

CCOutreach National Seminar
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Common Examination Areas:
Documents and Information Examiners Request and
How Advisers Can Use This Information to Enhance Their Compliance Programs*

An examination generally commences with the firm receiving a document request list. Many wonder why examiners request certain items and what analysis examiners will perform using such information. This document provides insight into the examination process for six broad topics: compliance review documentation; best execution and trade allocation; business continuity planning; areas for advisers to privately-offered pooled investment vehicles, including hedge funds; valuation; and soft dollars. Within each of these topics is a list of several items that examiners may request and various tests that examiners often perform using that information. These tests are often referred to as “forensic tests” or “forensic measures.”

There are a large number of forensic measures that provide useful information about the activities of funds and advisers. Many of these measures can be readily computed and analyzed by examiners. In addition, fund and adviser compliance staff may find such tests useful in administering their compliance program. The forensic measures discussed in this document are not an exhaustive list but, rather, an example of such measures, some of which are already widely used by both registrants and examiners.

Some of the examples of items requested and tests performed may not be specifically addressed in or required by the federal securities laws. However, as examiners, we have found that these items and tests help us identify risks which may represent weaknesses in control environments, identify conflicts of interest, and detect violations of the federal securities laws. If compliance policies and procedures are not established to detect or mitigate risks, at some point clients and/or investors may not be treated fairly and/or firms may operate in a manner inconsistent with the federal securities laws. As such, you may want to consider these tests as suggestions for establishing more effective compliance practices, policies and procedures to detect or mitigate control weaknesses.

A. Compliance Review Documentation

- **An inventory of factors creating risk exposure and/or conflicts of interest for the firm and its clients as a result of the nature of the firm’s operations.**
 - ✓ *Determine whether the firm has contemplated and/or made provisions for all the risks present. Unidentified risks could become areas of focus and are areas where violations may be present.*

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- **Documents that demonstrate how the firm’s policies and procedures detect, prevent, and/or mitigate the risks, conflicts, and/or breaches in compliance.**
 - ✓ *Determine that documentation demonstrates that the policies and procedures, when applied in practice, are working. For example, compliance documents, exception reports, or review sheets demonstrate that, among other things:*
 - *Investment decisions are consistent with clients’ mandates.*
 - *Registrant seeks and obtains best execution.*
 - *Investment allocations are fair and consistent with disclosures.*
 - *Prices used to value positions in clients’ accounts are accurate.*
 - *Reports provided to clients or shareholders are accurate.*
 - *Personal trading activities of access persons are consistent with Registrant’s code of ethics and fiduciary obligations.*
 - *Performance and marketing information is presented fairly and accurately.*
 - *Advisory fees are calculated correctly.*
 - *Fund shareholder turnover is consistent with disclosed policies and practices of the fund regarding market timing/late trading.*
 - ✓ *Determine the extent to which written policies and procedures are effectively utilized within the firm (i.e., how they are applied in practice).*
 - ✓ *Review exception reports, completed compliance checklists, reconciliations, management reports, and the results of any other testing to determine what controls the firm has in place to prevent, detect and correct violations.*
 - ✓ *Determine how and if violations or potential weaknesses are corrected when detected and whether such corrections are made in a timely manner.*
 - ✓ *Ascertain whether the firm’s compliance policies and procedures appear to be considered in the daily work of the firm.*

B. Best Execution/Trade Allocation

- **Firm’s trading blotter or purchase and sales journal for the inspection period. The record should also include the transactions of the firm’s access persons and proprietary accounts.**
 - ✓ *Calculate the average commission rates paid by each client and to each broker. A high volume of trades or high commission rates could indicate undisclosed soft dollar or referral arrangements.*
 - ✓ *Compare concurrent trades in the same security executed through several broker-dealers for price consistency.*
 - ✓ *Determine if block trades were allocated using average price and using consistent commission rates within the block.*

