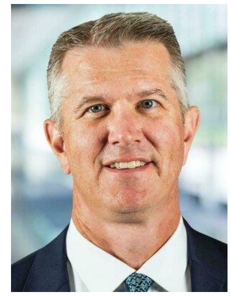
Reading Between The Lines Of SEC's 2023 Exam Priorities

By **Kurt Gottschall** (February 27, 2023)



Kurt Gottschall

Every year, the U.S. Securities and Exchange Commission's Division of Examinations puts tremendous effort into generating its 20-plus-page summary of examination priorities.

The internal process for creating the annual priorities unfolds over several months and includes input from every level, from line examiners up through the commissioners.

While at first blush the exam priorities may not appear to change much from year to year, a careful reading of the 2023 priorities reflects subtle directional shifts in the SEC's exam program and brand-new areas of focus for almost all registrants.

New Rules

Exam staff made clear that it plans to focus on several new rules by featuring them prominently in the 2023 exam priorities press release and the first substantive section of the document.[1]

Specifically, the SEC will examine for compliance with the marketing rule (Advisers Act Rule 206(4)-1), the derivatives rule (Investment Company Act Rule 18f-4) and the fair valuation rule (Investment Company Act Rule 2a-5).

As set forth in the September 2022 risk alert regarding the marketing rule, exam staff appears to be particularly interested in testing compliance with the substantiation requirement — being able to substantiate all material statements in advertising upon demand by the SEC — and the numerous performance advertising requirements.[2]

Private Funds

The Division of Examinations will continue to prioritize exams of advisers to private funds in 2023 and the foreseeable future because of their extraordinary growth. As noted in the priorities release, more than 35% of registered investment advisers currently manage approximately 50,000 private funds with assets exceeding $21 trillion.[3]

For risk areas in private fund exams, it's expected that exam staff will remain focused on the two most common deficiencies: conflicts of interest, and the calculation and allocation of fees and expenses.[4]

Other 2023 private fund examination priorities parallel recent enforcement cases.

For advisers to private equity funds, exam staff plans to analyze the calculation of post-commitment management fees, as well as the impact of valuation practices on fee calculations.[5]

Late in fiscal year 2022, the SEC also brought enforcement actions against nine private fund advisers for failing to timely deliver private fund audits to investors, failing to timely amend their Form ADVs to reflect the receipt of unqualified audit opinions of private fund financial statements, or both.[6]

The inclusion of these issues in the 2023 priorities indicates that exam staff will be on the lookout for similar violations in the coming year.[7]

The commission also remains concerned about advisers' potential misuse of alternative data, and therefore exam staff will continue to prioritize the review of alternative data-related policies and procedures and compliance with Section 204A of the Advisers Act.[8]

Each year, the exam staff also seeks to determine specific investment strategies or practices that may present heightened risks to investors in current economic conditions.

This year, the Division of Examinations intends to prioritize the review of the following types of private funds: (1) leveraged funds; (2) private equity funds that use affiliated companies and advisory personnel; (3) real estate-connected funds, particularly those with exposure to commercial real estate; (4) funds that sponsor or invest in special-purpose acquisition companies; and (5) adviser-led fund restructurings, including stapled secondary transactions and continuation funds.[9]

Regulation Best Interest

After Regulation Best Interest became effective in June 2020, the initial phase of SEC exams focused on compliance and disclosure obligations, particularly verifying that firms had adopted and implemented the regulation's policies and procedures, and delivered Form CRS and Reg BI disclosures to retail customers.[10]

However, the 2023 priorities and the January Reg BI risk alert indicate that exam staff now plans to review the care and conflicts of interest obligations, including recommendations regarding products, strategies and account types.[11]

In particular, the staff indicated its intention to review "processes for making best interest evaluations, including those for reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest."[12]

Exam staff also intends to review recommendations to retail customers concerning: (1) complex products such as leveraged exchange-traded funds or exchange-traded notes; (2) higher cost and illiquid products, including nontraded real estate investment trusts; (3) proprietary products; (4) strategies purporting to address rising interest rates; and (5) microcap securities.[13]

In assessing investment recommendations under Reg BI, it is highly likely that exam staff will expect documented consideration that products fit customers' investment goals, risk tolerance and investment horizons.

