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## SEC Announces 2014 Examination Priorities

Yesterday, the staff of the SEC's National Examination Program ("NEP") announced its examination priorities for 2014. Most of the priorities are the same as those identified by the SEC for 2013; however, compliance with new laws and regulations such as Rule 506(c) under the Securities Act and various provisions of the Dodd-Frank Act were added as examination priorities. Below are certain highlights of the examination priorities relevant to investment advisers to hedge funds and private equity funds.

### Core Risks

*Conflicts of Interest.* The staff will conduct examinations focused on conflicts of interest, including compensation arrangements for investment advisers; allocation of investment opportunities; controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts; and risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies.

*Marketing/Performance.* The staff will review the accuracy and completeness of advisers' claims about their investment objectives and performance. They will also review and test hypothetical and back-tested performance, the use and disclosure of composite performance figures, performance record keeping, and compliance oversight of marketing.

*Safety of Assets and Custody.* The staff has continued to observe non-compliance with the Custody Rule, including failure by advisers to realize that they have custody and various audit deficiencies. The staff will continue to test compliance with the Custody Rule and confirm the existence of assets through a risk-based asset verification process.

### New and Emerging Issues and Initiatives

*Never-Before Examined Advisers.* The staff will conduct focused, risk-based examinations of investment advisers that have not yet been examined by the NEP.

*Presence Exams.* The staff will continue its initiative to examine newly registered investment advisers – the vast majority of which are advisers to hedge funds and private equity funds. The staff will also continue to prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors, or where there are indicia of fraud, broker-dealer status concerns, or other serious wrongdoing.

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*Quantitative Trading Models.* The staff will examine quantitative portfolio management and trading strategies and assess, among other things, whether firms have adopted and implemented compliance policies and procedures tailored to the performance and maintenance of their proprietary models, including such procedures as (i) evaluating if any models are used to manipulate the markets; (ii) reasonably review or test the models and their output over time; (iii) maintaining proper documentation within required books and records; and (iv) maintaining a current inventory of all firm-wide proprietary models.

The examination priorities also address a variety of market-wide issues, including the following which are most relevant to investment advisers to hedge funds and private equity funds:

*Corporate Governance, Conflicts of Interest, and Enterprise Risk Management.* The staff will meet with senior management to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks.

*Review of Recent Legislative and Rulemaking Initiatives.* The staff will review general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c) under the Securities Act; generally will review, monitor, and analyze the use of Rule 506(c); and will evaluate due diligence conducted by broker-dealers and investment advisers for such offerings. Similarly, in the event that rules are in place regarding security-based swaps dealers and other registered entities created or impacted by the Dodd-Frank Act, the staff expects to allocate resources to conduct reviews of those registrants, as well as customer margin and operational practices resulting from centralized clearing for various security-based swap products.

For a complete list of the NEP's Examination Priorities for 2014, see <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>

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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:

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