ONPOINT / A legal update from Dechert's Financial Services Group

SEC Division of Examinations Releases 2024 Priorities

Authored by David P. Bartels, K. Susan Grafton, Anthony S. Kelly, Mark D. Perlow, Robert J. Rhatigan, Elise Kletz, and Michael McGrail

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Dechert LLP

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Key Takeaways:

- The SEC's Division of Examinations (EXAMS) published its report on 2024 Examination Priorities on October 16, 2023.[1]

- The 2024 Examination Priorities continue to reflect an examination program that is vigorous and broad in its focus.

- Many of the significant focus areas from the 2023 Examination Priorities remain key focus areas in the 2024 Examination Priorities including: compliance with recently implemented regulations; review of advisers to private funds; focus on registered fund fees and expenses; and standards of conduct for registered investment advisers and broker-dealers.

- A notable change from the prior year is the removal of environmental, social and governance (ESG) investing from the list of focus areas, though this may not signal a significant change in approach.[2]

- For fiscal year 2024, EXAMS staff expects to continue to increase in-person fieldwork.

EXAMS tends to carry forward major themes from year-to-year, and due to the shorter amount of time between the publication of the 2023 Examination Priorities and the publication of the 2024 Examination Priorities, several of the initiatives and focus areas from the 2023 Examination Priorities remain as 2024 Examination Priorities.[3] For example, investment advisers should continue to expect scrutiny of marketing activities and investment companies should anticipate inquiries regarding their use of derivatives and their derivatives risk management programs. For investment advisers to private funds, EXAMS repeats familiar themes related to conflicts of interest and expense allocation while also emphasizing portfolio management risks and due diligence practices. For broker-dealers, EXAMS will continue to focus on compliance with Regulation Best Interest and will focus on compliance with Form CRS, the Net Capital Rule and Customer Protection Rule. Additionally for broker-dealers, EXAMS will review broker-dealer equity and fixed income trading practices.

Additional statistical information regarding the examination program, compiled by Dechert from various SEC sources, is provided in the Appendix.

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1 2024 Examination Priorities, SEC Division of Examinations (Oct. 16, 2023). All statements in this *Dechert OnPoint* as to the intent or plans of EXAMS are based on the text of the 2024 Examination Priorities. At times, this *Dechert OnPoint* tracks the 2024 Examination Priorities without the use of quotation marks.

2 ESG investing was removed from the 2024 Examination Priorities. However, we believe that ESG investing will remain a priority for the SEC and EXAMS staff as the list of focus areas in the Examination Priorities report is not all inclusive. Furthermore, with recently proposed ESG rules for advisers, the continued focus on ESG disclosures and the finalized "Names Rule", which has ESG implications, we believe that ESG investing remains a priority for the SEC and note that clients should remain vigilant.

3 2023 Examination Priorities, SEC Division of Examinations (Oct. 16, 2023).

2024 Examination Priorities

Message from the Leadership Team of EXAMS

The Message from the Leadership Team emphasizes the EXAMS staff's engagement with market participants through examinations and proactive outreach, collaborative efforts with other federal and state regulators and a continued focus on risk-based processes and responses to emerging matters. Notable developments include:

- In fiscal year 2023, EXAMS staff conducted more in-person fieldwork but also provided virtual options to examiners and registrants to participate in different stages of an examination to broaden access.
- EXAMS launched a series of joint regulatory trainings with Financial Industry Regulatory Authority (FINRA) staff "to enhance communication and collaboration between both regulators."
- In fiscal year 2023, the EXAMS staff published nine risk alerts, including one highlighting the staff's focus on different aspects of the Marketing Rule under the Investment Advisers Act of 1940.
- Various organizational changes made in fiscal year 2023, such as the establishment of specialized teams within different examination programs to better address emerging issues and risks. These encompass crypto assets, financial technology—such as artificial intelligence—and cybersecurity.

