



**Advent**

## **SEC Exam Survival Guide: Prepare in 12 Steps**

A Practical Guide for  
Registered Investment Advisors

Advent Software, Inc.

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## Table of Contents

Introduction: Be Prepared .....	3
Why Us? Why Now? Triggers of Exams .....	4
Three Basic Types of Examinations .....	5
Hot Button Issues: The Top 10 Focuses of SEC Scrutiny .....	6
Red Flags to Avoid .....	7
Examining the Chief Compliance Officer .....	8
Prepare in 12 Steps .....	9
Nobody's Perfect: Understanding and Responding to Deficiencies .....	12
Maintaining Constant Preparedness .....	12
The Role of Technology in Supporting Compliance .....	13
Conclusion: Putting Compliance into Practice .....	14
About Advent Software .....	14

One of the Securities and Exchange Commission's most powerful enforcement tools is the on-site examination. Regulations allow the commission to conduct an exam of any registered investment advisory firm at any time, for any reason, announced or unannounced. It can be a stressful experience for the firm, with significant time and labor costs and the potential for business disruption. Compliance deficiencies can result in fines or other action, and can even land a firm on the SEC's watch list for greater scrutiny.

Much of that stress, disruption, and expense can be mitigated if a firm is prepared for an exam, and knows what to do and how to act when the examiners arrive. Firms may feel that if they have policies, procedures, and controls to protect clients, maintain records, and avoid conflicts of interest, they are prepared for an exam. But being compliant in and of itself is not the same as being prepared for the actual event. Knowing what to expect and how to prepare will help you avoid panic when you hear that knock on the door.

Preparation for an exam is not a one-time event. And the worst time to try and prepare is between the notification of an exam from the examiners and their arrival at the door. Instead, your goal should be to be in a constant state of preparedness. This document is intended to help you get there, with tips, suggestions, and recommendations compiled from Advent's partners, consultants and clients as well as the SEC itself. It does not constitute legal advice, and a review of your own compliance situation with your legal counsel is strongly recommended. But it will help you determine how prepared you are now, identify critical gaps in your compliance program, and take effective action today to prepare for an SEC exam tomorrow.

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## Why Us? Why Now? Triggers of Exams

What is the likelihood that your firm will be subjected to an examination by the SEC?

It's no secret in the investment industry that the rapid growth in the number of registered investment advisors (40 percent between 2001 and 2008) has outstripped the examiner staffing levels at the SEC. Thus, the SEC has set forth a "risk-based" ranking of firms for examination:<sup>1</sup>

- Large firms, based on assets under management, where a compliance breach could have an impact on a significant number of investors.
- Firms with a prior history of weak performance in an exam, or who have had an investor complaint signaling a weakness in controls.
- Firms engaged in activities that inherently increase risk, for example RIAs who are also broker-dealers with potential conflicts of interest.
- Newly registered firms.
- A random sample of firms not fitting any of the above criteria.

The majority of RIA firms fall into this last category. The SEC says that such firms should expect an exam a minimum once every ten years.

Preparation for an exam takes time, effort, and resources. Some firms may look at the odds and think they can put off the effort, or that their resources are better utilized elsewhere. This is a risky guessing game. The odds of having a serious illness may be low too, but that wouldn't stop you from investing in adequate medical insurance, taking steps to prevent disease, and heeding early warning signs. The same holds true of an SEC exam. Experts advise firms to figure that an exam is inevitable, and to start planning now to minimize its impact when it occurs.

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1. *Focus Areas in SEC Examinations of Investment Advisers: the Top 10*, speech by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, March 20, 2008  
<http://www.sec.gov/news/speech/2008/spch032008lar.htm>

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## Three Basic Types of Examinations

An SEC examination may involve an on-site visit to your office, in which the examiners will request and review documentation and interview appropriate staff members. Alternatively, you may receive a written request to provide specific information by mail. There are essentially three broad categories of examinations:<sup>2</sup>

**Cause Exams.** The highest priority SEC exam, a cause exam results from investor complaints, reliable tips, media reports, or the SEC's own risk assessment process for identifying questionable activity. Cause exams are focused on—but not restricted to—getting to the bottom of the alleged or suspected impropriety. As such, they are frequently unannounced.

