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## Examinations

# SEC Examination Lessons Learned During the Biden/Gensler Era and Looking Ahead

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As many expected, exams under SEC Chair Gary Gensler have become more targeted at private funds. With specialized teams (e.g., artificial intelligence (AI), crypto) aligned with areas of programmatic importance to the Commission and the return in earnest of in-person examiners, scrutiny by the SEC's Division of Examinations (Examinations) of certain topics tested in exams can be particularly intensive. The stakes are high, as there have been significant enforcement actions against fund managers, including some stemming from examination findings being referred to the SEC's Division of Enforcement (Enforcement).

This article explores recent substantive SEC exam priorities and emerging trends for private funds, with new areas of regulatory focus emerging with clarity alongside perennial areas of interest. The article also offers practical considerations for fund managers to consider when preparing for and navigating exams, including the potential role that remediation can play in the process.

See "[PE Industry in 2024: Navigating an Uncertain Examination and Regulatory Environment \(Part One of Two\)](#)" (Jan. 11, 2024); and "[SEC Charges PE Sponsor With Improper Accelerated Monitoring Fees and Continuation Fund Transfer](#)" (Dec. 14, 2023).

## 2024 Examination Priorities

Examinations published its [2024 examination priorities](#) (2024 Priorities) in October 2023 to align with the SEC's fiscal year, representing the first time the agency has released its examination priorities in advance of the calendar year. The 2024 Priorities highlighted several focus areas for Examinations, including:

- fees, with an emphasis on testing the impact of valuations on management fees in the post-commitment period;
- fund-level and investment-level expenses;
- adherence to contractual requirements regarding LP advisory committees, including consent processes or other notification requirements in fund documents; and

- the use of affiliated service providers.

See “[2024 SEC Examination Priorities: New Approaches to Old Areas of Concern](#)” (Dec. 14, 2023).

Unsurprisingly, given the proliferation of retail funds, for the second time in two years the 2024 Priorities noted a particular focus on private funds operating in parallel with registered investment companies. In addition, the 2024 Priorities reiterated Examinations’ attention to cybersecurity, not only at the adviser level but also extending to registrant visibility into the security of third-party vendors.

Further, although issues related to environmental, social and governance (ESG) investing did not appear in the 2024 Priorities, that omission is largely the result of sufficient ESG messaging and an understanding that examiners will continue to conduct ESG testing, as applicable. Examinations’ vigilance as to ESG issues has not receded.

As for emerging technologies, the 2024 Priorities flagged the following as focus areas:

- cryptocurrency assets;
- alternative sources of data; and
- emerging risks associated with AI, coinciding with its inclusion in FINRA’s most recent [examination priorities](#).

See our two-part series on AI in private funds: “[Emerging AI Technology and Valuable Legal- and Compliance-Related Applications](#)” (Nov. 16, 2023); and “[Challenges, Best Practices for Implementation and the Road Ahead](#)” (Nov. 30, 2023).

## Emerging Areas of Regulatory Focus

Although the annual priorities issued by Examinations always prove to be a useful messaging tool, on-the-ground activity by Examinations (and Enforcement) is the true barometer of how the priorities are translated into action.

It is important for fund managers, and specifically compliance officers, to be aware of evolving regulatory priorities. Indeed, in [remarks](#) delivered at SEC Speaks 2024, Director of Examinations Richard Best pointedly noted that “compliance officers and their staff must remain vigilant and scan the horizon for new and emerging risks to ensure their compliance programs continue to offer appropriate assistance and guidance to their firms, and strong protection to investors.”

## Use of AI

AI has become a high-priority focus of the SEC in a relatively short period of time as it seeks to stake a claim of regulatory authority over what promises to be a transformational technology in the securities markets. Despite the pending status of the SEC’s [proposed predictive analytics rule](#), Examinations has been actively using its existing rules and tools to scrutinize registrants’ use of AI.

At a high level, examiners are testing if a sponsor's AI uses are consistent with their disclosures to investors and their internal policies and procedures. Examinations officials have stated that AI is going to be a regular component of exams in 2024.

See "[SEC's Proposed Conflicts Rules for AI Erode Primacy of Disclosure and Investor Consent Principles](#)" (Sep. 7, 2023).

Although the SEC's focus on AI is expected to evolve, one current area of heightened interest is on the accuracy of a registrant's statements about AI. The SEC uses the term "AI washing" to characterize when entities misstate their use of AI (by analogy, this is similar to the term "greenwashing" in the ESG space). In February 2024, Chair Gensler warned that:

Investment advisers or broker-dealers also should not mislead the public by saying they are using an AI model when they are not, nor say they are using an AI model in a particular way but not do so. Such AI washing, whether it's by companies raising money or financial intermediaries, such as investment advisers and broker-dealers, may violate the securities laws.

