

PUBLICATIONS

5 SEC Exam Priorities Private Fund Managers Must Address

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On Feb. 7, the U.S. Securities and Exchange Commission's Division of Examinations published its 2023 examination priorities,[1] in which it reaffirmed that private fund managers will continue to be a top focus of SEC examinations.

The examination priorities combine a specific focus on private funds with other priorities highly relevant to private fund managers, including compliance with the SEC's new marketing rule;^[2] fiduciary duties and conflicts of interest; environmental, social and governance investing; information security and operational resiliency; and crypto investments and the use of emerging technologies.

Exams Staff Focus on Private Fund Managers

The exams staff identified the following areas of focus in examinations of registered investment advisers to private funds:

- Conflicts of interest;
- Calculation and allocation of fees and expenses — specifically, the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds;

- Compliance with the new marketing rule — particularly focusing on private fund managers' approaches to performance advertising and compensated testimonials and endorsements, such as solicitations — which was adopted in December 2020 and had a compliance date of Nov. 4, 2020;
- Policies and practices regarding the use of alternative data and compliance with Advisers Act Section 204A;^[3] and
- Compliance with the custody rule,^[4] noting as focus areas the timely delivery of audited financials and auditor selection.

The examination priorities note that the exams staff will focus on registered investment advisers to private funds that have specific risk characteristics, such as:

- Highly leveraged private funds;
- Private funds managed alongside business development companies;
- Private equity funds that use affiliated companies and personnel to provide services to fund clients or underlying portfolio companies;
- Private funds that hold certain hard-to-value investments, such as crypto assets and real estate-connected investments — emphasizing commercial real estate;
- Private funds that invest in or sponsor special-purpose acquisition companies; and
- Private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds.

These examination focus areas and risk characteristics likely do not come as a surprise, as they generally reflect concerns that the exams staff has long articulated, several of which are the subject of proposed rules currently under consideration by the SEC.^[5]

We have observed that the exams staff has focused on alternative data even for new registrants or firms with minimal usage of such data and that it expects policies, diligence files and disclosures for managers using alternative data.

The exams staff also noted that it will review the selection and use of service providers in general, which is consistent with the proposed outsourcing rule and trends that we have observed in examinations.

Private fund managers should assess their risk profile and approaches to these issues and make efforts to get ahead of potential examination scrutiny.

The New Marketing Rule

The exams staff will be focused on registered investment advisers' compliance with newly adopted rules, including the new marketing rule.[6]

In September 2022, the exams staff issued a risk alert[7] announcing an examination initiative on the marketing rule, and the examination priorities reiterate that focus.

Examiners will seek to confirm that private fund managers have adopted reasonably designed marketing rule policies and procedures, and have complied with the rule's substantive requirements.

The examination priorities identify a particular examination focus on whether advisers have a reasonable basis for believing that they will be able to substantiate material statements of fact, and if advisers have satisfied requirements and prohibitions relating to performance advertising, testimonials, endorsements and third-party ratings.

Private fund managers should review relevant marketing materials, testimonial and endorsement arrangements, and policies and procedures for compliance with the marketing rule.

The exams staff has been sending examination requests and scheduling interviews focused on marketing rule compliance as part of more comprehensive examinations of private fund managers.

Fiduciary Duties

The exams staff reiterated its yearslong focus on investment advisers' standards of conduct and fulfillment of their fiduciary duties.

Adequacy of disclosures was identified as an area of particular focus — e.g., whether disclosures contain all material facts and are sufficient to allow clients to provide express or implied informed consent — as well as

scrutiny of client agreements that purport to waive or limit an investment adviser's fiduciary duties, such as through hedge clauses.

We see continued emphasis on conflicts of interest in examinations, and the exams staff often scrutinizes the comprehensiveness and clarity of conflicts disclosures and investor consent processes.

Managers with annual Form ADV amendments due in March should consider whether existing conflicts disclosure is fully responsive to the form's instructions and contains all responsive material facts.

