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Legal Update

# SEC Announces 2024 Exam Priorities

On October 16, 2023, the Division of Examinations of the U.S. Securities and Exchange Commission (the "Division" and the "SEC," respectively) announced its examination priorities for 2024.[1] While the Division typically announces its examination priorities near the start of the calendar year, this is the first time that the Division has published its examination priorities this early, to align with the start of the fiscal year. The Division stated its hope that this will better inform investors and registrants of key risks, trends and examination topics on which the Division intends to focus in 2024.

As in prior years, the Division's examination priorities focus on areas that the Division believes pose emerging risks to the markets or to investors, in addition to existing core risk areas. The Division acknowledged the short interval of eight months since the publication of the fiscal year 2023 priorities and noted that several areas of focus from last year will remain as priorities for the Division in fiscal year 2024. Notably, in contrast to previous examination priorities, there was no specific focus area concerning Environmental, Social and Governance ("ESG") issues in the 2024 examination priorities, although the wording of this year's areas of focus is certainly broad enough to capture ESG-related regulatory concerns.

For fiscal year 2024, the Division identified the following focus areas for various market participants, including: (i) examinations of investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), including registered investment advisers ("RIAs") to private funds and funds registered under the Investment Company Act of 1940 ("Investment Company Act"); (ii) registered investment companies, including mutual funds and exchange-traded funds ("ETFs"); (iii) broker-dealers, including compliance with Regulation Best Interest ("Reg BI") and the use of Form CRS, financial responsibility rules and trading practices; and (iv) other market participants, including self-regulatory organizations, clearing agencies, municipal advisors and security-based swap dealers, among others.

Many of the areas highlighted by the Division align with industry expectations based on the guidance provided by the SEC and its staff in the recent years. Last fiscal year, the Division published nine risk alerts sharing insights and observations from examinations on various key topics, including firms' development and implementation of an identity theft prevention program and compliance with Regulation S-ID; observations from broker-dealer examinations related to Reg BI; issues identified in recent newly registered investment adviser examinations; issues arising from LIBOR-transition preparedness by investment advisers and investment companies; and compliance with anti-money laundering regulation.

The Division's risk alerts also highlighted areas that may be covered in certain examinations, such as the different aspects of Rule 206(4)-1 under the Advisers Act (the "Marketing Rule").[2]

The following provides a brief overview of the Division's examination priorities of certain practices, products and services applicable to investment advisers, investment companies, broker-dealers, and multiple or other market participants.

## Investment Advisers

### EXAMINATIONS OF INVESTMENT ADVISERS

***Investment Advisers' duty of care and duty of loyalty.*** The Division stated that it would continue to focus on whether investment advisers are complying with their fiduciary obligations under the Advisers Act, including (i) the obligation to serve the best interests of clients and not to subordinate a client's interest to the investment adviser's own interest; and (ii) the obligation to eliminate or make full and fair disclosure of conflicts of interest, such that a client can provide informed consent to the conflict. In examining whether an investment adviser has complied with its duty of care and duty of loyalty, the Division stated that it would focus on the following areas:

- whether an investment adviser has met the fiduciary standards with regards to ***products, investment strategies, and account types***, specifically focusing on advice relating to (1) complex products, such as derivatives and leveraged exchange-traded funds (ETFs); (2) high cost and illiquid products, such as variable annuities and non-traded real estate investment trusts (REITs); and (3) unconventional strategies, including those that purport to address rising interest rates. The Division identified that its focus may be emphasized on investment advice provided to older investors and those saving for retirement.
- an investment adviser's ***processes for determining whether investment advice was provided in a client's best interest***, including the processes for (1) making initial and ongoing suitability determinations; (2) seeking best execution; (3) evaluating costs and risks; and (4) identifying and addressing conflicts of interests. The Division will focus on the factors that an adviser considers in light of its client's investment profile, including investment goals and account characteristics. With regard to conflicts of interest, the Division stated that it will review how investment advisers address conflicts of interest, including (1) how an investment adviser mitigates or eliminates conflicts of interest where appropriate and (2) allocating investments to accounts in the scenario where an investor has more than one account (e.g., adviser fee-based; brokerage commission-based; wrap fee based).
- the ***economic incentives*** that an adviser and its financial professionals may have when it recommends products, services or account types to investors. Examinations will focus on the economic incentives and conflicts of interest to identify, among other things: (1) investment advice to purchase or hold onto certain types of investments or invest through certain types of accounts when lower cost options are available; and (2) investment advice regarding proprietary products and affiliated service providers that result in additional or higher fees to investors.
- examining the ***disclosures made to investors*** and whether all material facts relating to conflicts of interest were sufficiently disclosed to allow a client to provide informed consent to the conflict.

