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ACA COMPLIANCE GROUP

# ACA Insight

The weekly news source for investment management legal and compliance professionals

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## Get the Most from the Exam Postmortem

SEC examiners may visit an adviser for anywhere from one to multiple days. Most advisers will see their visits end with a number of deficiencies found, a few lucky ones will escape with no deficiencies found at all, and a very few unlucky ones will learn that they have been referred to the SEC's Division of Enforcement. Whatever the outcome of an examination, wise advisory firms will conduct an internal postmortem of the exam experience and lessons learned.

"You want to address that feeling you had in the pit of your stomach that kept you up at night during the exam, when you thought, 'Oh God, I hope the examiners don't look at

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## Procedures Designed to Prevent Conflicts of Interest are Not Just for Show

Conflicts of interest are among the big red flags that the SEC's Division of Enforcement looks for when investigating advisers. Firms that disclose such conflicts to clients and adopt procedures to handle the conflicts can avoid compliance problems, while at the same time build trust with both existing and prospective clients. But when advisers violate their own procedures and then fail to disclose that they did so, they will not only damage or lose that trust, they are likely to draw in investigators.

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## Watchdog Wants SEC to Improve Management of Information and Data Sources

Better acquisition and management of subscription contracts, better controls over certain purchases of electronic information sources (EIS), and better monitoring and tracking of those sources and others – that's what the SEC's Office of the Inspector General recommended to the agency in a recent final audit report. The agency concurred and basically said that it will jump right on resolving the problems.

The OIG, which periodically reviews and makes recommendations regarding various aspects of the SEC's operations, made nine specific recommendations in this report. Called "The SEC Should Take Action to Strengthen its Management of

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## After the Exam

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. . . ,'" said **Mayer Brown** partner **Adam Kanter**. "During the crucible of an examination, sometimes things occur to you that might not have occurred while you were preparing for the visit. You want to make sure that doesn't happen again, even if *this time* [emphasis Kanter] the SEC didn't actually focus on what you were worried they might."

> *"The state of mind of the CCO will tell you a lot about how the exam went."*

"After an exam, it is a good idea to consider both the process for responding to the SEC staff and the substance of the exam," said **Pepper Hamilton** partner **John Falco**. "On process, firms should review how efficient they were in responding to [exam] staff requests, both written and oral, how their interactions with the staff can be improved at the next exam, whether there were issues producing documents in a timely manner (location of records, electronic vs. paper, etc.), what type of burden was put on the adviser's resources and staff, and any way to improve the process going forward."

"On the substance, the adviser needs to be proactive in addressing exam issues identified by the exam staff in order to avoid being deemed non-responsive or a recidivist," he said. "Even if there were no exceptions identified by the staff, an examination provides an opportunity to review a firm's procedures and potentially improve them. Discussions with the exam staff will inform an adviser of focus areas of the staff, and staff views on best practices."

"There's a lot of learning that occurs during an exam," said **Morrison Foerster** of counsel **Kelley Howes**. "You may have been asked questions that you did not anticipate. You may have been asked for books and records that were not anticipated." A postmortem, she said, is an opportunity to review and address all that.

One good way for an exam postmortem to end is with the creation of something akin to a plan to handle future examinations. "Consider creating a spread sheet that assigns different people to different subjects, so that if future examiners ask questions about portfolio management, the person to speak with is 'X,' and if examiners ask about trading, the person to speak with is 'Y,'" Howes said.

There are two kinds of postmortems advisers should consider:

- **Daily.** If examiners are visiting for more than one day, hold a daily recap of the day's events with key stakeholders and outside counsel, Kanter said. Review what examiners asked to see, who they interviewed, and how employees responded to them. The advantage of having external counsel or a professional consultant present is that, among other things, they bring the experience of having worked with advisers during their exams. "They might suggest ways that other advisers have handled similar situations that may prove valuable," he said.
- **When the exam is over.** This is when all internal personnel, plus perhaps external counsel and/or a consultant, come together – and the sooner after the examiners have left, the better. "Perform the recap when it is still fresh in everyone's head," said Kanter. "Cover both what happened and what didn't happen," like questions or actions that you thought examiners would address, but didn't. Make sure the final postmortem includes not only the onsite examination itself, but how the firm handled document production requests made both prior to the visit and during the visit. Was the material quickly found, was it organized and complete, and was it provided by the deadline set by the Office of Compliance Inspections and Examinations (OCIE)? "Review how this was done and how it could be improved. If the documents were delivered by the deadline but with only a day to spare, that might not occur the next time, so consider ways to improve the process."