Electronic Communications

With the SEC imposing more than $1.2 billion in civil penalties during fiscal year 2022 for record-keeping and supervisory violations by some of the largest Wall Street firms, it should be no surprise that in 2023, exam staff will review registrants' policies and procedures regarding off-channel communications.[14]

For exam preparation, registrants should consider reviewing the remedial measures and voluntary undertakings set forth in the settled orders against the Wall Street firms.[15]

ESG

The Division of Examinations' continued prioritization of environmental, social and governance investments is clearly influenced by the SEC's extensive proposed ESG and climate disclosure rulemaking for both public companies and investment advisers, as well as strong investor inflows to these products.[16]

The 2023 priorities indicate that exam staff will evaluate so-called truth-in-advertising for ESG strategies, such as whether "funds are operating in the manner set forth in their disclosures" and if ESG products are appropriately labeled.[17]

In tellingly specific guidance, exam staff also indicated plans to evaluate ESG recommendations under Reg BI's care obligation, including "whether recommendations of such products for retail investors are made in investors' best interest."[18]

It's also expected that examinations will touch all types of ESG-branded investment strategies, including registered funds, private funds, model portfolios and separately managed accounts.

Revenue Sharing

Registrants need to pay particular attention whenever the annual priorities raise novel issues.

For 2023, exam staff noted new concerns regarding cash management, including "alternative ways that RIAs may try to maximize revenue, including revenue earned on clients' bank deposit sweep programs."[19]

In some cases, cash management can present potential conflicts of interest because advisers often receive greater revenue sharing from bank deposit sweep programs than from other highly liquid cash alternatives such as money market funds that may pay greater returns to their clients.

The 2023 priorities also make a separate, cryptic reference to other forms of revenue sharing, which may track prior enforcement cases alleging that advisers failed to adequately disclose conflicts of interests stemming from their markup and eventual retention of certain nontransaction fees charged by clearing broker-dealers.[20]

Cryptocurrency

Although the SEC has a more limited toolkit with which to conduct crypto-related exams, the staff alluded to the turmoil in the crypto industry and warned of its intention to "monitor and, when appropriate, conduct examinations of potentially impacted registrants."[21]

In particular, exam staff plans to evaluate whether registrants followed their respective standards of care when recommending crypto-related investments, as well as whether they "routinely reviewed, updated, and enhanced their compliance, disclosure and risk management practices" for crypto-assets.[22]

In light of FTX Trading Ltd.'s collapse and the related fallout in the crypto industry, registrants also should expect exam staff to take a close look at the custody of crypto-assets and the exposure of registrants and their investors to concentration risks and the high volatility of crypto-related assets.

Anti-Money Laundering and Suspicious Activity Reports

As in past years, exam staff devoted an entire section of the annual priorities to the obligations of broker-dealers and investment companies to establish anti-money laundering programs that are tailored to address the risks associated with firms' particular businesses and customers.[23]

In light of the current global business and economic sanctions environment, the 2023 priorities emphasize the importance of suspicious activity reports filings and compliance with Office of Foreign Assets Control and Treasury-related sanctions.[24] The Division of Examinations' emphasis on AML compliance also tracks substantial SEC enforcement activity over the past several years.[25]

Cybersecurity

Cybersecurity has become a perennial risk area for the exam program, and the current geopolitical environment has given no indications that such risks will recede in 2023.

In noting the proliferation of cyberattacks, especially ransomware attacks, the staff plans to evaluate compliance with Regulations S-P and S-ID, giving particular emphasis to cybersecurity controls for registrants' use of third-party vendors, products and services.[26]

Conclusion

Because the Division of Examinations serves as the "eyes and ears on the ground for the Commission," according to SEC Chair Gary Gensler, close scrutiny of the 2023 priorities provides a road map of the agency's focus in the coming year.[27] So what are the big-picture takeaways for 2023?

