INVESTMENT COMPANY INSTITUTE

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The SEC's Division of Examinations Publishes Its Examinations Priorities for 2023

[34931]

TO: ICI Members
Investment Company Directors
ICI Global Members
Chief Compliance Officer Committee
Internal Audit Committee
SEC Rules Committee
Transfer Agent Advisory Committee SUBJECTS: Anti-Money Laundering
Compliance
Cybersecurity
ESG
Exchange-Traded Funds (ETFs)
Fixed Income Securities
Investment Advisers
Operations RE: The SEC's Division of Examinations Publishes Its Examinations Priorities for 2023

For the eleventh year in a row, the SEC's Division of Examinations (EXAMS) has published its priorities for the coming year.[1] Highlights of the Priorities are briefly described below.

Message from the Leadership Team

Before describing those areas that EXAMS will focus on in conducting examinations during 2023, the Priorities begin with a "Message from the Leadership Team." This Message begins by noting the "four pillars" that govern its mission;[2] the risk-based approach it uses to identify firms to examine and the scope of those exams; its response to emerging risk areas;[3] and the increasing number of investment advisers. It also notes that "an important component" of carrying out its mission involves "recognizing and supporting compliance functions at [SEC] regulated entities." According to the Priorities, "EXAMS will continue to support and empower regulated entities' compliance functions to comply with federal securities laws through communication and transparency concerning our examination priorities and findings."[4]

The Message also discusses EXAMS broadening its "in-house expertise and capacity through the development of specialized working groups in key areas." These specialized working groups include "a diverse portfolio of areas including technology, equity markets and trading practices, fixed income and new products, investment companies, marketing and sales practices, private funds, transfer agents, and valuation matters."[5] Additionally, the Priorities notes that EXAMS "also leverages technology to collect and analyze large sets of data to help identify risk and better understand a regulated entity's business during examinations. . . . As 2023 unfolds, [EXAMS] will continue to leverage data analysis to monitor and identify potentially problematic activities, as well as to determine how best to scope examinations of those activities and firms." As part of this process, EXAMS is "also endeavoring to coordinate more closely with [its] foreign counterparts with the intended goal of enhancing oversight of [SEC] regulated entities from a global perspective."[6]

Notable New and Significant Focus Areas

Following the Message from the Leadership Team, the Priorities next discuss notable new and significant focus areas. This discussion is divided into four sections: (1) compliance with newly adopted rules under the Advisers Act and the Investment Company Act; (2) advisers to private funds; (3) standards of conduct (i.e., Reg. B-I, fiduciary duty, and Form CRS); and (4) ESG investing. These areas are briefly described below.

Compliance with Newly Adopted Rules

The newly adopted rules highlighted in the Priorities are the new Marketing Rule (Advisers Act Rule 206(4)-1), the Derivatives Rule (ICA Rule 18f-4), and the Fair Valuation Rule (ICA Rule 2a-5). In conducting these inspections, EXAMS will be focused on ensuring that registrants have adopted and implemented the necessary written policies and procedures and have complied with the substantive requirements of these new rules. As regards the fair valuation rule, EXAMS will also assess whether fund boards have complied with new requirements related to fund boards' oversight duties and their designation of someone to perform fair valuation determinations subject to the board's oversight.

Advisers to Private Funds

The Priorities note that advisers to private funds "represent a significant portion of the registered adviser population" Today, more than 5500 registered advisers, 35% of all such advisers, "manage approximately 50,000 private funds with gross assets in excess of $21 trillion."[7] Over the past five years, this represents an 80% increase in the gross assets of private funds, with retirement plans steadily contributing to this growth. As the Division examines private funds, it will be focused on 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); compliance with the new marketing rule (including performance advertising and compensated testimonials and endorsements); policies and practices regarding the use of alternative data and compliance with Section 204A of the Advisers Act; and compliance with the Adviser's Act custody rule (Rule 206(4)-2), including, if applicable, timely delivery of audited financials and the selection of permissible auditors.

