2023 SEC Division of Examinations Priorities

February 14, 2023

On February 7, 2023, the U.S. Securities and Exchange Commission's ("SEC") Division of Examinations ("EXAMS" or "Division") released its 2023 Examination Priorities ("2023 Priorities").[1] The 2023 Priorities provide a roadmap for the Division's priority areas for examinations over the upcoming year. The document reflects the Division's continued focus on private funds, crypto assets, and ESG, as well as attention to newly adopted rules for investment advisers and investment companies, such as the Marketing Rule (under the Investment Advisers Act of 1940 ("Advisers Act")) and the Derivatives Rule under the Investment Company Act of 1940 ("Investment Company Act")). In the midst of ongoing enforcement investigations relating to off-channel communications, EXAMS also will be scrutinizing policies and procedures for record-keeping of electronic communications in examinations of both broker-dealers and registered investment advisers ("RIAs"). Moreover, given the landscape of increased international sanctions, EXAMS has said it will focus this year on anti-money laundering ("AML") compliance. Across the 2023 Priorities, the Division has stated that special attention will be paid to potentially vulnerable investor groups, such as seniors and retirement savers.

Continued Focus on Private Funds

As in 2022, EXAMS will focus its attention on RIAs to private funds. Given the explosive growth of the private funds marketplace—with an 80 percent increase in gross assets over the past five years alone—and the increased investment by retirement plans in private funds, this continued focus is unsurprising.

When conducting examinations of RIAs to private funds, the Division intends to look at five specifically highlighted issues:

- conflicts of interest;

[1] *2023 Examination Priorities*, Division of Examinations, U.S. Securities and Exchange Commission (Feb. 7, 2023), available here.

- 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;

- compliance with the new Marketing Rule, including performance advertising and compensated testimonials and endorsements, such as solicitations;

- policies and practices regarding the use of alternative data and compliance with Advisers Act Section 204A; and

- compliance with the Custody Rule, where applicable, including the timely delivery of audited financials and selection of permissible auditors.

The 2023 Priorities also note an additional focus on RIAs to private funds "with specific risk characteristics," including highly leveraged funds; private equity funds using affiliated companies and advisory personnel in servicing their fund clients and underlying portfolio companies; private funds investing in or sponsoring Special Purpose Acquisition Companies ("SPACs"); private funds managed side by side with business development companies ("BDCs"); private funds holding difficult-to-value assets like crypto assets and real estate-related assets, focusing specifically on commercial real estate; and private funds involved in adviser-led restructurings.

Crypto Assets and Emerging Financial Technologies

In light of recent distress in the crypto markets and ongoing innovation in financial technologies more broadly, EXAMS will continue to focus on both areas.

In the crypto space, the Division will "continue to monitor, and when appropriate, conduct examinations" of firms affected by the downturn in crypto asset valuations. In addition, EXAMS will target new or never-before-examined registrants offering crypto or crypto-related assets. Examinations in this area will assess whether relevant market participants have "(1) met and followed their respective standards of care when making recommendations, referrals, or providing investment advice, to the extent required; and (2) routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices."

In both RIA and broker-dealer examinations, the Division will focus on digital technologies used to engage with and provide services to customers, including automated investment tools, and so-called "robo-advisers," which provide automated investment advice. The 2023 Priorities emphasize "digital engagement practices," which

EXAMS defines broadly to include any tools that use behavioral prompts, differential marketing, gamification, or any other design elements or features aimed at engaging with retail investors on digital platforms, including websites, apps, and social media. Examinations of digital engagement practices will assess, among other factors, whether recommendations or advice was provided, the fairness and accuracy of representations, and compliance with standards of conduct. EXAMS also will scrutinize risks associated with these practices, including, specifically, "the impact these practices may have on certain investors, such as seniors."

