Investment Management Update

March 2023

SEC Announces 2023 Exam Priorities

Key Notes:

- The Securities and Exchange Commission Division of Examinations ("Division") released its 2023 examination priorities.
- Priorities for registered funds and their advisers include compliance with new Rules 18f-4 and 2a-5 as well the board 15c approval process.
- Priorities for investment advisers include compliance with the new marketing rule, issues related to the management of private funds and ESG investing.

On February 7, 2023, the Securities and Exchange Commission ("SEC") Division of Examinations (the "Division") published its 2023 examination priorities, discussed below, providing insights into its risk-based approach and highlighting its mission to (1) promote compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy. The Division identifies four topics as "notable new and significant focus areas," which includes: (i) compliance with recently adopted rules under the Investment Advisers Act of 1940 ("Adviser's Act") and the Investment Company Act of 1940 ("Investment Company Act"); (ii) registered investment advisers ("RIAs") to private funds; (iii) standards of conduct; and (iv) environmental, social, and governance ("ESG") investing.

Additionally, the 2023 examination priorities include the following focus areas: information security and operational resiliency; crypto assets and emerging financial technology; investment advisers and investment companies; broker-dealer and exchange examination program; clearance and settlement; regulation systems compliance and integrity ("SCI"); FINRA and MSRB; anti-money laundering ("AML"); and the London Interbank Offered Rate ("LIBOR") transition.

Notable New and Significant Focus Areas

Compliance with Recently Adopted Rules under the Advisers Act and Investment Company Act

Marketing Rule (Advisers Act Rule 206(4)-1). The Division notes that it will assess whether the written policies and procedures that are reasonably designed to prevent violations by the advisers and their supervised persons of the new Marketing Rule have been adopted and implemented. The Division will also assess whether RIAs have complied with the requirement that they 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, as well as other substantive requirements of the Marketing Rule.

Derivatives Rule (Investment Company Act Rule 18f-4). For the funds that rely on the Derivatives Rule, the Division will assess whether registered investment companies ("RICs") have adopted and implemented policies and procedures reasonably designed to manage the funds' derivatives risk and to prevent violations of the Derivatives Rule pursuant to Investment Company Act Rule 38a-1. The Division will also review such funds' compliance with the Derivatives Rule, including: (i) the adoption and implementation of a derivatives risk management program; (ii) board oversight; and (iii) the adequacy of disclosures concerning the fund's use of derivatives to ensure they are not incomplete, inaccurate or potentially misleading.

Investment Company Act Fair Valuation Rule 2a-5. The Division will assess, among other things, the fund boards' compliance with the new requirements for (i) determining fair value; (ii) implementing board oversight duties; (iii) setting recordkeeping and reporting requirements; and (iv) permitting funds' boards to designate valuation designees subject to board oversight. They will also review whether adjustments have been made to valuation methodologies, compliance policies and procedures, governance practices, service provider oversight, and/or reporting and recordkeeping.

RIAs to Private Funds

The Division will continue focusing on RIAs to private funds as they continue representing a significant portion of the RIA population. The focus will be on the private fund RIAs' (i) conflicts of interest; (ii) calculation and allocation of fees and expenses; (iii) compliance with the new Marketing Rule; (iv) policies and practices regarding the use of alternative data and compliance with the Advisers Act Section 204A; and (v) compliance with the Custody Rule (Advisers Act Rule 206(4)-2). Additionally, the Division will focus on private fund RIAs with specific risk characteristics.

Standards of Conduct

Regulation Best Interest and Fiduciary Duty. The Division will continue to focus on broker-dealers and RIAs for compliance with their applicable standards of conduct, regulation best interest for broker-dealers and fiduciary duty for RIAs. The examinations will focus on:

- Investment advice and recommendation of products, investment strategies and account types;
- Disclosures of conflicts of interest related to advice and recommendations;
- Processes for "best interest" recommendations, including comparisons of available alternatives and evaluations of costs and risks;
- Factors, such as investment goals, that are considered in light of the investor's investment profile;
- RIAs' conflict of interest disclosures;
- RIAs' process for recommending complex products, high-cost and illiquid products, unconventional products and microcap securities; and
- Recommendations or advice to certain investors and specific account recommendations.

Aware that conflicts of interest may exist in all broker-dealers and investment advisers, the Division will seek to identify and understand the economic incentives for the broker-dealers' and investment advisers' recommendations, which will include reviewing established policies and procedures to identify such conflicts of interest and determine whether the compliance policies are tailored to the business models. The Division will review how firms manage their conflicts of interest and the existence of customer or client agreements that waive or limit their standard of conduct.

Form CRS. The Division will ensure that broker-dealers and RIAs comply with Form CRS, which includes the rules regarding relationship summaries.

ESG Investing

As RIAs and registered funds compete for investor demand for ESG-related investments and strategies, the Division will focus on ESG-related advisory services and fund offerings. They will also assess whether ESG products are labeled appropriately and if the recommendations of such products for retail investors are made in the investors' best interest.

