Proskauer

SEC Examinations in 2023 to Focus on “Riskier Private Funds” and New Marketing Rule

February 15, 2023

On February 7, 2023, the Division of Examinations (“Division” or EXAMS”) of the U.S. Securities and Exchange Commission (“SEC”) released its 2023 Examination Priorities (“Annual Priorities”). Released at the beginning of each calendar year, the priorities tend to repeat the previous year’s priorities, and consumers of these regulatory tea leaves need to search closely for clues as to what is new and meaningful. This year the Division helpfully identified certain “Notable New Significant Focus Areas,” which included two priorities affecting private funds.

Advisers to “Riskier” Private Funds

The Annual Priorities state that the Division will look at advisers that manage certain types of private funds that it believes are subject to heightened risk. In particular, the report identifies six (non-exhaustive) categories of private funds that the staff will focus on:

- highly-leveraged private funds;
- private funds managed side-by-side with Business Development Companies (BDCs);
- private fund advisers 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 (SPACs); and
- private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds.

Advisers managing these types of private funds should expect the scope of any SEC examination to focus on these risk areas and may want to prepare in advance by, among other things, reviewing (i) the adequacy of their client disclosures, (ii) the sufficiency of their valuation practices and compliance policies and procedures, and (iii) the adequacy of their risk management controls.

New Marketing Rule

As it has previously announced in a September 2022 Risk Alert, EXAMS will be conducting targeted reviews of advisers' marketing materials.[1] The staff will assess whether advisers have adopted and implemented written policies and procedures reasonably designed to prevent violations of amended Advisers Act Rule 206(4)-1 (the "Marketing Rule"). The Annual Priorities further identify certain substantive requirements of the Marketing Rule that will be looked at:

- whether the adviser has a reasonable basis for believing it can substantiate material factual statements; and.
- whether advisers are satisfying the specific requirements of the Marketing Rule when advertisements include performance information, testimonials, or third-party rankings.

All registered advisers employing marketing material need to have adjusted their marketing material to the new rule, and to have addressed key areas of the rule addressed by the Annual Priorities, particularly the complex (and sometimes ambiguous) new rules regarding the presentation of performance data.

Other Priorities Affecting Private Funds

The Annual Priorities include many other recurring themes seen in prior years that affect private fund advisers, including:

- disclosure of 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;
- policies and practices regarding the use of alternative data and compliance with Advisers Act Section 204A;[2] and

- compliance with Advisers Act Rule 206(4)-2 (the “Custody Rule”), where applicable, including timely delivery of audited financials and selection of permissible auditors.

Advisers Involved With Crypto and Crypto-Related Assets

The Division notes recent market disruptions caused by bankruptcies and financial distress among crypto asset market participants. The Division intends to “continue to monitor and, when appropriate, conduct examinations of potentially impacted or affected registrants,” including advisers whose funds invest in crypto or crypto-adjacent assets. They will “focus on new or never before examined registrants offering crypto or crypto-related assets.” This focus reflects the growing number of enforcement actions the SEC has recently brought involving participants in the crypto industry.

Specifically, the SEC staff will “assess whether [advisers] 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.” Finally, and although not specifically mentioned, all such advisers need to evaluate whether their engagement with crypto may involve the sale of unregistered securities.

Environmental, Social and Governance (“ESG”) Investing

The Annual Priorities reiterate concerns whether advisers are employing ESG strategies that are consistent with those they are marketing, *i.e.*, whether they are engaging in greenwashing.[3] Although ESG concerns occupied less real estate in the priorities report than last year, it is unlikely the examination staff’s attention has waned in light of pending rule proposals that would codify disclosure obligations regarding ESG activities and facilitate SEC staff oversight of ESG claims.[4]

Information Security and Operational Resiliency

In more than one section of the Annual Priorities, the Division expresses its concern with the heightened cybersecurity risk that regulated entities face. In light of these heighted risks, the Division plans on reviewing adviser practices to assess whether they are adequately designed to (i) prevent interruptions to critical services and infrastructure and (ii) protect investor information, records and assets. In conducting these assessments, the Division will focus on policies and procedures, governance practices, and responses to cyber-related incidents (if any).

Electronic Communications

Although mentioned only briefly, the Division indicates that examinations conducted in fiscal year 2023 will also focus on advisers' policies and procedures for the retention and monitoring of electronic communications and their enforcement of those policies. The SEC's Division of Enforcement is understood to be actively conducting sweep investigations of advisers' oversight of their supervised persons' work-related communications through off-channel applications. This sweep follows settlements of enforcement actions brought against l6 large broker-dealers that the SEC alleges failed to maintain required records as a result of the use of such applications.

---

[1] See Proskauer's September 2022 Alert related to Division's Marketing Rule Risk Alert.

[2] See *EXAMS Risk Alert: Investment Adviser MNPI Compliance Issues* (April 26, 2022)

[3] See *EXAMS Risk Alert: The Division of Examinations' Review of ESG Investing* (April 9, 2021)

[4] *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, Advisers Act Re. 6034 (May 25, 2022)

Related Professionals

- **Robert H. Sutton**
  Partner