Compliance with Recently Adopted Marketing Rule, Derivatives Rule, and Fair Valuation Rule

The Division's 2023 Priorities highlight EXAMS' efforts to examine compliance with three recently adopted and high-profile SEC Rules: the Marketing Rule, the Derivatives Rule, and the Fair Valuation Rule:

- *Advisers Act Marketing Rule*[2]—The Division "will, among other things, assess whether RIAs have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by the advisers and their supervised persons of the Marketing Rule." Moreover, EXAMS will "review whether RIAs have complied with the substantive requirements" of the Rule, "including the requirement that RIAs have a reasonable basis for believing they will be able to substantiate material statements of fact and requirements for performance advertising, testimonials, endorsements and third-party ratings." This focus area is unsurprising given the previous statements by EXAMS that they will conduct a broad sweep of adviser marketing practices in light of the new rule requirements.[3]

- *Investment Company Act Derivatives Rule*[4]—"If a fund relies on the Derivatives Rule, the Division will, among other things: (1) assess whether registered investment companies, including mutual funds (other than money market funds), exchange-traded funds (ETFs), and closed-end funds, as well as [BDCs], have adopted and implemented policies and procedures reasonably designed to manage the funds' derivatives risks and to prevent violations of the Derivatives Rule pursuant to Investment Company Act Rule 38a-1; and (2) review for compliance with Investment Company Act Rule 18f-4, including the adoption and implementation of a derivatives risk management program, board oversight, and whether disclosures

[2] Advisers Act Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1.

[3] *Examinations Focused on the New Investment Adviser Marketing Rule*, Division of Examinations, U.S. Securities and Exchange Commission (Sept. 19, 2022), available here.

[4] Investment Company Act Rule 18f-4, 17 C.F.R. § 270.18f-4.

concerning the fund's use of derivatives are incomplete, inaccurate or potentially misleading."

- *Investment Company Act Fair Valuation Rule*[5]—EXAMS will "(1) assess registered funds' and fund boards' compliance with the new requirements for determining fair value, implementing board oversight duties, setting recordkeeping and reporting requirements, and permitting the funds' board to designate valuation designees" to determine fair value "subject to oversight by the board"; and (2) review whether registered funds have made adjustments to "valuation methodologies, compliance policies and procedures, governance practices, service provider oversight, and/or reporting and recordkeeping."

Record-Keeping of Electronic Communications

Consistent with the Commission's recent high-profile enforcement actions and investigations relating to off-channel communications, EXAMS has stated it will assess registrants' record-keeping in this area. Exams of both broker-dealers and RIAs likely will include a review of policies and procedures relating to the record-keeping of electronic communications. Additionally, broker-dealer examinations will look at supervision in this area. In light of the ongoing nature of the Division of Enforcement's attention to this area, we expect to see a steady flow of enforcement referrals regarding this issue.

Enhanced Focus on Anti-Money Laundering ("AML") Compliance

Citing the current geopolitical environment and increase in sanctions globally, EXAMS also is prioritizing assessments of Bank Secrecy Act ("BSA") compliance. Broker-dealers and certain registered investment companies are required to establish AML programs that include policies and procedures designed to, among other steps, identify and verify the identity of customers and beneficial owners of legal entities, perform customer due diligence, monitor for suspicious activity, and file Suspicious Activity Reports ("SARs") with the Financial Crimes Enforcement Network ("FinCEN"). EXAMS will be evaluating registrants' compliance with these requirements to ensure that suspicious activity and "illegal money-laundering activities" are being identified and, as appropriate, timely referred to law enforcement.

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[5] Investment Company Act Rule 2a-5, 17 C.F.R. § 270.2a-5.

Additional Significant Focus Areas

The Division also identified the following areas as high priorities:

Environmental, Social, and Governance Investing

For the fourth year in a row, EXAMS highlighted ESG investing as an area of focus. The continuing attention reflects the ongoing popularity of ESG strategies in the marketplace. Registrants can expect the Division to focus on whether ESG branding or labeling accurately describes the investment or may be misleading. In addition, EXAMS will evaluate the suitability of ESG investment recommendations.