**Routine Exams.** A routine exam is not triggered by any underlying suspicion of a compliance breach. It's the kind of exam to which any firm can be subjected at any time. Firms that are higher in the SEC's risk-based rankings—firms with high AUMs, a history of regulatory trouble, or other signs of poor controls (such as incorrect or incomplete entries on a Form ADV)—will receive greater scrutiny than those at the low end. The SEC claims to examine such firms every three years.<sup>3</sup> Firms that are lower on the risk scale are selected at random for examination.

**Sweep Exams.** The SEC conducts sweep exams when it identifies a pattern of emerging or resurgent risks based on routine exams or its internal risk assessment process. These exams focus on the specific risk identified and the sweep will typically involve several firms to determine how widespread the targeted risk is.

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2. *Remarks before the Fund of Funds Forum*, by Gene A. Gohlke, Associate Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, November 14, 2005  
<http://www.sec.gov/news/speech/spch111405gag.htm>

3. *Ibid.*

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## Hot Button Issues: The Top 10 Focuses of SEC Scrutiny

The SEC's areas of focus may vary from one exam to another, depending on the examiners' initial impressions of a firm's internal controls and the reasons for the exam in the first place. With that in mind, the SEC's director of the Office of Compliance Inspections and Examinations recently communicated the agency's top 10 list to compliance officers.<sup>4</sup>

- 1. Controls over Valuation.** What controls is a firm using to value securities, and do its valuations reflect prices the securities would receive upon sale? Because many firms base client fees on the value of holdings, the SEC wants to be sure holdings are not overvalued.
- 2. Controls over Non-Public Information and Personal Trading.** The SEC is highly sensitive to insider trading, and "suspicious" trades have increased with the growth of the industry. Does the firm have a proprietary code of ethics, policies and procedures, and enforcement mechanisms to prevent the misuse of "material non-public information?"
- 3. Dealing with Senior Investors.** The aging of the baby boomers and the evolution from company pensions to defined contribution plans means more senior citizens are in the market than ever. What are firms doing to protect senior clients from abuses of trust in marketing, appropriate product selection, and other aspects of the relationship?
- 4. Compliance and Supervision.** SEC Rule 206(4)-7, enacted in 2003, requires firms to implement internal compliance review and risk-assessment programs—in effect, to police themselves. Whether they are actually doing so, and how effectively, has become a key area of interest for examiners.
- 5. Portfolio Management.** Are the firm's securities recommendations and investment decisions consistent with its stated policies and with its clients' objectives and restrictions? Examiners look especially closely at the use of derivatives in portfolios.
- 6. Brokerage Arrangements and Best Execution.** Are the firm's brokerage arrangements consistent with its fiduciary responsibility to protect client assets and interests? Examiners seek assurance that "soft dollar" arrangements are properly disclosed, and broker selection is not influenced by excessive commissions or kickbacks.
- 7. Allocation of Trades.** What policies and controls does the firm have in place to ensure fair allocation of trades and avoid favoritism toward certain clients? And are those policies being strictly followed?

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4. *Focus Areas in SEC Examinations of Investment Advisers: the Top 10*—speech by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, March 20, 2008 <http://www.sec.gov/news/speech/2008/spch032008lar.htm>

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**8. Performance Advertising, Marketing, and Fund Distribution.** What measures is a firm following to ensure that its performance claims are accurate? Is it compliant with the GIPS® standards? Do its advertising and pitch books contain misleading information? Are its sales practices ethical? The SEC says this continues to be an area of “high deficiencies.”

**9. Safety of Client Assets.** Does the firm have effective policies to prevent theft, loss, or misuse of client assets? Examiners will review performance claims relative to fee calculations, as well as custodial arrangements, reporting, and reconciliation practices.

