SEC Division of Examinations Issues 2022 Examination Priorities

Written by Robert G. Sawyer, Nicholas Gill, Samuel Hughes

April 27, 2022

Key Takeaways:

- SEC releases its examination priorities and areas of focus for 2022.
- Focus areas will include examination of advisers to private funds, disclosures relating to ESG investments and strategies, standards of conduct, information securities and digital assets, and other emerging technologies.

On March 30, 2022, the U.S. Securities and Exchange Commission ("SEC") Division of Examinations (the "Division") (formerly the Office of Compliance Inspections and Examinations) published its annual examination priorities for 2022 ("2022 Priorities") (available here). While not an exhaustive list of topics that the Division will review during an examination, the 2022 Priorities signal the Division's intent to focus on traditional areas of risk as well as several new and emerging issues. The Division will be focused on the following areas: private funds; environmental, social and governance ("ESG") investing; standards of conduct; information security and operational resiliency; emerging technologies and crypto-assets; standards of conduct for registered investment advisers and broker dealers and exchanges.

Private Funds' Growth Makes Them a Target

Given the SEC's proposal for sweeping changes to the rules applicable to private fund advisers[1], the inclusion of private funds in the 2022 Priorities is unsurprising. The Division noted that assets managed by private fund advisers have grown 70% in the last five years, that 35% of registered investment advisers ("RIAs") manage $18 trillion in private fund assets and that significant investments in private funds have come from state and local pensions, charities and endowments. It indicated that its exams would focus on: (1) 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; (2) the preferential treatment of certain investors by RIAs to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; (3) compliance with the Custody Rule; (4) the adequacy of disclosure and compliance with regulatory requirements for cross trades, principal transactions and distressed sales; and (5) conflicts around liquidity (including adviser-led restructurings and stapled secondaries). The Division also noted its intent to examine portfolio strategies, risk management and investment recommendations and allocations, particularly with regard to investments in Special Purpose Acquisition Companies ("SPACs"). Investments in SPACs have been a recent area of concern for the SEC, which proposed new rules on SPACs the same day that the Division released the 2022 Priorities. As such, advisers considering recommending an investment in a SPAC should proceed carefully, especially where the adviser is also the SPAC sponsor, and review their disclosures thoroughly.

Increased Scrutiny of Environmental, Social and Governance Investing

The Division's emphasis on ESG-related advisory services and investment products reflects the SEC's growing interest in this emerging trend. In March 2022, the SEC proposed rules on ESG disclosures for public companies in registration statements and periodic reports[2], and it is anticipated that further releases will address the use of ESG disclosures by advisers. The SEC is concerned with the lack of clarity surrounding what constitutes an ESG investment and the Division believes this lack of clarity may lead to misrepresentation to investors. As such, the Division will focus on whether RIAs and registered funds: (1) are accurately disclosing their ESG investing approaches; (2) have adopted and implemented policies, procedures, and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures, including review of their portfolio management processes and practices; (3) are voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates; and (4) are not overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (*e.g.*, greenwashing), such as in their performance advertising and marketing.

Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS

The Division will examine standards of conduct issues for broker-dealers and RIAs and how such firms are satisfying their obligations under Regulation Best Interest and the Advisers Act fiduciary standard to act in the best interests of retail investors. Examinations will assess practices regarding consideration of alternatives, management of conflicts of interest, trading, disclosures, account selection, and account conversions and rollovers. In particular, the Division will focus on the effectiveness of compliance programs, testing, and training that are designed to support retail investors. Broker-dealer examinations will assess firms' recommendations and sales practices, as well as their evaluation of whether a product is in their client's best interest. The Division will also assess firms' compensation structures for financial professionals and the potential conflicts created by those structures. RIA examinations will consider whether advisers are acting consistently with their fiduciary duty to clients. The Division will pay particular attention to the following practices: (1) revenue sharing arrangements; (2) recommending or holding more expensive classes of investment products when others are available; (3) recommending wrap fee accounts without assessing if they are in the best interests of the clients; and (4) recommending proprietary products resulting in additional or higher fees. Dually registered investment advisers and broker-dealers will be of particular interest to the Division. Examinations of such firms will emphasize potential conflicts of interest, including account recommendations and allocation of investments across different accounts. The sale or recommendation of high fee products, the sale or recommendation of proprietary products, incentives for financial professionals to place their own interests ahead of the clients and compensation that inappropriately influences investment recommendations will be subject to added scrutiny.

Information Security Remains a Top SEC Priority

Information security and operational resiliency continue to be priorities for the Division. With an eye toward preventing interruptions that may jeopardize the business and protecting investor information, records and assets, examinations will assess whether firms have taken adequate measures to: (1) safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (2) oversee vendors and service providers; (3) address malicious email activities, such as phishing or account intrusions; (4) respond to incidents, including those related to ransomware attacks; (5) identify and detect red flags related to identity theft; and (6) manage operational risk as a result of a dispersed workforce in a work-from-home environment. In doing so, the Division will assess the firm's compliance with Regulations S-P[3] and Regulation S-ID[4], where applicable.

In addition, the Division will review registrants' business continuity and disaster recovery plan, placing particular emphasis on the impact of climate risk and substantial disruption to normal business operations.

Emerging Technologies Stay an SEC Focus

The Division will prioritize examinations of registrants using developing financial technologies, such as crypto-assets, robo-advisers and mobile apps, and assess whether: (1) operations and controls in place are consistent with disclosures made and the standard of conduct owed to investors and other regulatory obligations; (2) advice and recommendations, including by algorithms, are consistent with investors' investment strategies and the standard of conduct owed to such investors; and (3) controls take into account the unique risks associated with such practices.

Though digital assets are noted as having been an existing area of interest, the Division has put a greater emphasis on the review of crypto-assets. The Division will review whether market participants involved with crypto-assets: (1) 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); and (2) 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).

Additional Focus Areas for RIAs and Broker-Dealers

For RIAs, in addition to the priorities listed above, the Division will focus its examinations on the following areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, and conflicts of interest and related disclosures.

For broker-dealers, in addition to the priorities listed above, the Division will focus its examinations on the following areas: products and services, best execution, pricing fairness, sale of over-the-counter securities and whether the firms making the recommendations are meeting their obligations under Regulation BI.

Conclusion

The themes in the 2022 Priorities are largely consistent with the themes the Division has stressed in prior years, particularly with respect to information security, emerging technologies and digital assets. The Division has put a greater emphasis on private funds, ESG investments, and standards of conduct. Across the areas of focus, a common refrain was the importance of having strong standards of conduct and procedures in place to prevent infractions before they happen.

Given this updated articulation of the Division's top agenda items, RIAs and registered broker-dealers should review and adjust their policies and procedures as needed to ensure that they address specifically and effectively each of the above issues that apply to them. In particular, RIAs that have yet to undergo an SEC exam, or have not done so in recent years, may expect to be a priority for the Division.

---

[1] See Foley Hoag's client alert, SEC Proposal - Private Fund Adviser Rules.

[2] See Foley Hoag's ESG Alert, Three Takeaways from the SEC's New Proposed Rules on Climate Disclosures.

[3] Regulation S-P requires registered broker-dealers, investment companies and RIAs to adopt written policies and procedures designed to protect customer records and information.

[4] Regulation S-ID requires regulated entities to adopt written policies and procedures to identify, detect and respond to identify theft.

RELATED INDUSTRIES

- Investment Advisers & Private Funds

RELATED PRACTICES

- Private Funds
- Private Equity Funds
- Venture Capital Funds
- Investor Representation
- Environmental, Social and Governance (ESG)
