Breaking Down The SEC's 2024 Examination Priorities

By **Kurt Gottschall and Kit Addleman** (November 15, 2023)

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This year, the U.S. Securities and Exchange Commission's Division of Examinations surprised everyone by releasing its 2024 examination priorities in October in order to better align the timing with the start of the SEC's fiscal year.[1]

Overall, the 2024 priorities signal a steady course from prior years, but they also include some specific new concerns and important twists on perennial risk areas.

Outreach and Transparency

Let's start by giving credit where credit is due — over the past several years, the Division of Examinations has greatly expanded the quantity and quality of public guidance through the issuance of risk alerts and compliance outreach events.

This added transparency should prompt compliance improvements even to registrants that are not examined in any given fiscal year, thereby amplifying the impact of the exam program.

Last year, department staff published nine risk alerts,[2] including particularly helpful observations regarding Regulation Best Interest and anti-money laundering compliance, along with an updated road map for newly registered adviser examinations.[3]

Complex Products

In recent years, the SEC chair and other commissioners have called out products or strategies that they view as potentially problematic for retail investors,[4] and the 2024 priorities continue that trend by repeatedly noting concerns regarding complex, high-cost and illiquid products.[5]

Drawing on the robust obligations set forth in the SEC's Regulation Best Interest and the SEC's 2019 fiduciary interpretation, the department plans to pay particular attention to leveraged exchange-traded funds, derivatives, variable annuities and nontraded real estate investment trusts.[6]

In preparing for such scrutiny, we recommend that compliance professionals review the April 2023 Staff Bulletin for Broker-Dealers and Investment Advisers Care Obligations,[7] which takes a deeper dive into the staff's view of registrants' obligations when recommending complex products to retail clients.

Investment Advisers

The most notable shift in exam priorities for investment advisers is the staff's intention to focus on advisers' adherence to the duty of care.[8]

For decades, the SEC focused almost exclusively on the duty of loyalty, with its attendant obligations for advisers to identify and fully disclose all conflicts of interest and obtain clients' informed consent to conflicts.

The new focus on duty of care obligations — which the commission recently cited as one of several grounds for an enforcement action against a private equity fund adviser[9] — suggests that the staff will review account types, product lineups and investment strategies for consistency with retail advisory clients' investment objectives.[10]

For line examiners up through senior leadership, new rules tend to receive a disproportionate share of focus and attention. Given the relatively recent mandatory compliance date for the marketing rule, it receives prominent placement in the 2024 priorities, including for advisers to private funds.[11]

The staff's emphasis last year was on advertisements provided to retail investors, as evidenced by the enforcement sweep concerning hypothetical performance advertised on websites.[12]

The 2024 priorities indicate continued focus on marketing rule fundamentals, including marketing-related disclosures on Form ADV and the substantiation of advertised information.[13]

Private Funds

Private funds are a perennial examination priority given their extraordinary growth, particularly in private equity and private credit strategies funds, and the recent expanded availability of those strategies to more investors.

We believe that the most notable shift for private fund exams will be the focus on limited partnership advisory committees and similar structures designed to evaluate and provide consent to conflicts of interest by fund managers.[14]

The 2024 priorities evidence skepticism regarding the adequacy of the limited partner advisory committee process, with staff planning to scrutinize adherence to contractual requirements, including notification and consent processes.[15]

The calculation of private fund fees and expenses — both at the fund-level and investment-level — remains an area of concern for exam staff.[16] In this area, the 2024 priorities remain unchanged from 2023 and include the calculation of post-commitment period management fees, the valuation of illiquid assets, and management fee offsets.[17]

The accuracy of fee and expense calculations and disclosures also should be top of mind as firms prepare for the more robust disclosure requirements contained in the recently finalized quarterly statement rule applicable to private fund managers.[18]

Investment Companies

Although investment company exams tend to be more labor-intensive for the staff, the 2024 priorities suggest plans to conduct more of these exams, with the staff seeking to make headway on the national backlog of registered investment companies that have never been examined.[19]

The 2024 priorities remind investment companies of their AML obligations.[20]

Here, firms should be mindful that in September, the Division of Enforcement brought a settled action against DWS Investment Management Americas Inc., a subsidiary of Deutsche Bank AG, for allegedly causing mutual funds it advised to fail to develop and implement a reasonably designed anti-money laundering program to comply with the Bank Secrecy Act and applicable Financial Crimes Enforcement Network regulations.

