Hogan Lovells

Private Capital Alert
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SEC's Division of Examination releases FY 2024 priorities

For over a decade, the Division of Examinations[1] within the U.S. Securities and Exchange Commission (the SEC) has released its annual examination priorities in the first quarter of each new calendar year. The Division, however, released its 2024 examination priorities on October 16, shifting the release of its annual priorities on the basis of the U.S. government's fiscal year, which began on October 1.[2]

Despite the slight change in timeline from calendar year to fiscal year, the Division says that it will continue to focus on many of the areas it has emphasized for years in its examinations. Compliance with the Marketing Rule, as well as new rules adopted by the SEC throughout 2023, will be important focus points, alongside longstanding private fund concerns, such as conflicts of interest, calculation and allocation of fees and expenses, and the allocation of investment opportunities.

Overview

The release, as in past years, reflects the examination priorities for investment advisers regulated by the SEC under the U.S. Investment Advisers Act of 1940 (the Advisers Act); investment companies registered under the U.S. Investment Company Act of 1940; broker-dealers registered under the U.S. Securities Exchange Act of 1934; and other market participants. The 2024 priorities follow the finalization of a broad-ranging set of new private fund rules adopted by the SEC in August,[3] with more than a half-dozen additional proposed rules under consideration.[4]

While most investment fund sponsors are not registered investment companies or registered broker-dealers, many are either (i) registered investment advisers (RIAs), which should expect routine examinations every few years by the SEC, or (ii) exempt reporting advisers (ERAs) relying on either the venture capital fund adviser exemption (i.e. those advising solely venture capital funds) or the private fund adviser exemption (i.e. those advising solely private funds with under $150 million in assets under management), excluding in each case the assets of any small business investment companies (SBICs).[5]

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1 Formerly the Office of Compliance Inspections and Examinations (OCIE). In its 2022 annual priorities, the Division stated that the removal of the word "compliance" from the Division's name is not intended to deemphasize the Division's long-standing focus on, and commitment to, promoting compliance.

2 The Division released its 2023 annual priorities eight months ago on February 7.

3 In general terms, the new private funds rule requires RIAs to (i) provide detailed quarterly statements from all private funds about fees and expenses, portfolio company reimbursement and net and gross performance data; (ii) obtain for each RIA-managed private fund an annual financial statement audit; and (iii) obtain either a fairness or valuation opinion in respect of adviser-led secondary transactions. The new rule prohibits both RIAs an ERAs from (i) engaging in certain restricted activities without LP consent or additional disclosures and (ii) to provide preferential treatment to certain investors in funds (though some preferential treatment may be provided with appropriate disclosure). Hogan Lovells summarized the new rules and their impact on advisers in a client alert available here.

4 Remaining proposed rules include those on (i) cybersecurity practices; (ii) a new framework for disclosures on environmental, social and governance (ESG) standards; (iii) additional changes to Form PF proposed jointly with the U.S. Commodity Futures Trading Commission (in addition to the changes the SEC adopted in May 2023 to revise Form PF); (iv) a new 'Outsourcing Rule' designed to provide diligence to investors regarding a firm's third-party service providers; (v) a broadening of the custody rule into a new 'Safeguarding Rule' (though, as noted above, the comment period has been reopened in light of adoption of the Audit Rule); and (vi) a rule introduced earlier this year designed to provide additional protections around the use of certain technologies, including artificial intelligence.

5 In a risk alert dated September 6, 2023, the Division noted that there are currently more than 15,000 RIAs managing in excess of $115 trillion in aggregate assets under management. The Division's staff continues to examine approximately 15% of all domestic and

As with the 2023 priorities, the Division continues to emphasize the "four pillars" of its mission: (i) promoting compliance; (ii) preventing fraud; (iii) monitoring risk; and (iv) informing policy. Given the shorter eight-month intervening period since the release of the 2023 priorities, many initiatives and focus areas from the 2023 priorities remain relevant.

Priorities for investment adviser review

Emphasizing that all investment advisers owe a duty of care and a duty of loyalty to their clients,[6] the Division lists four priority areas of focus for investment advisers generally:

- **Certain targeted strategies:** investment advice provided with regard to certain products, strategies and account types, particularly (i) complex projects, such as derivatives and leveraged exchange-traded funds (ETFs); (ii) high-cost and illiquid products, such as variable annuities and non-traded real estate investment trusts (REITs); and (iii) unconventional strategies, including those that purport to address rising interest rates.
- **Best interests of clients:** processes for determining that investment advice is provided in clients' best interest, including processes for (i) making initial and ongoing suitability determinations; (ii) seeking best execution; (iii) evaluating costs and risks; and (iv) identifying and addressing conflicts of interest. In particular, in reviewing how advisers address conflicts of interest, the Division will examine how firms (i) mitigate or eliminate such conflicts, when appropriate; and (ii) allocate investments to accounts where investors have more than one account. For RIAs that manage with multiple investment funds, this could include the allocation of opportunities to existing investors in respect of special-purpose vehicles or co-investment vehicles.
- **Economic incentives:** those incentives that an adviser may have to recommend products, services or account types (such as the source and structure of compensation, revenue or other benefits). For private fund advisers, this will generally involve incentives around the calculation of management fee and carried interest.
- **Disclosure to investors:** those disclosures made to investors and whether they include all material facts relating to conflicts of interest associated with the investment advice sufficient to allow a client to provide informed consent to the conflict. Private fund advisers should, in particular, provide to all potential investors sufficient disclosure containing all material facts (and not omitting any material facts) that are relevant to an investor's decision to subscribe for fund interests.

