SEC Division of Examinations' 2023 Priorities

The SEC's Division of Examinations (the "Division" or "EXAMS") recently published its annual examination priorities for 2023. The Examination Priorities memorandum sets out key areas the staff will focus on during its examinations of registered investment advisers and broker-dealers in the coming year. In some respects, it provides a playbook that firms should study to spot and remediate potential compliance issues. Below please find an overview of the key EXAMS priorities in 2023.

Please contact any one of Quinn Emanuel's SEC Enforcement Defense lawyers listed below for guidance in addressing your particular circumstances. In particular, C. Dabney O'Riordan joined Quinn Emanuel in December 2022 after 17 years at the SEC, including the last six years leading the Division of Enforcement's Asset Management Unit, which specializes in issues relating to investment advisers.

I. Background

EXAMS is responsible for examining various SEC-regulated entities, including registered investment advisers, exempt reporting advisers, and broker-dealers. In 2022, the Division examined approximately 15% of registered investment advisers and oversaw the return of over $50 million to customers and clients through the exam process. The staff draws on its observations from those examinations, as well as conversations with stakeholders within the SEC, their counterparts at other regulatory agencies, and market participants, to identify risks and trends that are significant to investors and the markets. Those risks and trends shape the Division's priorities, which are designed to help the it achieve its four-part mission to (1) promote compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy.

This year's 24-page summary of the Division's priorities is the first Examination Priorities memorandum for Director Richard Best, who was named Director of the Division on March 24, 2022. The 2023 Examination Priorities memorandum continues to reflect substantial overlap with the SEC's regulatory and policy agenda, including a focus on private funds, ESG, crypto assets, cybersecurity, and service providers.

II. Marketing Rule

No surprise given the Division's September 2022 alert, the Marketing Rule leads off the priorities and is mentioned in two separate places: first on its own as a new rule EXAMS staff will review, and again when discussing the Division's priorities involving private funds. The staff's stated focus for its Marketing Rule compliance examinations is twofold: (1) whether firms have adopted and implemented policies and procedures to comply with the Marketing Rule, and (2) whether firms are actually in compliance with the rule's substantive requirements, specifically referencing whether firms can demonstrate a reasonable basis for believing they can substantiate material statements of facts, and requirements regarding performance advertising, testimonials, endorsements, and third-party ratings.

III. Private Funds

The Division lists private funds under "Notable New and Significant Focus Areas". Since private funds are not new, presumably this means that private funds will be a significant focus for the Division this year. This continues a trend where the Division had expressed very limited, focused priorities regarding private funds under Chairman Clayton, to the much more expansive list of issues in the 2023 priorities. *See also* January 27, 2022 Exam Alert including its observations from examinations of private fund advisers. Conflicts and fee calculations remain front and center, but the Division has provided additional detail on what it plans to focus on. This includes various issues that have been the subject of SEC enforcement matters in the past, including,

- Fee calculations during post-commitment periods.
- Policies and procedures regarding the use of alternative data and compliance with Advisers Act Section 204A, which requires policies and procedures to avoid the misuse of MNPI. *See* April 26, 2022 Exam Risk Alert regarding Investment Adviser MNPI Compliance Issues.
- Compliance with the custody rule in terms of timely delivery of audited financial statements and the selection of auditors.

As noted above, EXAMS also specifically lists private funds' compliance with the Marketing Rule as a focus.

EXAMS says it will also focus on private funds that have "specific risk characteristics". There are six categories, including private funds that are (1) highly leveraged, (2) are managed along with business development companies (BDCs), (3) are private equity funds using affiliates to provide services to portfolio companies and fund clients, (4) own hard to value assets (e.g., crypto, commercial real estate), (5) invest in or sponsor a SPAC, or (6) are involved in adviser-led restructurings.

IV. Information Security and Operational Resiliency

This has been a priority going back many years; however, this year the Division notes that cybersecurity is currently an elevated risk given "larger market events, geopolitical concerns, and the proliferation of cybersecurity attacks, particularly ransomware attacks." As such, the Division plans to focus on firms' policies and procedures, and whether they are reasonably designed to protect customer and client information. While mentioned in the 2022 priorities, this year's priorities emphasizes the review of third-party service providers who may have firm business records or customer information, and ensuring that the service provider has adequate safeguards in place. Notably, new as compared to 2022, the Division is going to make sure that the actual location of the firm's records matches the disclosures to the SEC, so it is a good time to double check that your Form ADV accurately identifies all the locations of your books and records.

V. Crypto Assets

A firm that recommends crypto assets to clients or customers is more likely to get examined this year, especially if it is a new registrant or has never before been examined or if there are further stresses on the crypto markets. As in prior years, where the Division does examine a firm that invests in crypto assets, the Division states that it will be looking at whether it met the applicable standard of care when recommending a crypto investment, and whether it regularly updated its compliance, disclosure, and risk management practices.

