Hogan Lovells

Private Capital Alert
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SEC releases 2022 examination priorities with focus on private funds

On March 29, the Division of Examinations[1] (the Division) within the U.S. Securities and Exchange Commission (the SEC) released its annual list of examination priorities for investment advisers regulated by the SEC under the U.S. Investment Advisers Act of 1940 (the Advisers Act) and investment companies under the U.S. Investment Company Act of 1940 (the Company Act).

Private funds

In light of the SEC's February 2022 proposal of comprehensive new rules for private funds, and a January 2022 risk alert on private fund practices, it should be no surprise that the 2022 priorities list focuses heavily on private funds. The Division highlighted that more than 5,000 registered investment advisers (RIAs), totaling 35% of all RIAs, manage around US$18 trillion in private fund assets, marking a 70% increase in assets managed by private funds.

Among other things, the Division prioritized many of the core compliance matters that perennially top the list of RIA compliance concerns, including:

- 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 by RIAs of certain investors to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals;
- compliance with the Advisers Act 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;
- the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales; and
- 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.

ESG strategies

Also, not unsurprisingly given the SEC's recent interest in environmental, social and governance (ESG) standards, another priority will be RIAs and other funds offering and evaluating investments that employ ESG strategies or incorporate certain ESG criteria. The Division reiterated that there is a risk that ESG-related disclosures could involve materially false and misleading statements or omissions, thereby resulting in misinformed investors. In particular, the SEC pointed to (i) the lack of standardization in ESG investing terminology; (ii) the variety of approaches to ESG investing (such as the distinction between ESG consideration and ESG as a driving factor in investment strategy); and (iii) the failure to address legal and compliance issues with new lines of business.

1 Formerly the Office of Compliance Inspections and Examinations (OCIE). In its 2022 priorities, the Division stated explicitly that the removal of the word "compliance" from the Division's name is not intended to de-emphasize the Division's long-standing focus on, and commitment to, promoting compliance.

Fiduciary standard

The Division also emphasized standard of conduct for broker-dealers and RIAs under both Regulation BI and the Advisers Act fiduciary standard to act in the best interests of investors and not to place their own interests ahead of investors' interests. To that end, the Division emphasized that examinations will assess consideration of alternatives (including potential risks, rewards, and tradeoffs); management of conflicts of interest; trading and best execution; disclosures such as those provided in Form ADV, brokerage, advisory, or wrap fee account selection; and account conversions and rollovers. The SEC adopted, under the previous administration in June 2019, an interpretive release detailing the duty of care and loyalty and outlining its view on what that duty constitutes.

Information security

Since its first emphasis on cybersecurity in 2014, the Division continues to emphasize information security as a leading priority. This follows the SEC's proposal of additional rules last month regarding cybersecurity risk management for RIAs, registered investment companies, and business development companies.

As in prior years, the Division stated that it will review broker-dealer and RIA practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets. In particular, the Division will review whether firms have taken appropriate measures to (i) safeguard customer accounts and prevent intrusions, including verifying an investor's identity; (ii) oversee vendors and service providers; (iii) address malicious email activities, such as phishing or account intrusions; (iv) respond to incidents, including those related to ransomware attacks; (v) identify and detect red flags related to identity theft; and (vi) manage operational risk as a result of a dispersed workforce in a work-from-home environment.

In addition, the Division stated that it expects to review continuity and disaster recovery plans, with a particular focus on the impact of climate risk and substantial disruptions to normal busines operations.

Crypto-assets

Finally, the Division stated that it will focus on firms that are (or claim to be) offering new products or services, such as fractional shares, "finfluencers," or digital engagement practices to assess operations, controls, and standards of conduct.

For RIAs engaged with crypto-assets, the Division will continue to review custody arrangements and assess the offer, sale, recommendation, and trading of crypto-assets, as well as compliance practices, including crypto-asset wallet reviews, anti-money laundering reviews, and valuation procedures.

