Insights: Alerts

SEC's Division of Examinations Releases 2022 Examination Priorities

APRIL 19, 2022 Written by Jeffrey T. Skinner, Skyler D. Shields and Thomas B. Cain

Each year, the SEC's Division of Examinations (the "**Division**") releases its priorities for the upcoming year, providing SEC registrants with a helpful tool to assist in managing, reviewing, and updating their compliance programs. The 2022 Examination Priorities (the "**2022 Priorities**"), which were released last month, indicate a renewed focus on registered investment advisers ("**RIAs**") who manage private funds; a continued interest in protecting retail investors and ensuring accurate environmental, social, and governance ("**ESG**")-related disclosure; and a greater focus on the practices of RIAs and broker-dealers ("**BDs**") relating to emerging issues like information security, emerging technologies, and crypto-assets.[1]

The 2022 Priorities highlight the SEC's goals in light of the increasing number of RIAs,[2] total assets under management ("**AUM**"),[3] and complexity of the asset management industry.[4] The 2022 Priorities come on the heels of other SEC proposed rules and guidance involving RIAs, including two recent proposed rules, one related to private fund advisers regulation and the other to cybersecurity preparation and disclosure.[5] We discussed these proposed rules in our blog posts, SEC Proposes Significant Regulatory Overhaul for Private Fund Advisers and Man the Cyber Forts! – SEC Proposes New Cybersecurity Regulations for RIAs and Funds. The 2022 Priorities further emphasize the SEC's focus on these matters and indicate the Division's intent to examine registrants regarding these issues. This makes reviewing and reflecting on the 2022 Priorities in light of your firm's business vitally important to ensure that the policies, procedures, and practices at your firm reflect regulatory expectations, address the SEC's "hot button" topics, and avoid pitfalls and issues called out in the report.

Our summary of key focus points from the 2022 Priorities is below, beginning with a Table of Contents to assist in referencing topics of importance to you and your firm.

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Significant Focus Areas

Private Funds

The Division highlighted that more than 5,000 RIAs (over 35% of RIAs) manage approximately $18 trillion in private fund assets, and further noted that RIAs to private funds frequently have significant investments from state and local pensions with working family beneficiaries.[6] The size, complexity, and growth of the private fund market, coupled with significant examination findings, has spurned the Division (and the SEC has a whole) to renew its focus on RIAs to private funds.

The Division will review issues related to an adviser's fiduciary duty, and will assess risks, focusing on: (1) compliance programs; (2) fees and expenses; (3) custody; (4) fund audits; (5) valuation; (6) conflicts of interest; (7) disclosure of investment risks; and (8) controls around material non-public information.[7]

Specifically, the Division stated it will continue to review:

- Calculation and allocation of fees and expenses (including the calculation of post-commitment period management fees and the impact of valuation practices);
- Potential preferential treatment of certain investors by RIAs to private funds, particularly those that have experienced liquidity issues (e.g., imposing gates or suspending fund withdrawals);
- Compliance with the custody rule, including the "audit exception" to the surprise examination requirement and the related reporting/updating of Form ADV regarding audits and auditors;
- The adequacy of disclosure and compliance with regulatory requirements for cross trades, principal

transactions, or distressed sales; and

- Conflicts around liquidity, such as RIA-led fund restructurings (e.g., secondary transactions where new investors purchase existing investors' interests while also agreeing to invest in a new fund).

Additionally, the Division noted it will review RIAs': (1) portfolio strategies, (2) risk management, and (3) investment recommendations and allocations. In particular, the Division indicated it would focus on conflicts of interest and disclosures in these areas, conducting reviews of investments in special purpose acquisition companies ("**SPACs**") (particularly where the RIA is also the SPAC sponsor) and the practices, controls, and investor reporting around risk management and trading for private funds with indicia of systemic importance.[9]

Along these lines, the Division released a risk alert in January 2022 which highlighted observations from examinations of RIAs to private funds.[10] In this risk alert, the Division noted, among other items, its observations of RIAs to private funds failing to act consistent with material disclosures in private fund documents,[11] advertising misleading track records, and making statements in marketing materials that are misleading due to affirmative misstatements or material omissions.[12]

***KTS Practice Tip:** The multiple recent SEC releases related to RIAs to private funds (the private fund risk alert, the proposed rule regarding private fund advisers, and the 2022 Priorities) have further emphasized the SEC's enhanced focus on these registrants. Accordingly, we suggest that RIAs to private funds ensure that they are prepared for an examination. In preparation, RIAs should review, among other items, their: (1) existing disclosures for completeness and accuracy, and (2) practices and procedures for consistency with disclosed practices and procedures (*e.g.*, reviewing RIA practices vs. disclosures regarding conflicts committees, calculation of management fees, etc.). In other words, an RIA should ensure that it follows all material processes, practices and procedures that are disclosed in the RIA's private fund documents.

