

ALERTS

SEC Division of Examinations Releases 2024 Examination Priorities – What Private Fund Managers Should Know

October 31, 2023

On Oct. 16, 2023, the Division of Examinations (“Division” or “Exam Staff”) released its 2024 Examination Priorities (“Priorities”),^[1] months before these have typically been published to more closely align the release with the start of the SEC’s fiscal year, which began Oct. 1. This approach is consistent with the Division’s goal of more transparency, including with a risk alert it issued in September regarding how it selects examination targets.^[2] Much like in the 2023 Examination Priorities, the Priorities combine a specific focus on private funds with other priorities highly relevant to private fund managers. The Division has continued to conduct thematic sweeps of various types of advisers, including private fund managers (e.g., newly registered advisers and those with their principal office and place of business outside of the United States, particularly in the United Kingdom). Areas of focus during thematic sweeps have included marketing rule compliance and use of artificial intelligence, among many others.

In terms of frequency of examinations, the Division indicated that, as in prior years, priorities for being selected for an examination include advisers that have never before been examined (many of which are examined 12 months after registration) and advisers that have been registered for a number of years but have not been examined in recent years.

Focus on Private Fund Managers

Noting that advisers to private funds continue to be a significant portion of the SEC-registered investment advisers, the Division stated that it will again focus examinations on private fund advisers and identified the following topics as priorities:

- **Market Volatility and Interest Rate Changes:** The Division has historically sought to understand how advisers respond to market stress and volatility, with a focus on how advisers manage risk, whether advisers' representations regarding risk management have been accurate and whether investors have been treated fairly when losses occur. In the current environment, the Division will focus on funds experiencing poor performance, that are subject to significant withdrawals, hold difficult to value or illiquid assets and utilize significant leverage. This focus aligns with the recently adopted amendments to Form PF, which will, among other things, require that advisers to hedge funds provide timely reporting of significant investment losses, significant investor redemptions, the inability to meet redemption requests or the suspension of redemptions, and thereby give the Exam Staff a means to detect those funds that may be experiencing such events.[3]
- *In our experience, following – or sometimes during – periods of particular market stress or volatility, the Exam Staff has conducted targeted reviews of firms it believes may be impacted. Other exams often include requests that address risk management, comparison of fund performance to peers and valuations of illiquid assets. When redemptions are suspended or gates imposed, we have seen the Exam Staff spend significant time analyzing communications with investors to determine whether any investors received greater transparency and liquidity that may have disadvantaged other investors. While the new Private Funds Advisers Rule addresses preferential treatment, we expect the Staff to continue approaching these issues from a broader fiduciary perspective as well.*
- **Fee and Expense Allocations, Calculations and Valuations:** Recent examinations and enforcement actions have served to highlight the SEC's continued focus on the methodologies applied by private fund advisers when calculating and allocating fees and expenses, including the valuation methodologies used to value a fund's underlying investments (particularly those investments that are hard to value or are illiquid), how management fees are calculated after the commitment

period, whether fee offsets were appropriately applied and the consistency of such practices with disclosures. The Priorities confirm this focus will continue.

- *We have seen the Staff heavily scrutinize the valuations of illiquid assets, particularly where fees are calculated on an adviser's valuations, and will, at times, closely scrutinize the substance of individual valuations, not just the general valuation policy and process. We also see the Staff reviewing all aspects of the fee and expense calculations and allocations, identifying potential ambiguities as well as simple errors.*
- Investment Diligence: The Priorities confirm the Exam Staff's focus on investment diligence and make clear that private fund advisers will face scrutiny of their policies, procedures and disclosures related to investment due diligence, particularly for managers pursuing private equity and venture capital investments. Diligence and disclosures will be reviewed in light of an adviser's fiduciary duty, specifically its duty of care, which requires that an adviser conduct a reasonable inquiry into a client's objectives and develop a reasonable belief that advice is in the best interest of the client.
- *We have seen the Exam Staff identify circumstances where private fund managers could not demonstrate adherence to statements made in investor communications and due diligence questionnaires regarding the research and investment process. We have also observed the Exam Staff question whether diligence for specific investments satisfied the manager's fiduciary duty of care. Although ESG is not listed in the Priorities, we expect the Exam Staff, as part of reviewing disclosures and investment practices, will continue to find fault where 'managers' claims regarding consideration of ESG in the investment process do not match their practices.*
- Conflicts of Interest: The Exam Staff is perennially focused on how private fund managers address conflicts of interest, and 2024 will be no different. Highlighting that an adviser is required to "eliminate or make full and fair disclosure of all conflicts of interest" so a client can "provide informed consent to the conflict," the Division emphasized that it will continue to examine for advisers' adherence to their duty of care and duty of loyalty obligations.[4] Of particular interest will be instances where private funds are managed alongside registered investment companies and the use of affiliated service providers, the latter of which

will become even more transparent on account of the quarterly statement requirement in the new Private Fund Advisers Rules.