**10. Information Processing and Protection.** Does the firm have effective procedures for capturing, maintaining, and reporting information in its books and records? This includes policies and practices for retaining email and instant messages, protecting data from hackers, and disaster recovery.

Remember, while these are the primary areas of interest, they are not the only activities the SEC looks at. The degree of attention given to any one area will depend on the individual circumstances of the examination.

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You’ll have a good start on preparedness if you have addressed the most basic issues likely to set off alarm bells with the SEC, as outlined below.

**Lack of a Code of Ethics.** Every firm must have its own code of ethics, and it should be specific to the firm’s own policies and practices, not generic or “off the shelf.” The firm also needs to have a written policies and procedures manual, and it needs to be distributed to and acknowledged by all “covered persons,” which generally means anyone who has access to material non-public information.

**Failure to Make 13F Filings.** Any firm with \$100 million or more in equities in discretionary accounts must file quarterly 13F forms with the SEC listing those holdings and their values. Failure to do so may trigger an examination.

**Deficient Email and IM Retention Policy.** The SEC treats emails and instant messages the same way it treats printed, signed correspondence. All email must be retained and accessible on demand for a minimum of five years, and in some cases longer. Look into technology designed to capture, store, and index email for retrieval.

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## Red Flags to Avoid

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**Unclear Best Execution Practices.** The SEC expects firms to execute transactions in a manner that maximizes the client's proceeds to the extent possible, which places some burden of interpretation on the firm. It does not necessarily mean "lowest price." There are a number of methodologies for determining best execution. The SEC mainly wants to know that you have a policy and that you follow it, and that your trading practices are not influenced by broker relationships.

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## Examining the Chief Compliance Officer

Among the many factors the SEC will look at in an exam, an important one is the Chief Compliance Officer (CCO). Examiners will want to know the CCO has the experience and qualifications, familiarity with the regulations, knowledge of the firm's operations and, above all, the independence and authority to implement and enforce an effective compliance program.

The CCO should be prepared to answer tough questions delving into these areas. Membership in professional associations, credentials and certifications, attendance at industry and SEC forums, and publication subscriptions are all evidence of competence, commitment, and current knowledge. The firm must also be prepared to demonstrate that the CCO has the backing of senior management.

The effectiveness of the CCO begins with a firmwide understanding that protecting the client's best interest is in the firm's best interest. The firm's policies and procedures must be designed first and foremost to protect the investor. The CCO's job is to enforce those policies and, in so doing, protect the firm from running afoul of the SEC.

The on-site exam process typically starts with a telephone call to the CCO or firm principal to notify the firm that it has been selected for an examination and to schedule the visit. In most cases, unless it is purposely a surprise inspection for cause, it is a matter of weeks between the initial notification and the examination. In the interim, you will likely be asked to provide certain documents in advance of the visit.

If you have answers for the top 10 areas of scrutiny and have addressed the red flags cited earlier, you should be well prepared for the examiners' visit. But don't expect the process to take care of itself. You will need to be both responsive and proactive throughout the process. Below are 12 steps, presented more or less in chronological order, that will help you avoid last-minute scrambling and business disruption.

- 1. Acknowledge the notification and agree on dates.** It is important that the firm's principals and key staff be on hand during the examination. If the SEC's proposed dates conflict with travel schedules, negotiate dates that work for everybody. Examiners are flexible on this point, but it's ultimately their decision. Apprise senior management as well as legal counsel of the forthcoming exam.
- 2. Assign the CCO to lead.** Make it clear to both parties that the CCO is the primary communication channel and will be present for all meetings and discussions with the examiners. All interview requests should flow through the CCO, and the CCO should attend all interviews.
- 3. Make key staff available.** The firm's top executives, department heads, senior advisors, and compliance staff should all be on hand and prepared for interviews.
- 4. Assign additional responsibilities.** Before you ever get the call, you should have a committee and support staff assigned to prepare the requested documents.
- 5. Inform and educate employees.** Have a meeting of all staff to let them know about the exam. If it is a routine exam, make sure the staff understands that the firm either falls in a risk-based category that is examined regularly, or that the firm was selected at random for an examination—not for cause. Advise people that they may be interviewed and provide tips on how to respond. They should make sure they know what's being asked before answering, and ask for clarification when necessary. They should answer honestly, but limit their answers to what is being asked. They should not offer opinions or volunteer information that has not been requested. During the examination, they should not discuss the firm's business in the hallways, lunchroom, or reception area.