The EXAMS staff continues to be focused on building its internal expertise and expects to increase its engagement through more touchpoints, such as in-person fieldwork, compliance outreach events and speaking engagements. The message notes that with the industry's preparation to meet new regulatory requirements underway, the EXAMS staff "will need to consider the impact of these rules, which will influence potential examinations, compliance risks and new focus areas."

Investment Advisers

Examination of Investment Advisers

Fiduciary obligations. As in prior years, EXAMS will prioritize examining for advisers' adherence to their duty of care and duty of loyalty obligations. In reviewing advisers' adherence to these fiduciary duties, EXAMS continues to focus on:

- **Investments with higher costs, risk or complexity**. Investment advice provided to clients with regard to products, investment strategies and account types. EXAMS particularly emphasized those that it characterized as complex products (citing derivatives and leveraged exchange-traded funds (ETFs)), high cost and illiquid products (citing variable annuities and non-traded real estate investment trusts (REITs)) and unconventional strategies, including those that purport to address rising interest rates.
- **Specific client demographics**. Investment advice provided to certain types of clients, such as older investors and those saving for retirement.
- **How advisers make best interest determinations**. Processes for determining that investment advice is provided in clients' best interests, including processes for making initial and ongoing suitability

determinations, seeking best execution, evaluating costs and risks, and identifying and addressing conflicts of interests.[4]

- **Conflicts of interest**. How advisers address conflicts of interest including (1) mitigating or eliminating conflicts of interest, when appropriate, and (2) allocating investments to accounts where investors have more than one account.

- **Compensation conflicts**. Economic incentives and 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.

- **Conflicts disclosures**. Disclosures made to clients and whether they include all material facts relating to conflicts of interest associated with the investment advice sufficient to allow a client to provide informed consent to the conflict.

Compliance programs. EXAMS continues to focus on advisers' compliance programs, "including whether their policies and procedures reflect the various aspects of the advisers' business, compensation structure, services, client base, and operations and address applicable current market risks."[5] EXAMS' reviews of compliance programs will also assess whether the policies and procedures are sufficient to support compliance with advisers' fiduciary obligations. Particular examination focus areas will include:

- **Marketing Practice Assessments:** EXAMS will assess whether disseminated advertisements include any untrue statements of a material fact, are materially misleading or are otherwise deceptive and whether these advertisements comply with the requirements for performance, third-party ratings and testimonials and endorsements. EXAMS will also assess whether advisers, including advisers to private funds, have:

  - Adopted and implemented reasonably designed written policies and procedures to prevent violations of the Advisers Act and rules thereunder (including reforms to the Marketing Rule).

  - Appropriately disclosed their marketing-related information on Form ADV.

  - Maintained substantiation of their processes and other required books and records.

- **Compensation Arrangement Assessments**: EXAMS will focus on:

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4 2024 Examination Priorities, SEC Division of Examinations (Oct. 16, 2023). In furtherance of its focus on and prioritization of compliance relating to conflicts of interest, EXAMS will assess, among other things, whether the "adviser's policies and procedures are reasonably designed and implemented and whether the procedures prevent the advisers from placing their interests ahead of clients' interests."

5 2024 Examination Priorities, SEC Division of Examinations (Oct. 16, 2023). Examinations will focus on compliance policies and procedures, as discussed in the adopting release for the compliance rule under the Advisers Act (Rule 206(4)-7). See also SEC, Final Rule: Compliance Programs of Investment Companies and Investment Advisers, IA-2204 (Dec. 17, 2003).). Examinations focusing on compliance policies and procedures may include one or more of the following areas: portfolio management processes; disclosure 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.

  - Fiduciary obligations of advisers to their clients, particularly with respect to the advisers' receipt of compensation for services or other material payments made by clients and others.
  - Alternative ways that advisers try to maximize revenue.
  - Fee breakpoint calculation processes, particularly when fee billing systems are not automated.