Examination focus for all investment advisers

As always, the Division's examinations will focus on an adviser's compliance programs and whether the policies and procedures reflect the actual business of the investment adviser, including the business's compensation structure, services, client bases and operations, as well as applicable current market risks. In particular, the examination focus on compliance policy and procedures may include one or more of the following ten areas:

- portfolio management processes;
- disclosures made to investors and regulators;
- proprietary trading by the adviser and the personal trading activities of supervised advisory personnel;

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international advisers in each fiscal year. The Division prioritizes examinations of advisers than have never been examined, including recently registered advisers and those that have not been examined for a number of years. While the SEC is fully empowered to inspect and examine ERAs, those examinations are less routine than for RIAs and tend to focus on a smaller subset of issues when they occur.

6 In July 2019, the SEC released an interpretation that clarified the fiduciary duty that investment advisers (registered or unregistered/exempt) have to their clients under Section 206 of the Advisers Act that includes both a duty of care and a duty of loyalty. In particular, the SEC views the duty of loyalty as requiring that an adviser not place its interests above those of its clients and that the adviser provide sufficient disclosure for clients and investors to make informed investment decisions.

- safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- the accurate creation of required records and their maintenance in a manner that secures the records from unauthorized alteration or use and protects them from untimely destruction;
- safeguards for the privacy protection of client records and information;
- trading practices;
- marketing advisory services;
- processes to value client holdings and assess fees based on those valuations; and
- business continuity plans.

Furthermore, the Division identifies five clusters of examination focus:

- **Marketing practices:** an assessment of whether advisers have (i) adopted and implemented written policies and procedures designed to prevent violations of the Advisers Act, including the new Marketing Rule that took full effect in November 2022;[7] (ii) appropriately disclosed their marketing-related information on Form ADV; and (iii) maintained substantiation of their processes and other required books and records. The assessment will examine whether advertisements include any untrue statements of material facts, are materially misleading or otherwise deceptive and, as applicable, comply with requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements. Since taking effect in November 2022, the Marketing Rule, and implementing its various provisions, has been a top compliance priority for RIAs.
- **Compensation:** an assessment of compensation arrangements focusing on (i) fiduciary obligations of advisers to their clients with respect to receipt of compensation or other material payments made by clients and others; (ii) alternative approaches to maximizing revenue; and (iii) fee breakpoint calculation processes.
- **Valuation:** an assessment of valuation practices regarding advisers' recommendations to clients to invest in illiquid or difficult-to-value assets, such as commercial real estate or private placements.
- **Safeguarding:** an assessment for advisers' controls to protect clients' material non-public information (MNPI), particularly when multiple advisers share office locations, have significant turnover or use expert networks.
- **Disclosure:** an assessment to review the accuracy and completeness of regulatory filings (including, as appliable, Form CRS) with a particular focus on inadequate or misleading disclosures and registration eligibility.

In addition, the Division highlights additional policies and procedures it may prioritize, such as: (i) selecting and using third-party and affiliated service providers; (ii) overseeing branch offices when advisers operate from numerous or geographically dispersed offices; and (iii) obtaining informed consent from clients when advisers implement material changes to their advisory agreements. In each case, the Division will assess whether an adviser's policies and procedures are reasonably and appropriately tailored and implemented for the particular advisory business and whether they prevent the advisers from placing their interests ahead of clients' interests.

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7 The SEC adopted Rule 206(4)-1, the new "marketing rule" in December 2020, which replaced the old Rule 206(4)-1 (the "advertising rule") and old Rule 206(4)-3 (the "cash solicitation rule"). The Marketing Rule sets forth seven principles emphasizing fair and balanced disclosure, including a new standard for RIAs to substantiate material statements of fact. The Marketing Rule creates, for the first time, a formal definition of "advertisement," that also, for the first time, permits advisers to incorporate endorsements and testimonials into their marketing materials (with appropriate disclosures). The Marketing Rule also harmonizes and updates SEC guidance on using performance information, including the requirement that gross performance in all cases must be accompanied by the presentation of net performance, as well as strict requirements for related, extracted, hypothetical and predecessor performance.

