Proskauer

2024 SEC Examination Priorities –Takeaways for Registered Fund and BDC Managers

October 24, 2023

On October 16, 2023, the Division of Examinations (the "Division") of the U.S. Securities and Exchange Commission ("SEC") released its 2024 Examination Priorities ("Annual Priorities").[1] Unlike in previous years when the Division released its exam priorities at the beginning of the calendar year, the publication of this year's Annual Priorities aligns instead with the start of the SEC's fiscal year, which begins on November 1.

While this year's Annual Priorities repeat many of the topics identified in last year's examination priorities, the SEC highlighted several new areas of particular interest this year, including a new focus on anti-money laundering ("AML") programs. In addition, several of the areas of focus highlighted in the Annual Priorities relate specifically to registered funds and business development companies ("BDCs") (collectively, "funds"), including their advisers. Those specific areas of SEC focus include:

- fees and expenses incurred by funds, including any policies a fund has adopted regarding oversight of advisory fees and the implementation of any fee waivers or reimbursements, as well as the annual board approval process for advisory agreements under Section 15(c) of the Investment Company Act of 1940, as amended (the "1940 Act");
- derivatives risk management programs adopted and implemented by funds pursuant to Rule 18f-4, including board oversight of the programs and related disclosures about a fund's use of derivatives; and
- AML programs adopted by mutual funds, including whether a program is sufficiently tailored to the fund's AML risks considering its location, size, investment activities and investor base.

The SEC further noted that it would continue to review funds' compliance with other recently adopted rules, including Rule 22e-4 (liquidity risk management), and Rule 2a-5 (valuation of portfolio holdings), along with compliance with the conditions of any SEC exemptive order to which a fund or its adviser is subject, including those permitting co-investments with affiliates.

Fund Fees and Expenses

The Annual Priorities continue the SEC's recent focus on advisory fees charged to funds, including the impact of any related expense waivers and reimbursements, and the correction of any errors. In addition, the Annual Priorities identify four non-exhaustive categories of advisory arrangements on which the SEC intends to focus:[2]

- arrangements in which different advisory fees are charged to different share classes of the same fund in violation of Rule 18f-2;
- arrangements whereby a sponsor offers identical investment strategies through different distribution channels, but charges different fee structures;
- arrangements that involve "high" advisory fees relative to peers; and
- arrangements involving "high" fund fees and expenses where a fund's performance is weak relative to its peers.

As was the case last year, the SEC noted its intent to focus on the annual board approval process under Section 15(c) for fund advisory agreements as part of its consideration of overall fees and expenses borne by a fund. Accordingly, we expect the Division to not only scrutinize the specific process undertaken by a board in reapproving an advisory agreement, but to also scrutinize the specific data and other information sought and received by a board in connection with its Section 15(c) approval process. Notably, the categories of advisory arrangements highlighted in the Annual Priorities appear to suggest greater scrutiny than recent case law would require around the concept of "high" relative advisory fees, and high fees and expenses in connection with relatively poor performance.

In particular, the seminal Supreme Court case addressing Section 15(c) board obligations only requires a board to determine that the advisory fee is not "so disproportionately large that it bears no relationship to the services rendered and could not have been the product of arm's length bargaining."[3] Similarly, other courts have consistently granted great deference to the determinations made by boards in the Section 15(c) context, provided that they undertake a thoughtful and well-documented review process.[4] Such deference has continued to prevail even where an adviser may charge different fees among funds it manages, or where a fund's relative performance may fall below that of its peers.[5]

The focus on advisory fees is made more curious because of the significant decline in advisory fees paid by most fund investors over the last decade. This decline was precipitated not by the procedural requirements of Section 15(c) or the Section 36(b) litigation, but because of price competition caused, in part, by the gravitation of investors to lower-cost funds, including ETFs. To the extent the Division elects to focus its scarce resources on the procedural requirements associated with fund board approval of advisory fees, it may be targeting issues of concern during the last century.

Derivatives Risk Management Programs

Given the complex nature of the calculations required under Rule 18f-4, the Annual Priorities highlight a key SEC focus on funds' compliance with the derivatives risk management requirements under that rule. Notably, while we expect the SEC to review the derivative risk management programs adopted by funds generally, we anticipate a deeper focus on the various calculations required under Rule 18f-4, including how derivative instruments are valued for purposes of both the limited derivatives user test and for compliance with the "value at risk" ("VAR") test. We also expect heightened scrutiny around the mechanical VAR testing process if handled internally, or the oversight of that testing handled by a third-party administrator or compliance firm.

Tailored AML Programs for Mutual Funds

The Annual Priorities highlight the requirement under the Bank Secrecy Act of 1970 ("BSA") that mutual funds and broker-dealers establish AML programs that are sufficiently tailored to address the risks associated with the company's location, size, investment activities, customer base and types of products and services offered.[6] The Annual Priorities identify four non-exhaustive topics on which the Division will focus when examining mutual funds subject to the BSA:

- whether the mutual fund has appropriately tailored its AML program to its business model and associated AML risks;
- whether the mutual fund conducts independent testing of its AML program;
- whether the mutual fund has established an adequate customer identification program, including for identifying beneficial owners of customers which are not natural persons; and
- whether the mutual fund continues to meet its Suspicious Activity Report ("SAR") filing obligations.

