APRIL 6, 2022

2022 SEC Examination Priorities for Private Fund Advisers

On March 30, 2022, the SEC's Division of Examinations (the "Division") announced its examination priorities for 2022 (available here). The Division emphasized that the "tone at the top" is key to an effective compliance program, including a firm's commitment to and tangible support for compliance at all levels of an organization, compliance's active engagement across all business and operational lines and knowledgeable and empowered chief compliance officers with full responsibility, authority and resources to develop and enforce policies and procedures of the firm. Based on lessons learned during the COVID-19 pandemic, the Division also emphasized that an effective compliance program requires resiliency and should be developed and designed to withstand changes in market conditions, investor demand, key personnel, lines of business and other developments.

Certain highlights of the examination priorities particularly relevant to investment advisers to private equity, credit and hedge funds include:

- compliance risks, including those related to fees and expenses, custody, fund audits, valuation, conflicts of interest, allocations of investment opportunities, disclosures of investment risks and controls around material nonpublic information ("MNPI");
- environmental, social and governance ("ESG")-related strategies and related disclosures;
- information security risks, cyberattack-related risks and operational resiliency;
- implementation and integration of technology;
- digital assets;
- adequacy of compliance programs of registered investment advisers ("RIAs");
- London Inter-Bank Offered Rate ("LIBOR") discontinuation and transition;
- whether investment advisers are acting in accordance with their fiduciary duties; and
- dually registered investment adviser / broker-dealer firms.

Below are more detailed summaries of each of these examination priorities.

Private Fund Advisers and Private Offerings

The Division will continue to focus on investment advisers to private funds and will review compliance risks relating to:

- the calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds;
- the potential preferential treatment of certain investors by private fund advisers that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals;
- compliance with the custody rule under the Investment Advisers Act of 1940 (the "Advisers Act"), including the "audit exception" to the surprise examination requirement and related reporting and updating of Form ADV;
- the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions or distressed sales;
- conflicts around liquidity, such as GP-led fund restructurings, including stapled secondary transactions;
- portfolio strategies, risk management and investment recommendations and allocations, focusing on conflicts and disclosures around these areas, including review of private funds' investments in special purpose acquisition companies ("SPACs"), particularly where the private fund adviser is also the SPAC sponsor; and
- practices, controls, and investor reporting around risk management and trading for private funds with indicia of systemic importance such as outsized counterparty exposure or gross notional exposure when compared to similarly situated firms.

ESG Investing

The Division will continue to focus on RIAs that offer ESG-related investment strategies or incorporate certain ESG criteria and will review the consistency and adequacy of the disclosures RIAs and private funds provide to investors regarding these strategies, focusing on whether such RIAs are: (1) 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; (2) voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates; or (3) overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (e.g., greenwashing), such as in their performance advertising and marketing.

Information Security and Operational Resiliency

The Division will continue to work with RIAs to identify and address information security risks, including whether firms have taken appropriate measures to: (1) safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (2) oversee vendors and service providers; (3) address malicious email activities, such as phishing or account intrusions; (4) respond to incidents, including those related to ransomware attacks; (5) identify and detect red flags related to identity theft; and (6) manage operational risk as a result of a dispersed workforce in a work-from-home environment.

The Division will also be reviewing RIAs' business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations, including the maturation and improvements to business continuity and disaster recovery plans over the years as well as these RIAs' resiliency to anticipate, prepare for, respond to, and adapt to both sudden disruptions and incremental changes stemming from climate-related situations.

Crypto-Assets and Emerging Technologies

The Division's examinations of RIAs engaged with crypto-assets will review the custody arrangements for such assets and will assess the offer, sale, recommendation, advice and trading of crypto-assets. In particular, the Division will review whether RIAs involved with crypto-assets: (1) have met their respective standards of conduct when recommending to or advising investors with a focus on duty of care and the initial and ongoing understanding of the products (e.g., blockchain and crypto-asset feature analysis); and (2) 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 (i.e., data integrity and business continuity plans).

The Division will also conduct examinations of RIAs and broker-dealers that are using developing financial technologies to review whether the unique risks these activities present were considered by the firms when designing their regulatory compliance programs. RIA and broker-dealer examinations will focus on firms that are, or claim to be, offering new products and services or employing new practices (e.g., fractional shares, "Finfluencers" or digital engagement practices) to assess whether: (1) operations and controls in place are consistent with disclosures made and the standard of conduct owed to investors and other regulatory obligations; (2) advice and recommendations, including by algorithms, are consistent with investors' investment strategies and the standard of conduct owed to such investors; and (3) controls take into account the unique risks associated with such practices.

