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MOCK EXAMINATIONS

Mock Audits Are Essential Preparatory Tools for Fund Principals in the Current Regulatory Environment

By Michael Washburn

It can be difficult for an investment adviser, fund manager, compliance officer or other private fund executive who has never undergone an SEC examination to know what to expect or how best to prepare. Technical requirements and best-practice standards and expectations are often in flux, even under the current, supposedly pro-business administration and regulatory regime. See "Pro-Business Environment of New Administration Continues to Have Challenges and Pitfalls for Private Funds" (Sep. 14, 2017). In addition, regulators are developing and perfecting new technologies and methodologies for scrutinizing trading patterns over ever-longer periods of time.

Examiners are as exacting as ever in their demands, not only with respect to the variety of documents they wish to review but also the format in which respondents provide them. When furnishing materials and answers to examiners, it is critically important for advisers to provide correct information while remaining concise and avoiding contradicting other responses or unnecessarily opening up further avenues of inquiry. To fully prepare for an examination and all its rigors, the importance and utility of conducting a mock audit are difficult to overstate.

In a recent interview with The Hedge Fund Law Report, David Tang, counsel at Seward & Kissel with a concentration on regulatory-compliance consulting, provided his thoughts on mock audits, their prevalence in the industry and best practices for advisers to use mock audits to prepare for an SEC examination, and discussed other developments in the examination and enforcement arena. This article highlights Tang's key insights.

For additional commentary from Seward & Kissel partners, see "Fund Managers Must Address Investors' Fee and Liquidity Concerns to Maintain Strong Performance in 2017, While Also Preparing for Trump Administration Regulations" (Mar. 30, 2017); and "Lock-Ups and Investor-Level Gates Prevalent in New Hedge Funds" (Mar. 23, 2017).

HFLR: Are mock audits increasingly being used to prepare advisers for the issues and questions that will arise during an actual regulatory examination?

Tang: I would not necessarily say that they are being conducted on an increasing basis. They have always been a staple for advisers who want to be ready for SEC and other regulatory exams when they arise. We have assisted numerous clients with mock audits and have found them to be a good way for advisers to prepare for the exam process.

One of the benefits of undergoing a mock audit is that the adviser, when producing the requested documents, will generally create an inventory of all of its documentation based upon an SEC-style itemized request list. This forces the adviser to locate and organize a lot of documents that advisers are not generally accustomed to producing in the ordinary course of their businesses, and certainly not in the format in which the SEC requests them. As members of the adviser's mock audit team comb through those items, they start to think about them from a regulatory standpoint, which is not how they are ordinarily viewed.

Requests that relate to expenses are a good example. The adviser is running an asset management business, which tends to be an expense-laden type of business. During the normal course of business, the individual that is responsible for processing firm and client expenses may not be thinking about them from the perspective of who actually paid these expenses or why and how they were allocated.

The mock audit is a good exercise for advisers to pull all this documentation together, review the information and then go through it with a third party – typically legal counsel or a compliance consultant – who can assist the adviser to spot issues that it did not previously identify.

[For additional insight on how advisers can prepare for mock examinations, see "ALM General Counsel Summit Reveals How Hedge Fund Managers Can Prepare for SEC Examinations" (Nov. 19, 2015); and "Legal and Practical Considerations in Connection With Mock Examinations of Hedge Fund Managers" (Aug. 4, 2011).]

HFLR: Are there other examples that come to mind where advisers tend to maintain records in one format but the SEC is likely to request those records in a different format?

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Tang: The trade blotter is another example. Typically, an adviser will have to construct the blotter in a way that is consistent with the SEC's formatting requirements.

Another difference is that the SEC tends to categorize investors in a way that does not comport with how advisers generally characterize their investors. If the SEC requests the adviser to produce a list of investors based upon how the SEC classifies them, this can leave the adviser scrambling to review its investor list and try to classify them in a way that meets the criteria set forth by the SEC.