VI. Environmental, Social, and Governance (ESG) Investing

In recent years, there has been considerable investor demand for investment products and strategies that incorporate ESG criteria. In light of this trend, EXAMS will focus on ESG-related advisory services and fund offerings, including assessing whether funds are appropriately labeled, whether funds operate in the manner set forth in their disclosures, and whether recommendations of so-called ESG products are in investors' best interest.

VII. Fintech

The Division will continue to prioritize examinations of investment advisers and broker-dealers that engage in what the Division calls "digital engagement practices" (DEPs), as well as robo-advisers. The Division defines digital engagement practices as including (but not limited to) "behavioral prompts, differential marketing, game-like features … and other design elements or features designed to engage with retail investors on digital platforms." In particular, the EXAMS staff will consider whether the platform or application makes "recommendations" (and, if so, whether they are in investors' best interest), whether the platform's operations are consistent with its disclosures, and whether the adviser or broker-dealers has appropriately considered risks associated with its DEPs.

VIII. Reg BI and the Fiduciary Duty

Reg BI remains on the Division's priority list, and is discussed in conjunction with examinations looking at investment advisers acting consistent with their fiduciary duty, and making sure firms have identified and addressed their conflicts of interest in their policies and procedures. EXAMS notes it has "continued interest" in firms that are either dually registered as investment advisers and broker dealers or who have IA-BD affiliates. EXAMS will continue to look at the recommendations of certain types of products, including various complex products, high-cost and illiquid products, and proprietary products. EXAMS has also included among this list "unconventional strategies that purport to address rising interest rates" and microcap securities. A January 30, 2023 Exam Alert includes the staff's observations on Reg BI compliance from Broker-Dealer examinations.

IX. Registered Investment Advisers

The Division's priorities provide a shorter overview of how it conducts its examinations of registered investment advisers. While shorter, there appears to be a renewed emphasis on certain types of compensation as compared to the 2022 priorities. The Division notes three particular areas, including fee calculations, ways RIAs "try to maximize revenue" (specifically referencing bank deposit sweep programs), and then generally referencing "excessive fees" without further explanation of what they mean by excessive fees. There have been a number of SEC enforcement cases involving cash sweep programs, which could indicate greater scrutiny of these programs.

X. Registered Investment Companies

Registered investment companies are a perennial focus area for the Division. There are three new areas to note in the Division's priorities in this area. First, the Division states that it will evaluate board processes for approving fund fees, especially where the fund has poorer performance relative to its peers. Second, the types of funds the Division plans to focus on changed and expanded to include (1) turnkey funds, (2) mutual funds that converted to ETFs, (3) non-transparent ETFs, (4) loan-focused funds, and (5) medium and small complexes with "excessive staff attrition." Third, the Division notes it is "monitoring" the growth of volatility linked and single stock ETFs and may review those firms as well.

The Division will also be looking at registered investment company compliance with two new rules under the Investment Company Act of 1940. First, the derivatives rule in Rule 18f-4 of the Investment Company Act. Second, Rule 2a-5 addressing how funds and their boards should determine fair value of fund assets.

XI. Brief Mentions But Potentially Significant Issues for Investment Advisers

There were a few items mentioned in the priorities that were mentioned so briefly at the end of longer sections that you may have missed them, but could have greater significance than indicated by the brief mention.

A. Reviews for Hedge Clauses

For the first time, EXAMS specifically notes that it will be reviewing customer and client agreements that limit or waive the applicable standard of conduct, including hedge clauses. *See* Section I.C.1 at 12. Hedge clauses were an item the Division included in its January 27, 2022 Exam Alert including its observations from examinations of private fund advisers, and a hedge clause was part of the SEC's January 11, 2022 settled enforcement order against Comprehensive Capital Management.

B. Retaining and Monitoring Electronic Communications and Selecting Third-Party Service Providers

In Section IV.A., EXAMS includes a single line saying that it "will review RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers." There is a lot potentially covered in that single sentence.

Given the SEC's cases against broker-dealers for not retaining so-called "off-channel communications", through which the Division obtained nine-figure penalties against some firms for books and records and failure to supervise violations, as well as reports of additional Division of Enforcement investigations into investment advisers on this issue, this indicates that EXAMS is also going to focus on this issue for investment advisers. If you are a registered investment adviser and have not, in the context of the recent Enforcement cases, already taken a careful review of both your (1) policies and procedures regarding the retention of required books and records, and (2) your implementation of those policies and procedures, now is the time to do so.

As to third-party service providers, the 2022 priorities had only referenced third-party service providers in the context of registered investment companies, whereas here it is in a much broader category of all registered investment advisers. Given the proposed rule outlining standards by which registered investment advisers would have to vet and monitor service providers, that too seems to be an area that could get some traction within EXAMS.

XII. Broker Dealers

The priorities regarding broker-dealers remained much the same as in 2022 with one notable exception: the emphasis on reviewing broker-dealer compliance and supervisory programs. The Division will be looking at the firm's general compliance programs as well as recordkeeping of its electronic communications. Given the SEC's recent spate of cases against broker-dealers discussed above for not retaining so-called "off-channel communications", this indicates that Examinations is also going to continue focusing on this issue in its examinations.

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If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:

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