Priorities for advisers to private funds

The Division also lists seven priority topics relating specifically to advisers that manage private funds, some of which reflect new concerns compared to prior priorities:

- **Market conditions and interest rates:** portfolio management risks when there is exposure to recent market volatility and higher interest rates, including poor performance, significant withdrawals, valuation issues and leverage considerations.
- **LPAC governance:** adherence to contractual requirements regarding limited partnership advisory committees (LPACs) or similar structures, including adhering to any contractual notification and consent processes.
- **Fees and expenses:** accurate calculation and allocation of private fund fees and expenses (both fund-level and investment-level), including valuation of illiquid assets, calculation of post-commitment period management fees, adequacy of disclosures, and potential offsetting of such fees and expenses.
- **Portfolio diligence and management:** due diligence practices for consistency with policies, procedures and disclosures, particularly with respect to private equity and venture capital fund assessments of prospective portfolio companies.
- **Certain conflicts of interest:** conflicts, controls and disclosures regarding private funds managed side-by-side with registered investment companies and use of affiliated services providers.
- **Custody rule:** compliance with Advisers Act requirements regarding custody, including accurate Form ADV reporting, timely completion of private fund audits by a qualified auditor and the distribution of private fund audited financial statements.[8]
- **Form PF:** policies and procedures for reporting on Form PF, including upon the occurrence of certain reporting events.[9]

In the past two years, the Division had also identified (i) policies and practices regarding the use of alternative data and compliance with Section 204A of the Advisers Act, i.e. dealing with the use (and misuse) of MNPI; (ii) the potential preferential treatment by RIAs of certain investors to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; and (iii) the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales. While the Division does not list these particular issues as priorities for 2024, advisers should nevertheless consider these issues to continue to be compliance priorities that may arise during routine examination.

Risk areas impacting for all market participants

Finally, the Division identifies four risk areas of importance to the SEC that affect all market participants, including investment advisers:

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8 The SEC in February 2023 proposed an overhaul of the Custody Rule that would replace it with the Safeguarding Rule (proposed Rule 223-1). The SEC reopened the comment period for that proposal in light of the final adoption of the Audit Rule. The Safeguarding Rule would broaden the existing Custody Rule to include all assets held in an advisory account and not merely funds and securities (i.e. digital currencies, real estate or other commodities). As currently proposed, however, the Safeguarding Rule would not materially change the audit requirements currently established by the Custody Rule (other than to require non-US client financial statements to be reconciled with US GAAP).

9 The SEC adopted final amendments to Form PF, the confidential reporting form required for RIAs to private funds, in May 2023. The amendments, first proposed by the SEC in January 2022, mainly affect certain large hedge funds, and private equity funds, but they impose certain quarterly material event reporting requirements by all advisers to private equity funds that are required to file Form PF. The changes came a decade after the form was introduced, and they are designed to enhance the ability of the cross-governmental Financial Stability Oversight Council (FSOC) to monitor systemic risk as well as bolster the SEC's regulatory oversight of private fund advisers and investor protection.

- **Information security and operational resiliency.** Cybersecurity has been a top concern for the Division and the SEC for nearly a decade, and it continues to be a risk area for FY 2024 as well, as the Division continues to review practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets. The Division's focus will be on internal controls, oversight of third-party vendors, governance practices, responses to cyber-related incidents, and whether advisers adequately train staff regarding protection of client information.[10]
- **Crypto assets and emerging financial technology.** The Division continues to monitor the proliferation of crypto assets and emerging financial technology. While many private fund advisers do not make investments in these kinds of products, those that do should continue to maintain their standards of conduct when advising clients regarding crypto assets, as well as review, update and enhance compliance practices regarding risk disclosures, custody practices (including crypto assets wallet reviews), Bank Secrecy Act (BSA) requirements and cybersecurity protections, among others.
- **Regulatory systems compliance and integrity.** The Division points to the adoption by the SEC of the Regulation System Compliance and Integrity (SCI) in 2014 to strengthen the technology infrastructure of the U.S. securities markets. Regulation SCI, however, has relatively little bearing on the compliance practices of most investment advisers to private funds.
- **Anti-money laundering.** While the Advisers Act does not mandate specific anti-money laundering (AML) requirements for advisers, the Division notes that the BSA requires broker-dealers and certain registered investment companies to establish AML programs tailored to address associated risks. It is prudent for investment advisers, however, to develop an AML compliance program that meets basic AML and similar requirements under various statutes, including the U.S. PATRIOT Act of 2001. In addition, the Division will review whether advisers are monitoring Office of Foreign Assets Control (OFAC) sanctions and ensuring compliance with the sanctions.

Looking ahead

We are happy to discuss any aspects of the Division's 2024 examination priorities or other regulatory actions in respect of private funds under the Advisers Act or otherwise within the broader securities regulatory matrix to which private capital is subject. Hogan Lovells regularly represents RIAs who are subject to SEC examinations, as well as exempt reporting advisers who are also obligated to comply with certain aspects of the Advisers Act. We also have very active regulatory, cybersecurity, international sanctions and compliance, employment, public company, M&A and ESG practices, among others, that provide counsel to clients who deploy private capital across a broad range of regulated industries through a broad range of investment strategies.

10 The SEC proposed in February 2022 new rules that would require both RIAs and investment companies to adopt and implement written cybersecurity policies and procedures reasonably designed to address cybersecurity risks, which mandate certain measures to protect against incidents and protect investor information.

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