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# Alert

## SEC Examinations: What Private Fund Managers Can Expect in 2022

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The SEC has pivoted from the retail-oriented examination focus of the past several years. Private funds are now the number one examination priority. We have seen this in the work we do with our clients on examinations, and it is confirmed in the 2022 Examination Priorities released on March 30, 2022.[1] Private fund managers can take steps now to be prepared.

**Examination Focus on Private Fund Managers**

More private fund managers are being examined by the SEC than in recent years, and it appears this will continue. During the tenure of former Chair Jay Clayton, and continuing through 2021, protection of retail investors played the most prominent role in the exam priorities. For 2022, the Division of Examinations has placed private fund managers at the top of the priorities list.[2] That approach is consistent with the increase in examination activity of private fund managers we have seen in the past six months.

The Division of Examinations will continue to review the key issues for private fund managers, including: fiduciary duties, compliance programs, fees and expenses, custody, fund audits, valuation, conflicts of interest, disclosure of investment risks and controls around material non-public information.

Fees and expenses continues to be a key focus area. The Commission has made it very clear in its private fund adviser rule proposal that it views private fund fees and expenses to be too opaque in many instances. The proposed rulemaking will not decrease the focus on these issues. Indeed, we see it continuing on examinations, and the 2022 Examination Priorities also identify fees and expenses as a key focus area. Managers should consider, first and foremost, whether their disclosures and processes with respect to fees and expenses are both well designed and effective in practice. The SEC identifies some specific fee calculation issues, but by no means are these the only issues they are reviewing on examinations. The specific fee calculation issues identified are:

1. The calculation of post-commitment period management fees and the impact of valuation practices at private equity funds;
2. Advisory fee calculation errors, including, but not limited to, failure to adjust management fees in accordance with investor agreements;

[1] 2022 Examination Priorities, Division of Examinations (March 30, 2022) at https://www.sec.gov/files/2022-exam-priorities.pdf (the "Examination Priorities").

[2] *See* 2021 Examination Priorities, Division of Examinations (March 3, 2021) at https://www.sec.gov/files/2021-exam-priorities.pdf at 28 (the "2021 Examination Priorities"); Examination Priorities at 11.

3. Inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and

4. Failures to refund prepaid fees for terminated accounts or pro-rated fees for onboarding clients.

Preparation for examination on fees and expenses can include a *de novo* analysis of the relevant disclosures and procedures as well as a review of the testing processes and results.

The Examination Priorities identified several other focus areas specific to private funds:

1. Potential preferential treatment of certain investors by registered investment advisers ("RIAs") to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals;
2. **C**ompliance with the custody rule, including the "audit exception" to the surprise examination requirement and related reporting and updating of Form ADV regarding the audit and auditors that serve as important gatekeepers for private fund investors;

3. The adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions or distressed sales; and

4. Conflicts around liquidity, such as RIA-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund.

**Examination Focus on Emerging Risk Areas**

Emerging risk areas such as ESG disclosures, digital assets and the use of developing financial technologies, including alternative data research products, will receive continued scrutiny in 2022.

*The Focus on ESG Investing*

The SEC continues to identify its concern that advisers are making unsupported claims about their use of ESG. The Examination Priorities reinforce the observations in the Division of Examinations' April 2021 Risk Alert, as well as the 2021 Examination Priorities and numerous public statements by Chair Gensler and other SEC officials cognizant that RIAs are increasingly offering and evaluating investments that employ ESG strategies. The SEC's concern is that false or misleading statements or omissions could be used by advisers to present a "greener" picture of the adviser's activities. The exam staff will continue to focus on whether advisers are:

- Accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures, including review of their portfolio management processes and practices;

- Voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates;

- Overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (e.g., greenwashing), such as in their performance advertising and marketing.

With such intense focus on the accuracy of representations related to ESG investing, it can be useful for managers to maintain records that will support any claims about ESG that the adviser makes. In particular, affirmative representations about the role of ESG in the adviser's investment strategies may be scrutinized. While there are no specific requirements as to what would support such representations, managers should consider what they would be producing to the exam staff if requested to support such representations during an exam.

*The Focus on Cybersecurity*

The SEC has proposed a sweeping new rule concerning the cybersecurity obligations of investment fund managers. We have seen these issues as focus areas in private fund manager examinations for the past several years, and the 2022 Examination Priorities indicate that focus will continue. The exam staff will review business continuity and disaster recovery plans and will assess whether firms have measures in place to: 1) safeguard customer accounts and prevent unauthorized account access, 2) oversee vendors and service providers, 3) address malicious email activities, 4) respond to incidents, including ransomware attacks, 5) identify and detect identity theft red flags and 6) manage operational risk resulting from dispersed employees in a work-from-home environment.

