

SEC's OCIE Releases 2022 Examination Priorities for Investment Advisers, Broker-Dealers, and Other Financial Industry Professionals

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On March 30, the Office of Compliance Inspections and Examinations of the U.S. Securities and Exchange Commission (SEC) published its examination priorities for 2022 (the Priorities), which discuss its examination approach designed to address new or emerging risks to investors or to markets as well as perennial, well-established risk areas.

In the service of the SEC's so-called Four Pillars (i.e., promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy), the Priorities reflect an enhanced focus on advisers to private funds; environmental, social, and governance (ESG) investing; retail investor protections; information security and operational resiliency; emerging technologies; and crypto-assets.¹

Private Funds

The Priorities state, as a threshold matter, that the SEC will continue to prioritize SEC-registered investment advisers (RIAs) to private funds. The SEC states that it will focus on the following long-standing items pertinent to these advisers:

- The calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds
- The potential preferential treatment of certain investors in funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals
- Compliance with the Investment Advisers Act of 1940 (Advisers Act) Custody Rule, including the "audit exception" to the surprise examination requirement, and the

related reporting and updating of Form ADV regarding the audit and auditors that serve as important gatekeepers for private fund investors

- The adequacy of disclosure and compliance with any regulatory requirements pertaining to cross trades, principal transactions, or distressed sales
- Conflicts around liquidity, such as RIA-led fund restructurings, including so-called stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund sponsored by the RIA

In addition to the foregoing, the SEC notes that its examinations will focus on private fund advisers' portfolio strategies and risk management competencies; as well as the policies and procedures covering the advisers' investment recommendations and allocation determinations, focusing, as always, on conflicts of interest and related disclosures in all of these areas.

ESG Matters

The Priorities make clear that the SEC will continue to focus on ESG-related advisory services and investment products (e.g., mutual funds, exchange-traded funds (ETFs), and private fund offerings). Such reviews will typically focus on whether RIAs are:

- Accurately disclosing their ESG investing approaches and adopting and implementing policies and procedures covering their portfolio management practices to facilitate compliance with their ESG-related disclosures
- Voting client securities consistent with proxy

¹ <https://www.sec.gov/news/press-release/2022-57>

- voting policies and procedures and ensuring that the votes align with their ESG-related disclosures and mandates
- Overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (e.g., greenwashing), such as in their performance advertising and marketing

The focus on ESG investing presumably is intended to ensure that advisers who “talk the talk” on ESG in order to burnish their image in the market and attract investors actually “walk the walk” and act consistently with any declared ESG mandate.

Protection of Retail Investors

The SEC will continue to focus on the protection of retail investors, with particular emphasis on potential conflicts of interest, including with regard to account recommendations and allocation of investments across different accounts. Exams will address standards of conduct at these firms with reviews focused on whether and how these advisers are satisfying their obligations under Regulation Best Interest (Reg BI) and the Advisers Act fiduciary standard not to place their interests ahead of the interests of their retail clients.

Examinations will also include assessments of practices regarding the management of conflicts of interest (e.g., incentive practices that favor certain products or strategies over others), trading/brokerage and best execution, and the accuracy and completeness of disclosures required by Form ADV, Form CRS, and Reg BI. Examinations will also evaluate the overall effectiveness of compliance programs, testing, and training.

Among other items, examinations will continue to emphasize recurring issues that give rise to conflicts of interest, especially for advisers to retail investors:

- The sale or recommendation of high-fee products
- The sale or recommendation of proprietary products of the firms or their affiliates
- Incentives for financial professionals to place their own or their firms’ interests ahead of customers’/clients’ interests (e.g., transactions that reduce costs to the adviser and increase expenses borne by the client)
- Compensation structures that inappropriately influence investment recommendations

The substance of the SEC’s focus in the area of retail investor protection, however, did not significantly change from prior years. The SEC publication states that it will focus on the following, as expected:

- Revenue sharing arrangements
- Recommending or holding more expensive classes of investment products when lower-cost classes are available (e.g., RIAs that recommend no transaction fee for mutual fund share classes that have 12b-1 fees in wrap fee accounts where the RIA may be responsible for paying transaction fees)
- Recommending wrap fee accounts without assessing whether such accounts are in the best interests of clients, including the impact of the move to zero commissions on certain types of securities transactions by a number of broker-dealers
- Recommending proprietary products resulting in additional or higher fees

Dually registered RIAs and broker-dealers remain an area of increased interest and enhanced scrutiny for the SEC. In addition to the examination focus areas discussed above, examinations of these entities will emphasize potential conflicts of interest that are elevated at these firms, including conflicts associated with account recommendations and the allocation of investments between and among different accounts.

