

# THE SEC'S DIVISION OF EXAMINATIONS PUBLISHES 2022 EXAMINATION PRIORITIES AND PREVIEWS KEY FOCUS AREAS FOR REGISTERED INVESTMENT ADVISERS AND BROKER-DEALERS

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## **U.S. Investigations, Enforcement, and White Collar and Asset Management and Investment Funds Alert**

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On 30 March 2022, the Division of Examinations (the Division) of the U.S. Securities and Exchange Commission (SEC) released its examination priorities for the 2022 fiscal year. The Division highlighted five “significant focus areas”: (1) private funds, (2) environmental, social, and governance (ESG) investing, (3) standards of conduct (including satisfaction of fiduciary duty), (4) information security and operational resiliency, and (5) financial technology and crypto-assets. In addition, the Division identified core programmatic areas for registered investment advisers (RIAs) and broker-dealers as cornerstones of its examination program.

Collectively, the priorities reflect the overarching goal of the Division—and the SEC as a whole—to continue to incentivize managers to provide accurate and complete disclosure to investors, and to maintain fulsome and tested compliance programs, particularly with respect to newly emerging approaches to investment management and the risks they may pose. The concerns raised in the Division's priorities echo those expressed by the SEC in its recently proposed rules and other reforms, and in commentary by the Chair of the SEC and its other Commissioners.<sup>1</sup> RIAs, investment companies, and broker-dealers should be mindful of these recently announced priorities in preparing for forthcoming examinations, assessing investment activities and disclosures, and understanding potential enforcement threats going forward.

## **SIGNIFICANT FOCUS AREAS**

### **1. Private Funds**

The Division will continue to prioritize its focus on RIAs to private funds, and its examinations will review issues relating to disclosures, compliance programs, and controls around material nonpublic information.

In particular, the Division specified continued review of the following issues under the Investment Advisers Act of 1940 (the Advisers Act):

- the calculation and allocation of fees and expenses and related valuation practices;
- the potential preferential treatment of certain investors to private funds that have experienced liquidity issues;
- compliance with Rule 206(4)-2 under the Advisers Act (the so-called Custody Rule), the “audit exception” to the surprise examination requirement, and the related Form ADV disclosure requirements;

- the adequacy of disclosures and compliance with regulatory requirements for cross trades, principal transactions, or distressed sales; and
- conflicts related to liquidity, such as RIA-led fund restructurings and stapled secondary transactions.

The Division will also review private fund advisers' portfolio strategies, risk management, and investment recommendations and allocations, including by focusing on conflicts and disclosures relating thereto. For example, the Division will review private funds' investments in special purpose acquisition companies (SPACs), particularly where the adviser to the private fund is also the sponsor of the SPAC.<sup>2</sup> In addition, the Division will review "the practices, controls, and investor reporting around risk management and trading of private funds with indicia of systemic importance."

## 2. ESG Investing<sup>3</sup>

Consistent with prior pronouncements, task force initiatives, and other recent regulatory actions by the SEC and its staff, the Division will focus on ESG-related advisory services and investment products, highlighting in the priorities the lack of standardization in ESG investing terminology, variability among the approaches to ESG investing, and the extent to which RIAs and funds seek to effectively address legal and compliance issues with new lines of business and products (which RIA and fund efforts, in the Division's view, may not be sufficient). By reviewing RIAs' portfolio management processes and practices, the Division will focus on whether RIAs and registered funds are accurately disclosing ESG investing approaches and ensuring continued accuracy of such disclosures. This is again consistent with the SEC's demonstrated interest in ESG disclosures, including from an enforcement perspective, as indicated by recently reported investigations by the SEC's Division of Enforcement regarding this issue.<sup>4</sup>

In addition, the Division will examine whether client securities are voted in accordance with proxy voting policies and procedures and with client ESG-related mandates conditioning investments in a company on the strength of its ESG program. Finally, demonstrating the Commission's concerns over "greenwashing" (i.e., exaggerating the extent to which an investment program marketed as ESG-focused actually invests in assets that achieve ESG goals), the Division will consider whether RIAs have overstated or misrepresented in their marketing materials the extent to which ESG factors are considered in portfolio selection.<sup>5</sup>

## 3. Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS

The Division will also focus on standards of conduct for RIAs and broker-dealers, particularly with respect to how RIAs are satisfying their obligations as fiduciaries and how broker-dealers are satisfying any applicable obligations they may have under Regulation Best Interest. Specifically, the Division will assess whether RIAs and broker-dealers are acting consistent with their applicable standard of conduct with respect to retail investors, including in connection with the consideration of alternative investments, management of conflicts of interest (e.g., practices that favor certain products or strategies over others), trading practices (e.g., best execution obligations), Form ADV and Form CRS disclosures, and account selection, conversions, and rollovers.

