

CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT

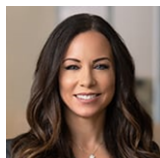
A SPECIAL REPORT FOR
PRIVATE FUNDS

2022-2023

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CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR PRIVATE FUNDS 2022–2023

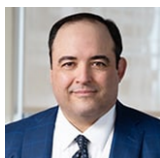
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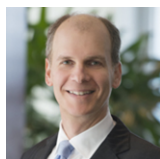
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CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR PRIVATE FUNDS 2022–2023

Private funds were a major focus of the US Securities and Exchange Commission's (SEC's or Commission's) enforcement and rulemaking programs in 2022, and we expect 2023 to be even more active. The Division of Examinations' 2023 Exam Priorities, released on February 7, 2023, highlight the inspection, examination, and regulation of registered investment advisers as a "Notable New and Significant Focus Area," promising increased attention from the Division of Examinations and the SEC's Regional Offices in 2023.¹

One legacy of 2022 will be the market turbulence that affected both traditional and new investment products, which can be expected to heighten the SEC's resolve to regulate private funds more heavily in 2023. Indeed, even before the collapse of crypto trading platform FTX Trading Ltd. (FTX) and its affiliated hedge fund in December 2022, the SEC was moving to require enhanced disclosure for private funds that invest in new and innovative investment products. The FTX matter will only increase pressure on the SEC to move forward on those efforts.

When this ambitious regulatory agenda is combined with an already heavy enforcement and examination focus on private funds, 2023 is likely to see private fund managers continue to attract a disproportionate amount of the SEC's attention. Outlined below are some key items that private fund managers should expect to face in 2023.

For readers concerned with how the SEC's examination and enforcement outlook will affect other investment advisers or broker-dealers, please see our [companion piece directed to investment advisers and broker-dealers](#).

GENERAL SEC ENFORCEMENT OUTLOOK

Penalties, Sweeps, New Hires, and Newton's Third Law

Two years ago, we devoted substantial space to reviewing SEC Chairman Gary Gensler's time at the Commodity Futures Trading Commission (CFTC) and forecasting a significant rise in SEC enforcement activity.² Last year we focused on Director Grewal's discussion of "speeding tickets" as an indication of an SEC willing to pursue and penalize routine violations.³ The statistics recently released by the SEC's Division of Enforcement reflect aggressive enforcement and outsized civil penalties untethered, in many instances, to past precedent.⁴

It would be simple to just say, "expect more of the same" because we do expect those trends to continue. However, even the least scientifically inclined among us might recall from high school physics Newton's Third Law: for every action (force) in nature there is an equal and opposite reaction. Over the last decade we have witnessed aggressive SEC enforcement approaches result in a number of unintended consequences that significantly affected the regulatory space.

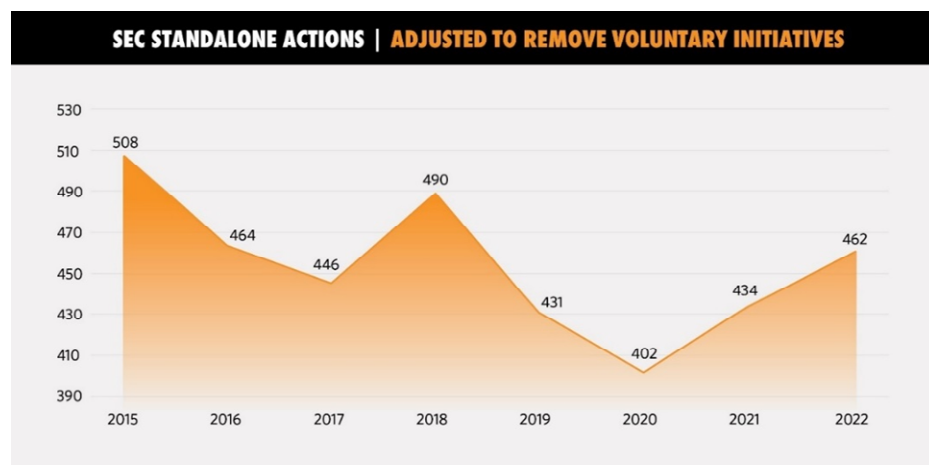
As defendants eschewed settlement and litigated in federal court, the SEC lost the right to assert principles of equitable tolling,⁵ disgorgement was deemed a penalty and time limited,⁶ and disgorgement was limited to personal gain.⁷ The SEC also suffered a successful challenge to the procedure for administrative law judge (ALJ) appointments,⁸ and insider trading cases became significantly more difficult for the SEC and Department of Justice to pursue.⁹ Indeed, the SEC appears to have forsworn its administrative forum altogether for any litigated matters.