Information Security and Operational Resiliency

Given the elevated risks related to cybersecurity attacks, the Division will continue to review broker-dealers' and RIAs' practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets. They will focus on the firms' policies and procedures, governance practices, and response 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. The evaluations will include a consideration of the firms' practices to prevent account intrusion and safeguarding customer records and information, a look into cybersecurity issues associated with the use of third-party vendors, and an assessment of systemically significant registrants' operational resiliency planning.

Crypto Assets and Emerging Financial Technology

The Division will conduct examinations of broker-dealers and RIAs offering new products and services or employing new practices, such as technological and online solutions. They will also assess whether market participants involved with crypto or crypto-related assets (i) met and followed their respective standards of care when making recommendations, referrals, or providing investment advice, to the extent required; and (ii) routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices. Additional focus will be placed on new registrants offering crypto or crypto-related assets or those that have not been previously examined, and on broker-dealer and RIA firms that employ digital engagement practices defined by the SEC as "tools with behavioral prompts, differential marketing, game-like features (commonly referred to as gamification), and other design elements or features designed to engaged with retail investors on digital platforms (e.g., websites, portals, and applications), as well as the analytical and technological tools and methods."

Investment Advisers and Investment Companies

Focus Areas for Examinations of RIAs

The Division will evaluate different aspects of the RIAs' operation and compliance practices for adoption and consideration of current market factors. They will review the compliance program and disclosures of RIAs in core areas, such as custody and safekeeping of client assets and valuation. The examination may also include a review of conflicts of interest, compliance issues, oversight and approval processes related to RIA fees and expenses. The Division may also review RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers. Priority will be set for the RIAs that have not been examined before or in several years.

Focus Areas for Registered Investment Companies, Including Mutual Funds and Exchange-Traded Funds

A few of the focus areas for RICs' examinations include assessments of compliance programs and governance practices, disclosures to investors, and accuracy of reporting to the SEC. The Division will focus on RIAs' fiduciary obligations to RICs, boards' processes for assessing and approving fund fees, and the effectiveness of the funds' derivatives risk management programs and liquidity risk management programs. Funds with specific characteristics will receive additional attention, as well as RICs that have never been examined or not examined in several years.

Broker-Dealer and Exchange Examination Program

Broker-Dealers

The Division will focus examinations on broker-dealers' compliance and supervisory programs, as well as recordkeeping of electronic communications. They will assess the adequacy of internal procedures and controls to safeguard customers' assets in accordance with the Customer Protection Rule and Net Capital Rule. Various aspects of the broker-dealer trading practices will be assessed, including conflicts of interest and compliance with Regulation SHO.

National Securities Exchanges

National securities exchanges will be assessed to determine whether they are meeting their obligations under the federal securities laws to provide marketplaces for facilitating securities transactions and serve as self-regulatory organizations. The examinations will focus on exchange operations intended to monitor, investigate and enforce member and listed company compliance with self-regulatory organizations rules and the federal securities laws.

Security-Based Swap Dealers ("SBSDs")

Examinations of SBSDs will focus on whether they have implemented policies and procedures related to compliance with SBS rules and whether they are meeting the reporting obligations under Regulation SBSR.

Municipal Advisors

The Division will examine whether municipal advisers have met their fiduciary duty to municipal entity clients and complied with the core standards of conduct and duties in MSRB Rule G-42. An evaluation will be made to examine whether conflicts of interest have been disclosed and whether municipal advisors have met their relationship documentation, registration, professional qualification and supervision requirements.

Transfer Agents

The Division will continue assessing transfer agent processing of items and transfers, recordkeeping and record retention, safeguarding funds and securities, and filings with the SEC. They will also focus on transfer agents that have certain types of issuers and those that utilize emerging technology.

Clearance and Settlement

The Division will examine registered clearing agencies for the SEC's Standards for Covered Clearing Agencies in addition to the required examination of clearing agencies designated as systemically important which the SEC serves as the supervisory agency. The examinations will include both risk-based exams and corrective action reviews. The focus for the year may include liquidity risk management, counterparty credit stress testing, governance and escalation, and compliance function.

Regulation Systems Compliance and Integrity

The Division will evaluate whether SCI entities have established, maintained, and enforced written policies and procedures as required with a focus on the following areas: software development life cycle, third-party dependencies, network segmentation, and application programming interface.

FINRA and MSRB

The Division will continue to conduct risk-based oversight examinations of FINRA with a focus on FINRA's implementation of investor protection initiatives and oversight of FINRA's examinations to make recommendations to improve FINRA's programs. Additionally, the Division will work with FINRA and the federal banking regulators to conduct examinations of registered firms to assess compliance with MSRB rules, as well as assess the risk assessment process at MSRB.

Anti-Money Laundering

Examinations of AML programs of broker-dealers and RICs continue to be a priority for the Division. The evaluations will ensure that the policies and procedures are adequately designed to identify suspicious and money laundering activities.

The LIBOR Transition

The Division will continue to monitor broker-dealer and RIA transition away from LIBOR, which could have a significant impact on the financial markets.

FOR MORE INFORMATION

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