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SEC Staff Announces 2016 OCIE Examination Priorities

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On January 11, 2016, the staff of the Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC) released its annual announcement on examination priorities in the coming calendar year.[1] While the announcement contains broad and general descriptions of areas in which the staff intends to focus, there are several key points to which advisers to hedge funds, private equity funds and other private funds should pay close attention.

First, the announcement specifically affirms the staff's continuing attention to fees and expenses allocated and charged by private fund advisers. In 2015, the SEC secured settlements with several private fund advisers in areas involving (i) allocation of management company operating expenses to fund vehicles[2] (ii) the disclosure of the assumption of broken-deal expenses incurred in connection with unconsummated portfolio company investments, and (iii) the disclosure of the receipt of accelerated monitoring fees received by advisers from portfolio companies upon their sale or initial public offering. In re-committing to its focus in this area, the staff appears to indicate that there remain fee and expense allocation and disclosure practices which it seeks to review and influence through its examinations (and potentially enforcement) programs.

The staff also references its interest in reviewing advisers to private funds that have exposure to potentially illiquid fixed income securities. It could be presumed that the staff's review would include disclosures and representations made to investors and potential investors with respect to such securities, as well as the adviser's controls over market risk management, valuation[3] and trading activity, and whether the liquidity of such investments could adversely impact the liquidity offered to investors.

The staff indicated that it will expand its focus in the area of cybersecurity to include the testing and assessments of advisers' implementation of procedures and controls. In the past year, the staff published summary observations of the findings from a series of examinations focused on cybersecurity risks,[4] released cybersecurity guidance from the SEC's Division of Investment Management,[5] and released a report on key examination topics in the area of cybersecurity.[6] The SEC also obtained its first enforcement settlement[7] against an adviser for violations of Rule 30(a) of Regulation S-P, which requires registered investment advisers to adopt written policies and procedures that are reasonably designed to safeguard customer records and information. Having devoted a significant amount of attention in the past year to information gathering and risk identification in the area of cybersecurity, it is likely that the staff would be interested in assessing the administration and effectiveness of procedures created in response to its guidance.

The staff also identifies private placements under Regulation D as an area of interest in 2016. Specifically the staff stated that it would be reviewing "whether legal requirements are being met in the areas of due diligence, disclosure, and suitability." This follows a SEC staff report[8] issued on December 18, 2015 regarding the accredited investor definition in Rule 501 of Regulation D which was mandated by § 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The announcement also references the staff's interest in reviewing controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts. This area was previously identified as presenting the potential for conflicts of interest in the staff's 2013[9] and 2014[10] examination priorities announcements. Specifically in 2013, the staff stated that it intended to "confirm that the registrant has controls in place to monitor the side-by-side management of its performance-based fee accounts, such as certain private investment vehicles, and registered investment companies, or other non-incentive fee-based accounts, with similar investment objectives, especially if the same portfolio manager is responsible for making investment decisions for both kinds of client accounts or funds."

The staff's 2016 announcement also notes a focus on pay-to-play and certain other key risk areas related to advisers to public pensions, including identification of undisclosed gifts and entertainment. Additionally, on December 16, 2015, both the Financial Industry Regulatory Authority[11] and the Municipal Securities Rulemaking Board[12] filed their respective proposed pay-to-play rules with the Securities and Exchange Commission, setting forth pay-to-play restrictions on broker-dealers and registered municipal advisors that act as placement agents for investment advisers or their managed funds. Advisers would be prudent to review their pay-to-play policies (including the designation of who would be a "covered associate" for purposes of the rule), confirm that recordkeeping requirements are complied with, and ensure that all staff members are adequately educated on the requirements and ramifications of political donations by, or on behalf of, an adviser's covered associates.

Finally, the 2016 announcement discloses that the staff will continue to review the supervision of adviser representatives in branch offices of SEC-registered advisers, including using data analytics to identify representatives in branches that appear to be engaged in potentially inappropriate trading. Analytic capabilities will also be used to identify recidivist individuals with a track record of misconduct, such as having been disciplined by a past employer or barred by a regulatory authority. The staff will seek to schedule examinations of investment advisers that employ these individuals, with the goal of assessing the level of compliance oversight and controls of these firms. The staff will also continue conducting focused, risk-based examinations of selected registered investment advisers and advisers that they have not yet examined.

In conclusion, the staff's 2016 announcement sets forth a broad and robust agenda of areas to be examined, which include both continuations of past themes as well as new initiatives. While the announcement itself covers all entities regulated by the SEC (excluding the national securities exchanges), advisers to private funds would be well-served to devote time and resources to assessing and assuring their preparedness in the specific areas articulated above.

[1] https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf

[2] By way of example: http://www.proskauer.com/publications/client-alert/sec-action-against-private-fund-adviser-highlights-importance-of-proper-expense-apportionment/

[3] http://www.proskauer.com/blogs/corporate-defense-and-disputes-blog/sec-sanctions-hedge-fund-advisory-firm-for-improper-valuations-of-illiquid-securities-07-06-2015/

[4] http://www.proskauer.com/publications/client-alert/sec-releases-results-of-cybersecurity-examination-sweep/.

[5] http://www.proskauer.com/publications/client-alert/cybersecurity-guidance-for-registered-investment-advisers/.

[6] http://www.proskauer.com/publications/client-alert/sec-to-conduct-second-round-of-cybersecurity-examinations/.

[7] http://www.proskauer.com/publications/client-alert/sec-announces-cybersecurity-enforcement-action/.

[8] http://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

[9] https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

[10] https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

[11] http://www.finra.org/industry/rule-filings/sr-finra-2015-056.

[12] http://www.msrb.org/News-and-Events/Press-Releases/2015/MSRB-Seeks-SEC-Approval-of-Pay-to-Play-Regulations-for-Municipal-Advisors.aspx.

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  Partner
- **Scott S. Jones**
  Partner
- **Charles (Chip) Parsons**

Partner

- **Bruno Bertrand-Delfau**
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