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SEC Examiner Maryellen Maurer Discusses Exams, Fees & Expenses, Valuation and Cybersecurity

As the Securities and Exchange Commission's examination process grows increasingly complex and encompasses an ever-greater number of firms, the downsides to an exam going poorly have increased dramatically. Bolstering the seriousness with which the commission is approaching the private funds space, there have been a bevy of enforcement actions against them recently—just as Director of the Division of Enforcement Andrew Ceresney warned in a speech delivered in May.

Against this backdrop, Navatar and ACG co-hosted a webinar during which Nicholas Donato, a Compliance Specialist at Navatar, and April Evans, chief financial officer and chief operating officer of Monitor Clipper Partners, sat down with Maryellen Maurer from the SEC's Office of Compliance Inspections and Examinations to discuss recent trends in enforcement. While the focus of the webinar was on the private equity space, the experts' discussion featured lessons that are instructive for hedge funds and private equity funds alike.

The Compliance Function

There is no getting around the increased demands placed on the compliance function at private funds. Addressing this, Maurer noted that it is acceptable for chief compliance officers—in particular those wearing multiple hats—to utilize junior compliance staff to take over the day-to-day detailed and administrative work that frequently makes up a substantial portion of the compliance load. Since junior staff can handle testing and even training, Maurer added the CCO needs to be engaged on "identifying the risks of the firm and doing [the] risk assessment," bearing in mind, however, as is repeatedly emphasized with compliance functions, ultimate responsibility cannot be "delegated to the junior person."

Maurer stressed that CCO's and other compliance personnel should stay on top of the SEC's priorities by paying close attention to SEC speeches and enforcement actions, because they provide valuable insight into the Commission's current thinking and focus. And while acknowledging the additional expense with outside consultants, Maurer noted that having an independent third party come in to provide supplemental information can be helpful.

The Examination Process

Over the past few years, the SEC has remained steadfast in its goal of examining both unexamined and higher-risk managers, and to that end, has assembled a team of departments across the agency to support OCIE examinations. Explaining how various groups within the SEC work together, Maurer noted examples such as the Asset Management Unit's industry experts who, among other things, "sharpen document request testimony, devise any kind of investigation thesis, build analytics around the thesis." Though AMU is primarily comprised of attorneys, the team also includes a former portfolio manager from an alternative manager, giving it a broader and more-experienced based lens through which to examine private funds.

Likewise, the Office of Chief Counsel will assist the examiner in pinpointing the right questions from a legal vantage, such as asking, and helping to determine, whether a co-investment vehicle is an actual client. The Private Funds Unit also supports OCIE by informing examiners' understanding of the GP/LP relationship or helping to hone OCIE's focus during an examination of a specific fund. At times, PFU will even meet with larger LPs, a move which indicates just how much investor concerns are driving the SEC in its monitoring of private funds. Maurer noted that "Igor [Rosenblitz] recently met with nine of a state's pension plans to find out from them what the SEC should be looking for, asking for and where their priorities lie."

When addressing the concerns that smaller and mid-sized managers have an outsize regulatory burden relative to their size, Maurer was somewhat sympathetic, but noted that "There's a natural scaling to the regulations and enforcement of those regulations." For instance, she explained, at lower AUMs funds make certain filings less frequently, or with the Form PF, funds don't have to necessarily complete the whole form. Additionally, smaller firms might not be dealing with the same issues reported in the press, like cybersecurity, an area in which a manager may have fewer systems or outside entities accessing its information, so it may require fewer policies and procedures. "All of that is natural scaling," Maurer said. "The rules say that you have to have a program that is 'right-sized' for your business. We are not looking for anything to be outsized. We don't believe there is a one-size-fits-all. There is always a 'nevertheless,' though, and that is: 'The rules are the rules and they apply to everyone.'"

Another area that comes up frequently at smaller firms is dual-hatting. "We see nothing inherently bad about having multiple hats, if you can handle all of them," Maurer said, then cautioned, "We do pay attention to whether or not you can handle all of them." Maurer explained that in her experience, sometimes the middle-market space can be the most susceptible to conflicts of interest, as firm's that size attempt to grow. In addition, valuation of private securities for both large and small firms should be process-based to arrive at a fair value. "So finally, there are many obligations and requirements of an RIA—which is what they call an investment advisor—from a compliance standpoint. So whether their expertise is internal or external, or a combination thereof, we don't care, we just want to make sure you're addressing your issues and are knowledgeable about your business," she summarized.