In recent exams, the exam staff has shown a particular interest in how advisers respond to and document cyber incidents, including the decision whether or not to report such incidents to investors or other affected parties. As advisers consider their cybersecurity programs, the proposed cybersecurity rules for RIAs can offer some guidance. While the full scope will be refined during the comment process, the proposed rules require policies and procedures, at least annual testing and an accompanying written report, cyber incident reporting to the SEC and investor disclosures of risks and incidents in Form ADV.

*The Focus on Emerging Technologies and Crypto Assets*

The Examination Priorities reflect the exam staff's ongoing concerns about automated investment advice, including mobile apps and other digital engagement practices, as well as an increased focus on crypto investing. Investment by fund managers in crypto assets are an area we increasingly see on examinations. The Examination Priorities stated that examinations of market participants engaged with crypto assets "will continue to review the custody arrangements for such assets and will assess the offer, sale, recommendation, advice, and trading of crypto-assets."[3]

The exam staff clearly expects firms to determine whether they have sufficient understanding of the assets to satisfy their fiduciary duties and standards of care. Advisers can also expect examiners to evaluate whether advisers "routinely review, update and enhance their compliance practices (e.g. crypto asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices[.]"[4]

*The Focus on Alternative Data Oversight*

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[3] Examination Priorities at 16.

[4] *Id*.

Following the Commission's enforcement action against alternative data provider, App Annie, in September 2021, it is not surprising that the 2022 Examinations Priorities identifies managers' oversight of service providers, and in particular the use of alternative data, as a priority for the third consecutive year. What the exam staff is looking for in particular is whether firms "are implementing appropriate compliance and controls around the creation, receipt, and use of potentially [sic] MNPI."[5] In a possible expansion of its focus, the exam staff included not only "alternative data" but also "data gleaned from non-traditional sources," which seems to be a nod to dynamic and rapidly changing investment research offerings that can present MNPI risks. Although the exam staff has yet to issue its much-anticipated alternative data risk alert, the exam staff has been keenly focused on the acquisition and use of alternative data. We expect the exam staff to continue reviewing firm's policies and procedures around the use of alternative data and web scraping and inspect diligence files to evaluate whether managers are appropriately considering the risks associated with such data sets.

**The Focus on Compliance Programs**

We have seen in examinations during the past year an increased focus on the compliance program itself. Deficiency letters have cited perceived inadequacies in both the chief compliance officers ("CCOs"), who design and implement the compliance program, as well as in the leadership of the adviser, who are responsible for supporting the CCO with resources and the appropriate "tone from the top" regarding compliance. The Examination Priorities include a two-page discussion about compliance. The exam staff stresses how important it is for the compliance program to have "participation and input across all business and operational lines."[6] The exam staff also emphasizes how important it is for the compliance program to be flexible and adapt to change, as well as to incorporate periodic reviews and testing. In recent examinations and in the Examination Priorities, the exam staff has made clear its expectations of advisers and their CCOs.

**Examination Outcomes**

The majority of examinations result in a deficiency letter and no other action by the Commission. Private fund managers are, however, well aware of the fact that examinations can lead to referrals to the SEC's Enforcement Division. In 2021, the number of enforcement referrals increased by 46%.[7] The increase in referrals highlights the need for exam preparedness and for a thoughtful and diligent approach to the examination process. There is also another outcome of examinations that does not get discussed often – the return of funds to investors. The exam staff keeps track of the amounts that firms return to their investors in connection with examinations. In 2021, the amount of these returns was 41% higher than the prior year.[8] The Examination Priorities indicate that the exam staff expects an increase in the number of referrals to the Enforcement Division and the amount of funds returned to investors as a result of the examination process. During an examination it is particularly important to consider any position the exam staff takes with respect to fees or expenses charged to client funds and investors as well as any other potential monetary benefit or harm.

[5] *Id.* at 17.

[6] *Id.* at 6-7.

[7] In fiscal year 2020, there were 130 referrals to the Enforcement Division. *See* 2021 Examination Priorities at 9. In fiscal year 2021, there were 190 referrals to the Enforcement Division. *See* Examination Priorities at 3.

[8] In fiscal year 2020, examinations resulted in firms returning more than $32 million to investors. *See* 2021 Examination Priorities at 9. In fiscal year 2021, examinations resulted in firms returning more than $45 million to investors. *See* Examination Priorities at 3.

As the SEC considers the most significant rulemaking for private funds since Dodd-Frank, and the Enforcement Division expands its efforts directed at private fund managers, the Division of Examinations has directed resources to continue drilling down on issues specific to private fund managers. Accordingly, preparing for examination requires careful attention, review and reconsideration of important aspects of the manager's business.

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