

Insights

SEC DIVISION OF EXAMINATIONS PUBLISHES 2024 EXAMINATION PRIORITIES

Nov 14, 2023

On October 16, 2023, the Division of Examinations (the “Division”) of the U.S. Securities and Exchange Commission (the “SEC”) published its annual Examination Priorities for 2024 (the “Exam Priorities”). Consistent with the Division’s priorities for 2023, the Division indicated that 2024 examinations will prioritize areas that pose emerging risks to investors or the U.S. capital markets, as well as core and perennial risk areas.

Below is a discussion of the Exam Priorities for registered investment advisers and a summary of the Exam Priorities for registered investment companies, broker-dealers, self-regulatory organizations, clearing agencies and other market participants.

INVESTMENT ADVISERS

The Division will continue to prioritize examination of registered advisers that have never been examined or have not been examined in several years.

The Division will focus on registered advisers’ adherence to their fiduciary duties, emphasizing:

1. investment advice with respect to complex products, high fee and illiquid products and unconventional strategies, such as those claiming to address rising interest rates, as well as advice to older and retirement investors;
2. processes for determining that advisers provide investment advice in their clients’ best interest, such as processes for suitability determinations, best execution, evaluation of costs and risks, and identification and management of conflicts of interest;
3. economic incentives for advisers and their professionals to recommend certain products, services or account types, particularly in the case of advisers that use affiliates for client services or are dually-registered as broker-dealers; and
4. adequacy of disclosures, such as whether disclosures related to conflicts of interest include all material facts associated with the investment advice sufficient to allow a client to provide informed consent to the conflict.

Examinations will continue to address the adequacy of advisers' compliance programs, including whether their policies and procedures reflect the advisers' current businesses and whether their annual compliance reviews are sufficient. In this connection, note that pursuant to recently amended SEC Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended ("Advisers Act"), annual compliance reviews must now be documented in writing.

Examinations also expect to pay particular attention to advisers' assessments in the following areas:

1. implementation of compliance infrastructure in light of recent amendments to Rule 206(4)-1 under the Advisers Act (the "Marketing Rule");
2. compensation arrangements;
3. valuations relating to recommendations to invest in illiquid or difficult-to-value investments;
4. safeguarding clients' material non-public information; and
5. the accuracy and completeness of regulatory filings.

The SEC has stressed the seriousness of compliance with the Marketing Rule in a number of ways. Not only is the topic highlighted in the Exam Priorities, the Division has also issued Risk Alerts on the subject. Significantly in September 2023, the SEC announced settled charges against nine advisers for advertising hypothetical performance to the public without adopting and/or implementing policies and/or procedures as required by the Marketing Rule. See [BCLP insight, SEC Enforcement Sweep Regarding Hypothetical Performance](#).

Private fund advisers remain a core focus area for the Division. Identified priority areas for private fund advisers include:

1. portfolio management risks in light of recent market volatility and higher interest rates;
2. adherence to contractual requirements regarding advisory boards;
3. accurate calculation and allocation of fees and expenses;
4. consistency with policies, procedures and disclosures with respect to diligence of prospective portfolio company investments;
5. conflicts, controls and disclosures related to certain side-by-side investments and use of affiliated service providers;
6. compliance with Advisers Act requirements regarding custody, including Form ADV reporting and audit obligations; and

7. policies and procedures for reporting on Form PF.

See Risk Areas Impacting Various Market Participants below for a discussion of additional examination initiatives applicable to advisers and other types of entities subject to SEC jurisdiction.

INVESTMENT COMPANIES

The Division will continue to prioritize examination of registered investment companies that have never been examined or have not been examined in several years.

The Division indicated that 2024 examination focus areas for registered investment companies may include: (i) fees and expenses and review of whether registered investment companies have effective written compliance policies and procedures concerning the oversight of advisory fees; (ii) derivatives risk management assessments and review of whether registered investment companies and business development companies have adopted and implemented written policies and procedures designed to prevent violations of the SEC's fund derivatives rule (Rule 18f-4 under the Investment Company Act of 1940, as amended); (iii) compliance with the terms of applicable exemptive order conditions, and (iv) issues related to market disruptions and volatility.

BROKER-DEALERS

Exam Priorities included four focus areas for broker-dealers:

1. Regulation Best Interest ("Regulation BI")^[1];
2. Form CRS, the customer relationship summary;
3. Broker-dealer financial responsibility rules – i.e., the Net Capital Rule^[2] and the Customer Protection Rule;^[3] and
4. Broker-dealer trading practices.

With respect to Regulation BI, the Division will, among other things, evaluate whether the broker-dealer has established, maintained and enforced written policies and procedures designed to achieve compliance with the general disclosure, care, conflict of interest and compliance obligations of the rule. Additional focus areas include: (i) recommendations regarding products, investment strategies and account types; (ii) conflicts of interest disclosures; (iii) conflict mitigation practices; (iv) processes for reviewing reasonably available alternatives; and (v) factors considered in light of an investor's investment profile, including investment goals and account characteristics. Examinations will prioritize recommended products that are complex, high cost, illiquid, proprietary or microcap securities, as well as recommendations to older investors and investors saving for college or retirement.