For broker-dealers, the Division will focus on firms' recommendations and sales practices relating to SPACs, structured products, leveraged and inverse exchange traded products, REITs, private placements, annuities, fixed-income securities, and microcap securities. The Division will review how broker-dealers evaluate cost and reasonably available alternatives as they relate to whether recommendations of such products are in investors'

best interest. Examiners will also assess compensation structures for broker-dealer representatives and may focus on the sales of securities by those who are highly compensated.

For RIAs, the Division will look at whether advisers are consistently satisfying their fiduciary duties, considering both duties of care and loyalty, including in connection with revenue sharing arrangements, share class selections, wrap fee account recommendations, and proprietary product recommendations. Such reviews will involve an assessment of RIAs' compliance policies and procedures addressing potential conflicts of interest and related investor disclosures.

The Division has identified dually-registered entities as of particular interest in light of the risks for “misaligned incentives that may result in recommendations and advice to retail investors, such as seniors and working families that is not in their best interest.” Reviews of such entities will parse recommendations of high fee products and proprietary products, transactions that improperly incentivize financial professionals, and compensation structures with the potential to inappropriately influence investment recommendations. While a renewed focus on Wall Street was expected from the Gensler SEC, this initiative demonstrates that the SEC will keep its focus on retail investors as well.

#### **4. Information Security and Operational Resiliency**

The Division will review broker-dealers' and RIAs' practices to prevent interruptions to critical services and to protect investor information, records, and assets. Specifically, the Division will review whether firms have taken appropriate measures to (1) safeguard customer accounts and prevent account intrusions; (2) oversee vendors and service providers; (3) address malicious e-mail activities (e.g., phishing); (4) respond to incidents, including those related to ransomware attacks; (5) detect red flags related to identity theft; and (6) manage operational risk resulting from employees working remotely. Notably, the Division will again be reviewing registrants' business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations, an effort that will build on previous examinations and outreach in this area. These examinations will include attention to the maturation of, and improvements to, business continuity and disaster recovery plans over the years, as well as registrants' resiliency as organizations to anticipate, prepare for, respond to, and adapt to both sudden disruptions and incremental changes stemming from climate-related situations. In light of the proposed cybersecurity reforms for investment advisers and investment companies, advisers and funds should anticipate more enhanced requests in this area.

#### **5. Emerging Technologies and Crypto-Assets**

The SEC is expected to continue its focus on cryptocurrency and digital assets, and enhanced examinations in this area, too, should be expected. The Division has identified several areas of inquiry in this space.

First, the Division is prioritizing RIAs and broker-dealers using digital investment advice or “robo-advisers” through mobile apps and tools, and firms that are offering other emerging digital engagement services or products, such as “Finfluencers” or fractional shares (e.g., a share of an asset that can be held and traded by multiple people, typically in the form of an NFT (non-fungible token) representing a fraction of revenue rights). Examinations will consider whether the firm has operations and controls in place consistent with the required standard of care; offers advice and recommendations consistent with investors' investment strategies; and provides controls that “take into account the unique risks associated with such practices.”

Second, the Division intends to review the custody arrangements of market participants engaged with crypto-assets. This assessment includes whether those engaging in crypto-asset transactions have shown an initial and ongoing understanding of the products consistent with their duty of care, and whether they routinely review, update, and enhance compliance practices, risk disclosures, and operational resiliency practices. By way of example, the Division specified crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures as compliance practices that will be subject to scrutiny. The Division also explained that it will conduct examinations of mutual funds and ETFs (exchange traded funds) offering exposure to crypto-assets to evaluate the compliance, liquidity, and operational controls established around portfolio management and market risk. Once again, this remains an ongoing focus for the SEC, both in the examination and enforcement spheres.

## **PERENNIAL EXAMINATION PROGRAM AREAS**

In announcing its priorities for 2022, the SEC also underscored core aspects of typical examinations.

