

# SEC Examinations for RIAs – What You Need to Know to Prepare

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By Michelle L. Jacko



**About the Author:**

Michelle L. Jacko is Managing Partner at [Jacko Law Group, PC](#) ("JLG"). She can be reached at [michelle.jacko@jackolg.com](mailto:michelle.jacko@jackolg.com).

A U.S. Securities and Exchange Commission (“SEC”) examination can appear overwhelming, particularly to a new Chief Compliance Officer (“CCO”). However, it does not need to be. In this article, we will explore what you need to know in order to prepare for an SEC examination and provide best practices and tips for helping you to prepare for the inevitable.

## I. Overview of the National Exam Program

All investment advisers registered with the SEC must adhere to the Investment Advisers Act of 1940 (the “Advisers Act”). The Division of Examinations (“EXAMS”) is responsible for overseeing investment advisers’ compliance with the Advisers Act. EXAMS conducts its reviews of investment advisers through the National Examination Program (“NEP”).

EXAMS’ mission is to safeguard investors, maintain market fairness, efficiency, and aid capital formation through examinations. Examination teams operate in regional offices across the U.S., with Washington, DC serving as the headquarters.

The NEP examines various financial entities, including investment advisers, investment companies, broker-dealers, and more, with three main objectives – to protect investors, preserve market integrity and gather information for rulemaking.

Firms subject to examination depend on evolving SEC priorities and various risk-based factors. Examination priorities are determined through information collection, communication with regulatory agencies, industry interactions, and responding to tips, referrals, or complaints. Additional resources enable more extensive examinations, expanding technology, and enhancing regulatory initiatives.

Regulations are more stringent than in the past and EXAMS demands more information to substantiate responses, analyze risks, explore potential conflicts of interest, and tie them to an adviser’s internal control system.

In September 2023, EXAMS issued a *Risk Alert* which provided a guide to advisers on the nature of information that may be requested as part of an SEC examination. Generally, the SEC uses a risk-based approach when it is examining its registrants. This may involve evaluation of how the registrant responds to risks associated with new product and service offerings, conflicts of interest, adaptation to new regulatory requirements and disclosures to clients.

## II. The Examination Process

EXAMS employs a selection process based on data analytics used by the SEC, which takes into account the risk profile of that firm. Firm risks include, among other things, tips, referrals, and complaints received by the SEC related to the registrant; business operations and practices (with higher risk profiles associated with advisers who have custody of client assets, advisers of private funds and advisers to crypto assets); advisers with recidivist deficiencies of compliance program concerns; associated persons’ disciplinary histories; conflicts of interest due to outside business activities, including advisors dually registered or affiliated with a broker-dealer; length of time between exams; and disclosure history of the registrant.

Generally, the SEC conducts four primary types of examinations:

1. **Risk-Based Routine Examinations:** These are based on risk matrices and can occur at unpredictable intervals.
2. **Limited-Focus Examinations:** These focus on specific areas such as compliance programs and specific books and records.

3. **“Sweep” Examinations:** Investigative examinations prompted by specific business concerns.
4. **For Cause Examinations:** Triggered by events like customer complaints, tips, or rule violations.

There are several stages involved in the examination process. Advisers are first alerted that they will be undergoing an examination when they receive a notification of the examination or a documentation request letter. Following the notification or document request, examiners perform an initial inquiry and identification where they access risk factors, procedural controls, and regulatory compliance.

After the initial inquiry, examiners may perform an onsite examination, using forensic testing, analytics tools, and interviews to evaluate compliance, or misconduct. Examiners may request additional documents, further explanation on unclear or vague information, and interviews. An exit interview concludes the onsite examination, allowing advisers to address any concerns identified in the examination.

After the examination, an exam completion letter is sent to the adviser and may indicate there were no findings of deficiencies; a deficiency was found; a deficiency was found, and a special meeting is requested; or serious deficiencies were found and has been referred to the SEC Division of Enforcement for investigation.