Standards of Conduct

The Division will prioritize examinations of broker-dealers for compliance with Regulation Best Interest and RIAs for compliance with their fiduciary duties.[6] The 2023 Priorities observe that "[a]ll broker-dealers and investment advisers have at least some conflicts of interest with retail investors" and promise close scrutiny in this area. Specifically, EXAMS will assess the economic incentives, such as commissions or revenue sharing arrangements that firms and individual professionals have to recommend certain products or account types and whether firms have adopted and maintained written policies and procedures to identify and disclose such conflicts.

Another focus of the 2023 Priorities call-out is recommendations regarding more complex products aimed at retail investors. These include exchange-traded products that provide access to derivatives or use leverage, as well as non-traded REITS. The Division also made specific mention of unconventional products that purport to address rising interest rates.

Focus Areas for Registered Investment Companies, including Mutual Funds and Exchange-Traded Funds ("ETFs")

The Division's "perennial focus areas" with respect to registered investment companies "include, among other topics, an assessment of registered investment companies' compliance programs and governance practices, disclosures to investors, and accuracy of reporting to the SEC." To assess these topic areas, EXAMS will maintain its focus on "boards' processes for assessing and approving advisory and other fund fees, particularly for funds with weaker performance relative to their peers." The Division will also review "the effectiveness of funds' derivatives risk management programs and liquidity risk management program, as applicable."

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6 See Commission Interpretation Regarding Standard of Conduct for Investment Advisors, Advisers Act Rel. No. 5248 (June 5, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf (providing that an RIA's fiduciary duty applies to all advisory clients and the entire adviser-client relationship).

EXAMS intends to focus on "funds with specific characteristics, such as:

- turnkey funds, to review their operations and assess effectiveness of their compliance programs;
- mutual funds that converted to ETFs, to assess governance and disclosures associated with the conversion to an ETF;
- non-transparent ETFs, to assess compliance with the conditions and other material terms of their exemptive relief;
- loan-focused funds, such as leveraged loan funds and funds focused on collateralized loan obligations, for liquidity concerns and to review" the impact of elevated interest rates on the funds; "and
- medium and small complexes that have experienced excessive staff attrition, to focus on whether such attrition has affected the funds' control and operations."

The Division will also examine "the proliferation of volatility-linked and single-stock ETFs, and may review such ETFs' disclosures, marketing, conflicts, and compliance with portfolio management disclosures, among other things." As with RIAs, EXAMS will prioritize examinations of registered investment companies that have never been examined, as well as those that have not been examined for many years.

Information Security and Operational Resiliency

Another continuing priority, EXAMS will "review broker-dealers' and RIAs' practices to prevent interruption to mission-critical services and protect investor information, records and assets." The Division notes the heightened cybersecurity risk environment "given the larger market events, geopolitical concerns, and the proliferation of cybersecurity attacks, particularly ransomware attacks." The 2023 Priorities recognize that cybersecurity is "a perennial focus area for registrants." Accordingly, examinations will focus on firm resiliency, including procedures, practices, and responses to "cyber-related incidents, including those related to ransomware attacks, and broker-dealers' and RIAs' compliance with Regulations S-P and S-ID, where applicable."

Examinations focusing on policies and procedures "will include a review as to whether they are reasonably designed to safeguard customer records and information," including personally identifiable information ("PII") and use or collection by third parties, "as well as whether the location of such records has been properly disclosed to the Commission, where required."

Examinations will also assess "whether there has been an unauthorized use of third-party providers, particularly for transition assistance when departing RIA personnel attempt to migrate client information to another firm," and "significant registrants' operational resiliency planning, such as their efforts to consider and/or address climate-related risks."

Security-Based Swap Dealers

In the second year of examinations for this new category of registrant, EXAMS will continue to focus on general implementation of policies and procedures to comply with the new requirements. EXAMS also identified accurate trade reporting to swap data repositories under Regulation SBSR as a particular focus.

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As in prior years, the 2023 Priorities promise assessments of registrants in a broad array of areas. Registrants should brace for thorough examinations and expect close attention on crypto offerings and use of innovative technology, conflicts of interest, marketing practices at advisers, ESG, cybersecurity, electronic communications policies, and BSA compliance. Many of the 2023 Priorities match up with recent areas in which the Division of Enforcement has been active, posing a heightened risk of referrals.

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