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CLIENT UPDATE

SEC 2013 EXAMINATION PRIORITIES FOCUS ON PRIVATE FUND SPONSORS

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The SEC's Office of Compliance Inspections and Examinations ("OCIE") published a report on February 21 outlining its examination priorities for 2013 and the areas perceived by the SEC staff to have "heightened risk." [1] The report addresses both market-wide priorities and priorities that are specific to each of the National Exam Program's ("NEP") four distinct program areas: investment advisers and investment companies, broker-dealers, clearing and transfer agents, and market oversight. This Alert focuses on the examination priorities identified in the OCIE report as most relevant to investment advisers to private equity and hedge funds.

Certain of the examination priorities are familiar. For example, over the last few years the SEC has repeatedly identified conflicts of interest as a focus of its risk-based approach,[2] and conflicts of interest continue to be a top examination priority in 2013. The February 21 OCIE report is of particular interest, however, because in the report the SEC staff has now formally identified emerging and policy issues to which careful attention should be paid by registered advisers to hedge funds and private equity funds – especially newly

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1 *See* "National Exam Program: Examination Priorities for 2013" (February 21, 2013), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf

2 *See* "Conflicts of Interest and Risk Governance," by Carlo di Florio before the National Society of Compliance Examiners (October 22, 2012), *available at* http://www.sec.gov/news/speech/2012/spch103112cvd.htm

registered advisers who, as a result of the presence exam strategy announced by the staff in the Fall of 2012, are likely to be facing an SEC exam within the next two years. Some highlights of the recently announced examination priorities that have particular relevance for private fund sponsors are addressed below.

MARKET-WIDE PRIORITIES IN 2013

The NEP's examination priorities include certain issues that apply to nearly all registrants and span the entire market. The NEP's most significant market-wide priorities include the following:

- Fraud Detection and Prevention. The NEP will continue its risk-based approach to targeting registrants and business practices by utilizing and enhancing quantitative and qualitative tools and analyses to identify market participants engaged in fraudulent or unethical behavior. As discussed below, the staff appears to be continuing to focus on what they believe to be aberrational performance.
- Corporate Governance and Enterprise Risk Management. The NEP will continue to meet with senior management and internal auditors, among others, to: (i) understand firms' approach to enterprise risk management; (ii) evaluate firms' tone at the top; and (iii) initiate a dialogue on key risks and regulatory requirements.
- Conflicts of Interest. The NEP will focus on specific conflicts of interest, steps registrants have taken to mitigate conflicts, and the sufficiency of disclosures made to investors. The staff will also look to the overall risk governance framework that firms have in place to manage conflicts on an ongoing basis.
- Technology Controls. The NEP may conduct examinations on governance and supervision of information technology systems for topics such as operational capability, market access, and information security, including risks of system outages and data integrity compromises that may adversely affect investor confidence.

EXAMINATION PRIORITIES SPECIFIC TO INVESTMENT ADVISERS IN 2013

The February 21 OCIE report identified certain risks that SEC staff believe are common to all or many of the business models utilized by investment advisers to private equity funds and hedge funds. The risks identified by the staff that they believe are of particular relevance to private fund advisers, and on which the NEP will focus in conducting examinations, include the following:

- Conflicts of Interest Related to Compensation Arrangements. The NEP will review financial and other records to identify undisclosed compensation arrangements (including undisclosed fee or solicitation arrangements, referral arrangements – particularly to affiliated entities – and receipt of payment for services allegedly provided to third parties) and the conflicts that they present.

- Conflicts of Interest Related to Allocation of Investment Opportunities. As part of a portfolio management review, staff will confirm that a registrant that manages funds that do not pay performance fees side by side with funds that do pay performance-based fees has controls in place to monitor the side-by-side management of the funds, particularly where the same portfolio manager is responsible for making investment decisions for both kinds of funds.

- Marketing/Performance. The NEP has stated that it will focus on the accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions and methodologies utilized, and related disclosures and compliance with record keeping requirements. In the OCIE report the staff noted, without further elaboration, that they will also review changes in advertising practices related to the mandate of the JOBS Act that the SEC rescind the "no general solicitation" condition for private offerings. Advisers should be particularly aware that the exam staff considers aberrational performance a potential indicator of fraudulent or weak valuation procedures or practices.