In March 2024, the SEC settled charges with two investment advisers for anti-fraud, Marketing Rule violations and policy violations in connection with false and misleading statements about their purported use of AI (one of the settlement orders made clear that the settlement originated from an examination). In a [press release](#) announcing the enforcement actions, Enforcement Director Gurbir S. Grewal commented, "As today's enforcement actions make clear to the investment industry – if you claim to use AI in your investment processes, you need to ensure that your representations are not false or misleading."

Advisers should be aware that examiners have been proactively scouring the internet for sponsor statements about AI, including on advisers' websites and social media accounts. With the threat of enforcement, punctuated by the recent AI-washing settlements, advisers should take great care with their AI-related statements and expect to be tested on them during examinations. Firms should also ensure that policies governing the acceptable use of AI (e.g., avoiding the ingestion of material nonpublic information (MNPI) in public or even proprietary AI tools) are actually followed in practice to avoid a policy-based adverse exam finding – or more severe consequences.

## Amended Marketing Rule

Examiners' focus on marketing materials has heightened since the amended Marketing Rule's compliance date on November 4, 2022. Examinations released risk alerts in [September 2022](#) and [June 2023](#) that were light on substantive commentary related to deficiencies, but rather were intended to prepare the industry for the staff's sustained focus on compliance. The most recent risk alert issued in [April 2024](#) contains more constructive guidance.

See "[The SEC's Marketing Rule in Focus: Highlights of the Latest Risk Alert](#)" (Aug. 24, 2023); and "[Marketing Rule Risk Alert Indicates That SEC Guidance Will Occur Via Imminent Examinations](#)" (Dec. 1, 2022).

Going forward, managers can expect significant ongoing scrutiny of marketing materials for compliance with the amended Marketing Rule, including with respect to:

- substantiation of material facts;
- adequate presentation of performance, particularly as to any presentation of gross internal rates of return (IRR) and net IRR where leverage is used; and
- appropriate presentation of third-party ratings, testimonials and endorsements.

Examiners are also testing for policy updates and specific training on the amended Marketing Rule.

See “[Marketing Rule FAQ Clarifies SEC Expectations for Calculating Net and Gross IRR When Using Subscription Credit Facilities](#)” (Apr. 4, 2024).

In addition, Enforcement has settled various enforcement actions against investment advisers for violations of the Marketing Rule. Although those first settlements arose from seemingly straightforward alleged violations with respect to hypothetical performance, Examinations and Enforcement staff are expected to increasingly gravitate to more nuanced scrutiny of other potential violations.

## Electronic Communications

Another area receiving increased attention from Examinations staff is the use and retention of various means of electronic communications. Although more Enforcement actions are expected on this topic, Examinations is likewise testing this area.

During examinations, managers are being asked about their process for monitoring and retaining communications (including email, text messages, messaging apps, instant messages and private messaging on social media) related to the adviser’s business. Likewise, a production demand for all forms of communications – often requiring the forensic imaging of personal devices – is now a routine staple of Enforcement investigations of investment advisers and their personnel.

## Fees

The appropriate charging of fees is a continual focus during SEC examinations, but in recent years a new area of focus has emerged. Specifically, Examinations has been testing the effect of valuation adjustments (e.g., write-downs, write-offs and permanent impairments) on management fees during the post-commitment period.

A 2022 SEC [risk alert](#) previewed the topic, although it did not garner significant attention at the time:

For example, private fund advisers did not reduce the cost basis of an investment when calculating their management fee after selling, writing off, writing down or otherwise disposing of a portion of an investment. Other private fund advisers used broad, undefined terms in the [limited partnership agreement], such as “impaired,” “permanently impaired,” “written down,” or “permanently written down,” but did not implement policies and procedures reasonably

designed to apply these terms consistently when calculating management fees, potentially resulting in inaccurate management fees being charged.

See “[Lessons From the SEC Risk Alert on Avoiding Disclosure Compliance Failures and Enhancing Diligence Efforts \(Part Two of Two\)](#)” (Mar. 29, 2022).

The topic gained more attention after an Enforcement [settlement order](#) in June 2023, and related questions are consistently appearing in ongoing examinations of investment advisers.

See “[SEC Enforcement Action Targets PE Sponsor’s Write-Down Mechanics and Related Disclosures to LPs](#)” (Jul. 13, 2023).

## Other Focus Areas

Certain topics, such as compliance programs and custody, will always be fruitful areas for testing during exams. The following perennial focus areas have seen updates or a shift in emphasis recently.

### Expenses

Examiners continue exacting testing of expenses and are generally expecting granular disclosure of fund expenses. Some expense categories frequently tested include:

- travel expenses (especially in the case of private travel);
- use of third-party consultants; and
- affiliated service providers.