Examinations will review the content and filing of Form CRS and its delivery to retail customers. Examinations will also further consider whether broker-dealers are compliant with the Net Capital Rule and Customer Protection Rule, as well as related internal processes, procedures, and controls. This review will also focus on paid lending programs and broker-dealer accounting for certain types of liabilities, such as reward programs, gift cards, and non-brokerage services. Examinations will also assess broker-dealer credit, interest rate, market, and liquidity risk management controls.

Examinations will address broker-dealer equity and fixed income trading practices, including compliance with short sale rules (Regulation SHO)^[4], alternative trading systems rules (Regulation ATS)^[5], and over-the-counter trading rules (Exchange Act Rule 15c2-11).

SELF-REGULATORY ORGANIZATIONS

National securities exchanges, the Financial Industry Regulatory Authority (“FINRA”) and the Municipal Securities Rulemaking Board (“MSRB”) are also subject to examination by the Division.

The Division will review whether national securities exchanges are meeting their obligations to enforce compliance with self-regulatory organization rules and federal securities laws, specifically in connection with order handling and surveillance, investigation, and enforcement programs to detect and discipline violations by member firms.

The Division will continue to conduct risk-based oversight of FINRA’s examination of certain broker-dealers and municipal advisors. The Division will provide recommendations to improve FINRA’s programs, its risk assessment processes, and its future examinations.

The Division, along with FINRA and certain federal banking regulators, will examine registered broker-dealers that deal in municipal securities or are municipal advisors for compliance with the rules of the MSRB. It will also apply a risk-based process to determine examination areas at the MSRB.

CLEARING AGENCIES

Examinations of clearing agencies will address core risk, processes and controls and other areas as required by the Act. The Division will also conduct risk-based examinations of other registered clearing agencies. These examinations will include reviews undertaken to assess the clearing agencies’ risk management frameworks; the adequacy and timeliness of remediation of any prior deficiencies; and (iii) additional risk areas identified in collaboration with other regulators.

OTHER MARKET PARTICIPANTS

The Division will also examine other market participants in 2024, including municipal advisors, security-based swap dealers, and transfer agents.

Examinations of municipal advisors will consider whether they are complying with their fiduciary duty to clients and their obligations to document municipal advisory relationships and disclose conflicts of interest. After MSRB Rule G-46[6] becomes effective in March 2024, the Division will be considering whether solicitor municipal advisors are complying with the core standards of conduct set forth in that rule.

Examinations of security-based swap dealers will address whether they have implemented policies and procedures related to compliance with applicable rules generally and whether they are meeting their obligations under Regulation SBSR[7] to report accurately security-based swap transactions.

The Division's examination of transfer agents will prioritize those transfer agents that service issuers of microcap or crypto-asset securities or that use emerging technology. The Division will also examine transfer agent processing, recordkeeping and record retention, safeguarding of funds and securities, and SEC filings.

RISK AREAS IMPACTING VARIOUS MARKET PARTICIPANTS

Information security and operational resiliency continue to be of utmost concern to the Division. Cybersecurity remains a perennial focus area. The Division will focus on registrants': (i) policies and procedures; (ii) internal controls; (iii) oversight of third-party vendors; (iv) governance practices; and (v) responses to cyber-related incidents, including ransomware attacks.

"Cyber resiliency" reviews will cover firm practices, policies, and procedures to prevent account intrusions and safeguard customer records and information. The Division will also be looking at how registrants are preparing for the upcoming reduction of the standard settlement cycle from two business days to one business day after trade date.

In recognition of the growth of investment in crypto assets and the accelerating use of emerging financial technology, the Division will prioritize examinations of broker-dealers and advisers that offer new products and services or employ new practices, particularly technological and online solutions that service online accounts. Areas of particular focus include: (i) automated investment tools; (ii) artificial intelligence; (iii) trading algorithms or platforms; and (iv) the risks associated with the use of emerging technologies.

Examiners will continue to monitor and examine registrants which focus on crypto assets or related products. They will review whether these registrants meet and follow their standards of conduct when recommending or advising customers and clients regarding crypto assets and whether they routinely review and update their compliance practices, risk disclosures, and operational resiliency practices.

In addition, the Division will evaluate whether critical market infrastructure entities, such as national securities exchanges, certain clearing agencies, self-regulatory organizations and automated

trading systems, have complied with the Regulation Systems Compliance and Integrity Rule^[8]– the rule designed to strengthen the technology infrastructure of U.S. securities markets.

Lastly, the Division will continue to focus on anti-money laundering (“AML”) programs to determine whether broker-dealers and certain registered investment companies are appropriately tailoring their AML programs to their business model, are conducting independent testing, and are establishing adequate customer identification programs.

CONCLUSION

Please do not hesitate to contact a member of our team to discuss anything in the Exam Priorities or any questions related to this memorandum.

FOOTNOTES

[1] Rule 15l-1 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

[2] Rule 15c3-1 under the Exchange Act.

[3] Rule 15c3-3 under the Exchange Act.

[4] Rule 200 et seq. under the Exchange Act.

[5] Rule 300 et seq. under the Exchange Act.

[6] SEC Release No. 34-97218; File No. SR-MSRB-2023-02 (March 29, 2023).

[7] 17 CFR § 242 of the Exchange Act.

[8] Rule 1000 et seq. under the Exchange Act.

RELATED PRACTICE AREAS

- M&A & Corporate Finance
- Corporate

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