

Legal Update

U.S. SEC Announces 2023 Exam Priorities

On February 7, 2023, the Division of Examinations of the U.S. Securities and Exchange Commission (the "Division" and the "SEC," respectively) announced its examination priorities for 2023.¹ This year, the Division identified new and significant focus areas including: (i) recently adopted rules under the Investment Advisers Act of 1940 ("Advisers Act") and Investment Company Act of 1940 ("Investment Company Act"); (ii) registered investment advisers ("RIAs") to private funds; (iii) Regulation Best Interest ("Reg BI") and fiduciary duty; and (iv) Environmental, Social and Governance ("ESG") investing.

Many of the areas highlighted by the Division align with industry expectations based on the guidance provided by the SEC in the recent years. Over the past two years, the Division has published 16 risk alerts sharing insights and observations from examinations on various key topics such as digital assets, amended Rule 206(4)-1 under the Advisers Act (the "Marketing Rule") and Reg BI.² The Division's focus on the Marketing Rule initiative, in particular, is not surprising given that it is a major change for advisers in the advertising and communications space and is widely considered one of the most significant changes for investment advisers in recent times. In addition, the regulatory regime for Reg BI has matured, and broker-dealers should expect enhanced examinations.

The following provides a brief overview of the Division's new and significant focus areas as well as continued focus areas covering issues from the investment advisers, investment companies and broker-dealers.

Notable New and Significant Focus Areas

RECENTLY ADOPTED RULES UNDER THE ADVISERS ACT AND INVESTMENT COMPANY ACT

Marketing Rule Compliance. The Division emphasized that it will focus on RIAs' compliance with the Marketing Rule. Generally, it will focus on whether RIAs have adopted appropriate written policies and procedures designed to prevent violations by RIAs and their supervised persons of the Marketing Rule. The Division will also focus on RIAs' compliance with the substantive requirements of the Marketing Rule, including the requirement that RIAs have a reasonable basis for substantiating material statements of facts and requirements for performance advertising, testimonials, endorsements, and third-party ratings.

Derivatives Rule Compliance. For investment companies registered under the Investment Company Act (“registered funds”) and business development companies (“BDCs”) relying on Rule 18f-4 under the Investment Company Act (the “Derivatives Rule”), the Division will, among other things: (1) assess whether RIAs and registered funds and BDCs have adopted and implemented policies and procedures reasonably designed to manage such registered funds’ derivatives risks and to prevent violations of the Derivatives Rule; and (2) review for compliance with the Derivatives Rule, including the adoption and implementation of derivatives risk management programs, board oversight, and whether disclosures concerning such registered funds’ use of derivatives are incomplete, inaccurate or potentially misleading.

Fair Valuation Rule. The Division will, among other things: (1) assess registered funds’ and fund boards’ compliance with the new requirements under Rule 2a-5 under the Investment Company Act, including for determining fair value, implementing board oversight duties, setting recordkeeping and reporting requirements and permitting funds’ boards to designate valuation designees to perform fair value subject to board oversight; and (2) 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

As noted by the Division, RIAs to private funds represent a significant portion of the RIA population. Given their significance, the Division will focus on private fund RIAs’: (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 private equity fund valuation practices; (3) compliance with the new Marketing Rule, including specific focus on performance advertising and compensated placement agent arrangements; (4) policies and practices regarding the use of alternative data and compliance with Section 204A of the Advisers Act (*i.e.*, insider trading); and (5) compliance with the Custody Rule (*i.e.*, Rule 206(4)-2 under the Advisers Act), where applicable, including timely delivery of audited financials and selection of permissible auditors.

Additionally, the Division will focus on RIAs to private funds with specific risk characteristics, such as (1) highly-leveraged funds; (2) private funds managed side-by-side with BDCs; (3) private equity funds that use affiliated companies or personnel as service providers; (4) private funds that hold “hard-to-value” investments, such as crypto assets and real estate-related holdings, with an emphasis on commercial real estate; (5) private funds that invest in or sponsor special purpose acquisition companies (*i.e.*, “SPACs”); and (6) private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds.

REG BI, FIDUCIARY DUTY AND FORM CRS

Dually registered broker-dealers and RIAs, as well as affiliated firms with dual-hatted personnel, continue to be an area of interest for the Division. During examinations, the Division will review: (1) investment advice and recommendations with regard to products, investment strategies, and account types; (2) disclosures made to investors (particularly conflict of interest disclosures); (3) processes for making best interest evaluations (*i.e.*, reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest); and (4) factors considered in light of the investor’s investment profile (*e.g.*, investment goals and account characteristics). In addition, specifically in the case

of RIAs, examiners will assess whether disclosures of conflicts of interest are sufficient to support a client's informed consent, whether express or implied.