See our two-part series “What to Expect From Today’s SEC Examinations and Enforcement Relating to PE Management Fees and Expenses”: [Part One](#) (Sep. 21, 2023); and [Part Two](#) (Oct. 5, 2023).

### MNPI

Fund managers should also continue to be mindful of their MNPI policies. Certain scenarios may present heightened risks related to MNPI, such as when an adviser uses expert networks, multiple advisers share office locations, etc. A recent [enforcement action](#) highlighted the importance of following MNPI procedures even in the absence of actual violative trading.

See “[SEC Enforcement Action Targets Non-Violative Use of MNPI Through Policy and Procedure Failures](#)” (Mar. 7, 2024).

In 2022, Examinations published a [risk alert](#) specifically addressing MNPI compliance issues. Looking ahead, it is possible that the SEC may start to focus on AI and MNPI. For example, weaknesses in network architecture might allow AI to collect private side information that could make its way into investment models and potentially cause the adviser to inadvertently trade on MNPI.

## Practical Guidance for Managers

Under the Gensler-led SEC in the Biden administration, private fund managers have been subject to more granular SEC exams and a more intensive enforcement environment. Whether or not managers engage in specific SEC preparation exercises (*e.g.*, mock versions of exams, day one presentations and staff interviews), there are various steps that managers can take to best position their firm for an exam to conclude with no or minimal deficiencies and to decrease the odds of a referral to Enforcement.

### Timing for Examinations

Fund managers cannot predict with accuracy when they will be subject to an examination, but generally speaking, managers can expect to be examined roughly every four to five years in the absence of certain factors that will trigger an examination more frequently. Interestingly, Examinations published its first ever process-focused [risk alert](#) in 2023, which covered precisely the topic of how managers are selected for examination.

See [“SEC Risk Alert and Accompanying Checklist Explains Examinations Process and Identifies Key Documents to Have Ready”](#) (Nov. 2, 2023).

The risk alert noted a few general factors that may trigger an exam, such as event-driven risks posing a risk to investors and the markets more broadly, and risks related to how advisers are complying with new regulatory requirements. The risk alert also noted certain firm characteristics that could affect exam frequency, including:

- highly leveraged private funds;
- private funds managed side by side with business development companies; and
- adviser-led restructurings (*e.g.*, stapled transactions and continuation funds).

In addition, the risk alert listed risks presented by particular firms that are especially useful to know, including:

- prior exam deficiencies;
- disciplinary history of associated individuals;
- changes in firm leadership;
- indications of vulnerabilities to market stresses; and
- press reporting.

Fund managers with any of those characteristics, or a combination of them, may see examination activity – or other outreach from the SEC staff – in the short to medium term.



## Practical Tips for Examination Preparation

Compliance teams should endeavor to stay ready for an examination at any time and be particularly mindful that an exam may be imminent in certain circumstances highlighted in the aforementioned risk alert.

To stay ready, a manager should consider keeping core documents handy or creating documents that will be useful in the event of an examination, such as:

- adviser organization chart;
- fund organization chart;
- “Day One Deck” (discussed below);
- list of compliance exceptions; and
- prior exam letters and responses.

Note that keeping documents in a duplicative pre-exam file could be particularly helpful to a manager in the event of turnover of the firm’s CCO or other compliance personnel.

## Stay Attuned to SEC Priorities and Enhance Compliance Programs Accordingly

Staying attuned to regulatory developments – including final rulemakings, SEC exam priorities, SEC risk alerts and SEC enforcement proceedings – can contribute to meaningful compliance program enhancements. For instance, in the wake of the amended Marketing Rule, it is critical that advisers update, and follow, their compliance policies accordingly.

## Document Annual Compliance Review and Consider Other Testing

Following the SEC’s August 2023 adoption of **new rules** for private fund advisers (PFAR), an adviser’s required annual compliance review must now be documented in writing. Attorney-client privilege may be asserted during the drafting process, but the staff will not respect privilege claims over the documentation of this required review. If sensitive issues requiring legal guidance arise during an annual compliance review, due care must be taken to ensure that privilege is not waived.

Separate from the annual compliance review, an adviser can consider other periodic testing focused on discrete areas, such as:

- reviewing AI-related statements in marketing materials;
- sampling certain expenses passed on to funds or portfolio companies (and thus indirectly to LPs); and
- compliance manual testing to ensure required testing, documentation and other referenced actions are occurring.

See our three-part series on the PFAR: “[Overview of the New Rules and Analysis of the Restricted Activity Requirements](#)” (Sep. 21, 2023); “[Details and Obstacles of the Quarterly Reporting Requirements](#)” (Oct. 5, 2023); and “[Issues to Monitor in Preferential Treatment, Adviser-Led Transactions and Annual Audit Rules](#)” (Oct. 19, 2023).