***Investment Adviser's Compliance Programs.*** The Division identified its continued focus on the compliance programs of investment advisers, including whether the investment advisers' policies and procedures address applicable market risks.

The Division identified the following areas of particular examination focus:

- **Marketing Practices.** The Division stated that it would examine whether advisers have: (1) adopted and implemented reasonably designed written policies and procedures to prevent violations of the Advisers Act and the rules thereunder, including reforms to the Marketing Rule; (2) appropriately disclosed their marketing-related information on Form ADV; and (3) maintained substantiation of their processes and other required books and records. Marketing practice reviews will also assess whether disseminated advertisements include any untrue statements of a material fact, are materially misleading, or are otherwise deceptive and, as applicable, comply with the requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements.
- **Compensation Arrangements.** The Division stated that it would assess the compensation arrangements of investment advisers, including: (1) the fiduciary obligations of advisers to their clients, including registered investment companies, particularly with respect to the advisers' receipt of compensation for services or other material payments made by clients and others; (2) alternative ways that advisers try to maximize revenue, such as revenue earned on clients' bank deposit sweep programs; and (3) fee breakpoint calculation processes, particularly when fee billing systems are not automated.
- **Valuation.** The Division stated it will examine advisers' recommendations to clients to invest in illiquid or difficult to value assets, such as commercial real-estate or private placements.
- **Safeguarding**. The Division will examine the controls of investment advisers to protect clients' material non-public information, particularly when multiple advisers share office locations, have significant turnover of personnel, or use expert networks.
- **Disclosure**. The Division will conduct disclosure assessments on the accuracy and completeness of regulatory filings, including Form CRS, with a specific focus on registration eligibility and inadequate or misleading disclosures.

The Division is also focused on advisers' policies and procedures for: (1) selecting and using third-party and affiliated service providers; (2) overseeing branch offices when advisers operate from numerous or geographically dispersed offices; and (3) obtaining informed consent from clients when advisers implement material changes to their advisory agreements. The Division's reviews in this regard will assess, among other things, whether the advisers' policies and procedures are reasonably designed and implemented and whether the procedures prevent the advisers from placing their interests ahead of clients' interests.

The Division stated that, as with previous years, it will continue to prioritize examinations of advisers that have not been examined for a number of years and advisers that have never been examined, including recently registered advisers.

## RIAs TO PRIVATE FUNDS

The Division noted that RIAs to private funds remain a significant portion of the RIA population. Given their significance, the Division stated that it would continue to focus on private fund RIAs and prioritize specific topics such as: (1) portfolio management risks from market volatility and higher interest rates (the Division noted that this may include private funds experiencing poor performance, significant withdrawals and valuation issues and private funds with more leverage and illiquid assets); (2) adherence to contractual requirements regarding limited partnership advisory committees or similar structures, including any contractual notification and consent processes; (3) accurate calculation and allocation of fees and expenses at the fund- and investment-level, including valuation of illiquid assets, the calculation of post-commitment period management fees, adequacy of disclosures and the potential offsetting of fees and expenses; (4) due diligence practices with respect to private equity and venture capital fund assessments of prospective portfolio companies; (5) conflicts, controls and disclosures regarding private funds managed side-by-side with registered investment companies and use of affiliated service providers; (6) compliance with the Custody Rule (Rule 206(4)-2 under the Advisers Act), including accurate reporting on Form ADV, timely completion of audits by a qualified auditor and the distribution of fund audited financial statements; and (7) policies and procedures for reporting on Form PF, including upon the occurrence of certain reporting events.

## REGISTERED INVESTMENT COMPANIES, INCLUDING MUTUAL FUNDS AND ETFs

The Division identified the importance of registered investment companies, including mutual funds and ETFs, to retail investors and those saving for retirement, and stated that it will continue to prioritize review of registered funds. The Division will conduct assessments of registered funds' compliance programs and governance practices, disclosures to investors and accuracy of reporting to the SEC. In assessing the compliance programs and governance practices of registered funds, the Division will 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 will review the valuation practices of investment companies, particularly for those addressing fair valuation practices (e.g., implementing board oversight duties, setting recordkeeping and reporting requirements, and overseeing valuation designees), and, as applicable, will assess the effectiveness of registered investment companies' derivatives risk management and liquidity risk management programs.

