

## Division of Examinations: 2023 Examination Priorities for Investment Advisers

**FEBRUARY 7, 2023:**



On February 7, 2023, the Division of Examinations of the United States Securities & Exchange Commission (“EXAMS”) published the 2023 Examination Priorities.

Like previous years, the 2023 Examination Priorities provides certain data regarding the scope of the examination program and the growth of the investment adviser community. The following are highlights of that data:

- In fiscal year 2022, EXAMS completed examinations of approximately 15% of the registered investment adviser population;
- The number of registered investment advisers grew to more than 15,000, overseeing more than \$125 trillion in assets under management;
- More than 5,500 advisers, totaling over 35% of all advisers, manage approximately 50,000 private funds with gross assets exceeding \$21 trillion; and
- In the past 5 years, there has been an 80% increase in the gross assets of private funds.

### Focus Areas for 2023

#### Advisers Act Rule 206(4)-1 (Marketing Rule)

EXAMS will assess, among other things, the following relating to the Marketing Rule:

- Whether advisers have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by advisers and their Supervised Persons;
- Whether advisers have complied with the substantive requirements of the Marketing Rule, including
  - o The requirement that advisers have a reasonable basis for believing that they will be able to substantiate material statements of fact;
  - o Performance advertising;
  - o Testimonials; and
  - o Third-party ratings.

#### Advisers to Private Funds

EXAMS will continue to focus on the following issues relating to advisers to private funds:

- Conflicts of interest;
- Calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices;

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- Compliance with the 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, including timely delivery of audited financials and selection of permissible auditors.

In addition, EXAMS will focus on advisers to private funds with specific risk characteristics, including such things as:

- Highly-leveraged private funds;
- Private funds managed side-by-side with business development companies;
- Private equity funds that use affiliated companies and advisory personnel to provide services to their fund clients and underlying portfolio companies;
- Private funds holding hard-to-value assets, such as crypto and commercial real estate;
- Private funds that invest in or sponsor Special Purpose Acquisition Companies; and
- Private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds.

#### Fiduciary Duty

EXAMS will continue to prioritize examinations of advisers for compliance with the fiduciary standard. EXAMS notes continued interest regarding dually registered advisers, as well as affiliated firms with financial professionals who service both brokerage customers and advisory clients.

Examinations will focus on such things as:

- Investment advice and recommendations with regard to products, investment strategies, and account types;
- Disclosures to investors, especially those relating to conflicts of interest associated with advice and recommendations;
- Processes for making best interest evaluations, including:
  - Reviewing reasonably available alternatives;
  - Evaluating costs and risks; and
  - Identifying conflicts of interest;
- Factors considered in light of the investor's investment profile, including investment goals and account characteristics;
- Whether conflicts of interest disclosures are sufficient so as to permit a client to provide informed consent;
- Advice recommendations regarding:
  - Complex products such as derivatives;
  - High cost and illiquid products, such as variable annuities and non-traded Real Estate Investment Trusts;
  - Proprietary products;
  - Unconventional strategies that purport to address rising interest rates;
  - Microcap securities; and
- Recommendations and advice to certain types of investors, e.g. senior investors saving for retirement, retirement account rollovers.

While not providing specific examples, EXAMS provides that “All . . . investment advisers have at least some conflicts of interest with retail investors.” In reference to this, EXAMS provides that it will seek to identify and understand economic incentives that a firm and its financial professionals have to recommend products, services or account types, such as the source and structure of compensation, revenue or other benefits. EXAMS will determine if advisers:

- Have established written policies and procedures to identify conflicts;
- Periodically review and update their policies and procedures; and
- Whether policies and procedures are tailored to the adviser’s business model, compensation structure, product menu and customer base.

In addition, EXAMS will review whether advisers have customer or client agreements that purport to inappropriately waive or limit their standard of conduct, such as through hedge clauses.

#### Form CRS

EXAMS will continue to review advisers’ compliance with Form CRS filing, delivery and posting requirements.

#### Environmental, Social and Governance Investing (“ESG”)

EXAMS will continue to review ESG-related advisory services. The staff will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are in investors’ best interests.

#### Information Security and Operational Resiliency

EXAMS provides that the current risk environment related to cybersecurity is considered elevated given the larger market events, geopolitical concerns and the proliferation of cybersecurity attacks, specifically ransomware attacks. In light of these risks, advisers’ practices to prevent interruptions to critical systems and to protect investor information remain paramount. Examinations will focus on the following:

- Advisers’ policies, procedures, governance practices and responses to cyber-related incidents;
- Compliance with Regulations S-P and S-ID;
- Whether advisers’ policies and procedures are reasonably designed to safeguard customer records and information, including both at advisers and any service providers to advisers;
- Whether the location of records has been properly disclosed to the SEC;
- Cybersecurity issues related to the use of third-party vendors; and
- Advisers’ business continuity planning.

#### Crypto Assets and Emerging Financial Technology

The Examination Priorities notes the proliferation of certain investments, (e.g. crypto) and emerging financial technology (e.g. the delivery of automated investment advice). Examinations will focus on advisers offering new products and services, or employing new practices, including the offer, sale, or recommendation of, advice regarding and trading in crypto and crypto-related assets. Specifically, EXAMS will assess whether advisers:

- Met and followed their fiduciary duty when providing such investment advice; and
- Routinely reviewed and updated their compliance disclosure and risk management practices.

In regards to the delivery of advisory services through an automated method, e.g. robo-advisory services, examinations will assess whether:

- Recommendations or advice were provided;
- Representations are fair and accurate;
- Operations and controls are in place consistent with disclosures made to investors;
- Any provided advice or recommendations are in the best interest of the investor taking into account the investor's financial situation and investment objectives; and
- Risk associated with such a delivery method are considered, including the impact on various investor types, such as seniors.

#### Examination Focus Areas

EXAMS provides that during a typical examination, the staff will review advisers' compliance programs and related disclosures, with a focus on the following areas:

- Custody;
- Valuation;
- Portfolio management;
- Brokerage and execution;
- Retaining and monitoring electronic communications;
- Third-party service providers; and
- Oversight and approval related to fees and expenses, including:
  - o The calculation of fees;
  - o Alternative ways that advisers may try to maximize revenue, including revenue earned on clients' bank deposit sweep programs; and
  - o Excessive fees.

Here is the link to the Exam Priorities: <https://www.sec.gov/files/2023-exam-priorities.pdf>