### The role of the CCO

Different employees in these recap sessions may have different opinions as to how an exam went. Some may feel that the examiners were satisfied, others may believe that they "stood up" successfully when challenged by examiners, still others may be distressed by not being able to answer examiners' questions or produce requested documents quickly.

A key person to listen to in these sessions is the firm's chief compliance officer. "The state of mind of the CCO will tell you a lot about how the exam went," said Kanter. The CCO, he suggested, should lead at least the major postmortem that occurs after the examiners leave, and "should be honest and forthright in terms of what went well and what did not go well."

"The CCO should have a direct relationship with whatever board the advisory firm has," said Howes. "The CCO should keep the board informed, tell it what occurred during the exam, and get the support of the board for the postmortem."

> *"Firms should review how efficient they were in responding to [exam] staff requests, both written and oral, how their interactions with the staff can be improved at the next exam, whether there were issues producing documents in a timely manner . . . , what type of burden was put on the adviser's resources and staff, and any way to improve the process going forward."*

## Employee attitudes

During exams, it is not uncommon for examiners to run into a variety of interactions with firm employees. Most will hopefully be cooperative and helpful, but it is also quite possible that some will be a bit defensive, perhaps even argumentative with examiners. The need for proper employee behavior with an absence of "attitude" should be among the topics brought up and discussed at a postmortem, so that it does not hurt the adviser during future examinations, Kanter said.

Consider bringing in a third-party litigator or consultant to address these sorts of situations, with the third-party engaging in some role-playing with the employees, said Howes. "People often don't understand how they come across until someone a bit removed brings it up." If hiring a third party to play this role is too expensive, consider having the CCO conduct this exercise, she said.

Also consider discussing the room your firm provided for examiners to use as their base. Was it appropriate in terms of size, in terms of location to other parts of the firm, did it have enough light, and more. At the same time, advisers should let employees know not to have off-the-cuff or other conversations nearby that examiners might overhear, Kanter said.

If your firm is one of those where examiners did not find any deficiencies, beware an attitude of "We didn't get any deficiencies, that means we are doing everything right." Most likely that is not the case, it simply means that the examiners did not find anything that resulted in deficiencies. "In truth, you may not receive deficiencies, but there still may be things that might have resulted in them that examiners failed to find, and there may also be things that did not go well, such as poor interviews," Kanter said. "Don't let a deficiency-free examination lull you into believing that a review and improvements are not necessary. It does not mean a return to 'business as usual.'"

## The deficiency letter

Most examinations result in a deficiency letter from the SEC with anywhere from one to 20 items listed that were cited by OCIE. Those deficiencies might include actions observed by examiners that were in violation of an adviser's own policies and procedures or that violated agency rules.

Probably the first thing, along with the postmortem, that a firm should do is respond to that deficiency letter, Kanter said. "The letter should state, 'Here is what we are going to do to correct the problems, and here is when we expect to have them completed.' Let them know you have modified your procedures, if necessary."

Sometimes, however, the examiners are simply mistaken, or perhaps unaware of all the facts and circumstances surrounding what they observed. When that occurs, Kanter said, let them know of the additional facts and circumstances – including any facts that show your firm was in compliance – in your response to the deficiency letter. Advisers should also be able to back up their point of view with necessary documentation.

The OCIE staff, after receiving an adviser's response, may sometimes have follow-up questions, but more often they will not. If they do, answer those questions promptly and accurately.

"Don't think you can get away with not fixing any deficiencies until your next exam, which could be three, five or 10 years away," Kanter said. The amount of years between exams will depend on the risk category that OCIE places your firm in. Those in a greater risk category can expect an exam sooner than those in a lower risk category.