ESG Investing

The 2022 Priorities highlight how RIAs and registered funds are increasingly offering ESG strategies to meet the constantly growing demand for ESG-related investments. The Division noted the heightened risk for materially false and misleading statements in the ESG-related investment space, potentially compounded by the lack of standardization in ESG investment terminology and the variety of ESG strategies. Accordingly, the Division indicated it will examine whether RIAs and registered funds are:

- Accurately disclosing their ESG investing approaches;[13]
- Voting client securities in accordance with their proxy voting policies and procedures – and whether those votes align with their ESG-related disclosures and mandates; or
- Overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (*e.g.*, greenwashing), such as in their performance advertising and marketing.[14]

***KTS Practice Tip:** On March 21, 2022, the SEC proposed new ESG-related rules for operating companies that would, in some ways, standardize ESG disclosures.[15] While these proposed rules will not affect registered funds, many in the industry expect that the SEC will soon propose ESG-related rules for registered funds. We advise RIAs and other industry participants to ensure that their ESG-related disclosures are consistent with the RIA's policies, procedures and practices, as well as SEC guidance in this area.

Retail Investor Protection - Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS

In the 2022 Priorities, the Division reiterated its focus on protecting retail investors, stating that it will continue to review BDs' and RIAs' compliance with their obligations under Regulation BI and the fiduciary standard under the Investment Advisers Act of 1940 to act in retail investors' best interests. Specifically, reviews will continue to assess, among other items:

- Consideration of alternatives practices (e.g., with regard to potential risks, rewards, and costs);
- Conflicts of interest management (e.g., incentive practices that favor certain products or strategies over others);
- Trading (e.g., RIA best execution obligations);
- Disclosures (e.g., disclosures provided in Form ADV and Form CRS, and made pursuant to Regulation BI);
- Account selection (e.g., brokerage, advisory, or wrap fee accounts);
- Account conversions and rollovers;
- Compliance program effectiveness, testing, and training that are designed to support retail investors; and
- Whether advice given to retail investors is in their best interests.[16]

BD Examinations

Examinations will review BD firms' recommendations and sales practices related to certain products including, but not limited to, SPACs, structured products, leveraged and inverse exchange traded products, private placements, annuities, municipal and other fixed income securities, and microcap securities.

Examinations will review BD's practices, policies and procedures concerning the cost evaluation of, and reasonably available alternatives to, the products listed above to ensure recommendations are in investors' best interests. Additionally, examinations will evaluate the compensation structures for financial professionals, with particular focus on the sale of securities by highly compensated financial professionals.[17]

RIA Examinations

Generally, RIA examinations will focus on whether advisers are acting in accordance with their fiduciary duties to clients (with respect to both duties of loyalty and care), including best execution obligations, financial conflicts of interest, and any attendant client disclosures. Examinations will focus on RIAs' practices related to:

- Revenue sharing arrangements;
- Recommending or holding more expensive classes of investment products when lower cost options are available;
- Recommending of wrap fee accounts without first assessing whether these accounts are in the best interests of clients (e.g., reviewing wrap fee suitability in light of a number of BDs moving to zero commissions on certain types of transactions); and
- Recommending proprietary products resulting in additional or higher fees.