## Prepare a Day One Deck

In anticipation of an examination, a manager can consider preparing an off-the-shelf Day One Deck. Day One Decks include foundational information that regulators ask for, including the manager’s:

- organizational structure;
- client types and assets;
- service provider relationships;
- investment processes; and
- compliance program details.

Having a draft Day One Deck available will free up a manager’s resources and attention during an SEC exam so it can focus on producing requested documents during the abbreviated time frames.

## Prepare for In-Person Onsite Examinations

Although many SEC examinations have been remote since March 2020, there has been a return to in-person onsite examinations in earnest over recent months. The 2024 Priorities also noted an intentional shift back to in-person examiner presence. Against that backdrop, it is prudent for managers to expect examiners to be present during any upcoming exams and to prepare a plan accordingly to ensure appropriate physical safeguards are in place.

As part of their preparation, managers can consider a mock presentation of the Day One Deck referenced above and/or mock interviews with personnel likely to be interviewed, such as the CCO, investment professionals and/or finance professionals. The manager interviewees should be familiar with both the assigned topics (*e.g.*, compliance, expense allocation, investment process, etc.) and best practices for interacting with Examinations staff.

See “[Arc of the Process of Conducting a Mock Examination and the Types of Issues Reviewed \(Part One of Two\)](#)” (Apr. 13, 2021).

## Practical Tips During an Exam

### Document-Related Considerations

Managers should endeavor to make timely productions, which can involve producing materials on a rolling basis and keeping Examinations staff informed of any production delays. When producing



documents (or in interviews with the staff), managers should be mindful not to unintentionally waive the attorney-client privilege. If necessary, a manager can protect privileged materials by withholding or redacting responsive materials, as applicable.

Further, fund managers should seek confidential treatment under the Freedom of Information Act when making productions in exams and follow the applicable rules on Bates numbering (*i.e.*, “the submitter of information must mark each page with ‘Confidential Treatment Requested by [name]’ and an identifying number and code, such as Bates-stamped number”). Instructions are available on the SEC’s website for submitting confidential treatment requests.

In addition to keeping records of documents produced during an exam, fund managers should be particularly mindful of keeping correspondence with the SEC staff. That process can be more challenging, however, when using the SEC’s secure website, as communications therein disappear after a period of time. A well-documented correspondence file can be invaluable when responding to deficiency letters, which may often be higher level or inadvertently mischaracterize earlier submissions or positions taken in an exam.

See “[When and How Are Fund Managers Required to Disclose Deficiency Letters to Investors? \(Part Three of Three\)](#)” (Apr. 23, 2019).

## Remediation Considerations

A fund manager may consider remediation during an exam or as part of the deficiency letter response. A manager may remediate because it realizes a mistake, and it may remediate in deference to Examinations staff in hopes of minimizing – though not completely eliminating – the risk of a referral to Enforcement.

One type of remediation involves monetary efforts (*e.g.*, reversing an erroneous expense allocation), for which fund managers should be sure to keep documentation, including calculations and any third-party verifications. Another type is non-monetary remediation (*e.g.*, updating disclosures or policy enhancements), which is designed to ensure a manager’s policies are in line with its practices and disclosures.

See our two-part series on SEC cooperation credit: “[Examining HeadSpin As a Framework for Optimal Remediation Measures](#)” (Jun. 1, 2023); and “[Inherent Obstacles to Fund Managers Receiving Full Credit](#)” (Jun. 15, 2023).

## Conclusion

Without a doubt, the examination landscape has evolved over the past three years. Updated regulatory priorities continue to evolve organically and in connection with new rules, and are often reflected in SEC priorities, SEC risk alerts and enforcement actions, as well as during examinations.

For those reasons, it is particularly important for fund managers to stay up to date on regulatory priorities no matter how they are expressed by the SEC. It is also key to bear in mind that the best exam preparation happens well before Examinations staff shows up. Therefore, it is critical for each firm to have a strong compliance program in place and to ensure that its disclosures and policies are consistent with their practices.

Updates to compliance programs should be made in the normal course, including with respect to emerging areas of regulatory focus and changes in practices. For particularly hot-button issues - e.g., the amended Marketing Rule, off-channel communications and the deployment of AI tools - policy enhancements should be coupled with trainings and compliance reminders.

With the right preparation, a manager should hope to conclude an exam as quickly as possible, reduce the existence or extent of deficiencies, and limit the likelihood of referral to Enforcement.

See [“Tips for Enduring an SEC Examination With the Lightest Possible Ramifications”](#) (Nov. 30, 2023).

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