Information Security and Operational Resiliency

In the Priorities, the SEC reiterates its view that advisers must be vigilant with respect to the protection of data that is critical to the operation of financial markets and the confidence of market participants. For that reason, the SEC will review advisers’ policies and practices with respect to the prevention of interruptions to mission-critical services and protection of investor information, records, and assets.

Among other areas relating to information security and operational resiliency, the SEC will review whether firms have taken appropriate measures to:

- Safeguard customer accounts and prevent account intrusions, including verifying an investor’s identity to prevent unauthorized account access
- Diligence and supervise vendors and service providers
- Address malicious email activities, such as phishing or account intrusions
- Respond to incidents, including those related to ransomware attacks
- Identify and detect red flags related to identity theft
- Manage operational risk as a result of a dispersed workforce in a work-from-home environment

The SEC will again be reviewing advisers’ business continuity and disaster recovery plans, with particular emphasis on the impact of

climate risk and disruptions to normal business operations.

Emerging Technologies and Crypto-Assets

The SEC expects to focus on the proliferation of firms that are choosing to provide automated digital investment advice to their clients (often referred to as “robo-advisers”), the increasing use of mobile apps by broker-dealers, and a proliferation of the offer, sale, and trading of crypto-assets. Among other things, the SEC intends to review whether these advisers have properly considered and accounted for the unique risks associated with these types of activities when designing their regulatory compliance programs.

The Priorities indicate that the SEC will focus on firms that are, or claim to be, offering new products and services or employing new practices (e.g., fractional shares, “Finfluencers,” or digital engagement practices) to assess whether:

- Operations and controls in place are consistent with disclosures made and the standard of conduct owed to investors and other regulatory obligations
- Advice and recommendations, including by algorithms, are consistent with investors’ investment strategies and the standard of conduct owed to such investors
- Controls take into account the unique risks associated with such products and practices

In addition to the foregoing, the SEC will review whether market participants involved with crypto-assets:

- Have met their respective standards of conduct when recommending to or advising investors with a focus on duty of care and the initial and ongoing understanding of the products (e.g., blockchain and crypto-asset feature analysis)
- Routinely review, update, and enhance their compliance practices (e.g., crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices (i.e., data integrity and business continuity plans)

Given the explosive growth in the number and types of these advisers, the evolving nature of the products coming to market, and the services these advisers provide (combined with migration and “gamification” of investing

to smart devices, and the volatility associated with many of these new products), it is expected that the SEC will continue to devote increasing resources and focus in this area.

Examination Approach

The mindset and approach of the SEC with respect to its examination program remains essentially unchanged. As part of its assessment of an adviser’s compliance program, the SEC will review whether the firm has implemented oversight practices to mitigate any heightened risks—so it is imperative that advisers continually evaluate their businesses, and identify how the risk profile of any of its products or practices may have changed. The SEC will also continue to focus on required disclosures and issues related to fees and expenses. In particular, the Priorities reiterate that examinations will concentrate on issues associated with (1) advisory fee calculation errors and compliance with investor agreements; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts or prorated fees for onboarding clients.

The Priorities reiterate the SEC’s long-standing prioritization of advisers that have never been examined, including recently registered firms, and those that have not been examined for a number of years. These examinations will generally focus, at least at the outset, on the overall compliance programs of these firms.

Conclusion

The annual publication of the Priorities presents an opportunity for investment advisers and other financial firms to evaluate and advance their compliance programs consistent with the evolution of their business and the products and services offered, the types of clients/ investors served, and emerging market risks. The Priorities contain a helpful roadmap for advisers (and compliance personnel) to upgrade their compliance programs by refining their policies, procedures, and disclosures in light of risks and conflicts clearly articulated by the SEC and subject to examination. As private fund advisers figure more prominently in recent iterations of the Priorities, and given the significant expansion of rules covering private fund advisers recently proposed², private fund advisers should be especially diligent and vigilant in the design and conduct of their compliance programs.³

² SEC Proposes New Rules and Amended Form PF Requirements for Private Fund Managers

³ Translating SEC Exam Priorities Into Compliance Action Items

As always, the SEC encourages firms to take a holistic view of their business with an emphasis on client or investor protection. While there has not been substantial movement in the priorities and areas of focus of regulators in recent years, the Priorities support the proposition that compliance is not a static function but instead a dynamic, living organism intended to evolve and mature with the demands of the business and the introduction of new products and new market risks.

Given the proliferation of digital assets and increased dependence on technology and infrastructure and tools available to advisers (and compliance professionals), the SEC continues to emphasize the centrality of thoughtful and robust infrastructure, information security policies, and related best practices concerning the protection of sensitive client information.

The above analysis of the Priorities is not exhaustive, and while it lays out the key areas of focus of the SEC examination program, the scope of any firm examination is determined through a risk-based approach that includes, among other things, analysis of a firm's history, including prior exams, operations, services, and products offered.

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