- ✓ *Determine whether any principal and/or cross trades have been conducted. If so, verify that appropriate disclosures have been given and client consent obtained. Verify prices at which such trades were conducted and commissions charged. Cross trades could also be conducted in an effort to “dump” securities on certain clients to benefit other clients.*
- ✓ *Review end of quarter/end of year trading for any evidence of “window dressing.”*
- ✓ *Calculate portfolio turnover for a sample of client accounts. Compare the turnover to the stated investment objective to look for disparities.*
- ✓ *Review proprietary and access person accounts for possible frontrunning and/or personal securities policies and procedures violations as well as execution prices and commission rates that are more favorable than those for client accounts.*
- **Performance returns for each client account for a specified 1-year period.**
 - ✓ *Compare performance among accounts to look for performance disparities. This could be an indication of favoritism or inequitable allocations. For example, compare the performance returns on:*
 - *Accounts with similar objectives;*
 - *Accounts with incentive-based compensation arrangements to those with asset-based compensation.*
 - *Accounts that received the 10 most profitable trades to other accounts with similar objectives.*
 - ✓ *Compare performance of personal, related, or proprietary accounts versus the performance achieved by clients. This could be an indication of favoritism towards insiders.*
 - ✓ *Calculate and compare the percentage of profitable trades in client accounts and personal, related, or proprietary accounts.*
- **A copy of brokerage allocation reports for a specified period, featuring the name of the firm, aggregate amount of agency commissions by the firm, and aggregate principal values or imputed compensation for principal transactions by the firm.**
 - ✓ *Compare the total brokerage amounts allocated to each broker. High allocations of trades could indicate a significant relationship with a particular broker.*

- ✓ *If a brokerage budget is prepared, compare total brokerage to this budget. Determine why certain brokers were used more or less than the brokerage target.*
- **A list of affiliated broker-dealers featuring their affiliation and a description of their clearing arrangements.**
 - ✓ *Review the total brokerage allocated to the affiliated broker. Determine whether the use of the affiliated broker is adequately disclosed.*
 - ✓ *Determine whether the brokerage and execution quality received by the affiliated broker is periodically and systematically reviewed and compared to other brokers to determine the appropriateness of the continued use of the affiliate.*
- **A list of broker-dealers with whom the firm has or had revenue sharing agreements for any purpose during the review period.**
 - ✓ *Determine whether the firm appears to be directing brokerage to such brokers in contravention of obtaining best price and execution.*
 - ✓ *Compare the brokerage and execution quality received by such brokers versus other brokers used by the firm.*
- **A list of all initial public offerings during the review period in which the firm's clients (including registered and unregistered funds), proprietary accounts or its access persons participated (i.e., purchased shares). Such record should include the security name, symbol, total number of shares, and the clients involved in the transactions.**
 - ✓ *Determine which client received shares of the IPO allocation. Determine whether certain accounts (e.g., accounts paying an incentive fee) may have been favored and/or whether the IPOs were consistent with client investment objectives.*
 - ✓ *Compare the performance of accounts with similar objectives to determine if IPOs were allocated consistently.*
 - ✓ *Determine if proprietary or access person accounts received IPO allocations and whether these allocations were consistent with the firm's disclosures and code of ethics.*
 - ✓ *Review the net gain or loss on IPOs and determine whether any accounts appeared to receive an inordinate number of "hot" IPOs.*

C. Business Continuity

- **All compliance policies and procedures and standard operating procedures relating to business continuity/disaster recovery.**
 - ✓ *Review the policies and procedures to determine whether contingencies have been sufficiently contemplated. For example, determine whether the policy, among other things, i) discusses what will happen in the event of the death or incapacitation of key personnel, ii) includes information regarding how to reach employees and service providers, iii) provides for back-up facilities in the event of dislocation due to a natural disaster or otherwise.*
- **Documentation regarding the results of the firm's most recent test of its business continuity plan.**
 - ✓ *Determine whether the firm has, in fact, conducted any such test.*
 - ✓ *If a test was conducted, determine its success and whether any necessary changes were or should have been made to the policies and procedures as a result of the test.*

D. Specific Areas for Advisers to Privately-Offered Pooled Investment Vehicles

- **The current version of the fund's offering document or private placement memorandum, organizational documents and operating agreements (e.g., partnership agreement).**
 - ✓ *Review stated investment objectives and restrictions. Determine whether any investments fall outside these stated objectives.*
 - ✓ *Based on the hedge fund's operations, investments, and any conflicts of interest, determine whether the offering documents include adequate and accurate disclosure, i.e., verify that all material information is properly disclosed to investors.*
 - ✓ *Verify that fees paid by investors are adequately and accurately disclosed.*
 - ✓ *Determine the manner in which fees are calculated and recalculate to verify that they are being calculated correctly.*
 - ✓ *Compare disclosures in the offering documents to other arrangements that may exist with investors, e.g., in side letters.*

