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SEC ANNUAL EXAM PRIORITIES FOCUS - WHAT YOU NEED TO KNOW

BY: Mark Shayne, ASA, CPA, ABV, CGMA, Senior Managing Director

On March 30th, The SEC's Division of Examinations issued its 2022 Exam Priorities.

The SEC listed five areas on which it would focus:

1. Private Funds
2. Environmental, Social and Governance (ESG) Investing
3. Standards of Content (Regulation Best Interest and Fiduciary Duty)
4. Information Security and Operational Resiliency
5. Emerging Technologies and Crypto-Assets

Private Funds

Over 5,000 Registered Investment Advisors manage $18 trillion of private fund assets. Assets under management (AUM) of advisors to private funds increased 70% in the past five years. The SEC's concern appears to stem from the fact that these funds have material investments from State and Local pension funds [whose beneficiaries include working families, charities and endowments].

Specifically, exams will emphasize the following: "(1) the 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; (2) the potential preferential treatment of certain investors by RIAs to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; (3) compliance with the Advisers Act Custody Rule, including the "audit exception" to the surprise examination requirement, related reporting and updating of Form ADV regarding the audit/ auditors that serve as important gate-keepers for private fund investors; (4) the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales; and (5) conflicts around liquidity, such as RIA-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund."

Also, receiving honorable mention were: (1) review of private funds' investments in Special Purpose Acquisition Companies (SPACs), particularly where the private fund adviser is also the SPAC sponsor; and (2) outsized counterparty exposure or gross notional exposure when compared to similarly--situated firms.

Valuation of illiquid assets is tritely, but correctly, called "an art, not a science." While the three valuation approaches (income, market and cost) are often cited as the basis for valuing illiquid or hard-to-value securities, there is no rote, objective formula for application of EBITDA multiples or constructing a discounted cash flow (DCF) model. This inherent subjectivity can allow bad actors to game the system for management's benefit and creates discomfort among regulators.

This helps explain why investors in many hedge funds and private equity firms have successfully pushed for independent valuations of portfolio investments since the financial crisis in 2007-2008.

Chair Gary Gensler and Commissioner Caroline Crenshaw have raised regulatory concerns about SPAC's earnings guidance and opaque structures, as well as the mix of equities and derivatives that can raise conflict of interest issues attending the de-SPAC process.

ESG

There is a risk that disclosures regarding ESG practices could involve materially--false and misleading statements, which can result in misinformed investors. This risk is compounded by: (1) the lack of standardization in ESG investing terminology (e.g., strategies that are referred to as sustainable, socially responsible, impact investing, and environmentally friendly); and (2) the variety of approaches to ESG investing, i.e., portfolio managers may use ESG factors as the main consideration in selecting investments or to achieve measurable ESG impact goals; or a portfolio may simply be labeled as ESG because of consideration of ESG factors alongside traditional financial, industry-related, and macroeconomic indicators.

Now that ESG is a thing, the SEC apparently wants to be sure that (with apologies to Gertrude Stein) "there is some there there."

Standards of Conduct

The SEC's Division of Examination will address standards of conduct issues for broker-dealers and RIAs, with reviews focused on how they are satisfying their obligations under both the Regulation BI and the Advisers Act fiduciary standard to act in the best interests of retail investors, not placing their own interests ahead of retail investors' interests.

Specifically, RIA examinations will focus on whether advisers are acting consistently with their fiduciary duty to clients, looking at duties of care and loyalty, including best execution obligations, financial conflicts of interest, related impartiality of advice, and attendant client disclosures. Focus areas include: (1) revenue sharing arrangements; (2) recommending or holding more expensive classes of investment products when lower cost classes are available; (3) recommending wrap fee accounts without assessing whether such accounts are in the best interests of clients; and (4) recommending proprietary products resulting in additional or higher fees.

Information Security and Operational Resiliency

Failing to prevent unauthorized access, use, disclosure, disruption, modification, inspection, recording or destruction of sensitive records may have consequences that extend beyond a private fund. It can compromise information and data of other market participants and retail investors.

The SEC will review whether firms have taken appropriate measures to: (1) safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (2) oversee vendors and service providers; (3) address malicious email activities, such as phishing or account intrusions; (4) respond to incidents, including those related to ransomware attacks; (5) identify and detect red flags related to identity theft; and (6) manage operational risk as a result of a dispersed workforce in a work-from-home environment. The SEC will also assess registrants' business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations.

Emerging Technologies and Crypto-Assets

The SEC's Division of Examination has observed a significant increase in the number of RIAs choosing to provide automated digital investment advice to their clients (often referred to as "robo-advisers"), continued growth in the use of mobile apps by broker-dealers, as well as a proliferation of the offer, sale, and trading of crypto-assets.

Examinations of market participants engaged with crypto-assets will review the custody arrangements for such assets and will assess the offer, sale, recommendation, advice, and trading of crypto-assets. Crypto-asset priorities are said to include whether market participants: (1) have met their respective standards of conduct when advising investors with a focus on duty of care and the initial and ongoing understanding of the products (e.g., blockchain and crypto-asset feature analysis); and (2) routinely review, update, and enhance their compliance practices (e.g., crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices (i.e., data integrity and business continuity plans).

We hope this summary is helpful.
As always, if you have any questions about valuation issues or best practices related to the new priorities for Private Funds, please feel free to contact me or my Empire colleagues.

Empire Valuation Consultants has grown into one of the nation's leading and most respected independent valuation consulting firms, preparing 45,000 valuations and assurance engagements over our 30-year history. Our wealth of valuation experience includes nearly every industry and type of investment (equity, debt, real estate-backed assets, intellectual property and intangible assets), offering clients well-balanced valuations that are specifically tailored to each situation. The success of our refined valuation process is reflected in the firm's reputation in the marketplace. Time and again, asset managers, accountants, attorneys and bankers turn to us for timely, defendable, and comprehensible valuation work.

Mark Shayne, ASA, CPA, ABV, CGMA is a Senior Managing Director at Empire Valuation Consultants, LLC. He is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers, and is a Certified Public Accountant (CPA) and Accredited in Business Valuation (ABV) by the American Institute of Certified Public Accountants.
He has prepared and supervised over 3,500 valuations of direct and indirect investments in debt, equity, and real-estate backed assets on behalf of major alternative asset managers worldwide. Mark received his BS degree (cum laude) from the Wharton School of Business, and earned an MBA with Distinction from NYU's Stern Graduate School of Business.
mshayne@empireval.com