

SEC's 2024 Examination Priorities for Investment Advisers

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The U.S. Securities and Exchange Commission (SEC) Division of Examinations (the Division) recently released its annual **Examination Priorities** for fiscal year 2024 (the Report). The Report underlines the Division's focus on certain practices, products, and services that it believes creates potentially heightened risks to investors and/or to the integrity of the markets. Examinations for fiscal year 2024 will prioritize areas that the Division believes pose emerging risks, as well as examinations of core and perennial risk areas.

This year's Report, which is not materially different from the 2023 Examination Priorities, emphasizes the importance of the fiduciary obligations placed on investment advisers. As a fiduciary, an investment adviser owes a duty of care and a duty of loyalty to its clients. An investment adviser must always serve the best interests of its clients and cannot place its own interests ahead of its clients'. In addition, an investment adviser is required to eliminate or make disclosures of all conflicts of interest such that a client can provide informed consent to such conflict.

The Division's examination of investment advisers will continue to prioritize an investment adviser's adherence to its duty of care and duty of loyalty obligations. In reviewing an investment adviser's compliance to its fiduciary standard, the Division will continue to focus on the following:

- Investment advice in connection with certain products, investment strategies, and account types, particularly those regarding (1) complex products (i.e., derivatives and leveraged exchanged-traded funds); (2) high-cost and illiquid products (i.e., variable annuities and non-traded real estate investment trusts); and (3) unconventional strategies, including those that purport to address rising interest rates.
 - The Report highlights the Division's focus on investment advice provided to certain types of clients, such as older investors and those saving for retirement.
- An investment adviser's procedures for determining if investment advice is provided in

the client's best interest, including procedures for (1) making initial and ongoing suitability determinations, (2) seeking best execution, (3) evaluating costs and risks, and (4) identifying and addressing conflicts of interest.

- Examiners will also review the factors that an investment adviser considers in evaluating a client's investment profile, including investment goals and account characteristics.
- The Report highlights the Division's focus on how investment advisers address conflicts of interest, including (1) mitigating or eliminating the conflicts of interest, when appropriate, and (2) allocating investments to accounts where investors have more than one account.
- Economic incentives that an investment adviser and/or its financial professionals may have considered in recommending certain products, services, or account types, such as the source and structure of compensation, revenue, or other benefits.
 - Such economic incentives may exist when there is revenue sharing, markups, or other incentivizing revenue arrangements.
 - The Report highlights the Division's focus on the economic incentives and conflicts of interest associated with investment 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 to identify (1) investment advice to purchase or hold on to certain types of investments (i.e., mutual fund share classes) or invest through certain types of accounts when lower-cost options are available, and (2) investment advice regarding proprietary products and affiliated service providers that results in additional or higher fees to investors.
- Certain disclosures made to investors and whether such disclosures contain all material facts relating to all conflicts of interest

associated with the investment advice necessary to allow a client to provide informed consent to the conflict.

Additionally, the Report emphasizes the Division's continued focus on the compliance programs enacted by investment advisers, including whether the policies and procedures of such programs reflect the various aspects of the investment adviser's business, compensation structure, services, client base, and operations, and whether such programs address applicable current market risks.

The Division's exam of an investment adviser's compliance policies and procedures will primarily focus on one or more of the following areas:

1. Portfolio management processes
2. Disclosures made to investors and regulators
3. Proprietary trading by the adviser and the personal trading activities of supervised advisory personnel
4. Safeguarding of client assets from conversion or inappropriate use by advisory personnel
5. 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
6. Safeguards for the privacy protection of client records and information;
7. Trading practices
8. Marketing advisory services
9. Processes to value client holdings and assess fees based on those valuations
10. Business continuity plans

The Division's compliance program reviews will also assess whether the policies and procedures are sufficient to support compliance with an investment adviser's fiduciary obligations. The Division's focus for such exams will be on the following:

- Marketing practice assessments for whether an investment adviser, including an investment adviser to private funds, has (1) adopted and implemented reasonably designed written policies and procedures to prevent violations of the Advisers Act (including reforms to the Marketing Rule), (2) appropriately disclosed marketing information on Form ADV, and (3) maintained substantiation of its processes and other required books and records.
 - Marketing practice reviews will also evaluate whether any distributed advertisements include any untrue statements of a material fact, are materially misleading, or are otherwise deceptive and, if applicable, comply with the requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements.
- Compensation arrangement assessments focusing on (1) fiduciary obligations of an investment adviser to its clients, particularly

with respect to the receipt of compensation for services or other material payments made by clients and others; (2) alternative ways that an investment adviser tries to maximize revenue, such as revenue earned on clients' bank deposit sweep programs; and (3) fee breakpoint calculation processes, particularly when fee billing systems are not automated.