Finally, examinations will review the adequacy of RIAs' compliance policies and procedures designed to address conflicts and ensure that advice is in the best interests of clients, as well as whether RIA disclosures are sufficiently detailed and clear to enable investors to provide informed consent where requested.[18]

Dually Registered RIAs and BDs

Examinations of dually registered RIAs and BDs will encompass the areas discussed above and will also focus on the potential conflicts of interest dual registration presents. Examinations will further consider whether firms' policies and procedures are (or will be) effective to mitigate, monitor and address conflicts, while also considering whether firms' policies and procedures minimize the risk of advice that is not in retail investors' best interests. For example, the Division's Examinations will include reviews of:

- Sales or recommendations of high fee products;
- Sales or recommendations of the firm's or its affiliates' proprietary products;
- Incentives for firm personnel to place their own or the firm's interests above clients; and
- Compensation structures that inappropriately influence investment recommendations.[19]

Information Security and Operational Resiliency

Both the Division and the SEC as a whole have highlighted that maintaining information security is a critical responsibility of market participants.[20] Consistent with this focus, the 2022 Priorities provided that examinations will assess whether firms have taken appropriate measures to:

- Safeguard customer accounts and prevent unauthorized account access;
- Oversee vendors and service providers;
- Address malicious email activities (e.g., phishing);
- Respond to incidents, including those related to ransomware attacks;
- Identify and detect identity theft red flags;
- Manage operational risks caused by remote work; and
- Establish and improve their business continuity and recovery plans, with a particular focus on the impact of climate risk and substantial disruptions to business operations.[21]

****KTS Practice Tip:*** The Division has regularly indicated the importance of testing as a critical means of ensuring that all policies and procedures are operating as designed. Accordingly, like other policies and procedures, RIAs and BDs should periodically test their cybersecurity policies and procedures. Testing may be done using a variety of methods, such as by practicing tabletop exercises (*i.e.*, where a firm analyzes and responds to a simulated information security breach). However, regardless of the testing method, testing should allow firms to detect and correct deficiencies in their policies and procedures.[22]

Emerging Technologies and Crypto-Assets

There has been an increase in the number of RIAs that provide automated digital investment advice ("robo-advisers"), the use of mobile apps by BDs, and the trading of crypto-assets. Given the recent emergence of these technologies, the Division will review whether firms considered these activities and the unique risks they impose when developing their compliance programs.

Emerging Technologies

RIA and BD examinations will focus on firms that utilize (or claim to be utilizing) new practices or offer new products.

These practices and products may include engaging “Finfluencers” (publishers of financial lessons and money tips on social media), utilizing digital engagement practices, or offering fractional shares. Examinations will assess registrants':

- Operations and controls to ensure consistency with disclosures, regulatory obligations and the standard of conduct owned to investors;
- Consistency of advice and recommendations with investors' investment strategies and the standard of conduct owed to these investors; and
- Controls, and whether the controls account for unique risks associated with the relevant practices.[23]

Crypto-Assets

The Division will continue to focus examinations of market participants engaged with crypto-assets on the custody arrangements for crypto-assets and the offer, sale, recommendation, advice, and trading of crypto-assets. Particularly, examinations will review whether market participants:

- Have a sufficient initial and ongoing understanding of the crypto-asset products they recommend; and
- Routinely review, update and enhance their: (i) compliance practices (*e.g.*, crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures); (ii) risk disclosures; and (iii) operational resiliency practices.

The Division will also review mutual funds and ETFs that offer crypto-asset exposure, assessing, among other things, these funds' compliance, liquidity, and operational controls around portfolio management and market risk.[24]

Investment Adviser and Investment Company Examination Program

RIAs

The Division highlighted focuses in several “core areas” and additional perennial issues, including: (i) marketing practices; (ii) custody; (iii) valuation; (iv) advisory fee calculations; (v) portfolio management; (vi) brokerage and execution; (vii) conflicts of interest and related disclosures; (viii) whether compliance programs focus on investment advice and the standard of conduct; (ix) oversight of service providers; (x) compliance resources; (xi) whether compliance programs have addressed heightened risks, including employing individuals with disciplinary history; (xii) shift from broker-dealer business model to advised accounts; and (xiii) operating from multiple branch offices.[25]

Registered Investment Companies, Including Mutual Funds and ETFs

The Division will continue to examine registered funds' compliance programs and governance practices, focusing on perennial areas, including: (i) disclosures to investors; (ii) accuracy of reporting to the SEC; (iii) compliance with new rules and exemptive orders; and (iv) liquidity risk management programs.