- Safety of Assets. The NEP will review the measures taken by registrants to protect client assets from loss or theft and the effectiveness of policies and procedures in this area. The staff will focus on whether advisers are complying with the provisions of the Custody Rule. In this connection, the staff will focus on whether advisers are: (i) appropriately recognizing situations in which they have custody as defined in the Custody Rule; (ii) complying with the Custody Rule's "surprise exam" requirement; (iii) satisfying the Custody Rule's "qualified custodian" provision; and (iv) following the terms of the "audited financial statement" exception to the independent verification requirements for pooled investment vehicles. Notably, in the OCIE report the staff noted, without elaboration, that they will review the adequacy of audits of private funds.[3]

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[3] Perhaps to emphasize the importance of this priority, on March 4, the SEC issued a Risk Alert on custody issues, noting several frequently cited deficiencies in this area. Of particular relevance to private fund managers, the SEC highlighted issues related to the audit approach used by many fund sponsors, which excuses the private fund sponsor from certain provisions of the rule if fund financial statements are distributed to investors within 120 days after the end of the fund's fiscal year (180 days in the case of a fund of funds). The SEC inspection staff has observed failures by certain private fund sponsors to comply with the conditions of this approach, including using an accounting firm that was not independent or registered with the PCAOB and subject to PCAOB inspection, publishing financial statements that were

- Pay to Play. The staff will review and assess the practical application of Rule 206(4)-5 under the Investment Advisers Act of 1940, the "pay-to-play" rule, which is designed to prevent advisers from obtaining business from state and local government entities in return for political contributions. This is not a new priority; in August 2012 OCIE issued a National Exam Risk Alert addressing concerns about compliance with pay-to-play rules applicable to municipal securities dealers. Although the 2012 Risk Alert reflected observations from broker-dealer examinations and explicitly stated that it did not address the obligations of investment advisers under the Advisers Act, the Alert does contain a number of interesting observations concerning compliance programs designed to address pay-to-play practices.

IMPLICATIONS FOR EXAMINATIONS OF PRIVATE FUND SPONSORS

Newly registered investment advisers, the majority of which manage private funds, are a key area of focus for OCIE this year. The NEP stated it intends to prioritize presence examinations of new registrants where the staff's analytics indicate higher risks to investors relative to the rest of the registrant population or where there are indicia of fraud or other serious wrongdoing. The February 21 OCIE report contains a reminder that OCIE is launching a coordinated national examination initiative designed to establish a meaningful presence with newly registered private fund sponsors.[4] The initiative is expected to run for approximately two years and will involve examining a substantial percentage of new registrants and reporting to the industry on its observations. Obviously, the exam staff's observations will be of great interest and may raised questions about a number of industry practices. In view of OCIE's national presence exam initiative, registered advisers to private equity and hedge funds should prepare for a possible examination taking into account the guidance set forth in the February 21 OCIE report.

Specifically, advisers to private funds should consider the applicability of the NEP's priorities to their businesses as they conduct their annual reviews of their compliance programs required by Rule 206(4)-7 and as they prepare for SEC examinations. Firms should test the effectiveness of policies and procedures for priority areas. Private fund sponsors should be proactive about identifying conflicts of interest, and should ensure that processes in place to identify potential conflicts are effective and that such processes will

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not prepared in accordance with GAAP, failing to distribute financial statements to all limited partners or on a timely basis, and failing to perform a final audit on liquidated private funds. *See* "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" (March 4, 2013), *available at* http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf

4 *See* "SEC Letter to Newly Registered Investment Advisers re: Presence Exams" (October 9, 2012), *available at* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf

continue to be effective in identifying conflicts of interest that may develop in the future. Moreover, firms should carefully review disclosures made to investors in marketing materials for consistency and transparency.

However, private fund advisers are reminded that the list of SEC priorities set forth in the February 21 report is not exhaustive and that the NEP will conduct examinations on issues that are not specifically addressed. In particular, prior SEC statements have indicated that the valuation of illiquid assets held by private equity and hedge funds is one of the SEC's 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.

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Please do not hesitate to contact us with any questions.

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