Conducting Exams

The Pre-Exam Process

Before an exam begins, there are steps a firm can take to help ensure a smoother process.

"The first piece of advice I would give is to be prepared before we arrive," said Maurer. Firms should also identify all of their conflicts of interest, along with a detailed explanation of how they are handled, how they're being mitigated and how they are disclosed. Additionally, Maurer advised, firms should take advantage of the sample request lists available from consultants and attorneys, and review them and test production times. "You'll often find things take a lot longer to produce than you think, and it's a lot more difficult to produce those things than you think."

So what sort of advance notice can a firm expect? If the private funds unit is investigating a firm, the typical lead time can run up to six weeks in advance compared with two weeks if an examination is performed by other units within the Commission. And if a firm's hectic schedule doesn't fit with the SEC's exam schedule, Maurer is quite candid: "There is not a lot [of flexibility], frankly. There are just too many moving parts at the SEC to switch things around, namely the coordination with how the exam fits into what areas the SEC is currently focused on, which examiners are going to participate in the exam and where it fits on the various team members' schedules."

While a request to change the dates of the examination might be met with rigidity, other accommodations can be made to take into account that individuals—outside of the legal and compliance staff—might have other, equally pressing obligations that take them outside the office. Maurer assured that phone calls for people in those roles are sufficient, and it behooves the firm to proceed with them, because every effort to keep the exam moving is in its "best interest."

During the Exam

One of the most important aspect of a firm's response during an examination is responsiveness. Maurer justified the need to prioritize the examination with, among other points, that the "SEC is not in that often, and the time between visits can be possibly many years. So it should be 'all hands on deck,' and that's not just the compliance piece."

During an exam, the CCO, no matter how many hats he or she wears, has to know the business and have a knowledge of his or her responsibilities with respect to compliance. The SEC always asks what percentage of the CCO's time is spent on compliance, and the answer is typically below 50%. "What we want to be sure is that during an exam, you don't leave us with the impression that compliance is an after-thought. Alternatively we do find people who say it is really important, but when asked what they do, they can't point to anything specific with regard to compliance," Maurer said. A CCO may go over personal trading and may know the other side, "But it's compliance we're here to talk about," she said.

Maurer also advised that during an exam, firms should "Proactively communicate with us. Don't let us be the ones to follow up with you asking when are you going to be able to produce something. If it's going beyond a deadline or beyond 24-48 hours since we asked for something, just give us an update. That being said, we don't want you to produce inaccurate information because you're rushed. If there is a need to slow it down to produce the information, that is as important as giving us accurate information."

Maurer finally added if a firm is using consultants or outside counsel to review documents before producing them to the SEC and date stamping them, the firm needs to "bake" that time into its production timeline. "We don't give you extra time to do that. You're absolutely fine doing it, but understand that the deadlines are there and however you want to manage them, just manage them."

Post exam

After the SEC visits a firm onsite, it's easy for a firm to feel unsettled while awaiting the results. Maurer emphasized, as someone who has been on the receiving end of exams throughout her career, that she understands the anticipation, but "An exam may go on for a while. It's not helpful to yourselves to try and gauge," how long it will take. "Something could be going on unrelated to your firm that is taking up the examiners' time, or it may be something with your firm that we're pursuing, but it may again be administrative issues."

The fact of the exam, regardless of the results of an individual firm's examination, can often yield positive results in the SEC's view. Maurer noted that "oftentimes an outcome of our exam is your firm decides on its own to add more compliance resources, or to shift some of your compliance hats over to somebody else."

Best Practices

Fee Disclosures

Regulators and investors alike have been focusing on transparency regarding fees, expenses and valuations of private fund managers. Regulators' concern is that by not clearly describing fees and expenses, firms are effectively hiding fees from their investors. The keen focus makes clear that accurate disclosures are necessary so that investors can make informed allocation decisions. Though there have been improvements in the area of disclosure, the SEC has taken the position that firms still have more work to do.