Key Takeaways

- The Annual Priorities highlight the SEC's continued focus on the implementation of recently adopted rules. While the Annual Priorities emphasize a focus on funds' derivatives risk management programs implemented under Rule 18f-4, we fully expect a similar focus on valuation processes under Rule 2a-5 and, in the case of open-end funds, liquidity risk management programs implemented under Rule 22e-4. Funds and their advisers may wish to review the methodologies employed for performing any required calculations under such rules, as well as the documentation evidencing any testing required as part of compliance with such rules.
- Given the apparent SEC focus on fund fees and expenses, advisers to funds may wish to review their annual Section 15(c) materials and, where appropriate, consider providing additional information or data to a fund's board to address any perceived variance in fees, expenses or performance – either relative to peers or to other funds with the same adviser. In particular, those funds that have underperformed peers recently and may have higher overall fee and expense loads may wish to provide their respective boards with longer-term performance data along with additional details around the fees charged and expenses borne by a fund in order to provide a sufficient basis for reapproving an existing advisory agreement. Similarly, advisers to funds with different non-distribution-related expenses across multiple funds may wish to address the distinctions between such

funds warranting different fees in the Section 15(c) materials they provided to each fund they manage.

- Advisers to funds with more complex advisory fee calculations, including net investment income or realized capital gains incentive fees, may wish to review their calculation methodologies to confirm conformity with the language of any applicable advisory agreement. Similarly, advisers should consider reviewing how any expense limitation agreements have been implemented, along with how and when reimbursements of previously waived expenses may be made under such agreements, to ensure consistency with the specific terms of such agreements.
- Mutual funds may wish to consider reviewing the sufficiency of their present AML programs in view of the points regarding appropriate tailoring of such programs noted in the Annual Priorities.
- In contrast with the 2023 examination priorities, the Division has removed its prior focus on environmental, social and governance ("ESG") investment strategies and related issues from the Annual Priorities. While the removal of this topic may suggest that ESG-related matters are being de-prioritized at the SEC level, board members of and advisers to funds should be aware that certain U.S. states continue to show a heightened regulatory interest in ESG topics and that the SEC is still considering rulemaking that, if adopted, would require publicly traded companies to make extensive climate-related disclosures.[7] We expect a renewed focus on ESG-related issues if and when a final rule is adopted by the SEC.

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[1] *See 2024 Examination Priorities*, Sec. & Exch. Comm'n Div. of Examinations (Oct. 16, 2023), available here.

[2] *See id.* at 12.

[3] *Jones v. Harris Associates, L.P.*, No. 08-586 (Mar. 30, 2010). *See also Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923 (2d Cir. 1982), aff'g 528 F. Supp. 1038 (S.D.N.Y. 1981), cert. denied, 461 U.S. 906 (1983).

[4] *See Kennis v. Metropolitan West Asset Management LLC*, No. 15-8162 (C.D. Cal. Aug. 5, 2019) (holding that substantial deference is owed to the board's determination regarding a fund's advisory arrangements resulting from its annual review and approval process, provided the process itself is robust, and that even where an adviser realizes economies of scale on a given advisory arrangement with a fund, its management fee will not be deemed excessive where it shares those economies of scale with the fund in the form of a fee break); and *Obeslo v. Great-West Capital Management*, No. 20-1310 (10th Cir. 2021), aff'g No. 16-cv-00230 (D.C. Colo. 2020) ("Courts are comparatively ill-suited to determine what fee structures most benefit shareholders. [. . .] Courts respect this statutory design by 'afford[ing] commensurate deference to the outcome of the bargaining process' when a board's 15(c) process is robust").

[5] *See, e.g.*, *Goodman v. J.P. Morgan Inv. Mgmt., Inc.*, No. 2:15-cv-2923, 2018 U.S. Dist. LEXIS 39209 (S.D. Ohio Mar. 9, 2018) (granting summary judgment to a defendant adviser who charged a higher fee to affiliated funds that it directly advised compared to the fee charged to unaffiliated funds that it subadvised, on the basis that the risks undertaken and scale of services provided as an adviser and as a sub-adviser are different); –and *Paskowitz v. Prospect Capital Management L.P.*, 232 F. Supp. 3d 498 (S.D.N.Y. 2017) (holding that a board was acting within its discretion to approve an advisory agreement even where a BDC allegedly charged higher fees than many of its peers, but had poorer relative performance than those peers).

[6] *Goodman, supra note 5* at 21.

[7] For example, earlier this month, California became the first U.S. state to implement statutory requirements regarding the disclosure and reporting of greenhouse gas emissions and climate-related financial risks by both public and private U.S. entities that conduct business in the state. For a detailed discussion of these statutory enactments, please refer to this Proskauer client alert; *see* SEC Proposes Broad New Climate Change Disclosure Requirements, Proskauer (March 2022). Separately but relatedly, the SEC recently amended the Names Rule in a way that is anticipated to impact registered funds that include ESG terms in their names. For a further discussion, please see this Proskauer client alert, available here.