- **Valuation Assessments:** EXAMS will review advisers' recommendations to clients to invest in illiquid or difficult to value assets, such as commercial real estate or private placements.
- **Safeguarding Assessments:** EXAMS will evaluate advisers' controls for protecting 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:** EXAMS will review the accuracy and completeness of regulatory filings, including Form CRS, with a particular focus on inadequate or misleading disclosures and registration eligibility.

EXAMS will also focus on advisers' policies and procedures for: (1) selecting and using third-party and affiliated service providers; (2) overseeing branch offices when advisers operate from numerous or geographically dispersed offices; and (3) obtaining informed consent from clients when advisers implement material changes to their advisory agreements.

Consistent with prior years, EXAMS prioritizes advisers that have never been examined and those that have not been examined for a "number of" years.

Examination of Investment Advisers to Private Funds

EXAMS will continue to focus on advisers to private funds and prioritize specific topics including, but not limited to:

- **Highlighted portfolio risks:** Portfolio management risks present when there is exposure to recent market volatility and high interest rates.
- **Conflicts review mechanisms:** Adherence to contractual requirements regarding limited partnership advisory committees or similar structures (e.g., advisory boards).
- **Fees and expenses:** Accurate calculation and allocation of fees and expenses (including valuation of illiquid assets, calculation of post commitment period management fees, adequacy of disclosures and potential offsetting of such fees and expenses).
- **Due diligence practices:** Due diligence practices for consistency with policies, procedures and disclosures (particularly with respect to private equity and venture capital fund assessments of prospective portfolio companies).
- **Conflicts related to other clients and affiliates service providers:** Conflicts, controls and disclosures regarding private funds managed side-by-side with registered investment companies and use of affiliated service providers.
- **Custody rule:** Compliance with Rule 206(4)-2 under the Advisers Act (Custody Rule).
- **Form PF reporting:** Policies and procedures for reporting on Form PF.

Investment Companies

EXAMS will continue to prioritize examinations of registered investment companies, including mutual funds and ETFs, due to their importance to retail investors. Examinations of registered investment companies will often include a review of compliance programs, governance practices, disclosures to investors and accuracy of reporting to the SEC. In conducting these reviews, EXAMS will focus on boards' processes for assessing and approving advisory and other fund fees (particularly for funds with "weaker" performance relative to peers), and will review valuation practices, particularly for those addressing fair valuation practices.

Fees and expenses. One examination focus area may include fees and expenses. EXAMS will review whether registered investment companies have adopted effective written compliance policies and procedures relating to the oversight of advisory fees and implemented any associated fee waivers and reimbursements and will review the boards' approval of the advisory contract and registered investment company fees. EXAMS will particularly focus on:

- Charging different advisory fees to different share classes of the same fund.
- Identical strategies offered by the same sponsor through different distribution channels but that charge differing fee structures.
- High advisory fees relative to peers.
- High fees and expenses, particularly those of registered investment companies with "weaker" performance relative to peers.

Derivatives risk management. EXAMS highlighted derivatives risk management assessments as another examination focus areas. EXAMS will review whether registered investment companies as well as business development companies (BDCs) have adopted and implemented written policies and procedures "reasonably designed to prevent violations of" the fund derivatives rules (Investment Company Act of 1940 Rule 18f-4). In its focus on compliance with the derivatives rule, EXAMS may review:

- The adoption and implementation of a derivatives risk management program.
- Board oversight of a derivatives risk management program.
- Disclosures concerning the registered investment companies' or BDCs' use of derivatives and whether these disclosures are incomplete, inaccurate or potentially misleading.
- The registered investment companies' or BDCs' procedures for, and oversight of, derivative valuations.

Other investment company focus areas. EXAMS will also review for compliance with the terms of exemptive order conditions and the issues associated with recent market dislocations and volatility. EXAMS will continue to prioritize registered investment companies that have never been examined and those that have not been examined in "a number of" years.