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- 6. Respond to requests promptly.** You will receive a request list, usually by fax. It will enumerate the documents to be provided before and during the exam. Review the request list; it will give you a better idea of the focus of the exam. Documents provided in advance may include your Form ADV Part II, Schedule F, your advisory agreement form, current client list, organizational chart, financial statements, your code of ethics, and your written compliance program and supervisory procedures. If any requested documents will take additional time to retrieve, advise the examiners when they can expect them in your initial response.
  - 7. Have a method for organizing and tracking documents.** Prepare a spreadsheet listing all documents to be provided with numbers assigned that match those on the request list. Organize the documents in boxes in hanging files labeled to correspond to the request list. Check off every document and complete the process in advance of the examiners' arrival.
  - 8. Make copies of all documents requested.** The CCO should have a duplicate of all the documents to be provided to the examiners. Make note of the date and time the examiners receive each document.
  - 9. Keep investment advisory records separate from other business.** The SEC is there to review your investment advisory business. Provide only what is requested and nothing more.
  - 10. Prepare a background presentation.** You should request an introductory meeting to give the examiners an overview of your firm, its services, and the scope of its business. You may want to consider a brief slide presentation. The purpose is to be proactive, establish a professional tone to the dialogue, provide context for the exam, and make a positive first impression. Include discussion of your internal compliance review process and key controls. This is an opportunity to exercise an appropriate measure of control over the exam process without trying to "stonewall" or dictate the outcome.
  - 11. Request an exit interview.** Generally the examiners will offer to discuss their findings at the conclusion of their visit, but if they do not, you should request an exit interview. Then you will learn of any deficiencies and can begin working to correct them in advance of the official written notification.

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**12. Consider requesting an exclusion from the Freedom of Information Act.** Protect your information from third parties by requesting your documents not be disclosed publicly. Under the Privacy Act of 1974, you may send a written request for your records or their correction to the FOIA/Privacy Office by e-mail (foiapa@sec.gov), fax (202-772-9337), or mail FOIA/PA Office (100 F Street NE, Mail Stop 5100, Washington, DC 20549). Include information that will assist the SEC's staff in identifying the records you are seeking to protect. They will notify you in writing within 30 days. Throughout the entire process, from the initial contact and subsequent communication through the end of the exam, remember: it pays to be courteous, professional, cooperative, and, above all, honest.

### On the Day of the Exam . . .

- A professional appearance counts. Offices should be clean and uncluttered. Staff should be punctual.
- Do not keep the examiners waiting.
- Ask the examiners for their business cards if they do not offer them to figure out who is in charge of the exam.
- The boxes containing the requested documents should be ready in the examiners' work space.
- The CCO should relocate temporarily to a desk or office adjacent to the examiners' work space.
- The CCO should confirm the schedule of meetings with specific individuals and let the examiners know he or she will be present for all interviews.
- All requests for additional information or photocopies during the exam should flow through the CCO. You can request that the examiners not make copies themselves. For any copies they request, make an additional copy for yourself.
- If deficiencies are called to your attention during the course of the exam, do everything you can to address and correct them. If you believe an issue has been cited in error, confer with legal counsel and make sure you have a strong case.

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## **Nobody's Perfect: Understanding and Responding to Deficiencies**

Do not be surprised when, in spite of your best efforts to root out deficiencies in advance, you are told you have some. More than 95 percent of examinations result in official deficiency letters, even if only one deficiency is cited. This is rarely a cause for alarm, but it requires immediate attention. If you follow the 12-step exam survival guidelines, you will learn about the most glaring, if not all, deficiencies before the letter arrives.