Whenever examiners return, however, the violations cited in the first deficiency letter that the adviser responded to by saying they were corrected "will be the first thing that examiners will look at in the next exam," he added. "Expect examiners to look for documentation as to when those corrections were made." A deficiency cited five years earlier that was corrected only six months before the latest exam should not be expected to go over well with OCIE.

## Procedures Designed

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Take the SEC's recent settlement with San Francisco-based **LendingClub Asset Management** (LCA), its former president, **Renaud Laplanche**, and its former chief financial officer, **Carrie Dolan**. The three will collectively pay more than $4.2 million to settle charges that Laplanche caused one of the adviser's private funds to benefit LCA's parent company at the fund's expense.

LCA, a registered adviser with approximately $1.3 billion in assets under management, provides advisory services to several private funds that purchase loan interests offered by the adviser's parent company, **LendingClub Corporation**, a publicly-traded online marketplace lending company, of which Laplanche is also CEO. From approximately December 2015 through April 2016, the SEC alleged, Laplanche caused one of LCA's private funds to purchase interests in certain loans that were at risk of expiring unfunded on the LendingClub platform. Had that occurred, LendingClub would have lost revenue.

"LCA caused [the private fund] to purchase these interests to benefit LendingClub, not [the fund], in breach of LCA's fiduciary duty," the agency said. The purchases were also inconsistent with adviser's loan allocation procedures as written in its Form ADV and its private placement memorandum for the fund, and the respondents also improperly adjusted monthly fund returns, the settlement order said.

"A fundamental issue arises when an advisory firm's financial interests are in direct conflict with the financial interests of its clients," said **Lewis Baach** partner **Jason Berland**. "Although a conflict is not always fatal, where there is no disclosure or where it appears that a firm is placing its own financial interests over that of its clients, such as wrongly using fund money to benefit a parent company at the expense of the fund, the conflict becomes a breach of a fiduciary duty and exposes an advisor to significant penalties."

### Response and reaction

"We are pleased to have resolution and closure," said LendingClub Chairman **Hans Morris**. "Following an internal review in 2016, LendingClub's board of directors accepted the resignation of Renaud Laplanche as chairman and CEO of the company. The board's decision was not made lightly, but the violation of the company's business practices, along with a lack of full disclosure by Mr. Laplanche during the review, was unacceptable. The allegations made by the Department of Justice and the findings of the SEC further support the board's decision to take swift and decisive action. We have full confidence in our new management team and we are a better company today."

Laplanche, in a statement released by his attorney, said, "I am pleased to have worked out a settlement with the SEC to put to rest any issues related to compliance lapses that might have occurred under my watch at LendingClub. I am glad that we can now put these issues behind us and focus on the important goals of making credit more affordable to consumers and delivering attractive returns to investors through disciplined underwriting and exciting product innovation. With the benefit of my prior experience, I feel better equipped to establish a strong culture of compliance and effective internal controls under the supervision of capable professionals."

An attorney representing Dolan said that "Ms. Dolan cooperated fully with the SEC in its investigation. Throughout her career she has acted in accordance with high ethical standards and she is happy to put this matter behind her."

"The takeaway from this settlement is that investment advisers should know that if they have an issue related to the disclosure of required information to investors, even if it is a first violation and no investors are being harmed, the SEC will likely not walk away or give the firm a pass," said **Baker Botts** partner **Bridget Moore**. "The case falls within the sweet spot of SEC Chairman **Jay Clayton's** protection of the investor from situations in which investors are not getting enough information to make fully informed decisions."

**Foley & Lardner** partner **Jessica Matelis** noted the role that the SEC's Complex Financial Instruments Unit played in the case, with the agency noting that two individuals in the unit conducted the investigation, even though it was largely an asset management related matter. The alleged relationship between LCA and its parent, Lending Club, apparently was considered complex enough to fall within the unit.

## LendingClub's business model

LendingClub Corporation, LCA's parent company, provides a platform that matches individual borrowers who want consumer credit loans with investors seeking to purchase securities backed by those loans, according to the settlement order. The parent company "offers whole and fractional interests in these loans to retail and institutional investors, and loans are originated by a third-party bank once all interests in a loan are sold to investors."