Broker-Dealers

Regulation Best Interest

For fiscal year 2024, EXAMS will focus on areas that pose emerging risks to investors or the markets and continue to focus on core and perennial risk areas. Continuing this examination priority from 2021, 2022 and 2023, in 2024 EXAMS will continue to focus on broker-dealers' compliance with their standard of conduct obligations of particularly regarding Regulation Best Interest. Regulation Best Interest establishes the standard of conduct for broker-dealers at the time they recommend a securities transaction or investment strategy to a retail customer: a broker-dealer must act in the retail customer's best interest and cannot place the financial or other interest of the broker-dealer or its associated persons ahead of the customer's interest. Broker-dealers must comply with the four component obligations set forth in Regulation Best Interest to satisfy their obligations under Regulation Best Interest.

EXAMS noted that in its review of whether broker-dealer recommendations are in customers' best interests, areas of particular interest will include: (1) recommendations of products, investment strategies and account types; (2) disclosures made to investors regarding conflicts of interest; (3) conflict mitigation practices; (4) processes for reviewing reasonably available alternatives; and (5) factors considered in light of the investor's investment profile (i.e., investment goals and account characteristics). Examinations will focus on those recommended products that are complex (e.g., derivatives and leveraged ETFs), high cost (e.g., variable annuities), illiquid (e.g., nontraded REITs and private placements), proprietary and micro-cap securities. EXAMS emphasized that it may also focus on recommendations to certain types of investors, such as older investors and those saving for college or retirement.

As part of the examinations, EXAMS will evaluate whether the broker-dealer has "established, maintained, and enforced written policies and procedures reasonably designed to achieve compliance" with the areas highlighted above and with Regulation Best Interest overall, and will consider whether these policies and procedures are reasonably designed based on the costs, risks and rewards of the securities and investment strategies recommended. EXAMS will continue to focus on dual registrants and its examinations will cover firms' conflicts of interest, and account allocation and selection practices. EXAMS stated it will also assess broker-dealers' supervision of branch office locations.

Form CRS

In 2024, EXAMS will continue to review the content of broker-dealer's relationship summary, such as how the broker-dealer describes the relationships and services it offers to retail customers, its fees and costs and its conflicts of interest. Similarly, EXAMS will continue to review broker-dealers' disciplinary history disclosures and to evaluate whether broker-dealers have met their obligations to file their relationship summary with the SEC and to deliver their relationship summary to retail customers.

Broker-Dealer Financial Responsibility Rules

In 2024, examinations will focus on broker-dealer compliance with the Net Capital Rule (Securities Exchange Act of 1934 Rule 15c3-1) and the Customer Protection Rule (Exchange Act Rule 15c3-3) as well as related internal processes, procedures and controls. EXAMS highlighted fully paid lending programs and broker-dealer accounting for certain types of liabilities (e.g., rewards programs, gift cards and non-brokerage services) as areas of review. EXAMS also noted that it will review "broker-dealer credit, interest rate, market, and liquidity risk management controls to assess whether broker-dealers have sufficient liquidity to manage stress events."

Broker-Dealer Trading Practices

In 2024, examinations will cover broker-dealer equity and fixed income trading practices. In particular, EXAMS noted that it will review compliance with Regulation SHO (including the rules regarding aggregation units and locate requirements), Regulation ATS and whether the operations of alternative trading systems are consistent with the disclosures provided in Forms ATS and ATS-N, and Rule 15c2-11 under the Exchange Act. EXAMS also noted that its examinations of wholesale market makers may include "quote generation, order routing and execution practices, market data ingestion, regulatory controls, and risk management."

Information Security and Operational Resiliency

The 2024 Examination Priorities warns that the current operational disruption risks in the cybersecurity environment are considered elevated due to geopolitical concerns and the recent increase in cybersecurity attacks. As a result, EXAMS intends to review firms' policies and procedures, governance practices and responses to cyber-related incidents.[6] EXAMS will review firms' policies and procedures as to whether they are reasonably designed to protect customer information and whether the location of such information has been sufficiently disclosed to the SEC. Given the recent increased reliance on remote work, EXAMS recognizes that customer identification must be accessible to personnel working from remote environments while implying that such arrangements require heightened vigilance. EXAMS will remain focused on cybersecurity issues related to third-party vendors, policies aimed at preventing unauthorized account intrusions and access to customer records and information, and registrants' operational resiliency planning.

