

FS Regulatory Brief

SEC Sweep Examination of Structured Products

Target Audience: Investment Advisers

In October and November 2009, the SEC sent notice letters to certain investment advisers announcing an examination of their trading procedures and valuation practices in the collateral pools of structured credit products, specifically collateralized debt obligations, collateralized bond obligations, and collateralized loan obligations (collectively, "CDO" instruments). The letters were sent from the New York Regional Office, which appears to be coordinating the exams. The SEC staff is requesting general information (organizational information, any pending or threatened litigation, Form ADV Part II), as well as information and processes specifically related to CDO transactions from January 1, 2006 to the present. Exam staffers have also been following up with requests for additional information.

Focus on CDOs

The SEC's letter states that examiners may wish to speak with various employees of the Adviser including, but not limited to, the Chief Compliance Officer, Risk Manager, Portfolio Managers and other senior officers and back-office personnel.

Although the examinations will focus on the trading, allocation and valuation procedures and related disclosures for CDOs, the staff may also review investment decision making processes, financial records, performance calculations, compensation practices and testing results, such as Over Collateralization Testing and the subsequent purchase and allocation of additional collateral.

Points to Consider

- The exam seeks information relating to cross-trades between advised or affiliated accounts. Specifically, transfers of a holding from a CDO managed by the Adviser or an affiliate to another account managed by the Adviser or an affiliate.
- The request asks for a description of how appropriate counterparties are located when trading with an account under management. Advisers should review and document these procedures and be prepared to discuss the process by which suitable counterparties are identified.
- The request asks for a description of how pricing is determined with regards to cross-trades. Advisers should review their pricing policy and ensure that proper disclosures have been made to investors. Personnel should be prepared to discuss the process for determining the price at which a cross-trade is done. Compliance personnel should be prepared to discuss the approval process for cross-trades and how the Adviser monitors for trades that are done outside the bounds of the policy. Advisers should consider implementing a standard approval form that requires pre-approval by Compliance and includes back-up documentation of pricing rationale.
- In cases where there has been a cross-trade between advised or affiliated accounts, exam staff has asked for a description of any beneficial interest of the Adviser or an affiliated person in the account in question. Advisers should consider whether affiliated accounts have been given favorable treatment and ensure they have proper procedures for ongoing monitoring of conflicts of interest and fiduciary duties.
- The Examiners have asked for details of any transactions executed with or through the Adviser or any affiliated person, including an affiliated broker-dealer. Advisers should consider whether any fees were paid to an affiliated broker when executing a

cross-trade to or from an affiliated account. If an adviser is paid based on the underlying assets of a CDO, it should consider whether reasonable assumptions were used when pricing the underlying assets. Managers should consider implementing procedures to flag overly-optimistic pricing, such as back-testing or establishing a pricing committee with checks and balances built into its structure.

- In addition to reviewing its policies, procedures and related disclosures in connection with the bullets set out above, Advisers should review its processes, disclosures and results relating to the "secondary" topics addressed in the sweep examination letters: investment decision making processes, performance calculations, compensation practices and testing results such as Over Collateralization Testing and the subsequent purchase and allocation of additional collateral.

Additional Information

If you would like additional information about the topic discussed in this FS Regulatory Brief or a redacted copy of the SEC's letter, please call:

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