# CLIENT UPDATE

# THE SEC'S EXAMINATION PRIORITIES FOR 2014

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The SEC's Office of Compliance Inspections and Examinations ("OCIE") recently published the priorities of its National Exam Program ("NEP") for 2014 (the "2014 Priorities"). The 2014 Priorities focus on areas perceived by the SEC staff to "have heightened risk."[1] The OCIE report addresses both market-wide priorities and priorities that are specific to each of the NEP's four distinct program areas: (i) investment advisers and investment companies; (ii) broker-dealers; (iii) clearing and transfer agents; and (iv) market oversight. This Client Update focuses on the examination priorities that are most relevant to investment advisers to private equity and hedge funds.[2]

Certain of the 2014 Priorities are familiar. For example, over the last few years the SEC staff has repeatedly identified conflicts of interest and custody as examination priorities, and these will continue to be the priority areas of focus in 2014. Certain of the 2014 Priorities are driven by recent regulatory developments. For example, in 2014, OCIE will focus on issues arising from the 2013 adoption of

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[1] *See* "National Exam Program: Examination Priorities for 2014" (January 9, 2014), available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

[2] The report includes a number of priorities that focus on registered investment companies. These priorities are not addressed in this Client Update.

Rule 506(c) under the Securities Act of 1933, which permits issuers to use general solicitations in connection with certain Regulation D offerings.[3]

Private fund managers and other investment advisers, particularly those that have not yet been subject to an SEC examination, should consider the 2014 Priorities in planning their compliance program objectives in the coming year and conducting the review of their compliance programs as required by Rule 206(4)-7. Specifically, private fund sponsors should be proactive in identifying potential conflicts of interest, ensure that processes in place to identify potential conflicts are effective, and review their disclosures to investors to be certain that the disclosures reflect potential conflicts and how they are addressed.

## MARKET-WIDE PRIORITIES FOR 2014

The 2014 Priorities include certain issues that apply to nearly all registrants and span the entire market. The most significant market-wide priorities include the following:

- Fraud Detection and Prevention. The NEP will continue to utilize and enhance quantitative and qualitative tools and analyses to identify market participants engaged in fraudulent or unethical behavior. In this connection, OCIE notes that, in 2013, NEP's resources expanded to include its Quantitative Analytics Unit, a team of specialists with post-graduate degrees in fields such as computer science and mathematics that is able to evaluate risks in the algorithms, models and software of the most sophisticated investment firms, as well as the NEP's Risk Analysis Examination initiative, which examines clearing firms and large broker-dealers.
- Corporate Governance, Conflicts of Interest and Enterprise Risk Management. The NEP will continue to meet with senior management and internal auditors, along with registrants' affiliates where appropriate, among others, to discuss how firms identify and mitigate conflicts of interest and legal, compliance, financial and operational risks. This is designed to help NEP evaluate a firm's control environment and "tone at the top," understand its approach to conflict and risk management and initiate a dialogue on key risks and regulatory requirements.
- Technology Controls. The NEP will continue to examine governance and supervision of information technology systems, operational capability, market access, information security and preparedness to respond to sudden malfunctions and system outages.

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3 Our Client Update on Rule 506(c) is available at http://www.debevoise.com/files/Publication/0dbc9759-a652-4232-9241-96b9bee6a5e3/Presentation/PublicationAttachment/6ebae50f-d8ea-4259-bc99-ada1e99d26e4/SEC%20Adopts%20Jobs%20Act%20Rules%20Eliminating%20Ban%20on%20General%20Solicitations%20in%20Certain%20Priv.pdf.

- Dual Registrants. The NEP considers the convergence among broker-dealer and investment adviser representative activity a significant risk and will continue to examine the conflicts this business model presents. The NEP will also continue to examine the impact of the different supervisory structures and legal standards of conduct governing the provision of brokerage and investment advisory services.
- New Laws and Regulations. The staff will review general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c). The staff also will be conducting reviews to assess compliance with the recently adopted rules by municipal advisors, security-based swaps dealers and other registered entities, as well as customer margin and operational practices resulting from centralized clearing for various security-based swap products.

## NEW AND EMERGING ISSUES SPECIFIC TO INVESTMENT ADVISERS

The OCIE has identified several "new and emerging issues" and priorities specific to investment advisers, several of which are particularly relevant for private fund sponsors.

- Risk-Based Examinations. The first initiative relates to advisers that have not yet been subject to an examination. The staff will utilize a number of strategies to conduct focused, risk-based examinations of the adviser population that has been registered for more than three years but has not yet been examined by the NEP.
- Presence Exams to Continue. The staff will also continue the 2012 "presence examination" initiative[4] to examine a significant percentage of the advisers that registered as a result of the Dodd-Frank Act. The five key focus areas of these presence examinations will continue to be marketing, portfolio management, conflicts of interest, safety of client assets and valuation. The staff will also continue to prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors, or where there are indicia of fraud, broker-dealer status concerns or other serious wrongdoing.
- Quantitative Portfolio Management and Trading Strategies. The staff will also focus on investment advisers that rely on quantitative portfolio management and trading strategies. The staff will assess, among other things, whether these firms have adopted and implemented compliance policies and procedures tailored to the performance and maintenance of their proprietary models, including such procedures as: (i) evaluating if

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[4] *See* our article, *When the SEC Knocks on Your Door, Will you Be Prepared?: Practical Steps PE Firms Should Take to Prepare for an SEC "Presence" Examination*, available at: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=b8a5ccc3-0b74-49cd-a104-846b0e7e2c24

any models are used to manipulate the markets; (ii) reviewing or testing the models and their output over time; (iii) maintaining proper documentation within required books and records; and (iv) maintaining a current inventory of firm-wide proprietary models.

- Interest Rate Risks. More generally, the SEC staff will monitor the risks associated with a changing interest rate environment and the impact this may have on bond funds and related disclosures of risks to investors. While the focus of this initiative is likely to be on registered investment companies, it may also have relevance to private fund sponsors (particularly for those private fund sponsors managing business development companies or registered funds that have fixed income strategies).

## OTHER 2014 PRIORITIES SPECIFIC TO INVESTMENT ADVISERS

As noted above, certain of the 2014 Priorities for investment advisers are perennial "core issues" and are not particularly novel. The core issues include the following:

- Safety of Assets and Custody. The SEC staff will continue to test compliance with Rule 206(4)-2 under the Advisers Act (the "Custody Rule"), paying particular attention to those instances where advisers fail to realize they have custody and therefore fail to comply with requirements of the Custody Rule.
- Conflicts of Interest. The SEC staff will conduct examinations focused on conflicts of interest inherent in a registered investment adviser's business model, including: (i) compensation arrangements for the adviser, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients; (ii) allocation of investment opportunities; (iii) controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts; and (iv) risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies.
- Marketing/Performance. The SEC staff will review the accuracy and completeness of advisers' claims about their investment objectives and performance, including by reviewing and testing: (i) hypothetical and back-tested performance; (ii) the use and disclosure of composite performance figures; (iii) performance record keeping; and (iv) compliance oversight of marketing.

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The NEP will undoubtedly focus on additional issues that emerge over the course of the year. In particular, we suspect that valuation issues will continue to be one of the top areas of enforcement and examination focus. Preparing in advance while keeping SEC concerns in mind should make the exam process proceed more smoothly and reduce the chance of a referral to the Division of Enforcement.

Please do not hesitate to contact us with any questions.

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