaluated accordingly, advisers should not overthink the extent to which taking remedial action will impact potential future Enforcement actions. Instead, advisers should focus on making the best decision with the available information. It is highly unlikely that positive remedial steps taken during an OCIE exam will have greater negative ramifications later on. Even if the issue is referred to Enforcement, if the SEC's process works as it should, the firm should receive full credit, or even greater credit, if the issue was remediated promptly and appropriately.

F. Referrals to Enforcement

At the conclusion of an exam, OCIE will provide a deficiency letter which identifies where the SEC views potential violations of laws and regulations and invites the firm to respond in writing and take appropriate action in response to the issues raised.²⁷ Firms should take full advantage of this opportunity and make as thorough a submission as possible.

The firm's submission will be closely considered by both OCIE and, in situations where OCIE has determined that Enforcement action should be considered, by Enforcement as well. Ultimately there

will be a process involving both groups within the SEC to decide whether Enforcement should open an investigation. It is possible to ask for additional meetings or calls with the SEC as this process progresses, but firms should assume that their written submission will be the principal basis on which the SEC makes its decision. In FY 2017, 7% of investment adviser exams resulted in a referral to Enforcement.²⁸ While it is impossible to predict with certainty whether a particular issue will result in a referral to Enforcement, the following factors may be relevant:

- **Referral to Enforcement is more likely where investors have been injured.** OCIE is more likely to refer matters to Enforcement in instances where there has been a recognisable injury to investors which is traceable to a clear violation of the securities laws, in particular to inadequate disclosures or an undisclosed conflict of interest between the adviser and clients. Injuries to markets through misuse of material non-public information and fraud or intentional misconduct generate similar Enforcement attention.
- **Referral to Enforcement is more likely if the deficiencies identified relate to areas of SEC policy focus.** The SEC may also identify particular areas – such as the subject matter areas referred to above – that present emerging trends in wrongdoing and want to take a public position on an issue. As a result, Enforcement referrals may be more likely as a policy or deterrent matter. If the issue is of interest to the SEC and the SEC sees value in an Enforcement settlement creating precedent on the issue, this can result in referrals even when there has been remedial action and cooperation.

IV Conclusion

With OCIE focused on more targeted, deep-dive examinations into high risk areas, the potential for Enforcement investigations following on to exams has never been higher. Accordingly, investment advisers should take scrupulous care in preparing for and managing the exam process.

Endnotes

1. U.S. Secs. and Exchs. Comm'n, *Fiscal Year 2019 Congressional Budget Justification Annual Performance Plan* (Feb. 12 2018) ("SEC FY19 Budget"), 30, available at <https://www.sec.gov/reports-and-publications/budget-reports/secfy19congbudgetjust>.
2. *Id.* at 105.
3. *Id.* at 27.
4. Melanie Waddell, *SEC to Probe Adviser, BD Fiduciary Compliance With ReTIRE Initiative*, ThinkAdviser, Mar. 3, 2017, available at <https://www.thinkadviser.com/2017/03/03/sec-to-probe-adviser-bd-fiduciary-compliance-with/?slretu rn=20180411160149>.
5. *Improving Investment Adviser Compliance*, Peter B. Driscoll (Sept. 14, 2017) ("Driscoll Speech") available at <https://www.sec.gov/news/speech/speech-driscoll-2017-09-14>.
6. *Id.*
7. SEC FY19 Budget at 27.
8. *Id.* at 106.
9. *Id.*
10. *Id.*
11. Driscoll Speech.
12. Leor Landa & James H.R. Windels, *Allocating Fees and Expenses: The SEC is Paying Close Attention*, 5 INT'L COMP. LEGAL GUIDE TO ALTERNATIVE INV. (2017).
13. *Id.*
14. *Id.*

15. *Id.*
16. *Id.*
17. *National Exam Program Risk Alert, The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers* (Sept. 14, 2017) ("Advertising Risk Alert") available at <https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf>.
18. The Advertising Rule states that an "advertisement shall include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities". Advisers Act Rule 206(4)-1(b).
19. Advertising Risk Alert.
20. SEC Press Release No. 2016-167, *Investment Advisers Paying Penalties for Advertising False Performance Claims* (Aug. 25, 2016), available at <https://www.sec.gov/news/pressrelease/2016-167.html>.
21. *Id.*
22. Stephanie Avakian, *The SEC Enforcement Division's Initiatives Regarding Retail Investor Protection and Cybersecurity* (Oct. 26, 2017) available at <https://www.sec.gov/news/speech/speech-avakian-2017-10-26>.
23. *National Exam Program Risk Alert, Observations from Cybersecurity Exams* (Aug. 7, 2017) ("Cybersecurity Risk Alert") available at <https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf>.
24. SEC FY19 Budget at 28.
25. *Id.* at 4.
26. Cybersecurity Risk Alert.
27. Under Section 4E of the Exchange Act, which was added as part of the Dodd-Frank act, OCIE must provide the deficiency letter not later than 180 days after the conclusion of the exam, unless senior OCIE employees extend the deadline for an additional 180 days after providing notice to the Chairman and Commission. 15 U.S.C. § 78d-5(b).
28. SEC FY 2019 Budget.

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