### III. What Advisers Can Do to Prepare for an SEC Exam

To have a successful SEC examination, it's crucial for advisory firms to be well-prepared before regulators arrive. Effective preparation involves evaluating organizational risks through several methods:

- **Conflict Inventory:** Identify and address conflicts of interest, such as outside business activities, compensation arrangements, and more. Maintain a conflicts inventory worksheet and update it at least annually.
- **Review Prior Deficiency Letters:** Address deficiencies noted in previous examinations and ensure any action steps promised in response letters have been completed.
- **Stay Informed:** Keep up with SEC's examination focus areas, risk alerts, and new regulations available on <https://www.sec.gov/exams>. Collaborate with senior management to identify potential risk areas.
- **Consider New Regulations:** Assess if the firm needs to develop new policies or enhance existing ones in response to recently promulgated regulations. Utilize an annual compliance policies and procedures worksheet.
- **Address Complaints and Allegations:** Investigate customer complaints and allegations of wrongdoing promptly to address internal controls accordingly.
- **Conduct a Risk Assessment:** Consider engaging an independent third party for a risk assessment to identify areas requiring additional attention or enhancement.
- **Demonstrate Compliance Dynamics:** Ensure the CCO demonstrates ongoing education and participation in industry events, certifications, and training. Consider developing a report on compliance actions taken during the year.

- **Mock SEC Examination:** Review the NEP initial document request list, the latest of which was provided through a Division of Examinations Risk Alert available at <https://www.sec.gov/files/risk-alert-ia-risk-and-requesting-documents-090623.pdf>, to assess the firm's readiness to gather requested information promptly.
- **Review SEC "Compliance Alerts":** Pay attention to SEC compliance alerts addressing areas of concern and suggestions to address examination deficiencies.

Similarly, the SEC, too, will prepare, with the SEC Staff taking deliberate steps to understand the registrant, its risks, compliance systems, and conflicts of interest affecting clients and investors. Key areas of focus include risk management, compliance controls, and oversight, including:

- **Product and Asset Level Risk Management:** The Staff will evaluate how the adviser manages risk at the product and asset class level.
- **Key Risk Management Functions:** Examiners will assess the structure and resources of key risk management, control, and compliance functions to ensure their effectiveness and independence.
- **Senior Management Oversight:** The SEC will evaluate senior management's role in overseeing risk management, including strategic planning, performance management, and compensation incentives.
- **Internal Reviews:** The Staff will examine how internal reviews verify the effectiveness of risk management, compliance, and control functions.
- **Governance and Risk Parameters:** Examiners will assess the governance structure's ability to set risk parameters, cultivate a risk management culture, oversee risk-based compensation systems, and manage the firm's risk profile.

#### IV. Customary Document Production Requests

Before conducting an examination, the SEC Staff will review various documents provided by the adviser, including disclosure documents, marketing materials, client communications, and more. The Staff will use this information to prepare for the onsite examination, with a focus on evaluating internal controls. Requests typically involve production focusing on the following key considerations:

- **Effective Risk Management** and whether the adviser manages risks effectively at the product and asset class level;
- **Structure and Resourcing** to assess if key risk management, control, and compliance functions are appropriately structured and resourced;
- **Senior Management Oversight** and whether senior management effectively oversees risk management within strategic planning, performance management, and compensation incentives;
- **Internal Reviews** to determine how such reviews provide assurance regarding the operating effectiveness of risk management, compliance, and control functions; and
- **Governance** evaluating the governance structure's ability to set risk parameters, promote a risk management culture, oversee risk-based compensation systems, and manage the firm's risk profile.

During this assessment, expect document requests covering a one- to two-year period. Examples of requested documents include policies and procedures, client disclosure documents, investment advisory agreements, code of ethics records, and more.