The Division will focus on:

- **Assessing fees and expenses**, and reviewing whether registered investment companies have adopted effective written compliance policies and procedures concerning the oversight of advisory fees and implemented any associated fee waivers and reimbursements. The Division identified the following particular areas of focus: (1) charging different advisory fees to different share classes of the same fund; (2) identical strategies offered by the same sponsor through different distribution channels but that charge differing fee structures; (3) high advisory fees relative to peers; and (4) high registered investment company fees and expenses, particularly those of registered investment companies with weaker performance relative to their peers. Examinations will also review the register funds' boards' approval of the advisory contract and registered investment company fees.

- **Derivatives risk management assessment** to review whether registered investment companies as well as business development companies have adopted and implemented written policies and procedures reasonably designed to prevent violations of the SEC's fund derivatives rule (Investment Company Act Rule 18f-4). Review of compliance with the derivatives rule may include review of the adoption and implementation of a derivatives risk management program, board oversight, and whether disclosures concerning the registered investment companies' or business development companies' use of derivatives are incomplete, inaccurate or potentially misleading. Examinations may also cover the associated registered investment companies' or business development companies' procedures for, and oversight of, derivative valuations.

The Division also stated that it would review registered funds for compliance with the terms of exemptive order conditions and issues associated with recent market dislocations and volatility, including whether registered investment companies that are in liquidation are following liquidation procedures.

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-Dealers

**Regulation Best Interest**. The Division identified the following areas of particular interest in reviewing whether the recommendations of broker-dealers are in their customers' best interest: (1) the broker-dealers' recommendations with regard to products, investment strategies, and account types; (2) disclosures made to investors regarding conflicts of interest; (3) conflict mitigation practices; (4) processes for reviewing reasonably available alternatives; and (5) factors considered in light of the investor's investment profile, including investment goals and account characteristics. The Division stated that its examinations will focus on recommended products that are: (1) complex, such as derivatives and leveraged ETFs; (2) high cost, such as variable annuities; (3) illiquid, such as nontraded REITs and private placements; (4) proprietary; and (5) microcap securities. Examinations may also focus on recommendations to certain types of investors, such as older investors and those saving for retirement or college.

The Division will also evaluate whether a broker-dealer has established, maintained and enforced written policies and procedures reasonably designed to achieve compliance with Reg BI, as well as compliance with the areas described above, including consideration of whether the policies and procedures are reasonably designed based on the costs, risk and rewards of the investment strategies and securities recommended to customers by the broker-dealer. Examinations may also assess broker-dealer supervision of branch office locations, as well as dual-registrants, including firms' conflicts of interest, account allocation and account selection practices.

**Form CRS**. The Division will review the content of a broker-dealer's relationship summary, such as how the broker-dealer describes: (1) the relationships and services that it offers to retail customers; (2) its fees and costs; and (3) its conflicts of interest, and whether the broker-dealer discloses any disciplinary history. These examinations will also evaluate whether broker-dealers have met their obligations to file their relationship summary with the SEC and deliver their relationship summary to retail customers.

**Broker-Dealer Financial Responsibility Rules.** The Division will review compliance with the SEC's Customer Protection Rule and Net Capital Rule and assess firms' credit, market and liquidity risk management controls to ensure that firms have sufficient liquidity to manage stress events. Other areas of focus include fully paid lending programs and broker-dealer accounting for certain types of liabilities, such as reward programs, point programs, gift cards and non-brokerage services.

**Broker-Dealer Trading Practices**. With respect to trading practices, the Division will focus on compliance with (i) Regulation SHO, including the rules regarding aggregation units and locate requirements, (ii) Regulation ATS and whether the operations of alternative trading systems are consistent with the disclosures provided in Forms ATS and ATS-N, and (iii) SEC Rule 15c2-11. Furthermore, during examinations of wholesale market makers, the Division's examinations may include quote generation, order routing and execution practices, market data ingestion, regulatory controls, and risk management.

## MULTIPLE MARKET PARTICIPANTS

### Information Security and Operational Resiliency

The Division will continue to review firms' practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets. The Division stated that operational disruption risks remain elevated due to the proliferation of cybersecurity attacks, firms' dispersed operations, intense weather-related events and geopolitical concerns, meaning that **cybersecurity remains a perennial focus area for all registrants**. Specifically, the Division will focus on firms' policies and procedures, internal controls, oversight of third-party vendors (where applicable), governance practices and response to cyber-related incidents, and compliance with Regulations S-P and S-ID. Specifically, with respect to third-party products and services, the Division will continue to assess how registrants identify and address risks to essential business operations and will also look at the concentration risk associated with the use of third-party providers, including how registrants are managing this risk and the potential impact to the U.S. securities markets. In addition, the Division will evaluate whether firms' practices are able to prevent account intrusions and safeguard customer records and information, especially as it pertains to firms' multiple offices.