In 2024, EXAMS will also assess registrant preparations for upcoming changes to shorten the standard settlement cycle for most broker-dealer transactions from two business days to one business day after the trade date. The compliance date for this rule is set for May 28, 2024.

Crypto Assets and Emerging Financial Technology

EXAMS notes that there has recently been a great expansion in the development and use of crypto assets and emerging financial technology, such as broker-dealer mobile applications and automated investment advice, and intends to conduct examinations of broker-dealers and RIAs offering such products and services. EXAMS will continue to monitor and conduct examinations of registrants that offer, sell, recommend or provide advice regarding crypto-related assets. The staff will assess whether registrants involved with crypto assets: (1) meet and follow the standards of conduct when advising customers with regards to retail-based and retirement assets and (2) routinely review, update, and enhance their compliance practices, risk disclosures and operational resiliency practices. EXAMS will also consider whether advisors are complying with the Custody Rule and will assess whether risks associated with the use of blockchain and distributed ledger technology have been properly addressed in disclosures and compliance procedures.

Anti-Money Laundering

EXAMS will continue to prioritize compliance with AML requirements in its examinations of broker-dealers and certain registered investment companies.[7] EXAMS will focus on evaluations of firms' fulfilling their AML obligations, including appropriately tailoring their AML program to their business model and associated AML risks, establishment of appropriate customer identification programs including for beneficial owners of legal entity customers, routine, independent testing and meeting their suspicious activity reporting obligations. EXAMS will also focus on how broker-dealers and investment advisers are monitoring Office of Foreign Assets Control (OFAC) sanctions and compliance with such sanctions.

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6 In fiscal year 2024, EXAMS will also focus on the policies and procedures designed to ensure the security of Regulation Systems Compliance and Integrity (SCI) systems including physical security of data centers. Regulation SCI was adopted in 2014 to bolster the technology infrastructure of the securities markets and requires covered entities, such as national securities exchanges, certain clearing agencies, FINRA and MSRB, to establish and enforce policies and procedures reasonably designed to ensure that their systems' capacity, integrity and security are sufficient to promote fair and orderly markets. Proposed amendments to Regulation SCI were released in March 2023 and would expand the definition of SCI entities to include registered security-based swap data repositors, all clearing agencies that are exempt from registration and certain large broker-dealers (in particular, those that exceed a total assets threshold or a transaction activity threshold in national market system stocks, exchange-listed options contracts, US Treasury securities, or Agency securities).

7 Pursuant to FinCEN regulations, only open-end investment companies are required to have AML programs in place.

Self-Regulatory Organizations and Clearing Agencies

The 2024 Examination Priorities discuss focus areas relating to self-regulatory organizations, such as national securities exchanges, FINRA and MSRB, and clearing agencies. These focus areas are largely unchanged from the 2023 Examination Priorities.[8]

Other Market Participants

Municipal Advisors

EXAMS will continue to focus on whether municipal advisors meet their fiduciary duty obligation to clients when providing advice regarding pricing, method of sale and structure of municipal securities. Examinations of solicitor municipal advisors during the second half of 2024 will focus on compliance of Municipal Securities Rulemaking Board Rule G-46, which becomes effective on March 1, 2024. This rule establishes the core standards of conduct, which include conflicts disclosures and documentation of client relationships.

Security-Based Swap Dealers (SBSDs)

Noting that SBSDs act as market makers or dealers in security-based swaps, EXAMS will focus on whether SBSDs have implemented policies and procedures to reasonably comply with security-based swap rules, including Regulation SBSR, which requires SBSDs to report transactions to swap data repositories. Additionally, EXAMS will focus on whether SBSDs are complying with applicable capital, margin and segregation requirements and relevant conditions in SEC orders governing substituted compliance.

