



2022 First Quarter Newsletter

Rule Proposals, Exam Priorities, Risk Alerts, & More for Investment Advisers

The first quarter of 2022 was the most active quarter for private fund advisers on risk and regulatory front in recent memory. Numerous rule proposals were announced that could have significant implications for private fund advisers. Widespread Russian sanctions by the U.S. and Europe are causing various challenges for private fund advisers. In addition, the SEC staff reminded private fund managers of perennial examination risk and focus areas in its annual priorities letter and in a second private fund adviser risk alert.

This Quarter's Headlines

On March 30th, the Division of Examinations released their [2022 exam priorities](#). The staff continues to focus on many perennial areas of the compliance program, including conflicts of interest, fees and expenses, operational resiliency, and ESG, along with a new focus on emerging technology and crypto assets.

Division of Examinations issued a second private fund [Risk Alert](#). On January 27, 2022, the staff summarized additional compliance issues observed by EXAMS staff (since their June 2020 Risk Alert) including failure to act consistently with disclosures; use of misleading disclosures regarding performance and marketing; due diligence failures relating to investments or service providers; and use of potentially misleading "hedge clauses."

Russian Sanctions – U.S. and Europe imposed sanctions in response to Russia's invasion of Ukraine is causing challenges for fund managers with sanctioned limited partners and deal counterparties.¹ The sanctions have renewed interest from lawmakers to extend AML rulemaking to investment advisers.²

In The Pipeline

New Proposed Rules for Advisers to Private Funds: These [rules and amendments](#) propose requiring private fund advisers to provide investors with quarterly statements with enhanced disclosures on fees, expenses, and performance. Also of note, the proposals would prohibit certain sales practices, conflicts of interest, and compensation types deemed "contrary to the public interest and protection of investors." Finally, while largely impacting registered advisers to private funds, the new rule proposal would impact all investment advisers in some capacity if adopted in its current form. See our breakout analysis in the subsequent pages.

Cybersecurity Proposal: Under this [proposed rule](#), registered advisers would need to adopt policies reasonably designed to address cybersecurity risks, conduct annual reviews of the policies, and report significant cybersecurity incidents and risks to the SEC in new Form ADV-C and Form ADV Part 2A.

Form PF Proposed Amendments: This [proposed amendment](#) would require large hedge funds and private equity funds to report events that could suggest significant stress for the fund and that could ultimately hurt investors. This proposal would also decrease the reporting threshold for large private equity advisers from \$2 billion to \$1.5 billion.

Proposed rule on climate-related disclosures: This [proposed rule](#) would require public issuers to disclose information about climate-related risks that could adversely impact their business. It would also require disclosure of greenhouse gas emissions, which quantifies exposure to climate risks.

¹ <https://www.wsj.com/articles/sanctioned-lps-complicate-private-equity-fund-dynamics-11649152801?tpl=pe>

² <https://www.nytimes.com/2022/03/30/business/oligarchs-hedge-funds-russia.html>



SPACs – This [proposed rule](#) would require additional disclosure and other investor protections in Initial Public Offerings by SPACs.

Short sale disclosure rule proposal: Private funds that have short positions would be required to report that data to the SEC monthly as part of the [proposed rule](#). The Commission would then also aggregate the data and release that information to the public for each individual security giving more clarity on short sale related data.

Did You Know?

In FY21, approximately 900 investment advisers registered with the SEC, bringing the total to almost 15,000, the highest growth on record for any single year.

Of the 3,040 examinations conducted by the SEC in FY21 (2,200 of which were examinations of RIAs), 2,100 resulted deficiency letters, and 190 were referred to enforcement.

Over the last 5 years, assets under management managed by advisers to private funds have increased by 70%.

2022 Exam Priorities

Released: March 30, 2022

On March 30, 2022, the SEC's Divisions of Examinations ("EXAMS, or the "Division"), released their 2022 examination priorities. Fees and expenses and conflicts of interest remain at the top of the list for private fund advisers, along with climate risks, ESG and a new focus on emerging technology and crypto assets.

Registered Investment Advisers ("RIA") to Private Funds – The Division will continue to focus on advisers to private funds and will assess compliance risks, including:

- Calculating and allocating fees and expenses correctly, including post-commitment management fees and the impact of valuation;
- Compliance with the Custody Rule, including the "audit exception" and updating the audit and auditors that serve as gatekeepers on Form ADV;
- Cross trades, principal investments, or distressed sales and whether advisers are providing adequate disclosures and complying with regulatory requirements;
- Scenarios that create conflicts around liquidity such as adviser-led fund restructurings, including stapled secondary transactions.

Environmental, Social and Governance ("ESG") – RIAs are continuing to assess and offer investments that have a strategy focus on sustainability due to the high investor demand. The risks involved with ESG investing involves misleading investors through materially false information or misleading statements.

- Implementing policies and procedures that disclose ESG investing approaches including a review of their portfolio management processes and practices;
- Do advisers' practices match up with their disclosures, including advertisements and proxy voting procedures and votes to assess whether they align with the strategies;
- Overstating or misrepresenting ESG factors in their performance advertising and marketing (e.g., greenwashing).

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Information Security and Operational Resiliency – Failure to prevent unauthorized breaches of sensitive client information can not only have a huge impact at the firm level but also could extend beyond the firm.