HFLR: When it comes to key personnel, how can mock audits help them prepare for the interviews that they may undergo during an actual examination?

Tang: During a mock audit, we identify certain key personnel, typically department heads – portfolio managers, the chief compliance officer (CCO) and the general counsel – who may be interviewed by the SEC during an onsite portion of the examination or who may participate in calls with the SEC. We run through some questions with each of these key persons based upon his or her area of expertise or the area in which he or she is working.

The goals of this exercise are to ensure that the person understands the questions being asked, articulates a concise and clear answer, tailors the response to the question and refrains from providing more or less information than what is required to be responsive to the question. Responding in this manner is something that most individuals need to practice, as it differs from the normal flow of conversation. It is a little bit more like a deposition, in some ways, where the interviewee must be precise with his or her answers.

In every organization, there might be one or two people who may have a difficult time in this kind of setting. It can be a little bit nerve-racking and disconcerting to sit in front of regulators and be peppered with questions. Most of the time, the person being interviewed is not sure where the SEC is really coming from or what the examiners are getting at.

It does take some time to adequately prepare for the interview part of the examination process. We want to ensure that the person being interviewed is not nervous and understands the dos and don'ts, so this can be a really important and helpful exercise. It will also help inform the CCO how these key persons will perform in this kind of environment.

HFLR: Is there a fine art to this process? In other words, how do individuals know when they have provided enough information to be responsive to the SEC's questions but have not disclosed information that is not strictly required and which may potentially harm the individual or the adviser?

Tang: I find that the best interviewees, for this purpose, are the ones who give the answer to the specific question that is being asked and then stop and wait for the next question. Those who meander, and go on to various topics that were not the subject of the original question, may open up new areas for the SEC. Consequently, that is something that each individual has to be careful about.

In a mock exam, I will ask a question, get a flavor for the answer, possibly ask some more questions and then call a time-out and give a tip. For example, I might say, "What I was really asking was, 'How often do you review best execution?' You started with a discussion about best execution but then started talking about soft dollars, mixed-use items and Section 28(e) of the Securities Exchange Act of 1934. You started going off onto different tangents. A more direct and succinct response would have been to say, 'We review our best execution once a quarter,' then stop and wait for the next question."

HFLR: Is it proper for advisers to inform the examiners that they do not have the information they want?

Tang: One of the most important things for advisers to keep in mind during this process is that it is crucial to be honest and tell the truth in these interviews. If the adviser does not have the information, then that is its honest answer: "I do not have that information." Making up an answer is not the truth; I would avoid that. It is entirely within the bounds of the process to go ahead and say, "I don't know the answer. I will look into it. I will let my CCO know, and he is going to report back to you."

Just as importantly, I would minimize the interaction directly between the examiners and the rest of the organization. I typically suggest that the CCO act as a quarterback for the process and serve as the conduit for the SEC.

That being said, I would never counsel someone to respond "I don't know; I need to check" as a tactic to evade a question. If you know the answer, give the answer, and if you do not know the answer, say you don't know the answer. The best way is to be upfront.

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There are many questions, by the way, that the interviewee may not know the answer to. For example, if an operations person is asked about the firm's marketing practices, it is fine for that individual to say that marketing is outside of the person's responsibilities and refer the examiners to the marketing director.

HFLR: Is operational risk a big focus of a lot of these audits?

Tang: Operational risk is typically not, in and of itself, a primary focus of the examination process. Advisers, however, should expect the SEC to review compliance oversight of operational risk. As a fiduciary, an investment adviser is expected to manage operational risk to ensure that it is protecting client assets. Part of this responsibility entails adopting controls around risk areas – for example, cash movement, disaster-recovery planning, transition planning and counterparty risk – that could put client assets in jeopardy. It also goes without saying that an adviser is expected to have a cybersecurity program. While the chief operating, risk and technology officers will typically be responsible for adopting procedures and controls around these areas, there should also be compliance oversight of the implementation of and adherence to these procedures and controls.