Compliance Programs

The Division will continue to review the compliance programs of RIAs, including the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest and related disclosures. The Division will assess whether policies and procedures are reasonably designed to prevent violations of the Advisers Act and its rules, including breaches of the RIA's fiduciary duty in violation of the antifraud provisions. Additionally, the Division will review compliance programs to examine whether they address that: (1) investment advice is in each client's best interest; (2) oversight of service providers is adequate; and (3) sufficient resources exist to perform compliance duties. In addition, to the extent that firms are using alternative data or data gleaned from non-traditional sources as part of their business and investment decision-making processes, reviews will include examining whether RIAs, including RIAs to private funds, are implementing appropriate compliance and controls around the creation, receipt and use of potential MNPI.

LIBOR Transition

The Division will continue to engage with RIAs and other registrants through examinations and outreach efforts to assess their exposure to LIBOR and their transition to an alternative reference rate, preparations for the cessation of many LIBOR rates beginning immediately after December 31, 2021, and the transition to an alternative reference rate, in connection with registrants' own financial operations, the exposures of their clients and customers and their obligations when recommending LIBOR-linked instruments.

Standard of Care

The Division will continue to examine investment advisers to assess whether, as fiduciaries, they have fulfilled their duty of care and duty of loyalty. This will include assessing, among other things, whether RIAs eliminate or make full and fair disclosure of all conflicts of interest. The Division will continue to focus on risks associated with fees and expenses, best execution and undisclosed, or inadequately disclosed, compensation arrangements.

Dually Registered Investment Advisers

Investment advisers that are dually registered as, or are affiliated with, broker-dealers, or have supervised persons who are registered representatives of unaffiliated broker-dealers, remain an area of interest for the Division. Areas of focus will include whether RIAs maintain effective compliance programs to address the risks associated with these business models, including conflicts of interest that arise from certain compensation arrangements and outside business activities, best execution and prohibited transactions.

Additional Takeaways

While these enforcement priorities drive many of the Division's examinations, the scope of any examination by the Division uses a risk-based approach that analyzes a myriad of factors, including an investment adviser's products and services offered, including certain products identified as having higher risk characteristics; compensation and funding arrangements; disclosures and representations made to clients; prior examination observations and regulatory history; whether the firm has never been examined, is newly registered or has not been examined in many years; material changes in firm leadership or other key personnel; and whether a firm has access to investor assets, i.e., custody. Investment advisers should consider reviewing their existing practices, policies and procedures regarding the above-mentioned enforcement priorities, including whether they have processes in place to monitor effectiveness and to pivot or update when appropriate. Finally, investment advisers should consider periodically reviewing and testing a firm's policies and procedures to ensure the ongoing adequacy and effectiveness of their compliance program.

*   *   *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Victoria S. Forrester
+1-212-373-3595
vforrester@paulweiss.com

Matthew B. Goldstein
+1-212-373-3970
mgoldstein@paulweiss.com

Udi Grofman
+1-212-373-3918
ugrofman@paulweiss.com

Amran Hussein
+1-212-373-3580
ahussein@paulweiss.com

Marco V. Masotti
+1-212-373-3034
mmasotti@paulweiss.com

Aaron J. Schlaphoff
+1-212-373-3555
aschlaphoff@paulweiss.com

Conrad van Loggerenberg
+1-212-373-3395
cvanloggerenberg@paulweiss.com

Lindsey L. Wiersma
+1-212-373-3777
lwiersma@paulweiss.com

Philip A. Heimowitz
+1-212-373-3518
pheimowitz@paulweiss.com

Caitlin T. Kelly
+1-202-223-7342
ctkelly@paulweiss.com

Christine Lin
+1-212-373-3294
clin@paulweiss.com

Allison Muth
+1-212-373-3744
amuth@paulweiss.com

Marc Palumbo
+1-212-373-3642
mpalumbo@paulweiss.com

Laura T. Schnaidt
+1-212-373-3558
lschnaidt@paulweiss.com

Jyoti Sharma
+1-212-373-3712
jsharma@paulweiss.com

Marian S. Shin
+1-212-373-3511
mshin@paulweiss.com

Maury Slevin
+1-212-373-3009
mslevin@paulweiss.com

Matthew J. Zweig
+1-212-373-3583
mzweig@paulweiss.com