The exams staff's continued focus on hedge clauses will likely receive further attention in connection with this year's expected finalization of the proposed private fund advisers rule, which suggests prohibiting private fund advisers from seeking reimbursement, indemnification, exculpation or limitation of their liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence — i.e., a lower standard than gross negligence — or recklessness in providing services to the private fund.

ESG Investing

The exams staff continues to identify ESG-related issues as a key focus area of examinations in 2023.

The examination priorities specifically note a focus on ESG-related advisory services and fund offerings, including compliance with relevant disclosures, whether ESG products are "appropriately labeled" and if retail investor recommendations related to such products are in investors' best interests.

Increased scrutiny of the accuracy of disclosures should encourage managers to maintain supporting records of ESG-related claims. Representations about the role of ESG in an adviser's investment strategies will likely be dissected.

Recent examinations have scrutinized ESG policies and disclosures, and private fund managers should consider what support could be provided to the exams staff upon request and address any gaps, efforts of which can also address the new marketing rule's substantiation requirements.

Information Security and Operational Resiliency

The examination priorities highlight the exams staff's continued focus on information security, specifically noting that it will look into advisers' policies and procedures, governance practices and response to cyber-related incidents, as well as compliance with Regulations S-ID and S-P, where applicable.

Focus areas for policies and procedures will include assessments of whether such measures are reasonably designed to safeguard customer records and information, as well as if the locations of such records have been properly disclosed to the SEC where required.

The examination priorities also highlight the prevention of account intrusions and the safeguarding of customer records and information; the use of third-party vendors, including unauthorized account access by such third parties; and operational resiliency for systemically significant registered investment advisers, such as efforts to consider climate risks.

This examination priority is consistent with last year's proposal of a sweeping new cybersecurity rule for registered investment advisers.[8]

The exams staff has increased its focus on cybersecurity in examinations, with particular emphasis on whether and how investors were notified when private fund managers experienced a breach or other cyber incident. The examination priorities make clear that this emphasis will continue.

Crypto Assets and Emerging Financial Technology

The examination priorities reflect the exams staff's ongoing concerns about the prioritization of compliance when registered investment advisers employ new technologies and practices,[9] or make new types of investments — e.g., crypto investing.

Noting the recent financial distress among certain crypto market participants, the exams staff stated that it will continue to monitor and, when it deems appropriate, conduct examinations of potentially impacted or affected registered investment advisers.

These examinations of crypto market participants will assess whether registered investment advisers (1) met and followed their respective standards of care when making recommendations, referrals or providing investment advice, to the extent required, and (2) routinely reviewed, updated and enhanced their compliance, disclosure and risk management practices.

The exams staff also specifically noted that it will focus on new or never-before-examined registrants offering crypto or crypto-related assets.

Crypto investing has been an increasing focus area in examinations, for both firms that primarily invest in crypto and those that invest in it as one part of a larger investment strategy.

Recent examinations have emphasized, among other topics, private fund managers' due diligence practices, custodial arrangements and disclosures to investors related to crypto investments.

Electronic Communications

Although the Division of Examinations did not specifically identify electronic communications as a focus area, it did state that the exams staff "will review RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers."

We continue to observe that the use of unapproved or "off-channel" communications for business purposes is a major focus area during SEC examinations, as well as a priority of the Division of Enforcement.

Private fund managers should review their personnel's electronic communications practices and assess the adequacy and effectiveness of their policies and technological solutions.^[10]

Conclusion

The examination priorities highlight that the exams staff 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 expected finalization this year

of the most comprehensive set of new rules for private funds affecting private fund managers since the Dodd-Frank Act.

Accordingly, preparing for examination requires careful attention, review and reconsideration of important aspects of a private fund manager's compliance program and business practices.

Related People



**Christopher
Avellaneda**

Partner
New York



**Kelly
Koscuiszka**

Partner
New York



**Tarik
Shah**

Special Counsel
New York



**Allison
Scher Bernbach**

Partner
New York



**Marc
Elovitz**
Partner
New York



**Tinika
Brown**
Special Counsel
New York

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