- **Account statements sent to investors during the current fiscal year, if any.**
 - ✓ *Determine whether investors receive information regarding their investment in the hedge fund.*
 - ✓ *Determine whether the statements accurately reflect the investors' holdings.*
- **Fund custodial statements.**
 - ✓ *Verify the existence of the hedge fund assets.*
 - ✓ *Compare the assets at the custodian to subscription agreements, any withdrawal notices, statements to investors, and financial statements.*

E. Valuation

- **Pricing procedures, including fair value and pricing override procedures, and guidelines regarding illiquid/restricted securities.**
 - ✓ *Determine the methods used to value securities. Incomplete procedures could result in mis-priced securities.*
 - ✓ *Compare the method in which securities are valued to the written procedures in place.*
- **A list of all securities that have been fair valued or priced by the firm.**
 - ✓ *Conduct an acid test. Compare the selling price to the fair value to determine the accuracy of the fair value pricing procedures.*
- **List of securities for which the price provided by a pricing service was overridden by the adviser, sub-adviser, general partner, managing member, or Board of Directors and the date of such override.**
 - ✓ *Determine the reasonableness of reason behind such overrides.*
 - ✓ *Review back-up research/documentation to determine that the override was appropriate. Inappropriate overrides could potentially be used to inflate the value of securities held by the fund.*

- **Documents that were used to calculate and which substantiate each of the net asset values that were used during the inspection period to price interests of purchasing and redeeming investors and/or for reporting to fund investors the value of their positions in the fund. At a minimum, the documents should show the date the net asset value was calculated and position level detail (both long and short), including a description of each separate asset and liability and descriptions and notional values of off balance sheet positions such as futures contracts.**
 - ✓ *Recalculate NAV to determine if there were any errors. Ascertain the accuracy of the NAV calculation process.*
 - ✓ *Look for large changes in per share NAV to detect potential errors or mis-priced securities.*
- **Valuations for illiquid securities and/or private placements held by the fund(s) during the review period.**
 - ✓ *Determine the method in which such securities are priced. Ascertain whether such securities appear to be reasonably priced and/or, if potentially mis-priced, to what extent NAV may be affected.*
 - ✓ *Calculate the percentage of fund holdings such securities constitute. Determine whether this falls within the percentages allowed by the fund's fundamental policies and restrictions.*

F. Soft Dollars

- **For any soft dollar arrangements, obtain a detailed description of how the product or service is used by the firm.**
 - ✓ *Determine whether products or services obtained with soft dollars are purely research or brokerage related or of mixed-use.*
 - ✓ *Ascertain whether all or only a select group of clients benefits from the product or service. Determine whether additional disclosure may be necessary.*
 - ✓ *Compare the intrinsic value of the product or service to the level of commissions paid for the product or service to determine appropriateness.*
- **Indicate whether the products or services received pursuant to soft dollar arrangements are within the Section 28(e) safe harbor.**
 - ✓ *Determine whether the firm properly discloses that commissions are used to pay for non-research items (i.e., products and services that fall outside the safe harbor).*

- **Allocation procedures used if items are considered to be mixed use.**
 - ✓ *If a product or service is deemed of mixed-use, determine the appropriateness of the allocation between hard and soft dollars. The allocation should be an accurate representation of the amount or level that the product is used for research.*

- **Provide the approximate annual amount of commissions on securities transactions needed to satisfy each soft dollar arrangement.**
 - ✓ *Review the firm's periodic and systematic evaluations of brokerage firms used. Determine whether the soft dollar broker is deemed to provide good execution.*
 - ✓ *Ascertain the level of commissions paid to soft dollar brokers. Firms with soft dollar arrangements with high commission requirements may forgo seeking best execution in order to satisfy their soft dollar commitments.*
 - ✓ *Compare the current level of brokerage sent to the soft dollar broker to the amount needed to satisfy the commitment. A high "balance" may again encourage firms to forgo seeking best execution in order to meet their commitment.*