Further, the Division stated it will prioritize examinations of certain types of funds, portfolio investments and fund practices, such as:

- *Money market funds* - which will be reviewed for compliance with applicable requirements, including stress-testing, website disclosures, and board oversight;

- *Business development companies* - which will be reviewed for their valuation practices, marketing activities, and conflicts of interest with underlying portfolio companies;
- *Mutual funds invested in private funds* - which will be reviewed for their risk disclosure and navigation of valuation issues;
- *Advisory fee waivers* - which will be reviewed to assess the sustainability of services for firms that provide the waivers; and
- *Trading activities of portfolio managers* - examining to determine if the activities may be designed to inflate fund performance.[26]

Additional Focus Areas Relating to BDs and Exchanges

Microcap, Municipal, Fixed Income, and Over-the-Counter Securities

The Division will prioritize examinations of BDs for compliance with their obligations in the offer, sale, and distribution of microcap securities (securities of companies with a market capitalization under $250 million).[27]

BD Operations

Examinations will continue to assess BD compliance with the Consumer Protection Rule and Net Capital Rule, focusing on the adequacy of internal processes, procedures and controls, and compliance with requirements for margin securities from clients.

The Division noted it will also continue to examine broker-dealer trading practices, including assessing BD compliance with best execution obligations in a zero commission environment and reviewing conflicts of interests arising in order routing (*e.g.*, conflicts arising from payment for order flow).[28]

National Securities Exchanges

The Division will examine national securities exchanges to assess whether they are meeting their federal securities laws obligations and will focus on exchange regulatory programs. Examinations may also assess and compare ESG initiative related advisory services offered to issuers.[29]

Security-Based Swap Dealers ("SBSDs")

Examinations of new SBSD registrants will primarily focus on general compliance with security-based swap rules.[30]

Municipal Advisors

The Division will examine municipal advisors to assess whether they meet their fiduciary and conflict disclosure obligations to municipal entity clients, as well as whether municipal advisors have met their registration, professional qualification, continuing education, and supervision requirements.[31]

Transfer Agents

The Division will continue to examine transfer agents, and will prioritize examinations of transfer agents that have never been examined, that service microcap or municipal bond issuers, use novel technologies (*e.g.*, blockchain or online crowdfunding portal applications), or engage in significant paying agent activity.[32]

Additional Examination Priorities

Clearance and Settlement Examination Program

The Division noted that, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, it will conduct at least one risk-based exam of each clearing agency designated as systematically important and for which the SEC serves as supervisory agency, focusing on core risks, processes, controls, the nature of operations, and financial and operational risk.[33]

Regulation Systems Compliance and Integrity

The Division will evaluate whether Regulation SCI entities have established, maintained, and enforced the required written policies and procedures.[34]

FINRA

The Division will conduct risk-based oversight examinations of FINRA. The Division's examinations may focus on a number of areas, including FINRA's operations and FINRA's examinations of certain BDs and municipal advisors.[35]

MSRB

The Municipal Securities Rulemaking Board ("**MSRB**") regulates the activities of BDs that buy, sell, and underwrite municipal securities, as well as the activities of municipal advisors. The Division, along with FINRA and the federal banking regulators, will examine registered firms to assess compliance with MSRB rules.[36]

The London Inter-Bank Offered Rate ("LIBOR") Transition

The Division, through examinations and outreach efforts, will assess firms' exposure to LIBOR and preparations for the discontinuation of LIBOR and the transition to an alternative reference rate.[37]

Anti-Money Laundering

The Division will continue to examine BDs' and registered investment companies' compliance with anti-money laundering ("AML") obligations, with a goal of evaluating whether policies and procedures are reasonably designed to identify suspicious activity and illegal money-laundering activities.

The Division stated that, given the importance of AML requirements, the Division will continue to prioritize examinations of firms' AML obligations in order to assess, among other things, whether firms: (i) have established appropriate customer identification programs; (ii) are satisfying their SAR filing obligations; (iii) are conducting appropriate due diligence on customers and verifying the identity of customers and beneficial owners of entity customers; and (iv) conducting robust and timely independent tests of their AML programs.[38]

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As in prior years, the 2022 Priorities do not contain an exhaustive list of issues the Division will prioritize in routine examinations and guidance in the upcoming year. However, we encourage RIAs, BDs, registered investment companies, and other market participants to review the 2022 Priorities and to consider whether their compliance programs adequately address, at a minimum, the issues identified therein.