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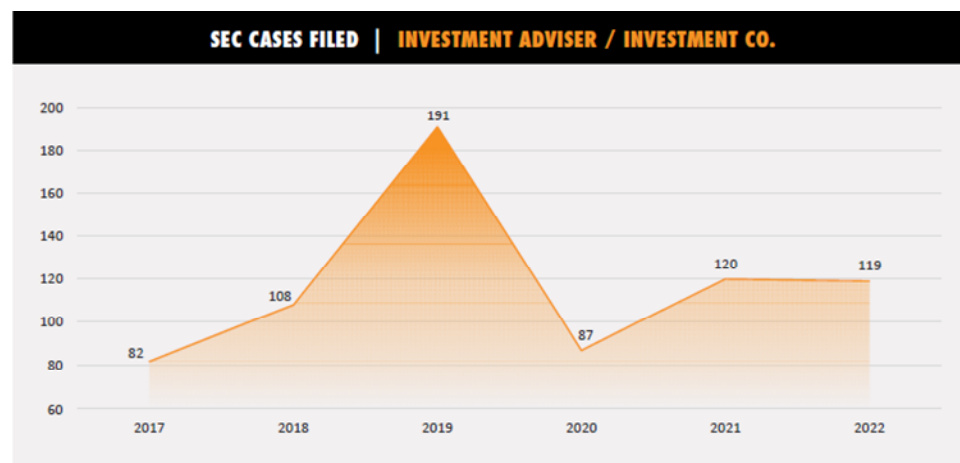
The equal and opposite reaction to oversized penalties and “speeding tickets” will again be litigation. We are not alone in this view: the SEC supported its request to Congress for increased enforcement headcount by noting that “it is expected that the number of litigated cases will continue to rise as [the Division of Enforcement] increasingly holds wrongdoers accountable for their misconduct with more meaningful and, in some instances, escalating sanctions. [The Division of Enforcement] requires additional resources to ensure that it has an adequate number of attorneys to staff the increasing number of litigated cases.”¹⁰

With increased litigation, we expect to learn whether “speeding ticket” cases have sufficient jury appeal. Further, because the determination of a civil penalty is governed by statutory “tiers” and decided by the judge, not the jury, in federal court,¹¹ the SEC’s justification for outsized civil penalties will be subject to significant scrutiny in litigation. All of these factors could, once again, significantly alter the enforcement landscape.

Consistent Enforcement Focus on Investment Advisers¹²



Although the overall results for enforcement reflect a significant increase in the number of SEC standalone actions, cases filed against investment advisers and investment companies did not proportionally increase. Instead, the increase was the result of more insider trading, broker-dealer, and issuer reporting and accounting cases. That said, enforcement actions are a trailing indicator of enforcement attention, as most investigations take a number of years to complete.



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Civil Penalties and Disgorgement

The SEC's position on civil penalties was recently articulated by Director Grewal:

With respect to penalties and remedies, simply put, they must be adequate to both punish and deter wrongdoing. If market participants think that getting fined by the SEC is just another expense to be priced into the cost of doing business, then penalties are neither effective punishment, nor deterrence. Market participants must realize that complying with securities laws is cheaper than violating those laws.¹³

Through its September 2022 fiscal year end, the SEC issued orders imposing nearly \$4.2 billion in civil penalties, which is the highest in any year by a significant margin.