Maurer said there is still an opportunity for advisers to improve governing documents and due diligence questionnaires regarding fees and expense allocations, and these improvements should be done proactively, before the SEC arrives to examine a firm. "It is something for advisers to think about and to take action on, rather than wait for us to arrive and tell you what to do. Unfortunately, that is still a scenario that we are often in. We understand that the governing documents have been produced long

before we arrived, and it may not be practical to have them amended when we arrive or immediately following speeches. However, if you allow the adviser or the GP to collect some form of compensation or share in compensation that takes away an asset from the LPs, you need to be sure that your documents and disclosures were in place before someone committed the capital. Before someone is committing capital they need to clearly understand where those expenses are going. That may actually involve you using your LPAC more often to get approval for some compensation and then notifying the LPs and then taking the action—not taking the action before."

Whatever policies and procedures are disclosed to investors and potential investors, Maurer advised managers to make sure they are actually engaging in any activities described, and that the policies and procedures in place take into consideration the SEC's concerns and enforcement action guidance. In many cases, on first blush, an adviser will give a knee-jerk response that they don't participate in activities the SEC is focused on, but when they talk through the issues or think about them a bit deeper, they realize they do participate in activities that fall under hot-button categories. Maurer advised managers to "think about [those issues] before we arrive."

Chief among the SEC's concerns is expense shifting, in particular, allocating broken deal expenses to funds and misallocating expenses, both between the manager and the fund(s) and between multiple funds run by the manager. "We see plenty of evidence of expense shifting, without proper disclosure, so I would recommend firms take apart a schedule of the fund expenses and make sure all of them are properly disclosed to the LPs prior to the commitment. Expense shifting we still continue to see includes the use of related party service providers—which appear to be full members of a manager's team—so operating partners, senior advisers, some captive consulting firms; and advisers who look like employees with access, but without controls around them, so they do have access and their expenses are not offset."

When allocating expenses, managers must consider whether the service or product benefits the fund or the firm. There are questions regarding software costs and, again, the analysis is whether software implemented will make the firm better or if it is somehow benefitting the fund.

There are also questions of how to allocate expenses related to outsourced, traditional back-office functions involving accounting, legal and risk, and regulatory filing, Maurer noted. The determination of how to allocate those expenses comes down to whether the functions are requirements of the fund, or come under an adviser's obligation and should be borne by the firm rather than the fund.

Another questionable expense is insurance, Maurer said. "Is that insurance really covering the funds, or is there a piece that is covering the management company?" she said managers should ask. During an examination, Maurer saw one firm that had insurance covering cybersecurity, but a portion of the policy covered information that could be stolen from employees. "It was not related to the fund, yet the fund was covering those expenses. It wasn't intentional, they simply didn't ask the questions enough, and then falsely informed investors that the adviser was charging 'below market rates'."

Valuation

Since certain private fund managers have been required to register with the SEC, the regulator has focused on fund managers' valuations of portfolio company investments. In the intervening years, trends have emerged showing where valuation practices have changed and where the industry still needs improvement.

"Valuation practices have definitely become better in terms of increasing the consistency of documentation around the processes," Maurer noted. "Firms are better able to produce the backup of how a value was arrived at. Firms are ensuring their valuation committee is looking at the same underlying materials each time."

But some areas still need improvement. Maurer elaborated, "We still find that everyone is not being fully transparent to the LPs about their practices, how they go about doing valuation as a summary document. It's good when you get into the details because it's best to be more transparent with the LPs. The best

thing a private equity firm can do to ward off any accusations is to be absolutely transparent on how they derive valuations. The LPs should be able to review the methodologies used by portfolio companies and clearly understand them in detail. For example, if there is a valuation summary page that you give to the LPs, they should be able to understand everything that is on that summary page, and you should be able to explain that to them."

Firms can also do better at approving valuations, as practices can sometimes run on both ends of the spectrum—some firms have a single person in charge of valuation, while others have a committee that relies on the underlying team, Maurer said. It is also problematic when firms don't ask enough questions and are a bit too trusting, not looking at the valuations inputs and instead relying on a junior employee without sufficient follow-up.

The SEC believes valuation is a priority, Maurer said, "Because folks are always raising money, so inflated values in valuations can be deemed misleading to investors with regard to their returns. Particularly in fundraising times, funds haven't been audited, and there are interim valuations. We see interim valuations as important because LPs base whether or not they are going to invest in the next fund based on how that fund did."

