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SEC Division of Examinations 2023 Exam Priorities

Legal Update
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The SEC, through its Division of Examinations (DoE), has published its exam priorities for 2023. According to the SEC, these priorities reflect practices and products that may present more risk to investors and/or the integrity of U.S. capital markets.

The DoE discusses several "notable new and significant focus areas" which are summarized below. Also summarized below are several areas of particular interest to Registered Investment Advisers (RIAs).

Advisers Act Rule 206(4)-1 (Marketing Rule)

As RIAs are aware, the new Marketing Rule reflects a big change from the previous rule and related no-action letters. The compliance date for the new Marketing Rule was November 4, 2022, thus by now advisory firms have likely updated their policies and procedures consistent with the new Rule. The DoE reminds us that this is a **core** examination area for RIAs.

In its exams, the DoE expects to focus on whether RIAs have adopted and implemented policies and procedures reasonably designed to prevent violations of the Marketing Rule by advisers and their supervised persons. The DoE will look at whether RIAs have complied with the substantive requirements of the Rule. This will include a focus on whether an RIA can substantiate material statements of fact and the requirements for performance advertising, testimonials, endorsements and third-party ratings.

RIAs to Private Funds

The number of RIAs advising private funds continues to grow, with over 35 percent of RIAs now doing so. RIAs to private funds represent approximately $21 trillion of gross assets under management. As a result, the DoE will continue to focus on these items with respect to RIAs to private funds:

1. Conflicts of interest;
2. 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;

3. Compliance with the Marketing Rule, including performance advertising and compensated testimonials and endorsements;
4. Policies and practices regarding the use of alternative data and compliance with Advisers Act Section 204A (regarding prevention of misuse of non-public information);
5. Compliance with the Custody Rule where applicable, including timely delivery of audited financials and selection of permissible auditors.

In addition to the areas noted above, the DoE will also focus on:

6. Highly leveraged private funds,
7. Private funds managed side by side with BDCs,
8. Private equity funds that use affiliated companies to provide services to the funds and accounts managed,
9. Private funds involved in special purpose acquisition companies (SPACs), and
10. Private funds involved in advisor-led restructurings.

Fiduciary Duty, Regulation Best Interest and Form CRS

The DoE reminds us that the fiduciary standard for investment advisers and Regulation BI for broker-dealers include the obligation to act in retail investors' best interests and not place the firm's or its representatives' interests above those of the client. The DoE will focus on compliance with these applicable standards of conduct.

Dually registered RIAs and broker-dealers are an area of particular interest to the DoE due to potential for conflicts of interest to arise. Examinations will focus on recommendations for products and investment strategies (and may focus on those involving more complex, high cost or illiquid products), appropriate disclosures, process safeguarding best interest evaluations, and consideration of an investor's investment profile. Exams may focus on senior investors and/or those saving for retirement (including recommendations of retirement account rollovers).

The DoE will continue to prioritize compliance with Form CRS requirements. Firms must deliver relationship summaries to new and prospective retail investors as well as to existing retail investors.

Additional Areas of Focus for RIAs

Operations and compliance programs

The DoE will continue to focus on RIA operations and compliance programs. In particular, the DoE will review custody, portfolio management, brokerage and execution and the calculation of fees.

Electronic Communications

The DoE will focus on electronic communication and the compliance program around such communications.

Hedge Clauses

The DoE will review client agreements to determine whether firms purport to inappropriately waive or limit their standard of conduct through hedge clauses.

Cybersecurity

Deeming the current cybersecurity risk environment to be “elevated,” the DoE will continue its “perennial focus” on cybersecurity by looking at RIA practices to prevent interruptions to critical services and protect investor information and assets. It will focus on firms’ policies and procedures (are they reasonably designed to safeguard customer information?), governance practices and response to cyber incidents. Related to this, the DoE will focus on cybersecurity issues associated with use of third-party products and services. The DoE will also look at compliance with Regulations S-P and S-ID, where applicable.

Crypto-related assets

In light of recent shock waves coursing through the crypto industry, the DoE will focus on RIA sales and recommendations of crypto-related assets, and whether firms have employed appropriate risk management practices.

Environmental, Social and Governance (ESG) Investing

With the increased popularity of ESG investing, the DoE will focus on ESG related advisory services and fund offerings to assess whether ESG products are properly labeled and if product recommendations are appropriate for retail investors.

Recently registered RIAs and those that have not been examined for years.

The DoE will again prioritize new RIAs and those that have not been examined in a number of years.

For More Information

To discuss any topic related to these exam priorities, please feel free to contact Matt Boos at 612.492.7180 or Julie Sprau at 612-492-7031 in our Investment Management Group.