Total Money Ordered (in millions)						
	FY 2022	FY 2021	FY 2020	FY 2019	FY 2018	FY 2017
Penalties	\$4,194	\$1,456	\$1,091	\$1,101	\$1,439	\$832
Disgorgement	\$2,245	\$2,395	\$3,588	\$3,248	\$2,506	\$2,957
	\$6,439	\$3,852	\$4,680	\$4,349	\$3,945	\$3,789

Disgorgement totals for 2020 and 2021 have been adjusted to exclude amounts ordered but waived. The currently-reported 2020 figure of \$3,588 (in millions) was previously reported as \$3,589 (in millions). The currently reported 2021 figure of \$2,395 (in millions) was previously reported as \$2,396 (in millions). No other years were adjusted.

Notably, disgorgement did not similarly increase, dipping to its lowest level in the last six years. Speaking about disgorgement, Director Grewal focused on the importance of civil penalties and cited headwinds due to recent adverse court decisions affecting the ability to secure disgorgement as reasons for the decline.¹⁴ But there may be a more compelling reason though: There is no demonstrable benefit to the registrant from the violations pursued.

Admissions

The off-channel communications cases that resulted in more than \$1.2 billion in civil penalty settlements included admissions, as predicted by Chair Gensler and Director Grewal at the beginning of their tenure.¹⁵ Director Grewal has cautioned that we should expect more admissions cases in the future: "Admissions are an incredibly powerful accountability measure and you should expect us to continue seeking admissions in similar cases. And as I've said before, when we put them on the table it's not to gain an advantage in negotiations. We'll litigate those matters."¹⁶

Direct From Enforcement Sweep Investigations

Over the last several years, we witnessed the advent of sweep investigations of registrant practices originating directly from the Division of Enforcement. Issue-focused sweeps were once a tool almost exclusively used by the Division of Examinations to police registrants, with the potential of resolving issues before an enforcement referral. Now these issues are being escalated by enforcement through investigations.

Director Grewal offered two reasons for the use of sweep investigations. First, recurring issues: "Another way that we work to address the declining trust in the financial markets is by conducting proactive enforcement sweeps and initiatives that specifically target recurring issues."¹⁷ Second, deterrence: "Filing

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multiple, coordinated actions simultaneously not only demonstrates accountability, but also has a more pronounced deterrent effect than if the Commission filed separate standalone cases at different times.”¹⁸

There is one more reason for this approach, and why we expect to see more sweeps in the future: efficiency. Because of repetition, a sweep investigation does not demand the same investment of enforcement resources as a series of standalone and unique investigations. One Enforcement staff attorney can handle a number of investigations in a single sweep.

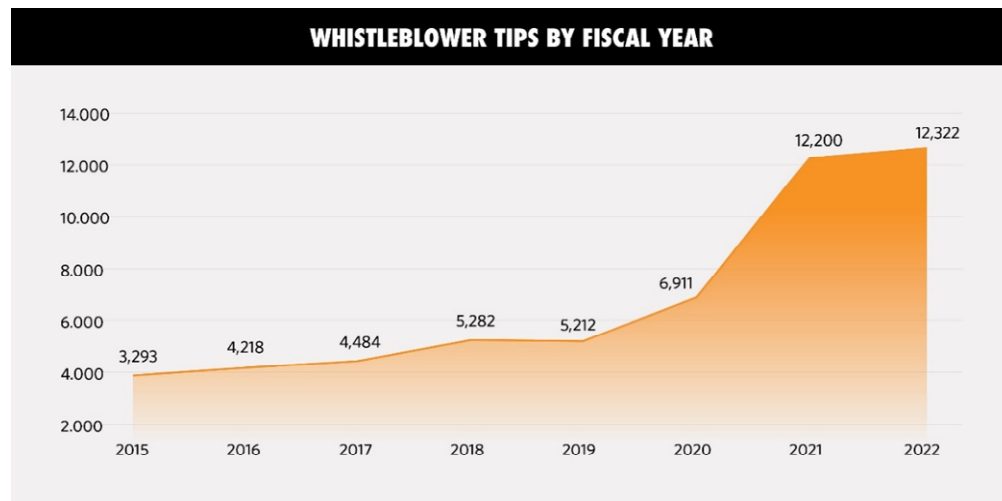
Increase in Enforcement Staff

The Fiscal Year 2023 Omnibus Appropriations Bill passed by Congress in December 2022¹⁹ gave the SEC all it was looking for in its 2023 budget, including an increased enforcement headcount,²⁰ which is expected to climb from 1,366 to 1,499. The rationale for this nearly 10% increase is to “strengthen [the Division of Enforcement’s] capabilities to investigate new and emerging issues, including crypto-asset markets, cyber-related risks, and the environmental, social, and governance space.”²¹ More investigative staff will mean more investigations.

