

March 5, 2021

## 2021 SEC Examination Priorities for Private Fund Advisers

On March 3, 2021, the SEC's Division of Examinations (the "Division")<sup>1</sup> announced its examination priorities for 2021.<sup>2</sup> The Division emphasized that culture and "tone at the top" are key to effective compliance programs and noted several hallmarks of effective compliance programs: compliance's active engagement in most facets of firm operations; early involvement in important business developments; knowledgeable and empowered chief compliance officers<sup>3</sup> with full responsibility, authority and resources to develop and enforce policies and procedures of the firm; and a commitment to and tangible support for compliance at all levels of an organization.

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 liquidity, adviser-led fund restructurings, disclosures of investment risks and conflicts of interest, compliance with the new offering rules, and the impact of recent economic conditions on portfolio companies;
- preparedness for LIBOR discontinuation and transition;
- whether investment advisers are acting in accordance with their fiduciary duties;
- ESG and social impact strategies and related disclosures;
- information security risks and cyberattack-related risks;
- implementation and integration of technology;
- digital assets;
- adequacy of compliance programs of registered investment advisers ("RIAs"); and
- dually registered investment advisers.

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 assess compliance risks, including a focus on liquidity and disclosures of investment risks and conflicts of interest. Specifically, the Division will review for: preferential treatment

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of certain investors by private fund advisers that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; portfolio valuations and the resulting impact on management fees; adequacy of disclosure and compliance with any regulatory requirements of cross trades, principal investments, or distressed sales; and conflicts around liquidity, such as adviser-led fund restructurings, including stapled secondary transactions. The Division will also focus on how firms are complying with the recent changes to the definition of accredited investor when making certain private offerings.

**Private Funds' Assets.** The Division will also focus on private fund advisers that have a higher concentration of structured products, such as collateralized loan obligations and mortgage-backed securities, to assess whether the funds are at a higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors. In addition, the Division will examine private fund advisers where there may have been material impacts on portfolio companies owned by the private fund due to recent economic conditions.

**LIBOR Transition.** As the financial service industry transitions away from LIBOR, the Division will engage with firms to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate.

**Standard of Care.** Last year, the Division integrated the Interpretation Regarding Standard of Conduct for Investment Advisers (the "Interpretation")<sup>4</sup> into the RIA examination program and will continue to examine investment advisers to assess whether, as fiduciaries, they have fulfilled their duty of care and duty of loyalty, as clarified by the Interpretation. 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, complex products, best execution, and undisclosed or inadequately disclosed, compensation arrangements.

**ESG and Social Impact.** As RIAs are increasingly offering ESG and/or social impact investment strategies, the Division will review the consistency and adequacy of the disclosures RIAs and funds provide to clients regarding these strategies and assess whether the firms' processes and practices match their disclosures. Relatedly, on March 4<sup>th</sup>, the SEC announced the creation of a Climate and ESG Task Force in its Division of Enforcement that will, among other things, focus on disclosure and compliance issues relating to RIAs' and funds' ESG strategies as well as proactively identifying ESG-related misconduct (such as material disclosure gaps and misstatements), including by using data analysis to identify potential violations.<sup>5</sup> In addition, the Climate and ESG Task Force will evaluate and pursue tips, referrals and whistleblower complaints on ESG-related issues, and provide expertise and insight to teams working on ESG-related matters across the Division of Enforcement.

**Information Security and Operational Resiliency.** The Division is focused on working with firms to identify and address information security risks, including cyberattack-related risks. The Division will review whether firms have taken appropriate measures to: (1) safeguard customer accounts and prevent account

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intrusions; (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; and (5) manage operational risk as a result of dispersed employees in a work-from-home environment. The Division will focus on controls surrounding online access to investor account information, the controls surrounding the electronic storage of books and records and personally identifiable information maintained with third-party cloud service providers, and firms' policies and procedures to protect investor records and information. The Division will continue to review firms' business continuity and disaster recovery plans.

**Use of Technology.** The Division will focus on the use, implementation and integration of technology by firms to facilitate compliance with regulatory requirements. In addition, the Division has observed that alternative data, or data gleaned from non-traditional sources, is increasingly being used by firms, including private fund advisers, as part of their business and investment decision-making processes. Reviews will include examining whether firms are implementing appropriate controls and compliance around the creation, receipt and use of such information.

**Digital Assets.** The Division's examinations will focus on management of digital assets, including trading, safety of client funds and assets, pricing of client portfolios, compliance, internal controls and supervision of employees' outside business activities relating to digital assets.

**Compliance Programs.** The Division will continue to review the compliance programs of RIAs, including whether those programs and their policies and procedures are reasonably designed, implemented and maintained; 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.

**Dually Registered Investment Advisers.** The Division will continue to prioritize examinations of 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. 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.

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Investment advisers should consider reviewing their existing practices, policies and procedures regarding the above-mentioned enforcement priorities.

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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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<sup>1</sup> On December 17, 2020, the SEC renamed the Office of Compliance Inspections and Examinations the “Division of Examinations.”

<sup>2</sup> See [SEC Division of Examinations 2021 Examination Priorities](#).

<sup>3</sup> In a November 2020 speech, Peter Driscoll, Director of the Division of Examinations, highlighted his views on what it means to have an empowered chief compliance officer in a position of sufficient seniority and with the necessary authority. See [The Role of the CCO - Empowered, Senior and With Authority](#).

<sup>4</sup> See [Commission Interpretation Regarding Standard of Conduct for Investment Advisers](#).

<sup>5</sup> See [SEC Announces Enforcement Task Force Focused on Climate and ESG Issues](#). See also [Paul Weiss Client Memorandum: SEC Turns up the Heat on Climate and ESG Disclosures](#).