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SEC Division of Examinations Announces 2022 Examination Priorities

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On March 30, 2022, the Division of Examinations (the “Division”) of the U.S. Securities and Exchange Commission (the “SEC”) announced its examination priorities for fiscal year 2022. The annual publication of the Division’s examination priorities is intended to align with the Division’s four pillars of promoting and improving compliance, preventing fraud, monitoring risk, and informing policy, and provide investors and SEC-registered investment advisers (“Advisers”) transparency into those areas it believes bring heightened risks to investors, registrants, and the markets. In general, the 2022 examination priorities reflect a continuation of known focus areas from recent years, perhaps indicating that they remain fertile ground for deficiency findings and referrals to the SEC's Division of Enforcement ("Enforcement").

Overview

The report notes that the Division completed 3,040 examinations in fiscal year 2021, a 3% increase from 2020 and on par with 2019. Additionally, during 2021, the Division issued more than 2,100 deficiency letters and made more than 190 referrals to the SEC’s Division of Enforcement. Further, the Division’s largest program, the Investment Adviser/Investment Company (IA/IC) Examination Program, completed more than 2,200 examinations of Advisers in 2021, an increase from the previous two years. Finally, the Division examined approximately 16% of Advisers, compared to 15% (the Division’s target the past several years) in 2020 and 2019. Notwithstanding the slight increase in coverage percentage, the Division indicated that it likely will soon have to lower its annual coverage target as the rate of increase in the number of Advisers continues to far outpace its staffing increases.

Consistent with prior Division publications, the report emphasizes that improving and promoting compliance remains at the forefront of the Division’s efforts and notes certain commonalities observed in resilient compliance programs, including:

- participation and input across all business and operations lines of the firm;
- flexibility to adjust to known variables in operations and business, along with established processes for monitoring effectiveness and pivoting or making updates when appropriate; and
- periodic review (including as to matters that arose previously, changes in business activities, and regulatory changes) and testing of policies and procedures to ensure the on-going adequacy and effectiveness of the compliance program (including routine periodic testing at set intervals, when certain transactions occur, and over extended periods to look for patterns or emerging trends).

The 2022 examination priorities are divided into the following five "significant focus" areas:

- Private Funds;
- Environmental, Social, and Governance ("ESG") Investing;
- Standards of Conduct;
- Information Security and Operational Resiliency; and
- Emerging Technologies and Crypto-Assets.

The report notes that, while all of these areas are critical, the list of priorities is not comprehensive and these will not be the only issues the Division addresses in examinations, risk alerts, and industry and investor outreach. The Division will continue to be flexible so that examinations also may cover new and exigent risks. In general, the priorities are tailored to focus on both emerging issues as well as core issues that have been part of the SEC's mission for decades, reflecting the Division's belief that previously noted deficiencies remain evident across advisory firms.

Below is a discussion of the examination priorities, as well as the Division's Investment Adviser and Investment Company Examination Program, focused on issues most relevant to Advisers.

Discussion

Private Funds

Noting that over 35% of the more than 5,000 Advisers manage approximately $18 trillion in private fund assets, the report indicates that the Division will continue to prioritize its focus on Advisers to private funds and review issues under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), including an Adviser's fiduciary duty. Consistent with prior years, it also will assess risks, with a focus on compliance programs, fees and expenses, custody, fund audits valuation, conflicts of interest, disclosures of investment risks, and controls around material nonpublic information ("MNPI").

More specifically, the Division will continue to review:

- 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 by Advisers to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals;
- compliance with the Advisers Act Custody Rule, including the "audit exception" to the surprise examination requirement and related reporting and updating of Form ADV regarding the audit and auditors;
- the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales; and
- conflicts around liquidity, such as adviser-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund.

The Division also will continue to focus on private fund Advisers' portfolio strategies, risk management, and investment recommendations and allocations, focusing on conflicts and disclosures around these areas. This will include review of investments in Special Purpose Acquisition Companies or "SPACs," particularly where the Adviser is also the SPAC sponsor. In addition, exams will continue to review the practices, controls, and investor reporting around risk management and trading for private funds with indicia of systemic importance, such as outsize counterparty exposure or gross notional exposure relative to similarly-situated firms.