Whistleblowers²²

Fiscal year 2022 saw the overall number of tips received through the SEC’s whistleblower program plateau at slightly more than 12,000 tips. The Commission awarded approximately \$229 million to 103 whistleblowers during the fiscal year. These figures are down from the previous year’s records, but still represent the second largest dollar amount and number of individuals awarded in a single fiscal year.²³

Although these numbers are still high, we are seeing a change in the distribution by subject matter. Tips regarding trading and pricing declined by approximately 50%, whereas tips concerning manipulation, offering fraud, and initial coin offerings (ICOs)/cryptocurrencies increased. Not surprisingly, ICO/cryptocurrency tips more than doubled from 762 to 1,718.



Nonetheless, given that whistleblower awards are paid to eligible individuals who voluntarily provide original information that leads to successful enforcement actions that result in monetary sanctions of more than \$1 million, the effect of hundreds of eligible whistleblowers has been, and will continue to be, substantial.



2022 RECAP

Private Fund Enforcement and Regulatory Developments

Shortly after he became SEC chair in April 2021, Gary Gensler made regulatory enhancements and enforcement actions involving private funds a priority for the SEC. In 2022, the SEC followed through on that commitment.

As Chair Gensler highlighted in congressional testimony in September 2022, the SEC has proposed a number of rules to enhance transparency for private fund investors, including a focus on advisers' fees, performance metrics, and side letter arrangements.²⁴ On the enforcement side, actions involving investment advisers and investment companies constituted the greatest percentage of cases the SEC initiated in its fiscal year ended September 30, 2022,²⁵ with actions involving private funds and their advisers constituting a significant portion of those cases.

2022 Regulatory Initiatives

In 2022, the SEC released at least four proposals that directly impact private funds and their advisers. According to Chair Gensler, these rules are intended to "drive greater efficiencies in the private funds market"²⁶ and include

- amendments to Form PF to require current reporting and amend reporting requirements for large private equity advisers and large liquidity fund advisers, and to enhance how large hedge funds report information regarding, among other things, investment exposures (including to cryptocurrencies), borrowing, currency exposure, and risk metrics;
- new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to require private fund advisers to provide investors with quarterly statements detailing certain information regarding fund fees, expenses, and performance, to prohibit providing certain types of preferential treatment to investors (e.g., side letter arrangements) and engaging in certain other activities, and to require disclosure of other preferential terms;
- new rules to require registered investment advisers to adopt and implement cybersecurity risk management policies and procedures; and

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- updates to the financial thresholds in the accredited investor definition, and other amendments to the rules relating to exempt offerings.

Although the SEC has extended the comment period for certain of these rules, indicating they are navigating more industry pushback than they may have anticipated, if the SEC adopts the rules it will represent a seismic shift in how the Commission regulates the private funds industry and in the amount of information managers will have to provide to the SEC and investors, potentially leading to still more regulatory inquiries.

2022 Enforcement Actions Involving Private Funds

As we foreshadowed last year, 2022 saw a shift away from the SEC's focus on actions impacting "Main Street" investors during Jay Clayton's chairmanship to increasing scrutiny of private fund managers and other big-ticket cases. The cases filed by the SEC against private fund managers in 2022 included allegations regarding the misallocation of expenses, erroneous fee calculations, mispricing of complex products to inflate valuations, and concealment of risks in a complex options trading strategy. And following through on its early 2022 promises to bring actions involving relatively minor violations of the federal securities laws and to hold individuals accountable, the SEC charged a number of hedge fund professionals and brought cases involving the Custody Rule and routine regulatory filings. Finally, the SEC concluded 2022 with a rapid response to the collapse of crypto trading platform FTX.