- Valuation assessments regarding recommendations to clients to invest in illiquid or difficult-to-value assets, such as commercial real estate or private placements.
- Safeguarding assessments in place to protect a client's material nonpublic information, particularly when multiple investment advisers share office locations, have significant turnover of representatives, or use expert networks.
- Certain disclosure assessments to review the accuracy and completeness of regulatory filings, with a particular focus on inadequate or misleading disclosures and registration eligibility.

The Report further highlights the Division's focus on investment advisers' policies and procedures for (1) selecting and using third-party and affiliated service providers, (2) overseeing branch offices when investment advisers operate from numerous or geographically dispersed offices, and (3) obtaining informed consent from clients when an investment adviser implements material changes to its advisory agreements. Such reviews will focus on whether an investment adviser's policies and procedures are reasonably designed and implemented and whether such procedures prevent the investment adviser from placing its interests ahead of the interest of the client.

Furthermore, the Report also stresses that the Division will continue to prioritize examinations of an investment adviser that has never been examined, including recently registered investment advisers and those that have not been examined for several years.

Examinations of Investment Advisers to Private Funds

A significant portion of the SEC-registered investment adviser population continues to be investment advisers to private funds. Therefore, the Division continues to focus its exams on investment advisers to private funds, giving priority to the following specific topics:

- Risks related to exposure to recent market volatility and higher interest rates, including, but not limited to, poor fund performance, significant withdrawals, valuation issues, and excessive utilization of leverage and illiquid assets.
- Adherence to contractual requirements regarding limited partnership advisory committees or similar structures (i.e., advisory boards), including adhering to any contractual notification and consent processes.

- Calculation of private fund 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 measures for consistency with policies, procedures, and disclosures, specifically with respect to private equity and venture capital fund assessments of prospective portfolio companies.
- Conflicts, controls, and disclosures regarding private funds managed side by side with registered investment companies and use of affiliated service providers.
- Compliance with Advisers Act requirements regarding custody, including accurate Form ADV reporting, timely completion of private fund audits by a qualified auditor, and the distribution of private fund audited financial statements.
- Policies and procedures for reporting on Form PF, including upon the occurrence of certain reporting events.

proposed rulemaking (including, without limitation, the new final private fund adviser rules and the proposed rule on the use of data analytics) as well as, among other things, the SEC's recent sweep on the use of artificial intelligence.

Additionally, the Division continues to emphasize the policies and procedures implemented as part of an investment adviser's internal compliance programs and the strategies employed for the mitigation of all conflicts of interest. Looking ahead to 2024, investment advisers should prioritize the exam focuses highlighted in this client alert (i.e., marketing practices, compensation arrangements, valuations, etc.). Additionally, investment advisers should consider the effect of new rulemaking on the space (i.e., the new private fund adviser rules, new Form PF reporting metrics, new 13D/13G reporting guidance and deadlines, new books and records requirements, and new Form N-PX for institutional investment managers, etc.) in looking ahead to 2024 and beyond.

Lowenstein Sandler will monitor future publications from the Division and provide further updates and analysis in subsequent Client Alerts so investment advisers can determine whether changes to their policies and procedures are required. Please reach out to one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding the 2024 Examination Priorities.

Our Thoughts

As noted earlier, the Division's 2024 Examination Priorities are not materially different from its 2023 Examination Priorities. Given the short time between reports (approximately eight months), the Division has attempted to straddle the line of continuity and change to reflect the fluidity of the evolving economic and regulatory landscape. Several of the prior year's priorities and initiatives remain part of the focus of the Division. However, adherence by an investment adviser to its fiduciary duties seems to be at the heart of the Division's 2024 focus. This focus on fiduciary duties is consistent with the SEC's recent final and

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