ESG

Consistent with prior Division publications, the report notes that Advisers and registered funds are increasingly offering and evaluating investments that employ ESG strategies or incorporate ESG criteria, in part based on investor demand. Further, there is a risk that disclosures regarding ESG-related portfolio management practices could involve materially false and misleading statements or omissions. As a result, the Division will continue to focus on ESG-related advisory services and investment products, including private fund offerings.

These reviews will focus on whether Advisers and registered funds are:

- accurately disclosing their ESG investing approaches and 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;
- voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates; or
- overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (g., "greenwashing"), such as in their performance advertising and marketing.

Standards of Conduct

In a continuation of long-standing examination practices, the Division will address standards of conduct issues for Advisers, with reviews focused on how they are satisfying their obligations under the Advisers Act fiduciary standard to act in the best interests of retail investors and not to place their own interests ahead of retail investors' interests.

Specifically, examinations will focus on whether Advisers are acting consistently with their fiduciary duty to clients, looking at both duties of care and loyalty, including best execution obligations, financial conflicts of interest, and related impartiality of advice. These reviews also will include an assessment of the adequacy of Advisers' (i) compliance policies and procedures designed to address conflicts and ensure advice in the best interest of clients, and (ii) disclosures to enable investors to provide informed consent.

Additionally, examinations will focus on the effectiveness of compliance programs, testing and training that are designed to support retail investors and working families receiving recommendations and advice in their best interests.

Information Security and Operational Resiliency

The Division will continue to review Advisers' practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets. Specifically, the Division 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;
- oversee 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; and
- manage operational risk as a result of a dispersed workforce in a work-from-home environment.

Further, the Division will focus on, among other things, Advisers' compliance with Regulations S-P and S-ID. Additionally, examination will continue to include a review of Advisers' business continuity and disaster recovery plans, with a particular focus on the impact of climate risk and substantial disruptions to normal business operations.

Emerging Technologies and Crypto-Assets

Noting a significant further increase in the number of "robo-advisers" and a proliferation of the offer, sale, and trading of crypto-assets, the Division indicated that it will continue to conduct examinations of Advisers that are using emerging financial technologies to review whether the unique risks these activities present were considered by the firms when designing their regulatory compliance programs.

Examinations will continue to focus on firms that are, or claim to be, offering new products and services or employing new practices to assess whether: (i) operations and controls in place are consistent with disclosures made and the standard of conduct owed to investors and other regulatory obligations; (ii) advice and recommendations, including by algorithms, are consistent with investors' investment strategies and the standard of conduct owed to such investors; and (iii) controls take into account the unique risks associated with such practices.

Examinations of market participants engaged with crypto-assets will continue to review the custody arrangements for these assets and will assess the offer, sale, recommendation, advice, and trading of crypto-assets. Specifically, examinations 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 (g., Blockchain and crypto-asset feature analysis); and
- routinely review, update, and enhance their compliance practices (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).

Investment Adviser and Investment Company Examination Program

The report discusses the Division's Investment Adviser and Investment Company Examination Program. Consistent with long-standing practice, during a typical examination, the Division will review the compliance programs of Advisers in one or more of the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures.

Additionally, the Division will examine whether compliance programs address that: (i) investment advice is in each client's best interest; (ii) oversight of service providers is adequate; and (iii) sufficient resources exist to perform compliance duties. Moreover, to the extent that firms are using alternative data or data gleaned from non-traditional sources as part of their business and investment decision-making processes, reviews will include examining whether Advisers are implementing appropriate compliance and controls around the creation, receipt, and use of potentially MNPI.

As part of its assessment of the effectiveness of a compliance program, the Division will continue to review whether the firm has implemented oversight practices to mitigate any heightened risks, including, for example, whether Advisers employing individuals with prior disciplinary histories implemented heightened oversight practices for these individuals, or Advisers operating from multiple branch offices have appropriately adapted their compliance programs to oversee the activities in their branches.

The Division also will continue to focus on Adviser disclosures and other issues related to fees and expenses, with a concentration on: (i) advisory fee calculation errors; (ii) inaccurate calculations of tiered fees; and (ii) failures to refund prepaid fees for terminated accounts or pro-rated fees for onboarding clients.

As in previous years, the Division will prioritize Advisers that have never been examined, including recently registered firms, and those that have not been examined for a number of years. Typically, these examinations focus on firms' compliance programs.

For more information, please contact one of our Private Funds Group partners.

Related Professionals

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