Management Fee Offsets and Excess Management Fees

In September 2022, the SEC charged a private equity fund adviser with failing to properly offset management fees and failing to adequately disclose to investors and potential investors information concerning management fee offsets.²⁷ In that matter, although the fund's offering documents permitted the adviser to borrow money from the fund to pay placement fees, the documents required prompt repayment of the loan through an offset of the quarterly management fees the adviser charged and collected. The adviser borrowed more than \$1 million to pay placement fees, but failed to offset management fees for 11 quarters and did not disclose that fact to investors.

Also in September, the SEC charged a venture capital adviser with overcharging management fees by making a number of errors in its favor, including failing to make adjustments to fee calculations based on write-downs of individual portfolio company securities and incorrectly including accrued but unpaid interest as part of the basis of the calculation of management fees for certain investments.²⁸ This action represents one of the few SEC cases against exempt-reporting venture capital advisers.

Misallocated Expenses

The SEC continued its campaign against misallocated expenses in 2022 by bringing charges against a private equity fund adviser for allocating undisclosed, disproportionate expenses to a fund it advised.²⁹ The expenses related to a credit facility used in a take-private transaction, which, the SEC alleged, should have been allocated proportionally between certain co-investors and one of the adviser's private equity funds. Instead, the adviser allegedly allocated a disproportionate percentage of the expenses to the fund and none to the co-investors, without disclosure to the fund's investors and in violation of the fund's organizational documents.

Complex Products and Valuations

The SEC brought two actions in 2022 involving private fund investments in complex products that were impacted by the financial turbulence at the outset of the COVID-19 pandemic. First, in February 2022, the SEC alleged that the principal of a hedge fund adviser fraudulently inflated the value of complex derivatives through a scheme that involved manipulating the code within a pricing service used to value

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those positions.³⁰ In doing so, the principal was alleged to have concealed massive losses that those positions sustained beginning in March 2020 as a result of COVID-related market volatility. The SEC later charged the adviser's chief risk officer for his role in the misconduct.³¹

Second, the SEC charged a large money manager and three of its portfolio managers with orchestrating an alleged scheme to conceal the downside risks of a complex options strategy used by private funds marketed and sold to more than 100 institutional investors.³² The alleged misconduct included the manipulation of financial reports and other information provided to investors to conceal the magnitude of the strategy's risk and performance and eventual losses at the start of the pandemic.

Cryptocurrencies

The SEC's scrutiny of conduct in the cryptocurrency space turned in part to private funds at the end of 2022, with the agency's quick action against the founder of crypto trading platform FTX.³³ In that action, the SEC alleged that FTX's founder diverted customer funds to a privately held crypto hedge fund he controlled and gave that fund special treatment on FTX. Notably, the SEC brought its case just weeks after FTX's collapse in November 2022. The case highlights the conflicts associated with hedge funds that are part of larger organizations and that transact with affiliates through either trading strategies or intercompany transactions.

Speeding Tickets

As we outlined last year, the SEC's Division of Enforcement promised to pursue "speeding tickets" in its enforcement actions—meaning charges involving relatively minor infractions—arguing that doing so helps prevent larger violations from occurring down the road. The SEC carried through on that promise in 2022 by charging at least 10 private fund advisers with failing to comply with the Custody Rule. Some also face charges of failing to update their Forms ADV to reflect the status of audits of financial statements for the private funds they advised.³⁴

2023 ENFORCEMENT AND EXAMINATION TRENDS

Based on the enforcement activity in 2022 and the recently released 2023 Exam Priorities, we expect the SEC to again focus a significant amount of attention on the private funds industry.