Transfer Agents

Transfer agents are primarily responsible for maintaining security holder records, recording ownership changes, distributing dividends and other payments to security holders, and liaising between issuers and security holders. Examinations will review processing of transfers, recordkeeping and retention, safeguarding of assets and filings with the SEC. EXAMS will prioritize transfer agents that service microcap and crypto assets and transfer agents that use emerging technology when performing transfer agent services.

Conclusion

The 2024 Examination Priorities provide insight as to how EXAMS determines examination targets, allocates the time and resources of EXAMS staff and, in certain instances, refers examination findings to the Division of Enforcement. The 2024 Examination Priorities provide important information regarding EXAMS' plans for this year and can be predictive of potential enforcement activity involving participants in the financial services industry. However, SEC examinations are not limited to items identified in the 2024 Examination Priorities; as in

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8 In recognition national securities exchanges' self-regulatory responsibilities, examinations will focus on the exchanges' obligations to enforce compliance and the exchanges' ability to detect and discipline member firm violations. Examinations may also include the review of exchange order handling. Regarding FINRA, EXAMS staff will review select areas based on risk-based oversight examinations and will conduct inspections of FINRA's major regulatory programs. Regarding MSRB, EXAMS staff will conduct examinations of MSRB itself and will examine registered firms to check compliance with MSRB rules. Under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, EXAMS has an obligation to annually examine each clearing agency supervised by the SEC that has been designated as systematically important and these annual examinations must assess the clearing agencies' core risks, processes and controls. Additionally, EXAMS intends to review registered clearing agencies' compliance with the SEC's written Standards for Covered Clearing Agencies and for fiscal year 2024, will focus on areas such as risk management and liquidity, third-party service providers, operations and the internal audit function.

the past, examination and enforcement activities are based on a variety of factors, and the staff's approach can change at any time in response to changes in its view of existing or emerging risks.

In its twelfth consecutive year of publication, the 2024 Examination Priorities continue to be an important tool for registered firms in assessing their compliance programs and preparing for examinations. While the Examination Priorities to a certain degree always represent the regulatory priorities of the SEC, the topics identified in the 2024 Examination Priorities in particular, reinforce the policy initiatives of the current SEC chair. Firms may want to consider carefully the 2024 Examination Priorities in assessing their readiness for potential document requests or examinations by EXAMS in the coming year, especially the newer focus areas identified in the 2024 Examination Priorities and reiterated herein.

Appendix – EXAMS Examination Statistics 2021-2023[1]

	2023[2]	2022	2021
TOTAL NUMBER OF EXAMINATIONS	3,125	3,119	3,040
NUMBER OF BROKER-DEALER EXAMINATIONS	353	368	333
BROKER-DEALER EXAMINATIONS AS % OF TOTAL EXAMINATIONS	11%	12%	11%
NUMBER OF INVESTMENT ADVISER EXAMINATIONS	2,324	2,314	2,251
INVESTMENT ADVISER EXAMINATIONS AS % OF TOTAL EXAMINATIONS	74%	74%	74%
NUMBER OF INVESTMENT COMPANY EXAMINATIONS	120	115	129
INVESTMENT COMPANY EXAMINATIONS AS % OF TOTAL EXAMINATIONS	4%	4%	4%

1 The data contained in this chart was compiled using the following SEC sources: Fiscal Year 2024 Congressional Budget Justification Annual Performance Plan & Fiscal Year 2022 Annual Performance Report; and Fiscal Year 2023 Congressional Budget Justification Annual Performance Plan & Fiscal Year 2021 Annual Performance Report. The table only references IA, BD and IC exams and excludes exams of other registrants.

2 Several 2023 figures are estimates subject to change when the SEC has finalized the data from FY 2023.

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