- Safeguard customer accounts and prevent account intrusions, including verifying an investor’s identity to prevent unauthorized account access;
- Oversee vendors and service providers;
- Address malicious email activities, such as phishing or account intrusions;
- Respond to incidents, including those related to ransomware attacks; and
- Identify and detect red flags related to identity theft; and
- Manage operational risk as a result of dispersed employees in a work-from-home environment.

Emerging Technologies and Crypto-Assets – Due to the increase in in the number of RIA’s advising on crypto assets the Division will be examining whether those firms have considered the unique risks they present.

- Operations and controls are in place that are consistent with disclosures;
- Advice and recommendations are consistent with the investors’ investment strategy;
- Controls are in place that account for the unique risks associated with emerging technology and crypto-assets (e.g., custody).

Private Fund Rule Proposals

Released: February 9, 2022

The private fund adviser proposal highlighted that there are over five thousand registered private fund advisers with over \$18 trillion in private funds assets under management, and accordingly “private funds and their advisers play an increasingly important role for the lives of every day Americans saving for retirement or college tuition.”

On February 9, 2022, the SEC proposed [new rules and amendments](#) under the Investment Advisers Act of 1940 that would apply to registered and exempt advisers to private funds. The proposals aim to increase transparency, competition, and efficiency between private fund advisers and private fund investors.

Quarterly Statements

This proposed rule would require a registered investment adviser to distribute quarterly statements of fees, expenses, and performance to the private fund’s investors. They would need to be distributed to investors within 45 days after each calendar quarter end. The SEC believes that this rule would allow investors to better assess and compare their private fund investments.

Prohibited Activities

This proposed rule would apply to both registered and exempt reporting private fund advisers, and would prohibit the following:

- Charging for unperformed services (e.g., accelerated monitoring fees);
- Charging certain fees and expenses associated with an examination or investigation of the adviser, compliance expenses;
- Charging expenses related to a portfolio investment on a non-pro rata basis when multiple clients and private funds invested in the same investment.
- Reducing the amount of clawback available by the amount of certain taxes paid;
- Seeking reimbursement, or limiting the private funds liability for a breach of fiduciary duty (e.g., use of hedge clauses);

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- Borrowing money, securities, or other fund assets from a private fund client.

Financial Audits

The proposed audit rule would require all registered advisers to obtain an annual audit, very similar to the current custody rule requirements. Of note, if adopted in its current proposed form, this would remove registered private fund advisers from choosing between the annual surprise examination or the annual financial audit approach to satisfy the custody rule requirements.

Preferential Treatment

Under the proposal, private fund advisers (registered or exempt) would be prohibited from providing preferential liquidity and preferential access to information about fund holdings if such terms could have a material negative impact on other investors or similar pool of assets. In addition, the proposal would require additional disclosures to investors for other types of preferential treatment granted in side letters.

Adviser-led Secondary Transactions

The SEC's proposed adviser-led secondaries rule would require advisers to keep a copy of the fairness opinion and material business relationship summary distributed to investors, a record of each addressee, the dates the opinion was sent, addresses, and the delivery methods.

Documenting the Annual Compliance Review

Finally, the SEC proposed amendments to the compliance rule that would require registered advisers, including registered advisers that do not advise private funds, to document in writing the annual compliance review.

Q1 Key Enforcement Actions

Since: January 1, 2022

Investment Adviser Fined for Breaking the Custody Rule

On March 30, 2022, the SEC settled charges against an investment adviser for \$75,000 for violating the Custody Rule. The Custody Rule requires that RIA's that have custody of client assets need to either have an annual surprise examination to verify assets or disperse to investors annual GAAP audited financial statement within 120 days of year end or 180 days for a fund of funds. The SEC alleged the adviser failed to timely deliver audited financials to investors and didn't have required audits performed. The SEC also found that they didn't have written policies and procedures in place for the allocation of expenses to and between funds, or written policies and procedures reasonably designed for the Custody Rule.

Exempt Reporting Adviser Caught Misleading Investors

On March 4, 2022, an exempt reporting adviser was given a cease-and-desist order and fined \$700,000 for materially misleading clients and conducting improper transactions. They included the misleading statements in marketing documents, emails to prospective investors, and on their website. Specifically, they stated that their management fee was "industry standard '2 and 20.'" This however was not the case. Instead of charging a two percent management fee and a twenty percent performance fee, the adviser charged investors management fees that totaled twenty percent. The adviser also made inter-fund loans and cash transfers between the funds and made loans to some funds. Commingling of investor assets were not stated in the operating agreements and violated the adviser's fiduciary duty. These specific transactions were also not disclosed to investors causing a conflict of interest for the adviser.



Q2 Upcoming Key Reporting and Disclosure Deadlines

April 30	Distribute Updated Form ADV Part 2A, and if applicable, Form CRS to Clients and Fund Investors Deadline for Distribution of Audited Financial Statements to Fund Investors
April 30	Employees' Transaction Reports Due for Q1
April 30	Annual Form PF Due
May 16	Form 13F Due
May 30	Hedge Fund Quarterly PF Due
June 29	Deadline for Distribution of Audited Financial Statements to Fund of Fund Investors