For RIAs and registered investment companies, these include:

- RIA compliance programs, with focus on whether a firm has implemented oversight practices to mitigate heightened risks;
- RIA disclosures relating to fees and expenses;
- Never-before-examined RIAs and registered funds; and
- Money market funds and business development companies.

For broker-dealers, these include:

- Compliance with obligations in the offer, sale, and distribution of microcap securities;
- Municipal issuer disclosure practices;
- Trading activity in fixed income securities;
- Satisfaction of Regulation Best Interest requirements in sales of over-the-counter securities;
- Compliance with the Customer Protection Rule and the Net Capital Rule; and
- Engagement by unregistered firms in activities that appear to require broker-dealer registration.

## **CONCLUSION**

By publishing its priorities, the Division has provided a window into what it intends to concentrate on in forthcoming examinations. The priorities also provide guidance into the views of the Division regarding the duties and obligations of RIAs, funds and broker-dealers regarding a variety of issues, and insight into what the Division of Enforcement may target in its investigations and proceedings. Though the SEC is working to address many of these issues through proposed rulemakings, it may not wait for rulemaking to conclude before utilizing its enforcement arm, as demonstrated by recent ESG-focused investigations. In light of this, and being mindful of these priorities, firms should evaluate their business activities and their compliance policies and procedures for potential areas of enhancement.

## FOOTNOTES

<sup>1</sup> For example, the SEC has announced a proposed rulemaking relating to cybersecurity risk management and incident reporting for RIAs and included in its regulatory agenda contemplated rulemaking to address ESG factors for RIAs and investment companies. See Press Release, “SEC Proposes Cybersecurity Risk Management Rules and Amendments for Registered Investment Advisers and Funds” (Feb. 9, 2022), <https://www.sec.gov/news/press-release/2022-20>; Press Release, “SEC Announces Annual Regulatory Agenda” (June 11, 2021), <https://www.sec.gov/news/press-release/2021-99>. The Division also previewed certain of these themes in its Risk Alerts from 2021. See, e.g., The Division of Examinations’ Continued Focus on Digital Asset Securities (Feb. 26, 2021), <https://www.sec.gov/files/digital-assets-risk-alert.pdf>; The Division of Examinations’ Review of ESG Investing (Apr. 9, 2021), <https://www.sec.gov/files/esg-risk-alert.pdf>.

<sup>2</sup> The SEC’s interest in and skepticism of SPACs is well documented. On 30 March 2022, the SEC announced a proposed rulemaking to increase investor disclosures in initial public offerings by SPACs. See SEC, “SEC Proposes Rules to Enhance Disclosure and Investor Protection Relating to Special Purpose Acquisition Companies, Shell Companies, and Projections” (Mar. 30, 2022), <https://www.sec.gov/news/press-release/2022-56>.

<sup>3</sup> For additional resources and information related to ESG issues, please see the K&L Gates dedicated ESG Emerging Issues resource [here](#).

<sup>4</sup> See, e.g., Benjamin Bain and Saijel Kishan, Bloomberg, Fund Managers Feel Heat in SEC Crackdown on Overblown ESG Labels (Sept. 3, 2022), <https://www.bloomberg.com/news/articles/2021-09-03/fund-managers-feel-heat-in-sec-crackdown-of-overblown-esg-labels>; Chris Prentice, Reuters, SEC’s Texas office probes banks over disclosures on guns, fossil fuels (Jan. 5, 2022), <https://www.reuters.com/markets/us/exclusive-secs-texas-office-probes-banks-over-disclosures-guns-fossil-fuels-2022-01-05/>.

<sup>5</sup> The Division of Enforcement has also homed in on issues relating to ESG investing. Last year, it created the ESG Task Force to coordinate and develop initiatives for identifying ESG-related misconduct, and the Director of the Division of Enforcement has signaled that greenwashing will be a focus area for the task force. See Gurbir Grewal, “2021 SEC Regulation Outside the United States – Scott Friestad Memorial Keynote Address” (Nov. 8, 2021), [https://www.sec.gov/news/speech/grewal-regulation-outside-united-states-110821?utm\\_medium=email%3Cutm\\_source=govdelivery#\\_ftn20](https://www.sec.gov/news/speech/grewal-regulation-outside-united-states-110821?utm_medium=email%3Cutm_source=govdelivery#_ftn20).

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