SilverVision:
Guide to 2021 SEC Exam Priorities

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Withstand scrutiny. Inspire confidence.

The past few months have featured a flurry of new regulatory developments with direct ramifications for private fund managers, particularly with the release by the SEC of its 2021 Exam Priorities and Division of Examinations' Continued Focus on Digital Asset Securities. This article reviews the most important areas of SEC focus, Silver's view and offers recommendations on proactive steps that investment advisers can take to prepare for an SEC exam.

Published annually, the SEC's Division of Examinations' announced priorities are designed to provide insights into the SEC's risk-based approach to examinations and identify areas where it believes potential risks to investors and U.S. capital markets may exist. According to the announcement, this year's priorities will have a greater focus on climate-related risks, as well as conflicts of interest for broker-dealers, investment advisers and attendant risks relating to FinTech.

Key Takeaways:

- ESG and climate risks are emerging as key priority areas for the SEC in 2021
- The SEC will further assess compliance risks and conflicts of interest associated with managers to private funds
- The SEC will continue to focus on Digital Asset Securities as an area of "unique risk to investors"

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Increased scrutiny of RIA compliance programs:

Given the growing list of rules and regulations for RIAs and the increased oversight challenges that come with monitoring business communications and other processes and procedures in a remote environment, it may be beneficial for RIAs to have an independent assessment and test the strength of their compliance programs.

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Increased scrutiny of RIA compliance programs

The SEC report notes that they will continue to examine the compliance programs of RIAs, including: (i) the appropriateness of account selection; (ii) portfolio management practices; (iii) custody and safekeeping of client assets; (iv) best execution; (v) fees and expenses; (vi) business continuity plans; and (vii) valuation of client assets for consistency and appropriateness of methodology.

The SEC will further prioritize reviewing the compliance programs of RIAs that have not been examined for a number of years and assess whether those compliance and the corresponding policies and procedures are reasonably designed, implemented and maintained.

The SEC further notes that RIAs are increasingly offering investment strategies that focus on environmental, social and governance (ESG) factors, with products and services that may be referred to by a variety of terms such as “sustainable”, “socially responsible”, “impact” and “ESG conscious”. The SEC will also continue to focus on products in these areas that are widely available to investors, which include open-end funds and ETFs, as well as those offered to accredited investors such as qualified opportunity funds.

Additionally, the SEC will review the consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these strategies; determine whether the firm’s processes and practices match their disclosures; review fund advertising for false or misleading statements; and review proxy voting policies and procedures and votes to assess whether they align with the strategies.

Silver recommendation:

Over the past year, the SEC has been increasingly providing guidance on how investment advisers can best model regulatory compliance programs to prevent violations and mitigate risks. Given the growing list of rules and regulations for RIAs and the increased oversight challenges that come with monitoring business communications and other processes and procedures in a remote environment, it may be beneficial RIAs to have an independent assessment and test the strength of their compliance programs.

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More disclosures of risks and conflicts:

Noting that over 36% of RIAs manage private funds, the SEC states that it will continue to look at advisers to private funds and assess compliance risks with a focus on liquidity and disclosures of investment risks and conflicts of interest.

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More disclosures of risks and conflicts

Noting that over 36% of RIAs manage private funds, the SEC states that it will continue to look at advisers to private funds and assess compliance risks with a focus on liquidity and disclosures of investment risks and conflicts of interest. It is further noted that there will be a focus on firms with a higher concentration of structured products, such as collateralized loan obligations and mortgage-backed securities, to evaluate whether the private funds are at a higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors.

Silver recommendation:

Quality disclosures are a function of quality policies and processes. Investment managers should build the right foundation for thorough and consistent reporting with buy-in from across the firm to ensure all levels of the organization are aligned. Further, firms should review and test these policies to account for changes in operations and regulations, which will impact the policy and, ultimately, the corresponding procedures and disclosures.

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SEC takes aim at climate and ESG funds:

The 2021 Exam Priorities include ESG and climate-related focus areas. In tandem, the Commission announced the formation of a Climate and ESG Task Force within the Enforcement Division that will develop initiatives to identify potential or actual ESG-related misconduct.

SEC takes aim at climate and ESG funds

The SEC has also set the stage for its increased attention on registrants' ESG practices, products and disclosures. The 2021 Exam Priorities include ESG and climate-related focus areas. In tandem, the Commission announced the formation of a Climate and ESG Task Force within the Enforcement Division that will develop initiatives to identify potential or actual ESG-related misconduct. These signals from the SEC represent a sea-change in the U.S. approach to ESG regulation and benchmarking and we expect further regulatory guidance to surface in the near term.

Silver recommendation:

The ESG regulatory landscape is constantly changing, both in the U.S. and internationally, with the introduction of new requirements like the Sustainable Finance Disclosure Regulation (SFDR) in the EU. While ESG program development can be dynamic and complex, avoiding enforcement or regulatory fines requires rapid alignment with best practices.

As one of the first ESG advisory practices for investment firms in the U.S., Silver's team of experts are available to help ensure ESG practices are synchronized with a firm's long-term investment strategy.

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Continued focus on digital assets:

As more securities industry participants are increasingly engaging in digital asset strategies, investment advisers must ensure proper classification of the securities as well as adapt and update their regulatory compliance programs accordingly.

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Continued Focus on Digital Assets as 'Unique Risk to Investors'

The Division of Examinations' Continued Focus on Digital Assets announcement released on February 26, 2021 to "assist firms in developing and enhancing their compliance practices" along with the maturation of distributed ledger technologies focused on three key areas: (i) portfolio management; (ii) custody; and (iii) disclosures.

As more securities industry participants are increasingly engaging in digital asset strategies, investment advisers must ensure proper classification of the securities as well as adapt and update their regulatory compliance programs accordingly. The SEC will "review the risks and practices related to the custody of digital assets by investment advisers and examine for compliance with the Custody Rule (Rule 206(4)-2 under the Advisers Act), where applicable." The SEC also indicated heightened focus on reviewing disclosures across firm materials including marketing and fund documents.

Silver recommendation:

In Silver's specialized experience, there is not a one-size-fits-all compliance program for the digital asset space. With more market participants engaging in cryptocurrency activities, each organization must undertake a thorough process to assess whether its token of choice is considered a security and to either develop or enhance existing regulatory compliance processes and procedures accordingly.

Silver provides Regulatory Compliance, ESG and Due Diligence Preparation advisory services to the investment management industry.

Drawing on industry experience to calibrate regulatory compliance best practices and investor demands with business realities, Silver's Regulatory Compliance team helps private equity, venture capital, hedge fund and digital asset firms maintain a culture of compliance through a range of services, including: Registration and Foundation Support; Ongoing Maintenance of Compliance Programs; Compliance Assessment; and SEC Exam Support.

Among the first to develop ESG advisory services for investment firms, Silver partners with clients to build ESG programs that withstand investor scrutiny and address the evolving regulatory environment.

Also, drawing from vast regulatory exam process experience, Silver's Due Diligence Preparation team helps managers prepare for and respond to investor inquiry throughout the formal investor due diligence process.

A minority and woman-owned business, Silver is headquartered in New York City and has an office in Los Angeles.

For more information visit silverregulatoryassociates.com

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References

SEC 2021 Exam Priorities: https://www.sec.gov/files/2021-exam-priorities.pdf
Division of Examinations' Continued Focus on Digital Assets: https://www.sec.gov/ocie/announcement/risk-alert-digital-assets

If you have any questions about how these or other 2021 SEC Exam Priorities may impact your firm, please contact us at info@silverreg.com.