LendingClub's advisory firm, LCA, advised several private funds that purchased interests in loans listed for sale on its parent company's platform, the agency said. "Each fund LCA advised had a different strategy with respect to risk, but all were formed to invest exclusively in LendingClub loans. LCA owed the funds a fiduciary duty to act in their best interests."

LCA would manage the funds through its investment policy committee, the three members of which were Laplanche, Dolan, and LendingClub's general counsel at the time, according to the settlement order. Laplanche was also the CEO of LendingClub and the president of LCA, while Dolan also served as the CFO of both companies.

At first, things appeared to be going well. The funds were formed in the beginning of 2010 and, the settlement order states, "for several years thereafter, the demand for interests in LendingClub loans, which were generally profitable, significantly exceeded LendingClub's supply."

Unfortunately, this did not last. "Returns on LendingClub loans began to decline beginning in late 2015, putting pressure on the profitability of the funds (which were invested in LendingClub loans) and on LCA's ability to attract new investors and retain existing investors," the SEC said.

## Problems and loan purchases

In regard to the fund involved in this settlement, LCA offered investors loan terms of 36 months or 60 months. The terms and other limits were designed so that fund investors would be invested in a broad mix of loans. For instance, according to the settlement order, the 36-month loans had less duration risk due to their shorter term.

"However, in early 2013, the available inventory on the LendingClub platform had changed from what it had been when [the fund] was first formed , and this and other factors made it difficult for [the fund] to obtain enough interests in 36-month loans," the SEC said. As a result, the agency said, the fund's holdings in 36-month loans fell short of the minimum limit beginning in March

2013, and the fund exceeded its upper limit for 60-month loans beginning in October 2013. These holdings were disclosed to investors in monthly statements.

Things got worse in late 2015, according to the settlement order, when two major institutional investors that had provided significant demand for 60-month loans stopped buying them. "As a result, by December 2015, LendingClub faced the prospect of not being able to fund a large number of 60-month loans. If these loans were not funded, they would expire on LendingClub's platform and the loan requests would be denied (thus making it more difficult for LendingClub to achieve its financial targets and potentially driving borrowers to competitors)."

Faced with this quandary, the SEC said, "LCA caused [the fund] to exclusively purchase interests in 60-month loans, without regard to the 36-month loan interests that were available and that [the fund] could have purchased under its disclosed allocation procedures. LCA, under Laplanche's leadership, directed these actions despite Laplanche's and others' knowledge of [the fund's] ongoing overconcentration problems and consistent efforts to address them."

LCA failed to let the fund's investors or prospective investors know that its reasons for purchasing the 60-month loans "included a desire to purchase interests in loans that were at risk of expiring, which constituted a conflict of interest that was material to investors," the SEC charged. "LCA's misuse of [the fund] contravened the allocation procedures and disclosures about conflicts of interest set forth in LCA's brochures and in [the fund's] private placement memorandum, which were provided to investors."

### Violations and sanctions

The settlement found violations of Sections 206(1) and (2) of the Advisers Act, both of which prohibit fraud, as well as Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule, for failure to adopt and implement written compliance policies and procedures. In addition, the SEC found that Rule 206(4)-8, which prohibits an adviser from making untrue statements of material fact, was violated, as was Section 207, which outlaws untrue statements of material fact on applications or reports filed with the Commission. Finally, the settlement states that Section 204(a) and its Rule 204-1(a), which require an adviser to amend its Form ADV promptly whenever information in the brochure becomes materially inaccurate, was violated.

The SEC chose not to charge the parent company, LendingClub, saying that it took note of several "remedial efforts" made by the company, including a review initiated by LendingClub's board of directors in May 2016 that led the company to self-report the problems uncovered, as well as its "extraordinary cooperation" with the agency's investigation.

LCA was also credited by the agency with remedial steps, including creation of a new governing board comprised of a majority of independent members, outsourcing its monthly valuation process to an independent third party, and reimbursing approximately $1 million to investors who had been hurt by the adjustments previously made.