- *We have seen increasingly specific requests for detailed records with respect to third-party and affiliated service provider due diligence. Exam Staff frequently seek to identify any economic aspect of an adviser's business operations that might be viewed as creating a conflict (e.g., receipt of fees or other non-pecuniary benefits or offsets or waivers of fees. We expect to continue to see a focus on the conflicts the Commission has identified in connection with GP-led secondaries.*
- LPACs and Advisory Boards: Considering the focus on conflicts of interest, it is not surprising that the Exam Staff will review mechanisms in fund organizational and offering documents that call for limited partnership advisory committees and advisory boards to review and/or provide consent to certain conflicts and conflicted transactions. The Exam Staff will seek to confirm that private fund managers are convening and engaging with such bodies, as required under those documents.
- *We have seen, for example, the Exam Staff identify situations where advisers did not seek consent from fund advisory boards for principal transactions, as required by the fund's organizational and offering documents.*^[5]
- The Custody Rule: The Exam Staff will focus on compliance with Rule 206(4)-2 ("Custody Rule"), particularly with respect to Form ADV reporting practices^[6] and the timely completion and delivery of audited financial statements by advisers relying on the audit exception to the independent verification requirement for limited partnerships and other types of pooled investment vehicles. This focus comes at the same time the SEC is considering its Safeguarding Rule proposal, which would substantially expand the obligations of advisers under the Custody Rule.
- *In addition to the recent enforcement actions charging advisers with violating the Custody Rule for failure to deliver timely audits and/or failure to accurately make disclosures with respect to custody in the ADV,*^[7] *we have seen widespread focus on these issues in adviser examinations and expect that to continue.*

- Form PF: Earlier this year, the SEC adopted amendments to Form PF, which require timely reporting of certain events related to hedge and private equity funds, and expanded reporting for large private equity fund advisers. The Priorities indicate that the Staff will focus on whether private fund managers have policies and procedures in place to address the new Form PF requirements by the Dec. 11 compliance date.[8] For large hedge fund advisers – i.e., any adviser having at least \$1.5 billion in regulatory assets under management attributable to hedge funds as of the end of any month in the prior fiscal quarter – the amendments require reporting within 72 hours of a variety of events, some of which involve quantitative analysis and others that require qualitative determinations. This can necessitate building monitoring systems and addressing certain interpretive issues that need to be tailored to the adviser. Thus, it is important that advisers leave themselves sufficient time in advance of Dec. 11 to develop policies and procedures.
- *As has been the case with the Marketing Rule, we expect the Exam Staff to begin reviewing compliance soon after the new rule goes into effect.*

Additional Topics Relevant to All Advisers, Including Private Fund Managers

Private fund managers should also be prepared for the examination topics the Exam Staff has identified in connection with examinations of all types of registered investment advisers. For example:

The Compliance Rule

Private fund managers can expect that the Exam Staff will continue its work assessing compliance with Rule 206(4)-7 (“Compliance Rule”). The Priorities reiterate the core compliance areas where the SEC has long articulated its expectation that registered investment advisers adopt and implement compliance policies and procedures appropriately tailored to the specific risks of their business, investment strategies and actual practices. The Priorities’ citation to, and incorporation of, the specific topics referenced in the Compliance Rule’s 2003 Adopting Release[9] signals that the Exam Staff still has its eyes on an adviser’s compliance with their long-standing core compliance obligations and is also consistent with increased enforcement activity related to policy failures.

The Marketing Rule

If the Division's two risk alerts^[10] on Rule 206(4)-1 ("Marketing Rule") had not put advisers on sufficient notice, the Priorities make clear that there will be a continued focus on compliance with the not-so-new-anymore Marketing Rule. The Exam Staff will continue to examine whether registered investment advisers have adopted reasonably-designed policies and procedures, can substantiate material facts in advertisements, and disclose their marketing practices accurately on Form ADV (e.g., Item 5.L. of Part 1A). The Division notes that reviews of marketing practices will "assess whether disseminated advertisements include any untrue statements of a material fact, are materially misleading, or are otherwise deceptive and, as applicable, comply with the requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements." This confirms what we have seen on many examinations already, where the Staff has sought back-up files from advisers to support material facts including in advertisements and identified circumstances where advisers utilized a marketing practice (e.g., predecessor performance), but did not appropriately reflect that in Form ADV.