Following recent proposed rules, recent SEC guidance, and the 2022 Priorities, it is apparent that the Division is paying close attention to registrants in the investment management industry, particularly with respect to certain issues, such as advisers to private funds, ESG investment, and cybersecurity issues. In addition, it appears that the Division is becoming even more aggressive in its Examination and Enforcement programs. Accordingly, we encourage registrants to engage regulatory counsel to prepare for examinations (including by through conducting mock examinations) and respond to any follow-on requests. If you have any questions about the 2022 Examination Priorities, or about the regulation of RIAs, BDs, and registered investment companies generally, please feel free to contact us.

By the ***Investment Management and Broker-Dealer Team*** *at* ***Kilpatrick Townsend & Stockton***

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Footnotes

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[1]Press Release, SEC, *SEC Division of Examinations Announces* 2022 *Examination Priorities* (Mar. 30, 2022), https://www.sec.gov/news/press-release/2022-57?utm_medium=email&utm_source=govdelivery (hereinafter, "Press Release") ; SEC, Division of Examinations, 2022 Examinations Priorities, (Mar. 30, 2022), https://www.sec.gov/files/2022-exam-priorities.pdf (hereinafter, "2022 Priorities").

[2] 2022 Priorities, at 4. The Division stated that there was a net addition of approximately 900 RIAs and that over the last five years, the number of RIAs has increased 20%, from approximately 12,250 to over 14,800. *Id*.

[3] *Id*. at 4. The Division stated that total AUM is now over $113 trillion, a nearly 70% increase from five years ago. *Id*.

[4] *Id.* at 4. The Division provided that the number of RIAs with more than $10 billion AUM has increased 30% in the past five years, that 60% of RIAs are affiliated with other financial industry firms, and more than 35% of RIAs manage a private fund. *Id* at 4.

[5]Press Release, SEC, *SEC Proposes to Enhance Private Fund Investor Protection* (Feb. 9, 2022), https://www.sec.gov/news/press-release/2022-19; Press Release, SEC, *SEC Proposes Cybersecurity Risk Management Rules and Amendments for Registered Investment Advisers and Funds* (Feb. 9, 2022), https://www.sec.gov/news/press-release/2022-20.

[6] 2022 Priorities at 11.

[7] *Id.* at 12.
[8] *Id.* at 11–12.
[9] *Id.* at 12.
[10] SEC, Division of Examinations, Observations from Examinations of Private Fund Advisers (January 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.
[11] For example, the Division observed RIAs to private funds failing to follow procedures related to limited partner advisory committees, calculation of management fees, liquidation and extension of fund terms, investing in accordance with the disclosed investment strategy, recycling practices and key person procedures. *Id*. at 2-3.
[12] The Division noted examples of misleading marketing materials included, without limitation, RIAs cherry-picking positive track records, using inaccurate data when creating track records and using track records of predecessors when the adviser was not primarily responsible for achieving the track record. *Id.* at 3-4.
[13] The Division also noted it will focus examination on whether the RIA has adopted and implemented policies, procedures, and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures (*e.g.*, reviewing their portfolio management processes and practices). 2022 Priorities at 12-13.
[14] *Id.* at 12–13.
[15] Press Release, SEC, *SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors* (Mar. 21, 2022), available at https://www.sec.gov/news/press-release/2022-46.
[16] 2022 Priorities at 13.
[17] *Id.* at 14.
[18] *Id.*
[19] *Id.* at 14–15.
[20] *See id.*; SEC, Cybersecurity (last modified Feb. 17, 2022), https://www.sec.gov/spotlight/cybersecurity.
[21] 2022 Priorities at 15.
[22] In January 2020, the Division reporting observing that many organizations with adequate response plans tended to include certain elements, including some that tested their policies and procedures using tabletop exercises. See SEC, Cybersecurity and Resiliency Observations, Jan. 27, 2020, available here.
[23] 2022 Priorities at 16.
[24] *Id.*
[25] *Id.* at 17–18.
[26] *Id.* at 18.
[27] *Id.* at 19.
[28] *Id.* at 20.
[29] *Id.*
[30] *Id.* at 21.
[31] *Id.*
[32] *Id.*
[33] *Id.* at 22.
[34] *Id.* at 23.
[35] *Id.*

[36] *Id.* at 24.
[37] *Id.*
[38] *Id.* at 25.
[39] *See* Press Release, *supra* note 1.

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