

SEC Division of Examinations' 2023 Priorities

FEBRUARY 22, 2023

On February 7, 2023, the U.S. Securities and Exchange Commission's ("SEC") Division of Examination (the "Division") announced its [annual list of examination priorities for 2023](#) (the "Priorities"), which provides insights into its risk-based approach, including the areas it believes present potential risks to investors and the integrity of the U.S. capital markets.

As a top priority, the SEC is highlighting the new marketing rule for registered investment advisers ("RIAs"), which became effective in November 2022. Consistent with years prior, the Division expects to focus on RIAs to private funds, following a wide-range of new rules for private funds proposed last February. The Priorities also highlight the SEC's focus on environmental, social, and governance ("ESG") standards and information security.

These Priorities are the first to be released under the Division's new director, Richard R. Best, who was appointed in May 2022. Under Best, the Division has elucidated "four pillars" for its mission: (1) promoting compliance, (2) preventing fraud, (3) identifying and monitoring risk, and (4) informing policy. These priorities are not exhaustive, and the Division's examinations are likely to focus on many areas beyond this list.^[1]

I. Examinations for Compliance with New Investment Adviser and Investment Company Rules

Over the past year, the SEC has adopted several significant new rulemakings as part of its efforts to drive efficiency in the capital markets and modernize SEC rules for the current economy and technologies. The Division is prioritizing examining registrants for compliance with these recently enacted rules:

Advisers Act Rule 206(4)-1 (the "Marketing Rule")^[2]: The Division notes that the new Marketing Rule is a "significant change to a core examination review area for RIAs," and as such, the Division will focus on whether firms have adopted and implemented policies and procedures to comply with the Marketing Rule, and whether firms are in compliance with the Marketing Rule's substantive requirements, including the requirement that RIAs have a reasonable basis for believing that they will be able to substantiate material statements of fact and requirements for performance advertising, testimonials, endorsements and third-party ratings.

Investment Company Act Rule 18f-4 (“Derivatives Rule”): The Division will: (1) assess whether registered investment companies, including mutual funds (other than money market funds), exchange-traded funds (“ETFs”) and closed-end funds, as well as business development companies (“BDCs”), have adopted and implemented policies and procedures reasonably designed to manage the funds’ derivatives risk and to prevent violations of the Derivatives Rule; and (2) review for compliance with the Derivatives Rule, including the adoption of a derivatives risk management program, board oversight, and whether disclosures concerning the fund’s use of derivatives are incomplete, inaccurate or potentially misleading.

Investment Company Act Fair Valuation Rule 2a-5: The Division will: (1) assess funds’ and fund boards’ compliance with the new requirements for determining fair value, implementing board oversight duties, setting recordkeeping and reporting requirements, and permitting the funds’ board to designate valuation designees to perform fair value determinations subject to oversight by the board; and (2) review whether adjustments have been made to valuation methodologies, compliance policies and procedures, governance practices, service provider oversight, and/or reporting and recordkeeping.

II. Significant Focus Areas

RIAs to Private Funds^[3]: RIAs to private funds are a significant portion of the RIA population, representing 3% of all RIAs and managing 500,000 private funds with gross assets exceeding \$21 trillion. The Division will likely continue to review issues such as an adviser’s fiduciary duty, and will assess risks, including a focus on compliance programs. Moreover, the Division will focus on conflicts of interest, fees and expenses (specifically noting post-commitment period management fees and valuation practices for RIAs of private equity funds), the new Marketing Rule, policies and procedures that address the use of alternative data and material nonpublic information, and compliance with the custody rule, including timely delivery of audited financials and selection of permissible auditors. The Division will also review private fund advisers’ portfolio strategies, risk management, and investment recommendations and allocations, focusing on conflicts and disclosures around these areas. Additionally, the Division notes it will also focus on private funds that have “specific risk characteristics,” including highly leveraged private funds, private funds managed side-by-side with BDCs, private equity funds using affiliates and advisory personnel to provide services to the fund’s portfolio companies and the fund, private funds with hard to value assets, such as crypto and real estate (the Division emphasized commercial real estate), and private funds engaged in adviser-led restructurings, including stapled secondaries and continuation funds.

Note that RIAs to private funds, should also review the Division’s priorities for RIAs generally – summarized below under “VI. Investment Adviser and Investment Companies.”

Regulation Best Interest and Fiduciary Duty^[4]: The Division notes that it will continue to prioritize examinations of broker-dealers and RIAs for compliance with their applicable standard of conduct. The Division’s examinations will focus on: (1) investment advice and recommendations with regard to products, investment strategies, and account types; (2) disclosures made to investors and whether such disclosures include all material facts relating to the conflicts of interest; (3) processes for making best interest evaluations; and (4) factors considered in light of the investor’s investment profile. The Division notes that it has “continued interest” in firms that are either dually registered as investment advisers and broker dealers or who have investment adviser-broker dealer affiliates.

Form CRS: The Division will prioritize compliance with Form CRS and continues to incorporate Form CRS into its core examinations of broker-dealers and RIAs.

III. Environmental, Social, and Governance Investing

The Division will continue its interest in ESG-related advisory services and fund offerings, focusing on whether funds are operating in the manner set forth in their disclosures⁵. Additionally, the Division will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in the investors’ best interests, and whether “greenwashing” practices are avoided.

IV. Information Security and Operational Resiliency

Since its initial emphasis on cybersecurity in 2014, the Division continues to emphasize information security as a leading priority. The Division notes that the current risk environment related to cybersecurity is elevated given the larger market events, geopolitical concerns, and the proliferation of cybersecurity attacks. As in prior years, the Division stated that it will review RIA practices to prevent interruptions to mission-critical services and to protect investor information, records and assets. As such, the Division intends to focus on firms' policies and procedures and governance practices, and whether they are reasonably designed to protect customer and client information. This year, the Division plans to focus on reviewing third-party service providers who may have firm business records or customer information, and ensuring that the service provider has adequate safeguards in place. Additionally, the Division will continue to assess systemically significant registrants' operational resiliency planning, such as their efforts to consider and/or address climate-related risks.