Examinations generally

The Division completed 3,040 examinations in FY 2021, a 3% increase from FY 2020, and only slightly below the 3,089 examinations it completed in FY 2019, including 2,200 examinations of investment advisers, in particular, reflecting an examination rate of approximately 16% of all RIAs, higher than the Division's 15% annual goal. Given the proliferation of RIAs over the past five years (a 20% increase from 12,250 to 14,800, including a gain of 900 RIAs in FY 2021), the Division stated that it will soon likely have to lower its annual 15% coverage target as the number of RIAs grows faster than SEC staffing increases.

The Division reiterated that its core RIA examination areas remain as follows: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures. Additionally, the Division will review compliance programs to examine whether they address that: (i) investment advice is in each client's best interest; (ii) oversight of service providers is adequate; and (iii) sufficient resources exist to perform compliance duties. The Division will also continue its focus on RIA disclosures and other issues related to fees and expenses, especially regarding (i) advisory fee calculation errors, including, but not limited to, failure to adjust management fees in accordance with investor agreements; (ii) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (iii) failures to refund prepaid fees for terminated accounts or prorated fees for onboarding clients.

As in previous years, the Division expects to prioritize RIAs and registered funds that have never been examined, including recently registered firms, and those that have not been examined for a number of years.

January risk alert for RIA clients

While this year's priorities report has released later than in past years, it follows a detailed January 27, 2022 risk alert where the Division provided detailed highlights as to where SEC staff are observing RIA violations, highlighting areas where RIAs might take care to review and revise their own policies and procedures as necessary:

— LPAC consents. The Division observed failures of private funds to obtain informed consent from their respective limited partner advisory committees (LPACs) as required under fund documents; in particular, the SEC highlighted (i) failure to seek consent for conflicts of interest; (ii) failure to seek consent until after the transaction occurred; and (iii) failure to provide complete information to LPAC members.

— Post-commitment period management fees. The Division observed failures in advisers who didn't follow practices previously disclosed in calculating fund-level management fees following the commitment period. The SEC cautioned that private fund governing documents (i.e. limited partnership agreements or "LPAs") used broad undefined terms such as "impaired," "permanently impaired," "written down," or "permanently written down" without having policies and procedures designed to apply these terms consistently.

— Failure to comply with LPA liquidation and fund extension terms. The Division observed failures to obtain required approvals as previously disclosed in the LPA, especially where this results in potentially inappropriate management fees being charged to investors.

— Failures relating to recycling practices. The Division observed advisers that didn't accurately describe their recycling practices that, again, may have resulted in the collection of excess management fees.

— Failures with respect to track record. In addition to failures to keep adequate books and records as to portability and predecessor performance, the Division observed inaccurate presentations of track records, including misleading disclosures with respect to benchmarks, cherry-picking, or failure to disclose material information about the impact of leverage on fund performance.

— Failures with respect to due diligence. Finally, in light of an RIA's fiduciary duties to its clients, the Division noted that an adviser must conduct a reasonable investigation into investments sufficient to ensure the adviser is not basing its advice on materially inaccurate or incomplete information. It therefore cautioned that advisers should have internal controls with respect to the underlying investments or private funds in which they invest, and that advisers should have due diligence policies in place (and actually follow the policies) for not only investment opportunities, but service providers, such as placement agents. In particular, the SEC staff found advisers that outlined a due diligence process in the fund LPA and/or marketing materials but that did not maintain policies and procedures related to the promised due diligence.

Hogan Lovells regularly represents RIAs who are subject to SEC examinations, as well as exempt reporting advisers who are also obligated to comply with certain aspects of the Advisers Act. We also have very active regulatory, cybersecurity, and ESG practices, among others, that provide counsel to clients who deploy private capital across a broad range of regulated industries through a broad range of investment strategies. We are happy to discuss any aspects of the Division's 2022 examination priorities or other regulatory actions in respect of private funds under the Advisers Act or otherwise within the broader securities regulatory matrix to which private capital is subject.

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