THOMPSON HINE

Investment Management Update

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SEC Announces 2025 Exam Priorities

On October 21, the Securities and Exchange Commission's (SEC) Division of Examinations (Division) released its 2025 examination priorities for investment advisers, investment companies, broker-dealers, and other market participants. The Division's focus includes core areas, such as disclosure and governance practices, along with a focus on compliance with new rules, the increased role of technology, and the adequacy of controls in place to protect assets and investor information. Additionally, examinations will continue to emphasize "emerging risk areas," including fiduciary duties, standards of conduct, cybersecurity, and artificial intelligence (AI).

Investment Advisers

Adherence To Fiduciary Standards of Conduct

The Division will continue to ensure that investment advisers adhere to their "duty of care and loyalty" to clients by continuing to focus examinations on the investment advice they provide, particularly related to:

- High-cost products
- Unconventional instruments
- Illiquid and difficult-to-value assets
- Assets sensitive to high interest rates or changing market conditions

The Division noted that it will also focus on advisers with affiliated broker-dealers and non-standard fee arrangements, especially in the context of adviser conflicts of interest.

Effectiveness of Compliance Programs

The Division will concentrate on determining if a compliance program is "reasonably designed to prevent the advisers from placing their interests ahead of clients' interests." The SEC noted that an adviser's compliance program may need to exceed the requirements of Rule 206(4)-7, depending on the types of products offered. The Division will specifically focus on an adviser's use of AI in its operations, such as portfolio management, trading, marketing and compliance, as well as the disclosure related to the adviser's use of AI.

Examinations of Advisers To Private Funds

The SEC noted that a significant portion of registered investment advisers operate private funds, and thus the Division will continue to focus on these advisers, specifically reviewing their practices to ensure disclosures are consistent with actual adviser practices and whether they have met their fiduciary duties to clients, especially in times of market volatility. The Division may prioritize advisers to funds with generally poor performance, those that have experienced significant withdrawals, highly leveraged funds, and funds with difficult-to-value assets.

Additionally, the Division will evaluate the accuracy of calculations and the allocation of private fund fees and expenses, along with the complete and accurate disclosure of conflicts of interest and risks. The Division noted that it will continue to focus on adviser compliance with recently adopted amendments to Form PF and the investment adviser marketing rule.

Recently Registered Advisers and Advisers Never or Not Recently Examined

The Division will continue to look to examine recently registered advisers and those that have never or not recently been examined.

Investment Companies

The Division recognized the importance and increased significance of registered investment companies (RICs), mutual funds, and exchange-traded funds to retail investors and retirement saving. It will remain focused on reviewing RICs' "compliance programs, disclosures and governance practices," specifically:

- Fund fees and expenses, along with any waivers and reimbursements
- Oversight of affiliated and third-party service providers
- Portfolio management practices and disclosures for consistency with claims about investment strategies or approaches and with fund filings and marketing materials
- Issues related to market volatility

The Division added that it will continue to monitor "developing areas of interest," such as RICs that have exposure to commercial real estate and new and amended rules. The Division noted that it will continue to look to examine newly registered funds and those that have never or not recently been examined.

Broker-Dealers

Regulation Best Interest

The Division will maintain its focus on examining broker-dealer practices related to Regulation Best Interest, including:

- Recommendations regarding products, investment strategies, and account types and whether the broker has a reasonable basis to believe the recommendation is in the customer's best interests and does not place the broker's interests ahead of the customer's
- Disclosures made to investors regarding conflicts of interest
- Conflict identification, mitigation, and elimination practices
- Processes for reviewing reasonably available alternatives
- Factors considered in light of an investor's investment profile, such as investment goals and account characteristics

Additionally, the Division noted that it will specifically focus on recommended products that are complex, illiquid, or present higher risk to investors, explaining that these products include highly leveraged or inverse products, crypto assets, and non-registered products. The Division will also focus on recommendations:

- Made using automated investment tools or digital engagement practices
- Related to opening margin or self-directed IRA accounts
- To certain types of clients, such as elderly investors

Form CRS

The Division will prioritize reviewing the content of relationship summaries, specifically how a broker-dealer describes its fees and costs, the services it offers retail clients, and relationships and conflicts of interest. The Division will analyze whether broker-dealers have properly filed their relationship summaries with the SEC and delivered them to customers.

