

**ALERTS**

## SEC Examinations Update: 2021 Examination Priorities

**March 4, 2021**

On March 3, 2021, the SEC's Division of Examinations released its 2021 Examination Priorities ("Exam Priorities"). While the Exam Priorities address the Division of Examinations' focus for all of the SEC's registrants, certain focus areas will be of particular interest to private fund managers. Consistent with what we have seen during examinations over the last 12 to 18 months, those focus areas include conflicts of interest, compliance programs, ESG and climate change, digital assets, alternative data and structured products.

- *Compliance Programs.* Not unexpectedly, the Division of Examinations will continue its focus on the overall strength of investment adviser's compliance programs, to confirm that "policies and procedures are reasonably designed, implemented, and maintained." Of particular relevance to private fund managers, the examination staff identified the following areas for assessment, "portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, business continuity plans, and valuation of client assets for consistency and appropriateness of methodology." This reinforces the SEC staff's focus on ensuring that investment advisers understand and effect their core responsibilities under the Compliance Rule (Rule 206(4)-7), particularly following the Division of Examination's November 2020 Risk Alert, which identified these same areas as being common sources of examination deficiencies.
- *"Knowledgeable and Empowered CCOs."* The Exam Priorities reiterated the recent statements of the Examinations Director Peter Driscoll

about critical attributes of a chief compliance officer: knowledge, seniority, authority, resources and tangible support from the C-suite and all levels of the organization.

- *ESG and Climate Disclosure.* While regulators in other jurisdictions have been active in promulgating rules related to the incorporation of ESG criteria by investment advisers into their research and investment process (and any related disclosures, including climate-related disclosures), the SEC had taken a different approach. The recognition in the Exam Priorities that investment advisers “are increasingly offering investment strategies that focus on sustainability” and statements that the examination staff will “review the consistency and adequacy of the disclosures [investment advisers] ... provide to clients regarding these strategies, determine whether the firms’ processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with [ESG] strategies” suggests a shift towards a more proactive approach among the staff of the Division of Examinations. This is a marked change, given that Division made only one reference to ESG in its 2020 Examination Priorities.
- *Digital Assets.* The Division of Examinations had made its focus on digital assets known just a few days ago, in a Risk Alert identifying recent examination deficiencies related to digital assets, and their likely focus of examinations going forward. Their inclusion in the Exam Priorities reiterates that attention. The digital asset risk alert identified the following as areas of focus for examinations going forward: diligence on digital assets; alignment of investment adviser regarding digital assets with an adviser’s fiduciary duty; maintaining appropriate books and records; custody and safekeeping; disclosure related to the “technical, legal, market, and operational risks” of digital assets; and valuation methodologies. The Exam Priorities largely reflect those themes with respect to examinations of investment advisers, and include a review of any digital assets specific policies and procedures as well.
- *Structured Products and Non-Performing Loans.* In a section dedicated to examinations of private fund managers, the Exam Priorities primarily discussed two topics, conflicts of interest (described below) and funds that hold a higher concentration of structured products, such as CLOs and mortgage-backed securities. Particularly, the examination staff will

seek to determine whether funds that hold these investments are at a “higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors.” We have observed that the Division of Examinations has shown increased willingness to conduct examinations of managers who employ these strategies as members of the examination staff have become increasingly sophisticated with respect to these products and work with their colleagues in other SEC divisions who have expertise with complex financial instruments.

- *Conflicts of Interest.* Since the SEC issued the Commission Interpretation Regarding Standard of Conduct for Investment Advisers (“Fiduciary Interpretation”), which, among other things, provided guidance with respect to how investment advisers can address conflicts of interest in light of their fiduciary duty, there has been increased examination focus on conflicts of interest (although the level of focus was already significant). In the Exam Priorities, the Division of Examinations indicated that will continue, with a particular focus on preferential treatment of investors in light of liquidity constraints; the impact of valuations on advisory fees; adequacy of disclosures with respect to cross trades, principal investments or distressed sales; and conflicts surrounding fund restructurings led by investment advisers. Examiners, particularly examiners in the Division’s Private Funds Unit, can spend substantial time addressing these topics during examinations.
- *Alternative Data.* Examination staff have been reviewing the use of alternative data by registered advisers throughout the past year and the Exam Priorities indicates this focus will continue. The focus will include “whether firms are implementing appropriate controls and compliance around the creation, receipt, and use of such information.”

With respect to private fund managers, the Exam Priorities reflect certain long-standing (compliance programs, conflicts of interest) and certain relatively new (ESG, digital assets, structured products) areas of focus. As the SEC moves into an era with new leadership, these focus areas can be expected to develop further.

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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.

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