2023 Exams Focus

The 2023 Exam Priorities make no secret that the Commission views the examination and inspection of private fund managers as central to the examination program. The one-time afterthought in the division's priorities is now front and center as a "Notable New and Significant Focus Area." The Exam Priorities note that private fund advisers now constitute 35% of all registered investment advisers, managing more than 50,000 private funds with gross assets in excess of \$21 trillion.³⁵

Private fund advisers preparing for examinations should expect heightened scrutiny in the following areas:

- 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
- Compliance with the Marketing Rule,³⁶ including performance advertising and compensated testimonials and endorsements, such as solicitations
- Policies and practices regarding the use of alternative data³⁷ and compliance with Advisers Act Section 204A

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- Compliance with Advisers Act Rule 206(4)-2 (the Custody Rule), where applicable, including timely delivery of audited financials and selection of permissible auditors³⁸

The SEC's selection of advisers for examination is driven by risk analysis. Private funds that have the following risk characteristics will have a higher likelihood of examination:

- Highly leveraged private funds
- Private funds managed side by side with business development companies (BDCs)
- Private equity funds 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 cryptoassets and real estate-connected investments, with an emphasis on commercial real estate
- Private funds that invest in or sponsor special purpose acquisition companies (SPACs)
- Private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds³⁹

Finally, private fund advisers that have never been examined should expect a higher likelihood of examination in 2023.⁴⁰

2023 Enforcement Focus

New rulemaking and exam priorities are excellent predictors of enforcement activity. The SEC's Enforcement staff will be looking for examples of misconduct to support the need for those rules, especially when it comes to conflicts associated with side letters and investment terms.

Overall, we anticipate the SEC's Division of Enforcement will focus on the following types of conduct in 2023:

1. **Fees and Expenses.** With the end of a long bull market, many hedge funds experienced a negative annual performance for the first time in more a decade.⁴¹ Given the SEC's traditional focus on fee calculations, we can expect investigations and examinations to focus on how managers calculated fees in 2022, particularly for funds that may have fallen below their high-water mark. For funds that are below their high-water mark, the SEC is expected to scrutinize renegotiated terms and disclosures to investors about any investors that might negotiate different fee arrangements through side letters or other agreements. This scrutiny would be in keeping with Chair Gensler's questioning of different fee structures and the use of side letters and his commitment to bring greater transparency to these practices. For private equity advisers, the cases brought by the SEC in 2022 involving expense allocations and management fee offsets signal a continued focus on those practices, and we expect that trend to stay in 2023.
2. **Valuation.** With the expected focus on fee calculations, we also predict that the SEC will continue to scrutinize valuation practices by private fund managers. The SEC touted its significant valuation cases from 2022 prominently,⁴² and believes these cases have widespread impact. In light of the difficult economic climate in 2022, the SEC is likely to scrutinize not only individual asset valuations, but also practices that might smooth performance (by slowly writing down the value of an asset to avoid a sharp decline), boost returns (by artificially inflating the value of certain assets), or obscure a poor investment (by using a down year to finally write down the value of an asset that might have been impaired earlier). These are all practices the SEC has criticized in prior economic downturns, and to which it could easily return in 2023. Managers that invest in complex products that are valued using models or other estimates should also enhance their practices around ensuring that those valuations accurately reflect fair value, as the SEC is keenly focused on how those valuations are derived and

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whether the methodology matches the adviser’s disclosures. Finally, we expect the SEC to continue using data analytics to identify performance outliers that warrant further scrutiny.

- Risk Disclosures.** In 2022, the SEC announced rules or pursued investigations concerning disclosures around cybersecurity risk and breaches and exposure to cryptocurrencies and other digital assets. Although the focus of certain of these initiatives was on public companies, the SEC is likely to also scrutinize private fund managers’ disclosures of significant risks posed by these events or investments. The proposed rule that would require quarterly disclosures to investors signals the SEC’s expectation that private funds provide timely updates to their investors, and—even before the adoption of the rule—we would not be surprised if the SEC were to focus on related disclosures in investor reports. In particular, the potential effect that data breaches or concentrated investments in digital assets might have on performance are prime areas where the SEC could turn its attention.
- Conflicts of Interest.** Conflicts represent a perennial focus area for the SEC’s Enforcement and Examinations staffs, and we expect that scrutiny to continue, with some new twists. Proposed rules focused on side letters, redemption rights, and enhanced transparency continue to indicate that the SEC will be looking for enforcement cases that support its perceived need for those rules. A case the SEC brought against a private fund manager in 2022 arising from alleged conflicts associated with a SPAC transaction also demonstrates that, although the SPAC market has cooled significantly, the Enforcement staff is still scrutinizing completed SPAC deals in which private funds participated.⁴³ In particular, the SEC can be expected to continue its analysis of conflicts associated with SPAC transactions in which private funds participated alongside other clients advised by the same manager, or alongside the manager itself.

