

2024 SEC Examination Priorities for Investment Advisers

by David Tang and Michael Schmieder

The SEC's Division of Examinations (the "Division") announced its examination priorities for fiscal year 2024.^[1] This eUpdate includes observations on the examination priorities and a list of examination priorities that impact SEC-registered investment advisers ("advisers"), including private fund advisers.^[2]

Dorsey Observations

Many of this year's examination priorities for advisers remain the same as in the prior year with the notable absence of matters pertaining to environmental, social, and governance ("ESG"). Despite ESG being absent from the Division's examination priorities, it is likely that the SEC will continue to focus on ESG related issues. The SEC has expended significant resources on ESG, including the establishment of an ESG and Climate Task Force. The SEC has also proposed new rules requiring, among other things, advisers that consider ESG factors to make additional disclosures regarding ESG strategies in Form ADV.

Another item that is not included in this year's examination priorities is off-channel communications, which has been an area of intense scrutiny. The SEC has sent a clear message with a long list of enforcement actions resulting in over \$1.5 billion in penalties that it will continue to target recordkeeping violations involving off-channel communications. While not mentioned in the Division's examination priorities, advisers should stay on alert for compliance with electronic communications policies and be prepared to demonstrate an effective and robust recordkeeping program upon examination.

The Division reiterated that, as with previous years, it will continue to prioritize examinations of advisers that have never been examined, including recently registered advisers, and those that have not been examined for a number of years. In view of the steady frequency and growing scope of the Division's examinations, advisers should take steps to prepare for examinations and regularly review the adequacy and effectiveness

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of their compliance programs. Dorsey's compliance services are available to advise firms through the SEC examination process, and assist with exam preparation and mock audits.

Investment Adviser Examination Priorities

In its examination priorities, the Division stated that it will examine advisers' adherence to their fiduciary duties, focusing specifically on:

- Investment advice to clients with regard to products, investment strategies, and account types with respect to complex products, such as derivatives and leveraged ETFs; high cost and illiquid products, such as variable annuities and non-traded real estate investment trusts; and unconventional strategies, including those that purport to address rising interest rates. The Division will focus on processes for determining that investment advice is provided in clients' best interest, including making initial and ongoing suitability determinations, seeking best execution, evaluating costs and risks, and identifying and addressing conflicts of interest.
- Conflicts of interest, including specifically how advisers address, mitigate or eliminate the conflicts of interest, and the allocation of investments to accounts where investors have more than one account.
- Economic incentives that advisers have in recommending products, services, or account types, such as the source and structure of compensation, revenue, or other benefits. Exams will focus on conflicts of interest associated with advisers that are dually registered as broker-dealers, use affiliated firms to perform client services, and have financial professionals servicing both brokerage customers and advisory clients.
- Investor disclosures, including specifically whether those disclosures include all material facts relating to conflicts of interest.
- Compliance Programs, including whether advisers' policies and procedures reflect the various aspects of the advisers' business, compensation structure, services, client base, and operations, and address applicable current market risks.^[3] In reviewing adviser's compliance programs, the Division places a high priority on its review of advisers' annual compliance reviews.
- Anti-Money Laundering, including advisers' monitoring of, and compliance with, Office of Foreign Assets Control sanctions.

Additional focus areas of adviser examinations include:

- Marketing practice assessments for whether advisers, including private fund advisers, have adopted policies and procedures to prevent violations of the Marketing Rule under the Investment Advisers Act; appropriately disclosed their marketing related information on Form ADV; and maintained substantiation of their processes and other required books and records. The Division will assess whether adviser advertisements include any untrue statements of a material fact, are materially misleading, or are otherwise deceptive; and comply with the Marketing Rule's requirements regarding performance reporting (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements.
- Compensation arrangement assessments that focus on advisers' fiduciary obligations to their clients including alternative ways that advisers try to maximize revenue, such as revenue earned on clients' bank deposit sweep programs; and fee breakpoint calculation processes, particularly when fee-billing systems are not automated.

- Valuation assessments regarding the valuation of illiquid or difficult to value assets, such as commercial real estate or private placements.
- Safeguarding assessments of advisers' controls to protect clients' material non-public information, particularly when multiple advisers share office locations, have significant turnover of investment adviser representatives, or use expert networks.
- Disclosure assessments of regulatory filings including Form CRS, with a focus on inadequate or misleading disclosures and registration eligibility.

Private Fund Adviser Examination Priorities

The Division will continue to focus on examinations of private fund advisers, and prioritize topics such as:

- Portfolio management risks present when there is exposure to market volatility and higher interest rates, including private funds experiencing poor performance, significant withdrawals and valuation issues, and private funds with more leverage and illiquid assets.
- Adherence to contractual requirements regarding limited partnership advisory committees or similar structures (e.g., advisory boards), including adhering to any contractual notification and consent processes.
- Accurate calculation and allocation of private fund fees and expenses, including post commitment period management fees and potential offsetting of such fees and expenses.
- Due diligence practices and associated policies and procedures, particularly with private equity and venture capital fund assessments of portfolio companies.
- Conflicts regarding private funds managed side-by-side with registered investment companies and use of affiliated service providers.
- Compliance with the requirements of the Custody Rule, including accurate Form ADV reporting, timely completion of private fund audits by a qualified auditor and the distribution of private fund audited financial statements.
- Policies and procedures for reporting on Form PF, including upon the occurrence of certain reporting events.^[4]

Crypto Assets and Emerging Financial Technology

Crypto assets and emerging financial technology are areas that remain high on the Division's list of concerns. The Division continues to closely watch crypto assets and their associated products and services, focusing on the offer, sale, recommendation of, advice regarding, trading in, and other activities in crypto assets or related products. With respect to emerging financial technology, the Division remains focused on certain services, including automated investment tools, artificial intelligence, and trading algorithms or platforms, and the risks associated with the use of emerging technologies and alternative sources of data.

^[1] SEC Division of Examinations 2024 Examination Priorities *available at* <https://www.sec.gov/files/2024-exam-priorities.pdf>.

^[2] In addition to advisers, the Division's examination priorities include focus areas for

registered investment companies, broker-dealers, self-regulatory organizations, clearing agencies, other market participants.

[3] The Division's examination of compliance policies and procedures may include one or more of the following areas, as discussed in the adopting release for Rule 206(4)-7 of the Investment Advisers Act of 1940: portfolio management process; disclosures made to investors and regulators; proprietary trading by the adviser and the personal trading activities of supervised advisory personnel; safeguarding of client assets from conversion or inappropriate use by advisory personnel; the accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction; safeguards for the privacy protection of client records and information; trading practices; marketing advisory services; processes to value client holdings and assess fees based on those valuations; and business continuity plans.

[4] See Dorsey eUpdate: SEC Amends Form PF to Require Event Reporting *available at* <https://www.dorsey.com/newsresources/publications/client-alerts/2023/5/sec-amends-form-pf-to-require-event-reporting>.