

SEC Exam Priorities 2022 and Compliance

The Division of Examinations announced its 2022 Exam Priorities in a release dated March 30, 2022 (here). The 2022 priorities are, as usual, a blend of traditional considerations from past programs mixed with new and at times emerging issues. Each of the areas, as well as the program, are grounded in the four pillars of the program: promoting compliance; preventing fraud; identifying and monitoring risks; and informing policy. During the exam the Division will prioritize “several significant focus areas that pose unique emerging risks to investor and the markets . . .”

The program begins with what are called “Significant Focus Areas” which are then divided into several specialty areas. The five focus areas are common to the overall program. They are: 1) Private Funds; 2) ESG or Environmental, Social and Governance Investing; 3) Standards of Conduct; 4) Information Security and Operational Resiliency; and 5) Emerging Technologies and Crypto Assets.

Private Funds represent one of the largest RIA segments, currently at about 35% of advisories and \$18 trillion. Over the past five years there has been a 70% increase in the assets managed by these funds. The funds range from fairly straightforward investment vehicles to those that are very complex.

Exams plans to focus on traditional questions such as issues under the Advisers Act. Those include the fiduciary duty of advisers as well as the risks and the focus of the funds. Exam will assess the risks faced by the funds as well as the compliance programs, fees and expenses, custody arrangements, valuation methods and disclosures employed.

The program will also consider five specific items: 1) the calculation and allocation of fees and expenses; 2) the potential preferential treatment by some RIAs to funds that have experienced issues with gates, liquidity, suspensions, and withdrawals; 3) compliance with the Advisers Act, including the custody rule; 4) compliance with regulatory requirements and disclosure obligations; and 5) conflicts around liquidity and

Related Capabilities

- Banking & Financial Institutions
- Securities & Financial Services Litigation & Enforcement
- Investment Management
- Investment Funds
- FinTech
- Privacy & Social Media
- Environmental, Social, Governance (ESG)

stapled secondary transactions.

Finally, the Division will examine the portfolio strategies, risk management and investment recommendations and allocations. This will include fund investments in special purpose entities or SPACs, particularly when the adviser is also a SPAC sponsor. Practices, controls and investor reporting will also be evaluated, particularly where there is outsized counter-party exposure.

ESG investing represents a growing trend, spurred by investor demand. There is a risk with these programs of false and misleading statements. This stems in part from the lack of standardization in the area as well as the size and growing complexity of the area. There are also a variety of approaches being employed which can increase risk.

The Division will focus on three key points here. First, the accuracy of the disclosure regarding ESG investing. Second, the voting of client securities in accord with proxy voting policies and procedures regardless of whether it aligns with the ESG related disclosures. Third, if the fund is overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection.

Standards of Conduct focuses on Regulation BI, Fiduciary Duty and Form CRS. Exam will focus on how these standards are being satisfied. For broker-dealers and RIAs there will be a focus on compliance programs, testing, and training that is “designed to support retail investors and working families receiving recommendations and advise in their best interest.”

Broker-dealer exams will focus on sales practices related to SPACs, structured products, leveraged and inverse exchange traded products, annuities, municipal securities and other fixed income investments and microcap securities. Exams will also consider and evaluate costs, and available alternatives as well as recommendations of products. In addition, the compensation structure as well as any related conflicts will be evaluated.

RIA exams will focus on whether advisers act consistently with their fiduciary duties to clients as well as conflicts and disclosures. Four areas are key: 1) revenue sharing arrangements; 2) recommending or holding more expensive classes of shares; 3) the recommendation of shares that carry fees and 4) recommendations regarding proprietary products. Compliance policies and procedures and their design and implementation will also be evaluated.

Dually registered RIAs and broker-dealers are an “area of interest for the Division.”

There will be an evaluation of potential conflicts of interest, including those from account recommendations and allocations of investments across different accounts. Exams will focus on: 1) the sale or recommendations of high fee products; 2) the sale or recommendation of proprietary products of the firm or affiliates; 3) incentives for financial professionals to place their own firm’s interest before that of customers and clients; and 4) if the compensation structures inappropriately influence investment recommendations. Written policies and procedures will also be analyzed.

Information security and operation resiliency is critical to ensure business continuity. Thus, the Division will review broker-dealer and RIA practices designed to prevent interruptions to mission-critical services and protect investor information. Accordingly, Exams will consider: 1) measures taken to safeguard customer accounts and prevent intrusions; 2) evaluate steps taken to oversee vendors and service providers; 3) examine steps taken to address malicious email activities; 4) responses to incidents; 5) steps taken to identify and detect red flags; and 6) evaluate steps taken to manage operational risk as a result of a dispersed workforce. Finally, the exams will consider business continuity and steps taken in this area.

Emerging tech and crypto assets will also be examined. Specifically, the Division will review the use of “robo-advisers” and the growing trends in this area. The unique risks in these areas will also be evaluated.

Similarly, Exams will evaluate the controls of RIAs and broker-dealers who are involved with crypto assets. Custody arrangement for the assets will be reviewed. In addition, consideration will be given to if those involved in these areas and if they have met their standards of conduct with respect to recommending and giving advice, a point which wraps back to each of the other areas discussed.

Comment

The Division of Examinations covers the waterfront of regulated entities. From investment advisers to broker-dealers and investment companies, the Division’s Examination Priorities 2022 discusses key questions for each. Building on themes developed over the years, the Division plans to examine a range of issues such as: compliance with the custody rule by private funds; climate and ESG questions presented by certain market professionals and products; compliance with the varying standards of conduct applicable to market professionals; cybersecurity and operational resiliency in an evolving environment in which cyber-attacks are ever present; and the new questions presented by so-called “robo” advisers and crypto assets which remain a fascination of many but are often little understood.

The Exam Priorities are a valuable guide not just for preparation to meet with the Division. They also offer insight into key areas and issues faced by market professionals. Yet the best preparation for a meeting with Exams begins not with the Division’s discussion of its priorities but with the instillation, implementation and continued improvement of an effective compliance system driven from the top down. It is that system, key to the proper operation of the professional organization, that serve investors and the public as guided by the tone from the top. It is impact of that tone from the top as implemented by the organization that Exams evaluates.