Financial Responsibility Rules

The Division will maintain its focus on ensuring that broker-dealers meet net capital rule requirements and customer protection rule requirements and have the necessary related processes and procedures in place. Examinations will also assess broker-dealer operational resiliency programs, such as supervision of third-party and vendor-provided services. The Division will also evaluate applicable liquidity controls to ensure broker-dealers have adequate liquidity during stress events.

Trading-Related Practices and Services

The Division noted the importance of and its continued focus on broker-dealer fixed-income and equity trading practices, specifically the "structure, marketing, fees, and potential conflicts associated with offerings by broker-dealers to retail customers," along with the trading practices associated with pre-IPO companies and "the sale of private company shares in secondary markets." Additionally, the Division will review broker-dealers' execution of retail orders, including when and if orders are marked as "held" or "not held," along with the pricing and valuation of "retail-focused instruments," including municipal securities. Finally, the Division will continue to review whether a broker-dealer is appropriately relying on the bona fide market making exception for purposes of Regulation SHO.

Risk Impacting Various Market Participants

Information Security and Operation Resiliency

Cybersecurity

The Division will maintain its focus on reviewing cybersecurity systems to determine if registrants are "reasonably managing information security and operational risks," noting that the importance of examining cybersecurity policies and procedures continues to increase. The Division explained that it will continue to pay particular attention to policies related to data security, access controls, and responses to cyber-related incidents.

Regulations S-ID and S-P

The Division will continue to assess compliance with Regulations S-ID and S-P as necessary, noting that these examinations will specifically focus on a firm's policies and procedures, internal controls, third-party oversight, and governance practices. The Division will also review policies related to safeguarding customers' information, specifically policies in place to identify, detect, and prevent identity theft and to prevent account intrusions, as well as whether there is adequate firm training on theft prevention programs. The Division noted that it will engage with firms during examinations to assist in preparing for the upcoming Regulation S-P compliance date.

Shortening of the Settlement Cycle

The Division will focus on broker-dealer compliance with the reduced standard settlement cycle to T+1 along with compliance with Rule 15c6-2. Additionally, it plans to review advisers' compliance with the amended books and records requirements associated with the change in settlement date. The Division noted that it will evaluate advisers' operational and technology changes associated with the shortened settlement cycle.

Emerging Financial Technologies

The Division will maintain its focus on the continuing increase in available financial technology, including automated investment tools and AI, along with the risks that come with these new technologies. It will specifically examine firms that utilize digital engagement practices, such as digital investment advisory services and recommendations, focusing on whether:

- The representations made are fair and accurate
- The operations and controls are consistent and adequately disclosed
- The advice produced by an algorithm is consistent with investors' investment profiles or stated strategies
- Adequate controls are in place to confirm the recommendations meet regulatory obligations to investors

The Division noted that it will prioritize reviewing registrant representations with respect to AI to ensure the capabilities and uses are accurately represented. It will also examine whether proper controls and policies are in place to monitor the use of AI.

Crypto Assets

The Division will maintain its focus on crypto assets and continue to monitor and conduct examinations "when appropriate," noting that these examinations will focus on the offer and sale, recommendation and advice, trading, and other activities involving crypto assets. Additionally, examinations will review whether registrants:

- Meet and follow their respective standards of conduct when recommending or advising on crypto assets,

specifically an initial and ongoing understanding of the products, with retail and older investors
- Routinely review and update their compliance practices, risk disclosures, and operational resiliency practices

Regulation Systems Compliance and Integrity (SCI)

During examinations of SCI entities, the Division will focus on:

- Policies and procedures regarding operational, business continuity planning, and testing practices
- The effectiveness of response plans, specifically the decision to disconnect from or reconnect to another registrant or third party that is experiencing a cyber event or when the SCI entity is facing a cyber event
- Policies and procedures related to operation management tools to ensure proper levels of security

AML

The Division will again focus on AML programs during examinations of RICs and broker-dealers, specifically to ensure that AML programs:

- Are appropriately tailored to the business model and associated AML risks
- Are independently tested
- Include appropriate customer identification programs, including for beneficial owners of legal entities
- Meet SAR filing requirements

Finally, the Division will determine if broker-dealers and advisers are monitoring the Department of Treasury's Office of Foreign Assets Control sanctions and ensuring compliance with them.

Conclusions

While many of the SEC's examination priorities remain the same year after year, advisers and funds should continue to expect a focus on newly adopted rules and issues reflected in rules that were not adopted (such as AI usage and private fund rules).

FOR MORE INFORMATION

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