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2023 SEC Division of Examinations Priorities: Takeaways for Private Fund Advisers

Executive Summary

On February 7, 2023, the SEC's Division of Examinations (the "Division") announced its examination priorities for 2023 (available [here](#)). The priorities reflect the Gensler administration's continued focus on private fund advisers. They also reflect an increased scrutiny on issues that are relevant for many private fund advisers. In light of the priorities, private fund advisers may wish to review their business practices as well as their policies and procedures relating to:

- compliance with the substantive requirements of the Marketing Rule (Advisers Act Rule 206(4)-1), including performance advertising (e.g., gross performance must be accompanied by net performance) and compensated endorsements and testimonials, such as solicitations made by placement agents;
- management fee calculations, particularly with respect to post-commitment/investment period basis for charging management fees, particularly as it pertains to determinations of write-offs/write-downs and disclosures as to how such determinations are made;
- the allocation of fees and expenses, including conflicts of interest related thereto and compliance with related disclosures provided to clients and in SEC filings;
- the use of "big" or "alternative" data, including whether information used is obtained legally; and
- compliance with the Custody Rule (Advisers Act Rule 206(4)-2), where applicable, including timely delivery of audited financials and selection of permissible auditors.

The Division indicated specific focus on advisers to private funds with the following risk characteristics:

- highly leveraged private funds;
- private funds managed side-by-side with business development companies;
- private equity funds that use affiliated companies and advisory personnel to provide services to their fund clients and underlying portfolio companies;
- private funds that hold certain hard-to-value investments, such as crypto assets and real estate-connected investments, with an emphasis on 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.

Accordingly, advisers to private funds with these characteristics should be aware that their businesses may be subject to increased scrutiny in the coming year and may wish to pay particular attention to their business practices and policies and procedures related to these risk areas.

Below are more detailed summaries of the Division's priorities particularly relevant to private fund advisers.

Marketing Rule

The Division will assess whether SEC-registered investment advisers ("RIAs") have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by the advisers and their supervised persons of the Marketing Rule. Notably, the Division will also review whether RIAs have complied with the substantive requirements of the Marketing Rule, including the requirement that RIAs have a reasonable basis for believing they will be able to substantiate material statements of fact and requirements for performance advertising, testimonials, endorsements and third-party ratings. This is a new addition to the priorities for 2023.

Private Fund Advisers

As highlighted above, the Division will continue to focus on RIAs to private funds and will review compliance risks relating to:

- conflicts of interest;
- 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;
- compliance with the new Marketing Rule, including performance advertising and compensated testimonials and endorsements, such as solicitations;
- policies and practices regarding the use of alternative data and preventing the misuse of material nonpublic information (Advisers Act Section 204A); and
- compliance with the Custody Rule, where applicable, including timely delivery of audited financials and selection of permissible auditors.

ESG Investing

The Division will continue to focus on RIAs that offer environmental, social and governance ("ESG")-related investment strategies or incorporate certain ESG criteria and will review the consistency and adequacy of the disclosures RIAs to private funds provide to investors regarding these strategies, focusing on whether such RIAs are operating in the manner set forth in their disclosures and whether ESG products are appropriately labeled.

Information Security and Operational Resiliency

The Division will continue to review RIAs' policies, procedures and practices to prevent interruptions to mission-critical services and to protect investor information, records and assets, including those relating to: (1) cyber-related incidents and ransomware attacks; (2) Regulations S-P and S-ID, where applicable, including whether related policies and procedures are reasonably designed to safeguard customer records and information; (3) account intrusions and safeguarding customer records and information, including personally identifiable information; and (4) cybersecurity issues associated with the use of third-party vendors, including RIA visibility into the security and integrity of third-party products and services. In addition, the SEC will

continue to assess systemically significant RIAs' operational resiliency planning, such as their efforts to consider and/or address climate-related risks.

Crypto Assets and Emerging Technologies

The priorities indicate a growing emphasis on crypto assets and emerging financial technologies and a refined approach that focuses on an investment adviser's duty of care. The Division will continue to review whether RIAs involved with crypto or crypto-related assets: (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. In addition, the Division will focus on new or never before examined RIAs offering crypto or crypto-related assets.

Compliance Programs

The Division will continue to review the compliance programs of RIAs, including the following core areas: custody and safekeeping of client assets, valuation, portfolio management and brokerage and execution. Examinations may also include a review for conflicts of interest, allocations and/or calculations of fees and expenses. The Division also signaled the importance of retaining and monitoring electronic communications and selecting and using third-party service providers.

LIBOR Transition

The Division will continue to assess RIA and broker-dealer preparation for the transition away from LIBOR which is currently scheduled for discontinuation in mid-2023.

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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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