The modern-day compliance function really touches on every aspect of an investment adviser. This is somewhat of a wake-up call for some people in the compliance community, but at this point it is a reality. Compliance needs to be involved in essentially every area of the business.

[For more on how advisers can manage operational risk, see our three-part series "Top Ten Operational Risks Facing Hedge Fund Managers and What to Do About Them": Part One (Oct. 18, 2012); Part Two (Nov. 9, 2012); and Part Three (Feb. 1, 2013).]

HFLR: Before Mary Jo White stepped down as SEC Chair, she proposed doubling the agency's enforcement staff. With a bit of hindsight, have we seen the fruits of that doubling in the form of stricter compliance standards and requirements?

Tang: There is definitely more of an environment where compliance programs are designed with the regulatory exam in mind. In the past, advisers thought about managing money and compliance programs as part of their fiduciary duties toward their clients, and that was their primary responsibility: protecting the interests of their clients. From that principle came all the adviser's compliance policies and procedures.

Now, there is not only that issue, but on top of that, compliance officers must consider:

- What will the SEC think?
- What are the SEC's technical requirements and best-practice expectations?
- What has the Commission said about an issue?

A good example might be inadvertent custody. An investment adviser may not know that there is language in the custodial agreement that technically gives it the right to withdraw assets other than for trading purposes. The SEC has said that, based on that language, the adviser is deemed to have custody and must comply with the custody rule. It is somewhat of a broadening of the scope of compliance to build a program that is not only meeting the adviser's fiduciary duty but also SEC-exam focused. Compliance officers are playing to their audiences in their roles these days.

[For examples where an adviser may have inadvertent custody, see "Avoiding Common Pitfalls Under the Custody Rule: Inadvertent Custody, Delivery Failures and GAAP Compliance (Part One of Two)" (Mar. 23, 2017).]

HFLR: How can compliance officers prepare for being scrutinized by some of the new tools and methodologies that the SEC has rolled out, such as the National Exam Analytics Tool (NEAT), which allows the agency to trace trading patterns over a longer period?

Tang: Advisers and their investment teams should be cognizant of the fact that their trading will be analyzed, and they have to be even more careful as a result. Innocent trading, based on analytics or patterns, could be construed as indicative of something nefarious.

For example, if a portfolio manager has a call with company management days before earnings about a name that the firm does not typically trade in, the portfolio manager subsequently puts on a big trade in that name and that trade ends up being a winner that follows closely with the conversation, has there been any insider trading? Absolutely not. But, will it be scrutinized by the SEC? Potentially, because the Commission will use its analytic tools to look at big traders in that name, along with the earnings, and it will know that the firm has not traded in that name in the past. If the SEC combines that with the fact that the portfolio manager just had a discussion with the company's chief financial officer, that may be an item of interest to the SEC. This is not particularly new, but I would venture to say that the Commission's tools are enhanced compared to what was available to it in the past.

[For more on the SEC's use of technology, see "OCIE Director Marc Wyatt Details Use of Technology and Coordination With Other Agencies to Execute OCIE's Four-Pillar Mission" (Nov. 3, 2016).]

HFLR: Besides mock audits, what exercises do you see as being particularly useful to help prepare for the eventual examination?

Tang: Other than mock audits, an adviser's own internal periodic testing is critical. Compliance should routinely be probing the firm's biggest risks, asking:

- What are we seeing that could be indicative of insider trading?
- What are we seeing in employees' personal trading?
- How are we complying with our expense-allocation policies?
- How are we testing our valuation procedures?

As the firm identifies potential conflicts of interest, the compliance function should be conducting tests to determine if there is, in fact, a conflict. The same principle applies to the firm's annual review. An adviser should not wait until a magical week in the year to conduct its annual review; rather, it should be conducting ongoing reviews throughout the year.

[For more on annual reviews, see "How Hedge Fund Managers Should Approach Preparing For, Conducting and Documenting the Annual Compliance Review": Part One (Mar. 22, 2012); and Part Two (Mar. 29, 2012).]