EXAMS will focus on those advisers to private funds that have specific risk characteristics such as highly-leverage 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 that hold certain hard-to-value investments (such as crypto assets and real estate-connected investments with an emphasis on commercial real estate); private funds that invest in or sponsor Special Purpose Acquisition Companies; and private funds involved in adviser-led restructuring.

Standards of Conduct

With respect to standards of conduct, EXAMS will focus on:

- Investment advice and recommendations related to products, investment strategies, and account types;
- Disclosures made to investors and whether they include all material facts relating to conflicts of interest;
- The process used to make best interest evaluations, including the review of reasonably available alternatives, evaluation of costs and risks, and the identification and addressing of conflicts of interest; and
- Factors considered in light of the investors' investment profile, including investment goals and account characteristics.

EXAMS may give special attention to complex products, such as derivatives, ETFs, ETNs, and ETPs; high cost and illiquid products, such as variable annuities and non-traded REITS; proprietary products; unconventional strategies that purport to address rising interest rates; and micro-cap securities. Also, recommendation or advice to certain types of investors (e.g., senior investors or those saving for retirement) may be an area of focus.

EXAMS will also seek to identify and understand the economic incentives[8] firms have for recommending products or services and whether they have adopted written policies and procedures to identify conflicts of interest. Such policies and procedures should be tailored to the firm's particular business model, compensation structure, and product menu and customer base; sufficient to support compliance with the standards; and reviewed and updated periodically, as appropriate.

ESG Investing

When it comes to EXAMS review of ESG investing, in 2023 EXAMS "will continue to focus on ESG-related advisory services and fund offerings, including whether the funds are operating in the manner set forth in their disclosures. In addition, the Division will assess whether ESG products are appropriately labeled and whether recommendation of such products for retail investors are made in the investors' best interest."[9]

Information Security and Operational Resiliency

Under the heading of Information Security and Operational Resiliency, the Priorities discuss how EXAMS will continue to review registrants' practices to prevent interruption of mission-critical services in order to protect investor information, records, and assets. Their focus on this topic will include firms' policies and procedures, governance practices, and response to cyber-related incidents, including those related to ransomware. The policies and procedures will be reviewed to ensure they are reasonably designed to safeguard customer records and information - whether such records and information reside on the registrant's systems and or are stored with a third-party. EXAMS will also be reviewing cybersecurity issues associated with the use of third-party vendors, including the registrant's visibility into the security and integrity of third-party products and services.

Crypto Assets and Emerging Financial Technology

According to the Priorities, the Division will continue to monitor registrants' involvement with crypto assets. These exams will focus on the offer, sale, or recommendation of, advice regarding and trading in crypto or crypto-related assets.

Investment Advisers and Investment Companies

Investment Advisers

The Priorities note that, during a "typical" examination of an adviser, EXAMS reviews

the compliance programs and related disclosures . . . in one or more core areas, such as custody and safekeeping of client assets, valuation, portfolio management, and brokerage and execution. Often examinations also include a review for conflicts, compliance issues and the oversight and approval process related to [the adviser's] fees and expenses, including: (1) the calculation of fees; (2) alternative ways that [advisers] may try to maximize revenue, including revenue earned on clients' band deposit sweep programs; and (3) excessive fees.[10]

In addition to the above core focus areas, EXAMS will also review advisers' policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers.

Investment Companies, Including Mutual Funds and ETFs

According to the Priorities, the "Division prioritizes examinations of registered investment companies, including mutual funds and ETFs, given their importance to investors."[11] Areas of focus for these exams will include the investment companies' compliance programs and governance practices, disclosures to investors, and accuracy of reporting to the SEC. Particular areas of focus will include the fiduciary obligations of advisers to registered investment companies, including their receipt of compensation for services or other material payments made by investment companies. In reviewing the investment companies' compliance programs and governance practices, EXAMS will, in part, "continue to evaluate boards' processes for assessing and approving advisory and other fund fees, particularly for funds with weaker performance relative to their peers."[12] Another area of focus will be the effectiveness of funds' derivatives and liquidity risk management programs.