- Insider Trading.** In 2021, the SEC pushed the envelope in insider trading enforcement with its “shadow trading” case involving a defendant who bought call-option contracts in a competitor company after learning that the acquisition of his employer was imminent, which was likely to have a positive impact on the competitor’s stock price.⁴⁴



In 2022, the SEC continued its aggressive approach to insider trading, most notably with an action in which a trader’s alleged inside information included observing that his friend, who was on the board of directors of a company whose stock the trader acquired, had become “unusually busy” on company-related matters.⁴⁵ The case drew a dissent from Commissioner Hester Peirce, who questioned whether this observation could constitute material nonpublic information.⁴⁶ The trader settled the case against him, depriving us of a judicial determination of whether this kind of “soft” information could support an insider trading case. But the SEC’s pursuit of the action demonstrates its willingness to think creatively about how to support its insider trading cases, and we expect the SEC to continue doing so in 2023.

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6. **“Speeding Ticket” Cases.** We expect the Enforcement staff to continue pursuing speeding ticket cases, and that penalties for such matters will only increase for private fund managers charged with violations that have already been the subject of prior cases. Accordingly, private fund managers would be wise to review their custody compliance, Form ADV disclosures, and Form PF and Section 13 filing practices to ensure they satisfy their regulatory obligations. Violations of these technical rules have been the subject of past sweeps, and the SEC will expect private fund managers to have enhanced their practices in these areas accordingly.

Relatedly, the SEC has used the “speeding ticket” approach to pursue violations of the record retention requirements of the federal securities laws resulting from the use of “off-channel communications” such as text messaging. In September 2022, the SEC imposed steep fines on 16 investment banks over their record retention practices,⁴⁷ and has reportedly turned its attention to whether employees of investment advisers similarly used text messaging in violation of SEC rules.⁴⁸ If they have not done so already, registered investment advisers should enhance their procedures and surveillance in this area in preparation for the inevitable scrutiny they will receive from the SEC. The 2023 Exam Priorities also promise continued attention to monitoring and retaining electronic communications, a likely source of referrals to enforcement.⁴⁹

7. **Environmental, Social, and Governance (ESG) and Marketing.** With continued investor demand for ESG investment products and strategies, we can once again expect the SEC to focus examination and enforcement resources on the review of ESG-related disclosures—both in fund offering documents and in marketing materials—as well as on ESG-related policies and procedures. Last year the SEC’s Climate and ESG Task Force filed multiple cases targeted at what it perceived as ESG misconduct, including two actions against investment advisers—one alleging misstatements and omissions about ESG considerations in making investment decisions for certain mutual funds it managed, and the other for allegedly failing to follow its policies and procedures involving ESG investments.⁵⁰ We expect enforcement actions like these to continue in 2023.

The Division of Examinations again included ESG in its 2023 Exam Priorities, specifically categorizing ESG as a “Significant Area of Focus,” and stating it will continue to examine “whether the funds are operating in the manner set forth in their disclosures.” While the division will continue to “assess whether ESG products are appropriately labeled,” new this year it will examine “whether recommendations of such products for retail investors are made in investors’ best interest.”⁵¹

Finally, the SEC has issued rulemakings in this area, and while we await the final rules expected later this year, the staff will certainly look to the current proposals⁵² for guideposts for their reviews and investigations in this area.

CONCLUSION

The SEC’s increased focus on private fund activity in 2022 and the trends we foresee in the coming year promise to bring a steady stream of novel, complex, and “speeding ticket” cases against private fund advisers.

As new rules are poised for adoption and effectiveness and economic uncertainty continues in the financial markets, the SEC’s Enforcement and Examination staffs are certain to look for cases that align with Chair Gensler’s criticism of certain longstanding practices in—and his desire to bring greater transparency to—the private funds market.

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