Some of the products highlighted as potential focus areas include: (1) complex products (*e.g.*, derivatives, leveraged exchange-traded funds ("ETFs"), exchange-traded notes ("ETNs") and other exchange-traded products ("ETPs")); (2) high cost and illiquid products (*e.g.*, variable annuities and non-traded REITs); (3) proprietary products; (4) unconventional strategies that purport to address rising interest rates; and (5) microcap securities. Recommendations or advice to certain types of investors (*e.g.*, senior investors) and specific account recommendations (*e.g.*, retirement account rollovers and 529 plans) may also be reviewed during examinations.

With respect to conflicts of interest, the Division will review firms' written policies and procedures to identify conflicts of interests with retail investors and whether they are sufficiently tailored to the firm's business. Additionally, the Division will review economic incentives (*e.g.*, revenue sharing, commissions or other incentivizing revenue arrangements); how firms are managing identified conflicts; and whether firms have terms in customer agreements that inappropriately waive or limit their standard of conduct (*e.g.*, use of hedge clauses).

The Division also notes that compliance with Form CRS will continue to be prioritized and incorporated into the Division's core examinations.

ESG INVESTING

Given the rising investor demand for ESG-related investments and strategies incorporating certain ESG criteria, the Division will continue its focus on ESG-related advisory services and fund offerings, including whether the funds are operating in the manner set forth in their disclosures. Additionally, the Division will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in investors' best interest.

Information Security and Operational Resiliency

The Division will look at firms' practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets. Specifically, the Division will review firms' policies and procedures, governance practices and response to cyber-related incidents, and compliance with Regulations S-P and S-ID. For the policies and procedures, the Division will evaluate whether they are reasonably designed to safeguard customer records and information (including information stored through a third-party provider) as well as whether the location of such records has been properly disclosed to the SEC as required.

In addition, firms' practices to safeguard customer information and to prevent intrusion will be evaluated. In particular, cybersecurity issues associated with the use of third-party vendors will be reviewed, including visibility into the security and integrity of third-party services and instances of departing RIA personnel attempting to migrate client information without authorization to another firm using third-party providers for transition assistance.

As done in the prior years, the Division will assess systemically significant registrants' operational resiliency planning this year.

Crypto Assets and Emerging Financial Technology

Given the increase in 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 (e.g., on-line brokerage services, internet advisers, automated investment tools and trading platforms, including “robo-advisers”).

With respect to crypto assets and their associated products and services, the Division will monitor and examine broker-dealers and RIAs affected or potentially impacted by the recent financial distress among crypto asset market participants. This year, the focus will be on new or never before examined registrants offering crypto or crypto-related assets. The Division will assess whether the firms: (1) met their standards of care when providing investment advice/recommendations or referrals and (2) routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices.

Another focus area this year will be digital engagement practices employed by broker-dealers and RIAs. The examinations of such practices will assess whether (1) recommendations or advice was provided (e.g., through the use of social media marketing and social trading platforms); (2) representations were fair and accurate; (3) operations and controls in place were consistent with disclosures made to investors; (4) any advice or recommendations were in the best interest of the investor; and (5) risks associated with such practices were considered.

Investment Advisers and Investment Companies

RIAS

The Division will remain focused on whether the various aspects of RIAs’ operations and compliance practices have appropriately adopted and considered current market factors, including those that might impact valuation and the accuracy of RIA regulatory filings. In a typical examination, the Division reviews the compliance programs and related disclosures of an RIA in one or more core areas, such as custody and safekeeping of client assets, valuation, portfolio management, and brokerage and execution. In addition, examinations generally include a review of conflicts, compliance issues and oversight and approval processes related to RIA fees and expenses, including revenue earned on clients’ bank deposit sweep programs. Additionally, examinations will review RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers.

Similar to prior years, the Division will prioritize RIAs that have never been examined, including recently registered firms, and those that have not been examined for a number of years.

REGISTERED FUNDS, INCLUDING MUTUAL FUNDS AND ETFs

In reviewing registered funds, the Division will conduct assessment of registered funds’ compliance programs and governance practices, disclosures to investors and accuracy of reporting to the SEC. The Division will focus on the fiduciary obligations of RIAs to registered funds, particularly with respect to their receipt of compensation for services or other material payments made by registered investment companies. The Division will also continue to evaluate boards’ processes for assessing and approving advisory and other fund fees, particularly for funds with weaker performance relative to their peers. In

addition, the Division intends to assess the effectiveness of funds' derivatives risk management programs and liquidity risk management programs, as applicable.

The Division will also focus on registered funds with specific characteristics, such as: (1) turnkey funds,³ (2) mutual funds that converted to ETFs; (3) non-transparent ETFs; (4) loan-focused funds; and (5) medium and small fund complexes that have experienced excessive staff attrition. The Division will also monitor the growth of volatility-linked and single-stock ETFs, and may review such funds' disclosures, marketing, conflicts, and compliance with portfolio management disclosures, among other things.

Similar to prior years, the Division will prioritize examinations of mutual funds or ETFs that have not previously been examined or have not been examined in a number of years.