The SEC adopted rule changes to **shorten the standard settlement** cycle for most broker-dealer transactions from two business days after the trade date to one business day after the trade date. In connection with this change, the Division will assess registrant preparations associated with this shortening of the settlement cycle, which has a compliance date of May 28, 2024.

The Division will focus on cybersecurity issues associated with the use of third-party vendors, including registrant visibility into the security and integrity of third-party products and services.[3] The Division will also review whether there has been an unauthorized use of third-party providers.

### Crypto Assets and Emerging Financial Technology

The Division continues to monitor the proliferation of crypto assets and emerging financial technology, including mobile applications and automated investment advice. The Division will focus on broker-dealers and advisers offering new products and services or employing new practices, particularly technological and online solutions that service online accounts aimed at meeting the demands of compliance and

marketing. The Division also stated that it remains focused on certain services, including automated investment tools, artificial intelligence, and trading algorithms or platforms.

With respect to crypto assets and their associated products and services, the Division identified the "continued volatility" of the crypto asset markets and will continue to 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.

With respect to crypto assets that are funds or securities, the Division will consider whether advisers are complying with the custody requirements under Rule 206(4)-2 of the Advisers Act, and will assess whether any technological risks associated with the use of blockchain and distributed ledger technology have been addressed, including whether compliance policies and procedures are reasonably designed, accurate disclosures are made and the risks pertaining to the security of crypto asset securities are addressed.

## Anti-Money Laundering ("AML")

The Division reiterated that financial institutions, including broker-dealers and certain registered funds, establish AML programs that are tailored to address the risks associated with the firm's location, size and activities. The Division stated that it will continue to review firms' AML programs and assess whether firms are: (1) appropriately tailoring their AML program to their business model and associated AML risks; (2) conducting independent testing; (3) establishing an adequate customer identification program, including for beneficial owners of legal entity customers; and (4) meeting their suspicious activity report ("SAR") filing obligations. Examinations of certain registered investment companies will also review policies and procedures for oversight of applicable financial intermediaries. The Division will also review whether broker-dealers and advisers are monitoring sanctions of the Office of Foreign Assets Control and ensuring sanctions compliance.

## Other Market Participants

### SECURITY-BASED SWAP DEALERS ("SBSDS")

The Division will assess whether SBSDs have implemented policies and procedures on Security-Based Swap rules generally and whether SBSDs are meeting their obligations to accurately report security-based swap transactions under Regulation SBSR. Moreover, examinations will focus on whether security-based swap dealers are complying with applicable capital, margin, and segregation requirements and relevant conditions in SEC orders governing substituted compliance

### MUNICIPAL ADVISORS

The Division will continue to 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 new MSRB Rule G-46, which becomes effective on March 1, 2024 (*i.e.*, core standard of conduct and duties for

solicitor municipal advisors, including disclosure of conflicts of interest and documentation of client relationships).

### TRANSFER AGENTS

Examinations will focus on transfer agent processing of items and transfers, recordkeeping and record retention, safeguarding of funds and securities, and filings with the SEC. The Division will also focus on transfer agents that service microcap and crypto assets issuers as well as those that use emerging technology.

## Concluding Thoughts

The 2024 examination priorities reflect the Division's views regarding significant regulatory issues impacting the industry. As we head towards 2024, we expect that we will remain in a challenging regulatory and enforcement environment. Given the earlier than usual release of the Division's priorities, RIAs, registered investment companies and broker-dealers should review the 2024 examination priorities closely and incorporate in any ongoing or annual review of their overall risk and compliance management process. The 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 programs.

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## ENDNOTES

[1] SEC Division of Examinations, 2024 Examination Priorities (October 16, 2023).

[2] See SEC Division of Examinations, Risk Alerts on Observations From Broker-Dealer and Investment Adviser Compliance Examinations Related to Prevention of Identity Theft Under Regulation S-ID (Dec. 5, 2022), Observations from Examinations of Investment Advisers and Investment Companies Concerning LIBOR-Transition Preparedness (May 11, 2023) 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 Anti-Money Laundering, LIBOR Transition for Investment Advisers and Investment Companies and Reg BI.

[3] The SEC adopted final rules on cybersecurity risk management, strategy, governance and incident disclosure earlier this year. *See* Securities and Exchange Commission, Release Nos. 33-11216; 34-97989, *Final Rule: Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosur*e (July 26, 2023), available at https://www.sec.gov/files/rules/final/2023/33-11216.pdf. See also our related Legal Update.

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