First, the 2023 priorities summary gives no indication that the SEC plans to make any significant adjustment regarding the number of examinations, the typical depth of those examinations or the balance of examinations between types of registrants.

Over the past several years, the Division of Examinations has remained remarkably consistent in its annual examination of approximately 15% of registered investment advisers and investment companies, and together with the Financial Industry Regulatory Authority, examining about half of broker-dealers each year.[28] It's expected that the agency will maintain very similar coverage ratios in 2023.

Second, the Division of Examinations appears to be embracing its mission pillar to inform policy.

Under Gensler, the SEC proposed significant new rules in 2022, and as the commission seeks to finalize many of those proposed rules in 2023, many of the examination priorities appear designed to detect deficiencies that may help the agency fine-tune proposed rules governing private funds, ESG and climate disclosure, and cybersecurity.

Third, the SEC's level of scrutiny for compliance with newly adopted rules will increase over time.

For example, because the compliance date for the marketing rule came in November, less than four months ago, exams in this area may use a lighter touch, focusing on whether registrants have revised their policies and procedures and made reasonable efforts to comply with the substantiation requirement.

In contrast, the 2023 priorities make clear that the exam staff's focus on Reg BI — which became effective in June 2020 — has progressed well beyond the basic compliance and disclosure obligation to now include a review of the much more complicated duty of care and conflicts of interest obligations.

Fourth, the 2023 priorities provide evidence of the Division of Examination's increased willingness to identify and focus on specific strategies or products that it believes pose a higher risk to investors, either generally or given current market conditions.

This year's priorities include risks that appear to be tailored to 2023 such as "real estate-connected investments, with an emphasis on commercial real estate" and "strategies that purport to address rising interest rates," alongside products with inherent structural risks like levered ETFs and nontraded REITs.[29]

Registrants with strategies in the SEC's sights face a much higher probability of being examined — either individually or as part of a sweep.

Regardless of a registrant's size or investment strategies, a careful review of the 2023 examination priorities will help legal and compliance personnel be better prepared whenever the SEC staff comes knocking.

Kurt Gottschall is a partner at Haynes and Boone LLP and a former director of the SEC's Denver regional office.

[1] https://www.sec.gov/files/2023-exam-priorities.pdf at 9.

[2] https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf.

[3] https://www.sec.gov/files/2023-exam-priorities.pdf at 10.

[4] https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[5] See e.g., https://www.sec.gov/news/press-release/2022-154.

[6] https://www.sec.gov/news/press-release/2022-156.

[7] https://www.sec.gov/files/2023-exam-priorities.pdf at 10.

[8] See e.g., https://www.sec.gov/news/press-release/2021-176; https://www.sec.gov/files/2023-exam-priorities.pdf at 10.

[9] https://www.sec.gov/files/2023-exam-priorities.pdf at 11.

[10] https://www.sec.gov/files/2021-exam-priorities.pdf at 20.

[11] https://www.sec.gov/files/2023-exam-priorities.pdf at 11; https://www.sec.gov/file/exams-reg-bi-alert-13023.pdf.

[12] Id.

[13] Id. at 12.

[14] https://www.sec.gov/news/press-release/2022-174.

[15] Id.

[16] https://www.sec.gov/news/press-release/2022-46; https://www.sec.gov/news/press-release/2022-92.

[17] https://www.sec.gov/files/2023-exam-priorities.pdf at 13.

[18] Id.

[19] Id. at 16.

[20] Id. at 12.

[21] Id. at 15.

[22] Id.

[23] Id. at 23.

[24] Id.

[25] See e.g., https://www.sec.gov/news/press-release/2022-220.

[26] https://www.sec.gov/files/2023-exam-priorities.pdf at 14.

[27] https://www.sec.gov/news/press-release/2022-87.

[28] https://www.sec.gov/files/2023-exam-priorities.pdf at 1; https://www.sec.gov/files/2022-exam-priorities.pdf at 4.

[29] https://www.sec.gov/files/2023-exam-priorities.pdf at 11-12.