Other areas of focus and their scope will be funds with "specific characteristics" such as:

- Turnkey funds – to assess their operations and the effectiveness of their compliance programs;
- Mutual funds that converted to ETFs – to assess governance and disclosures related to the conversion;
- Non-transparent ETFs – to assess compliance with the conditions and other material terms of their exemptive relief;
- Loan-focused funds (e.g., leveraged loan funds and funds focused on collateralized loan obligations) – to assess liquidity and the impact of elevated interest rates on them;
- Medium and small fund complexes that have experienced "excessive staff attrition" – to assess whether such attrition has affected their controls and operations;
- Volatility-linked and single-stock ETFs – to assess their disclosures, marketing, conflicts, and compliance with portfolio management disclosures among other things.

Those registered investment companies that have never been examined or not examined in several years will remain a priority for the Division. These exams will likely focus on corporate governance, the adviser contract approval process, fund codes of ethics, practices that deviate from disclosures, and the implementation and effectiveness of the fund's compliance program, including the oversight of service providers.

Transfer Agents

Under the heading of Transfer Agents, the Priorities note that EXAMS will continue to examine transfer agents' processing of items and transfers, recordkeeping and record retention, safeguarding of funds and securities, and filings with the Commission. These exams will be focused on those transfer agents that service certain types of issuers such as those issuing microcap and crypto assets and transfer agents that use emerging technology to perform their transfer agent functions.

Anti-Money Laundering

According to the Priorities, the importance of conducting AML reviews of broker-dealers and "certain" investment companies has been elevated due to the current geopolitical environment and the increased imposition of international sanctions. Also elevated is the SEC's review of firms monitoring compliance with OFAC and Treasury-related sanctions. The Division will continue to prioritize these reviews to ensure that firms have established appropriate customer identification programs and to determine whether they are: satisfying their SARS filing requirements; conducting ongoing due diligence on customers; complying with beneficial ownership requirements; and conducting robust and timely independent tests of their AML programs. The goal of these reviews will be to evaluate whether registrants have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

The London Interbank Offered Rate (LIBOR) Transition

The Priorities note that the discontinuation of LIBOR in mid-2023 "could have a significant impact on the financial markets and may present a material risk for certain market participants, including [registered investment advisers], broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies overseen by the Division."[13] Accordingly, EXAMS will continue to assess these registrants' preparation for the transition.

Miscellaneous Priorities

Other topics discussed in the Priorities as areas of focus for EXAMS in 2023 but not summarized in this memo include: Broker-Dealers (p. 17); National Securities Exchanges (p. 18); Security-Based Swap Dealers (p. 19); Municipal Advisors (p. 19); Clearance and Settlement (p. 20); Regulation Systems Compliance and Integrity (Reg. SCI) (p. 21); and FINRA and the MSRB (p. 22).

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Notes

[1] See 2023 Examination Priorities, Division of Examinations, U.S. Securities and Exchange Commission (Feb.6, 2023) ("Priorities), which is available at: https://www.sec.gov/files/2023-exam-priorities.pdf.

[2] These four pillars are: promoting compliance, preventing fraud, monitoring risk, and informing policy.

[3] During 2022, these emerging risk areas included: continued market volatility; cyber-events, and "market disruptions caused by recent bankruptcies and financial distress among crypto asset market participants." Priorities at p. 1.

[4] Priorities at p. 2.

[5] Priorities at p. 4.

[6] Priorities at p. 5.

[7] Priorities at p. 10.

[8] These "economic incentives" may include revenue sharing, commissions, or other incentivizing revenue arrangements. Priorities at p. 12.

[9] Priorities at p. 13.

[10] Priorities at p. 16.

[11] Id.

[12] Id.

[13] Priorities at p. 23.