Maurer said the SEC does rely on auditors to get some comfort with valuation, but the regulator will still ask questions and review how a firm or its auditors arrived at reasonable rates, along with their methodology. "We look at what testing they are doing, go onsite and look at their work papers and compare that to what the GP is telling us when they do their own reviews and how they're working with the auditors. The auditors sometimes find all of the issues and sometimes they don't, so we can't give 100% reliance on what the auditors are doing. We have to look at valuations sometimes as if the auditors aren't there. I would say that we do have a senior specialized examiner that focuses on valuation that works very closely with the private funds unit."

Maurer said the SEC has no preference between an LP committee or an in-house team led by the CFO reviewing and verifying valuations. "We are seeing, as valuation becomes more of an issue, that firms are bringing in outside entities, which could include LPs that are invested in the firms. Another trend we are seeing is compliance people being a little too hands-off for what we were expecting. The compliance people should know the process and be able to do the testing. They need to know why that's happening and whether or not it's appropriate."

Cybersecurity

"Cybersecurity is a relatively new area for the SEC," said Evans, "and one of the challenges is you can never be 100% secure, so safeguards can always be improved." For that reason, Maurer emphasized that OCIE is laser-focused on the issue.

The challenge for firms is that "The federal securities laws don't specifically address a firm's requirements for cybersecurity preparedness," Maurer explained, there only exist "rules and regulations tangentially that address firms' responsibilities in the area, [specifically,] Regulation SP, the identify theft rule, regulations involving safeguarding of books and records which you hear about a lot, and the compliance rule that's specific to investment advisers."

For additional regulatory guidance, Maurer noted that in 2014, the OCIE staff conducted reviews of 105 firms, 49 of which were investment advisers of varying sizes, and the staff's observations from those reviews were published in a February 2015 risk alert. Phase two of OCIE's cybersecurity reviews was also published in 2015.

Guidance from cybersecurity exams conducted in 2016 may trickle down to practitioners more slowly than guidance from 2014's exams. "The 2016 exam results have been shared with the SEC to help inform the staff on industry practices, but we don't know if they will make them public," Maurer explained. "There were about 50 firms across the U.S. examined. What they are looking for is if you can readily answer questions about what your vulnerabilities are and what you're going to do to address them. And

we absolutely understand that there is so much that can be done, but you have to decide yourselves where that spot is. We can't tell you where that spot is or opine on that."

The SEC also will not opine on what a firm's exact cybersecurity practices should be—for instance, whether it will keep sensitive data onsite or migrate it to the cloud. "But what we do say," said Maurer, "is you should establish a set of standards for protecting client information, and we want to see what your standards are and be sure that they are protected." In that regard, she continued, "There are tools out there that can be helpful for you. There's something that's called the Federal Financial Institution Council, and they have a document that helps you identify the risks and determine your cybersecurity preparedness, including related to the cloud."

Though the SEC is not precise about how firms should best implement cybersecurity operations, it is precise in the questions it will ask about the practices chosen. Maurer explained, "These are things we will ask about: Are you looking at your agreements? An example is using Dropbox. We went on one exam, and they were using the one that anyone can use and sign up for, and there aren't necessarily controls around that, and the service provider can access the information. In contrast, with the other Dropbox service, the corporate service, there are controls around that." She added, "If there is any kind of password protection going on, and if we come in and ask for documents, if your service provider cannot go in and reset the passwords for you, you should have a way to do that. In short, we're not saying you can or cannot use the cloud, we just ask that you have [appropriate] controls around it."

Data maps are also useful for the SEC because they show firms "are covering the issues and thinking about it, and [they] make the questioning go a lot more efficiently and help us understand that [cybersecurity] is an area you are thinking about, and we can move on from that," Maurer noted.

Succession Planning

In June, the SEC floated a rule proposal that would force RIA's—including private funds—to mandate succession planning. As Maurer explained, the rule requires advisers to "adopt and implement a written plan addressing how to provide continued adviser services and protect client assets and information in the event of a business disruption." A firm's plan would have to address the particular risks of the adviser's operations in the event of natural disasters, cyber attacks, technology failures and key people departing the firm, among other scenarios.

Calling the proposed rule "prescriptive" compared to the current "principles-based" regime currently relating to business continuity plans (via the compliance program rule), Maurer stressed the Commission's belief that implementation of this rule will ultimately "assist advisers in preserving the continuity of services in the event of a business disruption."