## V. Management and Employee Interviews

The SEC's examination program focuses on an advisory firm's culture of compliance and the effectiveness of its compliance program. This assessment includes reviewing a firm's mitigation of conflicts of interest, annual review reports, implementation of internal controls and action steps taken based on prior examination findings. Often the Staff wishes to conduct interviews with key employees to further explain the document production already provided. To prepare your team for the Staff's interviews, consider these best practice tips:

- Carefully listen to the examiner's question; let them finish asking questions before responding.
- Pause before responding to gather your thoughts.
- Do not speculate! It is better to say "I will get back to you" than to guess.
- Provide concise, clarifying answers, responding only to the question asked.
- Be professional and respectful, avoiding sarcastic remarks.
- Review key documents prior to the interview in preparation.
- If a question is too broad, or is complex and difficult to follow, ask for clarification.

Often times during the interview process, the Staff may request a demonstration of the firm's operational systems. Common areas of focus include portfolio management, trading and trade reconciliation, advertisement reviews, and advisory fee reconciliations. This process can be managed effectively by designating a contact person to be "behind the keyboard" to demonstrate certain operational systems used, and for accessing files the Staff wants to see. Oversee and administer delivery of any sensitive information with the help of outside counsel. If documents are produced, be sure to maintain a running list of specific records requested by the Staff and note each area demonstrated.

## VI. MANAGING THE REGULATORY EXAMINATION

One of the most important things for investment advisers to do prior to the examination team's arrival is to plan ahead. Once the examiners arrive, consider these best practice tips during the actual examination.

- a. Make a Good First Impression:** It is key to set a positive tone and make a good first impression on examiners. Consider preparing a presentation which covers, among other matters, an overview of your organization, your affiliates, the products and services offered, the firm's internal control environment and your compliance culture. Explain how you manage risk in key business processes and map them to your internal control systems.
- b. Set Ground Rules and Control the Process:** During the initial interview, set the ground rules for the examination and points of contact for the Staff. For example, establish early on who the firm's primary contact is for document production, interview schedules, and coordination efforts with examiners, your internal team and outside resources, such as counsel and compliance consultants. This will help keep things organized and flowing.

- c. **Demonstrate the Dynamics of the Compliance Program:** Showcase your compliance program's resources, controls and proactiveness in detecting and preventing issues. In addition, demonstrate the efforts of your compliance personnel and the culture of compliance throughout the enterprise.

## VII. FINAL STAGES OF THE EXAMINATION PROCESS

As the examiners wind down their requests for production and interviews, often they will provide an exit interview, which sets forth the SEC's initial findings. This provides an opportunity for there to be additional dialogue to clarify processes and ask questions prior to a final report being issued. Here is what to expect.

- a. **The Exit Interview:** The exit interview typically informs a firm about the examiners' initial findings and concerns. Once the exam is concluded, the examiners will finalize their conclusions in a written report and deliver this to the firm who then must respond typically within 30 days from the date of receipt of the report.
- b. **Examination Findings Letter:** Findings can range from no comments to serious deficiencies. The most favorable outcome is a closing letter with no comments, indicating no deficiencies were found. However, most firms receive a deficiency letter that describes issues discovered during the examination and cites relevant regulations that were potentially violated. Serious deficiencies may lead to referral to the SEC's Enforcement Program or other regulators for further investigation.
- c. **Formal Inquiries:** When serious concerns are identified, the SEC's Division of Enforcement may launch a formal inquiry to further investigate the matter. Engaging legal counsel is critical for those subject to a formal inquiry to navigate through and address the various areas of concern raised by the Staff.
- d. **Enforcement Proceedings:** The Division of Enforcement often becomes involved when serious problems are found. Enforcement proceedings may result in injunctions, monetary penalties, disgorgement, industry bans, and more. Cooperation with the SEC's investigation may lead to reduced charges or sanctions. A Wells Notice may provide an opportunity for the potential defendant to respond to allegations before enforcement proceedings commence.

## Concluding Thoughts

A successful SEC examination hinges on thorough preparation. A robust compliance program supported by senior management is vital. Regularly test policies and controls, engage third parties for mock examinations, review conflicts of interest, promote compliance education, and ensure competent supervision. These steps not only prepare your firm for an SEC examination but also enhance the overall compliance program for the protection of investors. ■