The letter will give you a deadline for taking measures to correct the deficiency and responding to the SEC. Correct the deficiencies as quickly as possible and let the SEC know you have done so in writing. If for any reason you cannot meet the deadline, you should respond immediately and explain how you plan to address the deficiency and why you need additional time. If the examiners understand that you recognize the issue and fully intend to address it, they will usually grant the extra time required to resolve the issues.

You also have the right to request confidentiality. Confer with legal counsel and the SEC about filing for protection of your information under the Freedom of Information Act.

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## **Maintaining Constant Preparedness**

Although you may shift into high gear upon receiving notice of an exam, you should operate all year around as though that call is coming any day. Review your policies and procedures manual at least once a year. Be sure all covered employees have acknowledged receipt of the manual. Make sure such basic information as names of key staff—especially the CCO—are current. Review your internal compliance process and be sure it can pass the test of Rule 206(4)-7. Check your Form ADV for accuracy and thoroughness. Double-check all previous correspondence from the SEC to make sure prior deficiencies, if any, have been cleared up.

Many firms bring in outside consultants to review their operations, often former CCOs. If you choose to do so, make sure they have significant experience with the examination process. It is also suggested to conduct a periodic internal audit or “mock exam” to test preparedness. This is best done in conjunction with your legal counsel, so that any issues that are uncovered remain confidential.

The best foundation for preparing for an exam, of course, is a strong culture of compliance and adherence to the principle of protecting the clients' interest, backed by a CCO with knowledge of the rules and the authority to enforce them. An exam is an ordeal, but it is far less so for firms that have nothing to hide.

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## The Role of Technology in Supporting Compliance

Just as technology plays an increasingly important role in investment operations, it also figures more prominently in compliance and examinations. Regulators are interested to know whether a firm is following best practices, particularly in trading, account reconciliation, and overall books and records retention.

Today's investment technology can help you reduce the labor and expense associated with an examination. It helps you ensure the accuracy of your data and maintain audit trails. It makes it easier to locate and retrieve the documentation the examiners are requesting, and to report it in a clear format. The systems you use and the way you use them can give examiners greater confidence that you are exercising due diligence and have the controls in place to properly monitor your activities for compliance.

The most advanced portfolio management, trading, and accounting systems on the market today have best practice compliance and audit features built in. Technology solutions exist today that enable you to turn many aspects of your policies and procedures into automated processes, notably pre- and post-trade checking and portfolio monitoring to ensure adherence to the firm's investment guidelines. Besides relieving staff of the tedious and error-prone burden of checking for compliance, these systems and the information they contain will make it easier to demonstrate compliance when an audit occurs.

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## **Conclusion: Putting Compliance into Practice**

An SEC examination is hardly ever painless, but proactive planning can lessen the pain substantially and enable you to continue conducting your daily business without undue disruption. To recap, you should:

- Assume an exam is inevitable; operate as though the call could come tomorrow.
- Know the SEC's key areas of interest and common red flags, and make sure you have addressed them.
- Conduct an annual review of your exam preparedness, perhaps including an internal audit or mock exam.
- Have an action plan for the day you are notified that you have been targeted for an exam. The plan should encompass both preparation of documents and preparation of staff.
- Confer with your legal counsel and know your rights regarding privacy and confidentiality.
- Conduct yourself with professionalism, confidence, and courtesy during the exam.
- Take advantage of current technology to ensure that your firm's information is accurate and thorough, to make data easy to locate and retrieve, and to demonstrate best practices in books and records retention.

Above all, infuse your everyday business with a strong culture of compliance, as evidenced by your people, your policies, and your processes. And make it readily apparent to examiners when they walk in the door.

### **About Advent Software**

Advent Software, Inc., a global firm, has provided trusted solutions to the world's leading financial professionals since 1983. Firms in 60 countries using Advent technology manage investments totaling US\$18 trillion. Advent's quality software, data, services, and tools enable financial professionals to improve service and communication to their clients, allowing them to grow their business while controlling costs. Advent is the only financial services software company to be awarded the Service Capability and Performance certification for being a world-class support organization.

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