V. Crypto Assets and Emerging FinTech

Acknowledging recent disruptions in the crypto asset market, the Division will continue to monitor the proliferation of certain types of investments and emerging financial technologies. The Division will conduct examinations of broker-dealers and RIAs that utilize financial technologies or new practices, including technological and on-line solutions to meet the demands of compliance and marketing and to service investor accounts (for example, internet advisers, automated investment tools and trading platforms). Examinations of registrants will focus on whether: recommendations were made or advice was provided through social media and trading platforms; representations are fair and accurate; operations and controls in place are consistent with disclosures made to investors; any advice or recommendations are in the best interest of the investor taking into account the investor's financial situation and investment objectives; and risks associated with such practices are considered, including the impact these practices may have on certain vulnerable investors.

VI. Investment Adviser and Investment Companies

The Division noted that typical examinations of an RIA focus on compliance programs and related filings in core areas, including custody, valuation, portfolio management and brokerage and execution. Examinations often include a review of conflicts, compliance issues generally, and oversight and the approval process related to fees and expenses. The Division also noted it will examine RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers. As in previous years, the Division prioritizes RIAs that have never been examined and those that have not been examined for a number of years.

Regarding investment companies, the Division states that it will evaluate board processes for approving fund fees, especially where the fund has poorer performance relative to its peers. Additionally, the Division plans to focus on: (1) turnkey funds, (2) mutual funds that converted to ETFs, (3) non-transparent ETFs, (4) loan-focused funds (particularly for liquidity and the impact of rising interest rates), and (5) medium and small complexes with "excessive staff attrition." The Division will be examining registered investment company compliance with the derivatives rule in Rule 18f-4 of the Investment Company Act and Rule 2a-5 addressing how funds should determine fair value of fund assets. Similar to RIAs, the Division will prioritize investment companies that have never been examined and those that have not been examined for a number of years.

VII. Broker-Dealer and Exchange Examination Program

Similar to previous years, the Division will review broker-dealers' risks, including credit, market, and liquidity risk management controls. In addition, the Division will focus on the following key areas: (1) safeguarding customer funds and controls around the Customer Protection Rule and the Net Capital Rule; (2) electronic communications and recordkeeping; (3) conflicts of interest related to order routing that may negatively impact retail investors; (3)

Regulation SHO, especially aggregation units and the locate requirements; (4) fixed income pricing and confirmation disclosures; (5) municipal issuer disclosures when underwriting; and (6) anti-money laundering programs.

VIII. Clearance and Settlement

Per the Dodd-Frank Act, the SEC is required to examine, at least once annually, each clearing agency designated systematically important and for which the SEC serves as their supervisory agency. The examinations specifically analyze the agencies' core risks, processes, controls, and the nature of their operations. In addition, non-systematically important agencies may be subject to risk-based examinations.

Per the priorities, the SEC has stated that in 2023 areas of focus in these risk examinations will include liquidity risk management, counterparty credit stress testing, governance and escalation, compliance function, and the SEC's own risk in its supervisory role.

IX. Regulation Systems Compliance and Integrity (SCI)

The SEC Commission adopted Regulation SCI to strengthen the technology infrastructure of U.S. securities markets, specifically as they pertain to creating written policies and procedures for national securities exchanges, registered and certain exempt clearing agencies, and other critical market infrastructure entities.

Per the priorities, the Division will evaluate whether SCI entities have established and enforced these policies, including whether these procedures are reasonably designed for software development, the use of third parties, and ensuring security generally.

X. FINRA and MSRB

The Division will be conducting risk-based examinations of the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking board ("MSRB"). For FINRA, the Division may conduct risk-based oversight examinations to identify FINRA's operations that are crucial to investor protection and market integrity, such as implementing Regulation BI and Form CRS, which may lead to further Division recommendations. Similarly, the Division may conduct risk-based oversight examinations of the MSRB, including examinations of registered firms to assess compliance with MSRB rules.

XI. Anti-Money Laundering

The SEC emphasized the importance of conducting examinations of AML programs given current geopolitical tensions and increased international sanctions. Thus, the Division will prioritize examinations of broker-dealers and certain registered investment companies for their compliance with AML obligations, including whether they are satisfying their Suspicious Activity Reports ("SAR"), beneficial ownership, and due diligence requirements.

XII. LIBOR Transition

The Division emphasized that they are continuing to assess broker-dealer and RIA preparation for the discontinuation of LIBOR in mid-2023.

[1] Information regarding the SEC Division of Examinations' list of priorities released in 2021 and 2022 is available [here](#) and [here](#), respectively.

[2] Winston & Strawn LLP's prior summary of the Marketing Rule is available [here](#). Information regarding the Risk Alert released by the SEC Division of Examinations on September 19, 2022, relating to the Marketing Rule is available [here](#).

Information regarding the Risk Alert released by the SEC Division of Examinations on January 27, 2022, relating to certain compliance issues observed during examinations of registered investment advisers that manage private funds is available [here](#).

Information regarding the Risk Alert released by the SEC Division of Examinations on January 30, 2023, relating to common deficiencies and perceived weaknesses noted in broker-dealers' compliance with the obligations of Regulation Best Interest is available [here](#).

Information regarding new rules and amendments under the Advisers Act proposed by the SEC on May 25, 2022, requiring investment advisers, investment companies, and business development companies to provide enhanced disclosure of ESG issues to investors is available [here](#).

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