

Senior SEC Officials Discuss Asset Management Examination and Enforcement Initiatives and Priorities for 2012

In several recent public appearances, senior members of the SEC staff have commented on their current examination and enforcement priorities for the asset management industry in 2012.¹ Although each speaker qualified his comments as an expression of solely his own opinion, several common themes emerged from their remarks.²

Compliance Concerns

The Office of Compliance Inspections and Examinations (“OCIE”) is concerned that asset management firms are not committing sufficient resources to compliance. To address this concern, the SEC is consistently asking firms to identify the level of resources they devote to compliance and how they have determined the adequacy of those resources.

The Enforcement staff is looking to bring cases where a firm’s compliance policies and procedures do not satisfy the requirements of Rule 206(4)-7 under the *Investment Advisers Act of 1940* and Rule 38a-1 under the *Investment Company Act* (the “Compliance Rules”). Under this initiative, weaknesses in compliance programs may constitute sufficient violations in and of themselves to justify enforcement action, rather than being treated simply as an add-on to violations of other substantive rules. For example, two recent enforcement actions were brought against “examination recidivists” who did not adequately correct compliance program deficiencies previously identified by the staff, and a third case involved a sloppy compliance program that was a proximate cause for other violations. More cases will continue to arise under the Compliance Rules and an informal “two strikes, you’re out” approach may be applied in the future. Under this approach, the failure to correct compliance deficiencies after a negative SEC comment could result in higher fines and time-out penalties. More information about recent enforcement actions that have focused on Compliance Rules violations is available in Ropes & Gray’s alert [here](#).

Focus on Aberrational Performance

The SEC staff has been increasing its focus on funds with outlying performance. Three recent enforcement cases were built using new technologically-savvy techniques for identifying outlier performance. More information about the SEC’s “Aberrational Performance Inquiry” is available in Ropes & Gray’s alert [here](#).

Registration and Inspection of Private Equity and Hedge Funds

OCIE intends to commence letter inspections of many newly registered hedge funds and private equity funds shortly after the March 31st registration deadline. These letter inspections will be intended to assess which firms may be appropriate targets for on-site inspections. In determining which firms to target for an on-site inspection, OCIE will focus on the adequacy of compliance controls described in responses to the letter

¹These staff members include Kevin Kelcourse, Assistant Director of the Enforcement Division’s Asset Management Unit in the Boston Regional Office, who spoke at a Boston Bar Association Event on December 14, 2011; Douglas Scheidt, Associate Director/Chief Counsel of the Division of Investment Management, who spoke at a DC Bar Association Event on January 10, 2012; and James Capezzuto, Associate Regional Director for Examinations in the New York Regional Office, who spoke in New York on January 12, 2012.

²This alert does not summarize all topics addressed in their speeches, but rather highlights points of particular interest. Each of the discussions below is intended as a summary of statements made by one or more speakers and does not reflect the legal conclusions or recommendations of Ropes & Gray lawyers.

request. OCIE and the Enforcement Division are gearing up to examine private equity firms, and the Asset Management Unit has added a staff member with industry experience in private equity.

Expense Disclosure

One speaker highlighted two expense disclosure issues about which the OCIE staff is concerned. Firms often fail to disclose all expenses charged to clients and, particularly in the hedge fund and private equity fund context, “house” expenses and personal expenses are sometimes improperly allocated to clients.

Portfolio Management Disclosure

In addressing failures to comply with investment guidelines or investment strategies, the Enforcement staff is not receptive to arguments that the deviations are immaterial or ultimately benefited investment performance for clients. Examples cited by two speakers include disclosing a liquid-investment strategy despite significant illiquid portfolio positions, overstating the degree to which portfolio managers use models, and failing to update disclosure documents when strategies change. One speaker suggested that the Enforcement staff may scrutinize disclosures made outside of a product’s offering documents, such as a portfolio manager’s oral representations. The Asset Management Unit may pursue misstatements of the qualifications of portfolio managers in Form ADV, as well.

Mutual Fund Fees and Board Conduct

The SEC has been focusing on its publicized initiative with respect to mutual fund board oversight of fees, valuation of portfolio securities, and fair value determinations. The recent case against Morgan Stanley Investment Management involved fees inappropriately paid to a sub-adviser which was not providing the advisory services specified in its sub-advisory agreement. The Investment Management Division is on the alert for similar fact patterns, as well as situations where sub-advisers to a fund are performing a substantial amount of the advisory function, but the adviser nonetheless is collecting large fees for portfolio management of the relevant fund. The initiative is not about second-guessing fund boards or their business judgment as to compensation of advisers, but rather about making sure the Board’s fee review process is being conducted properly. It was noted that the initiative has revealed significant variation across the industry as to the level of diligence applied to the Section 15(c) advisory contract approval process. More information about the enforcement action against Morgan Stanley Investment Management is available in Ropes & Gray’s alert [here](#).

Preferential Redemptions

The Asset Management Unit is working with the SEC’s Division of Risk, Strategy, and Financial Innovation on cases where different investors in funds were given different liquidity or other information. Growing out of such cases as the 2009 enforcement action charging Evergreen with securities law violations for telling only certain shareholders about the fund’s valuation problems, this initiative focuses on the equitable treatment of investors. Private funds that hold illiquid securities in side pockets may also come under scrutiny, especially if the structure has the effect of increasing fees paid to managers.

Verification of Assets

The verification of the custody of assets remains an OCIE priority for all advisers. One speaker urged that firms should prepare reconciliation reports comparing internal records with reports from third-party custodians, all exceptions should be resolved promptly, and the resolutions should be documented.

Quantitative Models

The OCIE staff expects active compliance department involvement in the testing of quantitative models for investing and trading, and documentation evidencing such compliance testing. More information about the 2011 enforcement action against AXA Rosenberg relating to its failure to promptly correct an error in a quantitative model is available in Ropes & Gray's alert [here](#).

Private Placement Agents

Three issues were discussed with respect to private placements. Compliance with the new “accredited investor” standards is a top priority. OCIE also plans to address payments to unregistered finders and marketing activities that violate the private placement rules and could be deemed general solicitations. The Enforcement staff is paying close attention to assessing full disclosure of fees and proper documentation for placement agents and distribution agents.

Use of Social Media

The use of social media will be a focus for OCIE in coming periods. The recent enforcement action and OCIE compliance alert about the use of social media were a warning to the industry that the use of social media must be monitored and must comply with the SEC requirements.

If you would like to learn more about the developments discussed in this alert, please contact the Ropes & Gray attorney with whom you regularly work or any partner in the Ropes & Gray Investment Management group, listed below.

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