In addition to the $4 million civil money penalty assessed against LCA and the $200,000 penalty and three-year bar against Laplanche, the SEC levied a $65,000 penalty against Dolan. LCA and Dolan were censured.

## Watchdog Wants

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Electronic Information Sources, Data Sources and Print Materials," the report may give a sense of quiet satisfaction to advisory firms and others who have been found wanting for similar problems, such as not having proper policies and procedures.

The SEC now has 45 days to provide the OIG with a written corrective action plan to address the watchdog agency's recommendations.

Quite a bit of money, relatively speaking, is spent by the agency on these sources of information and data, according to the report. In fiscal years 2016 and 2017 alone, the SEC spent $40 million for EIS (such as the **Dow Jones** Factiva global news database), data sources (such as **Bloomberg** news and professional services), and print material subscription contracts (i.e., *The Wall Street Journal*), with an additional $184,409 on purchases of these same types of items through the use of government purchase cards (GPCs).

Advisers, investment companies and other SEC registrants can "take some comfort that your regulator is also being regulated," said **K&L Gates** partner **Vincente Martinez**. "Overall, the OIG is only asking for slight improvements rather than anything major. The biggest issue appears to be the underused Bloomberg terminals, because those are very expensive."

"If the Office of the Inspector General held the Commission to the standard of investment advisers, it would have sought civil penalties and disgorgement for these lapses in policies, procedures and controls," said **Stark & Stark** attorney **Max Schatzow**. "As one example, the Commission's library staff spent nearly $9,000 on publication desk sets that were not needed. As another example, the Commission's staff did not detect calculation errors in vendors' price quotes that resulted in unnecessary spending of $157,650 in taxpayers' money. Lastly, the Commission has 89 Bloomberg terminals at $22,500 each and certain of these terminals were not used for extended periods. I find it all somewhat disingenuous that the Commission holds registrants to a higher standard than it holds itself."

"Our overall objective was to assess the SEC's management of EIS, data sources and print materials in FYs 2016 and 2017," the OIG said. "Specifically, we sought to determine whether the library, either directly or through SEC divisions, offices and/or working groups, developed and implemented effective controls for acquiring, maintaining and tracking information and data source subscriptions, including proper assessment of agency needs and associated costs."

In conducting the audit, the report said, OIG interviewed SEC leadership, contracting staff, library staff and working group members; surveyed 27 agency divisions and offices about their EIS, data source and print material acquisitions and their knowledge of related agency policy; and reviewed supporting documents for a "judgmentally selected sample" of subscription contracts and GPC transactions from FYs 2016 and 2017.

The OIG's audit report is divided into three findings, each containing a set number of recommendations, with nine recommendations in all. Following are some of the results.

## Policies and procedures

One of the OIG's findings was that the SEC should establish policies and procedures regarding usage of its EIS, data source and print material resources, including Bloomberg Resources.

The library relies on vendor reports and user feedback to assess usage before renewing subscriptions, as well as to determine whether to cancel or transfer a license to another user, the audit report said. "However, because the library had not established policies and procedures for obtaining and analyzing usage information, vendor-provided usage reports were not always available or presented inconsistent information."

"In addition," the report continued, "we identified 128 instances of Bloomberg terminals and licenses (that is, resources) that were not used for a month or longer between December 2014 and March 2018. However, SEC divisions and offices – not the library – retain the authority to cancel or transfer Bloomberg resources and no policies or procedures existed to govern the decision-making process. This limits the library's ability to ensure the SEC's Bloomberg resources are fully used." The 128 instances cost the SEC approximately $231,745, the OIG said.

## Subscription contract oversight

Another of the audit report's findings was that the SEC's acquisition and oversight of subscription contracts needs improvement. "We found discrepancies in vendors' price quotes that went undetected because the Office of Acquisitions' contracting staff . . . did not always validate the quotes," the report said. "As a result, the SEC did not detect calculation errors in two vendor price quotes totaling $157,650."

"Furthermore," the report said that, among other findings, "three of the 22 contract files we reviewed were incomplete and did not contain adequate support for critical decisions related to the contracts' fair and reasonable price determinations. This occurred because contracting staff did not fully document price analyses, resulting in price determinations that could not be independently validated." ☙

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