Alternative Data and New Technologies

The Division will continue its focus on certain services provided by investment advisers, including automated investment tools, artificial intelligence and trading algorithms or platforms, and the risks associated with the use of emerging technologies and alternative sources of data. We have already seen this year a targeted (and ongoing) examination sweep of advisers regarding their potential use of artificial intelligence in the research and investment process.

Additional examination topics the Exam Staff will focus on include: Material Nonpublic Information Controls; Accuracy of Regulatory Filings; Supervision of Multiple Offices of the Adviser; Consent to Changes in Governing Documents; and Cybersecurity Risks and Controls.

The Division's Continued Focus on Crypto, and Sanctions

Given the continued volatility of, and activity around, the crypto markets, the Division will continue to monitor and, when appropriate, conduct examinations related to crypto investing activities. With respect to crypto

assets that the SEC believes are funds or securities, the Division emphasized that it will consider whether advisers are complying with the Custody Rule with respect to those assets. In addition, the Division will assess whether any technological risks associated with the use of blockchain and distributed ledger technology have been addressed, including whether compliance policies and procedures are reasonably designed, accurate disclosures are made, and the risks pertaining to the security of crypto asset securities are addressed.

The Priorities also highlight that the Division will review whether advisers are monitoring for and complying with the sanctions laws administered by the US Department of the Treasury's Office of Foreign Assets Control, which is consistent with some of the sanctions-focused examinations that started in 2022 at the outset of the recent Russia-Ukraine war.

Conclusion

The Priorities highlight that the Division has directed resources to continue focusing on issues specific to private fund managers. This is consistent with the Division of Enforcement's expanded efforts directed at private fund managers and the adoption of amendments to Form PF and the Private Fund Advisers Rules, which represent the most comprehensive set of new rules affecting private fund managers since the Dodd-Frank Act (not to mention the myriad other proposed rules applicable to advisers). Accordingly, preparing for examination requires careful attention, review and reconsideration of important aspects of a private fund manager's compliance program and business practices.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] <https://www.sec.gov/files/2024-exam-priorities.pdf>

[2] <https://www.sec.gov/files/risk-alert-ia-risk-and-requesting-documents-090623.pdf>

[3] See Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund

Adviser Reporting, <https://www.sec.gov/files/rules/final/2023/ia-6297.pdf>. *Also see* our Alert on how to prepare for these changes, <https://www.srz.com/resources/sec-form-pf-reporting-changes-effective-dec-11-2023-and-june-11.html>.

[4] The SEC views “an investment adviser’s obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty” and enforceable under the antifraud provision of Section 206 (See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>). The “duty of care” is more frequently the subject of SEC enforcement actions (See *In the Matter of American Infrastructure Funds, LLC*, <https://www.sec.gov/files/litigation/admin/2023/ia-6428.pdf> and *In the Matter of SparkLabs Global Ventures Management, LLC and SparkLabs Management LLC, and Bernard Moon*, <https://www.sec.gov/litigation/admin/2022/ia-6121.pdf>).

[5] Notably, in the adopting release for the Private Fund Advisers Rule, the SEC articulated concerns that, in certain situations, LPACs or boards of directors may not have sufficient independence, authority, or accountability to oversee and consent to conflicts of interest, and it is possible that these concerns could become more prominent in SEC exams.

[6] See, e.g., an adviser’s responses to Item 9 and Section 7.B.(1).(23) of Part 1A, and Item 15 of Part 2A).

[7] See <https://www.sec.gov/news/press-release/2023-168> and <https://www.sec.gov/news/press-release/2022-156>.

[8] The compliance date for new Section 5, which addresses current reporting events for large hedge fund advisers, and new Section 6, which addresses quarterly reporting events for all private equity fund advisers, is Dec. 11, 2023. The compliance date for amended Section 4, which addresses annual reporting for large private equity fund advisers, is June 11, 2024. See <https://www.srz.com/resources/sec-form-pf-reporting-changes-effective-dec-11-2023-and-june-11.html>.

[9] Such areas include: (1) portfolio management; (2) the accuracy disclosures made to investors and regulators; (3) proprietary trading by the adviser and personal trading; (4) safeguarding of client assets; (5)

recordkeeping; (6) privacy of client records and information; (7) trading practices; (8) marketing; (9) valuation and fee calculation; and (10) business continuity. See <https://www.govinfo.gov/content/pkg/FR-2003-12-24/pdf/03-31544.pdf>.

[10] See <https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf> and <https://www.sec.gov/files/risk-alert-marketing-rule-announcement-phase-3-060823.pdf>.

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