

Dealing with the SEC: A Different Approach



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Situation

The SEC has trumpeted its intention to significantly increase the number of firms examined and the resulting enforcement actions. Advisors – as well as funds and broker-dealers – must prepare for their inevitable SEC visit.

Making matters more challenging, SEC examiners, just like investment managers, must decipher the mandates of the Dodd-Frank Act as applied to a wide range of businesses, including wealth managers, hedge funds, private equity firms and family offices. Sometimes, in the course of regulatory examinations, legitimate differences of opinion arise regarding how and which rules apply to the firm being examined.

The challenge for registered advisors: How to best represent themselves in an SEC examination, in which differences of opinion with a primary regulator can have serious consequences? Simply displeasing an examiner could prompt the examination staff to refer the matter to their Enforcement colleagues. The potential stakes are enormous, as the commencement of an Enforcement investigation – even without an actual action or public penalty – could affect client decision-making and cost an investment executive his/her job.

Action

Cipperman Compliance Services (CCS) has significant experience with, and sensitivity to, the complex issues that arise during an examination as they affect the SEC, management, the CCO, and counsel. CCS leverages a team with diverse expertise in legal, financial and regulatory issues, and a depth of experience working with a range of clients.

In one instance, a CCS family-office client had recently registered as an investment advisor as a result of the Dodd-Frank Act of 2010. The firm received a letter from the SEC advising them of their first examination. The client was a family office with an affiliated entity that performed all administrative functions for the families. When the SEC examiner submitted his list of areas to address to the firm, it included questions about constructive custodial arrangements involving the firm's affiliate and certain private investment vehicles. The firm believed that the SEC examiner misunderstood key elements about how the firm operated and misinterpreted some of the rules cited. Unfortunately, the examiner's perceptions had the potential to generate significant deficiencies or an Enforcement referral.

How to respond to the SEC staff became a significant concern. Initially, management, upon the urging of outside counsel, wanted to respond aggressively and confrontationally in an attempt to get the examiners to back down. However, CCS professionals knew a more cooperative approach would serve the client's purposes more effectively. Acting as the firm's CCO, CCS worked to educate the client about the most productive way of dealing with an SEC examiner and about the firm's new responsibilities as a registered advisor. At the same time, CCS organized all relevant material to make for an efficient review and worked cooperatively with the SEC examiner. CCS explained the firm's business model in language the examiner understood and responded in a thoughtful and direct way regarding the examiner's concerns.

Cipperman professionals view their CCO role as serving a variety of functions: interpreting the law; advocating for the client; managing the relationship between the client, its advisers and the SEC; and managing the response to the SEC.

In the end, this approach benefited the client. While the firm did receive a deficiency letter from the SEC, each of the issues cited could be addressed without significant cost or disruption. More significantly, the exam did not result in an Enforcement action.

In another instance, an SEC examiner alleged that a fund platform violated its fiduciary duty by failing to offer load funds that may have been less expensive for high-balance clients. The SEC examiners questioned whether the firm was offering no-load funds to clients rather than load funds because the higher expense ratios resulted in greater revenue sharing income. Firm management was offended that the SEC essentially accused them of lying to their clients to line their own pockets. In truth, the firm only offered no-load funds because the marketplace demanded an NTF-only platform and because of the operational difficulties of offering both load and no-load funds in a retail wrap product. The firm believed that the SEC examiners misapplied broker-dealer suitability concepts to situations occurring 8-10 years prior. The SEC suggested that the firm might have to reimburse millions of dollars in fees earned over a 10-year period.

Once again, the client and its outside counsel preferred an aggressive approach in its response to the SEC examiner. CCS professionals interceded, however, calling upon the independence and credibility established by CCS in its experience with the SEC. They methodically and respectfully responded to the examiner's issues, speaking in the SEC's language and explaining the firm's position as compared to the staff's perceptions. After the firm responded to a deficiency letter, the SEC staff rebutted. The client and CCS soon met with SEC representatives and, while all issues have yet to be resolved, CCS helped to defuse the mounting contentiousness in way that ultimately resulted in a productive conversation rather than destructive litigation.

Outcome and Benefits

When an advisor, fund or broker-dealer receives news that it will be the subject of an SEC exam – take it seriously. Even if the firm is in full compliance, the potential stresses on the company and its employees' time and resources can be significant. Knowing how to handle such an examination is key to navigating the process quickly and with the fewest deficiencies possible. Cipperman professionals view their CCO role as serving a variety of functions: interpreting the law; advocating for the client; managing the relationship between the client, its advisers and the SEC; and managing the response to the SEC. The firm's goal is to minimize the impact of the exam – as quickly as possible – while maintaining a productive, trustful relationship with the SEC.

About Cipperman Compliance Services

Cipperman Compliance Services provides CCO and compliance services to registered funds and money managers. We customize compliance solutions to fit your business: full or partial compliance outsourcing, consulting engagements, and tailored compliance tools. Cipperman & Company is a law firm devoted exclusively to the investment management industry. We work on a wide range of transactional and regulatory matters, with concentration on four core areas: Fund Formation, Distribution, Compliance, and Technology.

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