Broker-Dealer and Exchange Examination Program

BROKER-DEALERS

General compliance and supervisory programs, including those for electronic communications and related recordkeeping, are going to the focus of examinations on broker-dealers this year. For broker-dealers that hold customer cash and securities, the Division will review compliance with the Customer Protection Rule and the Net Capital Rule and assess firms' credit, market and liquidity risk management controls to ensure that firms have sufficient liquidity to manage stress events.

With respect to trading practices, the Division will focus on conflicts of interest with retail investors in order routing and execution and compliance with Regulation SHO. For alternative trading systems, the particular focus will be on firms' compliance with Regulation ATS and whether the operation is consistent with the disclosures in their Form ATS-N.

In terms of municipal securities and other fixed income securities, the Division will review fairness of pricing, compliance with confirmation disclosure requirements and municipal issuer disclosure obligations. Additionally, in reviewing over-the-counter securities and microcap securities, the Division will focus on firms' compliance with Rule 15c2-11 under the Securities Exchange Act of 1934 (the "Exchange Act") and the penny stock disclosure rule (*i.e.*, Rules 15g-2 to 15g-6 under the Exchange Act). Furthermore, the Division will review whether the firms may be involved in the illegal distribution of unregistered securities.

NATIONAL SECURITIES EXCHANGES

The Division will focus on exchange operations 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")

The Division will assess whether SBSDs have implemented policies and procedures on Security-Based Swap rules generally and SBSDs are meeting obligations under Regulation SBSR.

MUNICIPAL ADVISORS

The Division will assess whether municipal advisors have met their fiduciary duty to their clients; disclosed conflicts of interest; and met their relationship documentation, registration, professional qualification and

supervision requirements. In addition, the Division will review compliance with MSRB Rule G-42 (*i.e.*, core standard of conduct and duties of municipal advisors).

TRANSFER AGENTS

Examinations will focus on transfer agents that service microcap and crypto assets issuers as well as those that use emerging technology.

Clearance and Settlement

This year, the examination areas of focus, among others, include liquidity risk management, counterparty credit stress testing, governance and escalation and the compliance function.

Regulation Systems Compliance and Integrity (“SCI”)

Examination of SCI entities will be focused on written policies and procedures of SCI entities. Specifically, the Division will review whether the policies and procedures are reasonably designed to address the following areas: (1) software development life cycle (*i.e.*, review and keep current systems development and testing methodologies); (2) third-party dependencies (*i.e.*, ensure that third-party operated systems have adequate levels of capacity, integrity, resiliency, availability and security); (3) network segmentation (*i.e.*, review of a security threat to SCI systems if a system is breached); and (4) application programming interface (*i.e.*, ensure SCI systems have adequate levels of security to maintain the SCI entity’s operational capability).

Anti-Money Laundering (“AML”)

In response to the elevated importance of AML programs given the current geopolitical environment and the increased imposition of international sanctions, the Division will prioritize examinations of broker-dealers and certain registered investment companies for compliance with their AML obligations to assess whether firms have: (1) established appropriate customer identification programs; (2) met their Suspicious Activity Reports filing obligations; (3) conducted ongoing due diligence on customers; (4) complied with beneficial ownership requirements; and (5) conducted robust and timely independent tests of their AML programs.

The London Interbank Offered Rate (“LIBOR”) Transition

The Division will continue to review broker-dealer and RIA preparation for the transition away from LIBOR. LIBOR is currently schedule for discontinuation in mid-2023.

Concluding Thoughts

The 2023 examination priorities reflect the Division’s effort to address issues identified with the significant macro events impacting the industry throughout the past year. RIAs, registered investment companies and broker-dealers should review the 2023 examination priorities closely and should consider addressing topics applicable to their business as part of their overall risk and compliance management process. In addition to the SEC’s examination priorities discussed herein, broker-dealers should review the Financial Industry Regulatory Authority, Inc.’s (“FINRA”) 2023 Report on FINRA’s Examination and Risk Monitoring

Program published earlier this year.⁴ The announced priorities do not represent an exhaustive list of the areas the Division will focus on with respect to registrants, so firms should continue to adopt a comprehensive, risk-based approach with respect to their compliance program.

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ENDNOTES

¹ SEC Division of Examinations, [2023 Examination Priorities](#) (February 7, 2023).

² See SEC Division of Examinations, Risk Alerts on [The Division of Examinations’ Continued Focus on Digital Asset Securities](#) (Feb. 26, 2021), [Examinations Focused on the New Investment Adviser Marketing Rule](#) (Sep. 19, 2022) and [Observations from Broker-Dealer Examinations Related to Reg BI](#) (Jan. 30, 2023). See also our related Legal Updates on SEC’s Risk Alerts on [Digital Asset Securities, new Marketing Rule](#) and [Reg BI](#).

³ “Turnkey funds” references funds that utilize a turnkey solutions provider for infrastructure purposes (*i.e.*, to organize, operate, and service the funds, such as governance and compliance services).

⁴ FINRA, [2023 Report on FINRA’s Examination and Risk Monitoring Program](#) (Jan. 2023). See our [Legal Update on FINRA’s 2023 Report](#).

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