This was the SEC's first-ever case against an investment adviser to a registered fund for AML-related violations pursuant to Rule 38a-1 of the Investment Company Act.[21]

Perhaps with an eye toward the likelihood of market volatility in the coming year, the vision also plans to review compliance with the SEC's fund derivatives rule, Investment Company Act Rule 18f-4.[22]

Broker-Dealers

In keeping with the prior year, the 2024 priorities indicate that exam staff will continue to review compliance with all four Regulation Best Interest obligations: disclosure, care, conflicts of interest and compliance.[23]

The latest priorities carried forward from the prior year the identical list of products most likely to be examined under the Regulation Best Interest microscope, including:

- Complex products such as leveraged ETFs;
- Higher cost products such as variable annuities;
- Illiquid products such as nontraded REITs and private placements;
- Proprietary products; and
- Microcap securities.[24]

The remaining broker-dealer priorities signal a subtle shift back to fundamentals, with emphasis on the net capital rule, which requires that broker-dealers maintain minimum capital levels to protect customers and creditors from losses if firms fail, and the customer protection rule, which requires that broker-dealers safeguard customer assets, including segregating customer assets from firm proprietary accounts.[25]

Enumerated areas of concern include fully paid lending programs and accounting for certain types of liabilities such as reward or point programs.[26]

In light of the uncertain economic environment, exam staff also plan to review broker-dealers' management of credit, interest rate, market and liquidity risks.[27]

The 2024 priorities also indicate plans to focus on fundamental broker-dealer and platform trading practices, including short sale trading practices pursuant to Regulation SHO, and the regulation of alternative trading systems under Regulation ATS.[28]

Exam staff also plan to review compliance with Exchange Act Rule 15c2-11 — also known as the piggyback exception — which the commission narrowed in 2020.[29]

ESG

Many commentators have noted the conspicuous absence of environmental, social and corporate governance from the 2024 priorities.

However, we caution against reading anything into that omission because ESG will remain an important focus for the commission under Chair Gary Gensler. At most, the exam saff may be anticipating that the compliance dates for the widely expected climate change disclosure rules will extend beyond this fiscal year.

That said, we expect the staff to test ESG truth in advertising, such as whether funds are operating as set forth in their disclosures.[30] We also believe that the staff may test whether ESG products comply with the recently amended names rule, which requires registered funds whose names suggest a particular type of investment to adopt policies requiring 80% of their value in such investments.[31]

Also, as reflected in recent enforcement actions, we consider it likely that examination and enforcement staff will continue to scrutinize ESG-related compliance procedures such as the application of ESG criteria by portfolio management teams.[32]

Artificial Intelligence

Since the rollout of Chat GPT captured the popular imagination, every industry has been forced to consider the potential benefits and implications of artificial intelligence.

Not to be left behind, exam staff have formed a specialized team to help evaluate emerging risks in AI.[33] The 2024 priorities did not specify the backgrounds of AI team members or explain how they may be deployed during examinations.

But it's a good bet that any registrants experimenting with or implementing AI-assisted algorithmic trading or client interface should expect questions regarding those functions.

Higher Interest Rates and Commercial Real Estate

In preparing the priorities each year, exam leadership polls line staff from across the country to get a boots-on-the-ground perspective regarding emerging issues, economic trends and other challenges.

In that vein, the 2024 priorities include strategies "that purport to address rising interest rates,"[34] and private funds' "exposure to recent market volatility and higher interest rates."[35]

The staff's 2023 concerns regarding the commercial real estate market appear to have receded somewhat, except with respect to the valuation of "illiquid or difficult to value assets, such as commercial real estate," according to the report.[36]

Off-Channel Communications

While off-channel communications are not explicitly mentioned in the 2024 priorities, this issue is not going away any time soon.

After imposing eye-popping civil penalties in fiscal year 2022 for recordkeeping and supervisory violations by some of the largest Wall Street firms, the agency maintained a similar pace in fiscal year 2023, charging nearly two dozen firms, imposing significant penalties and requiring admissions and the retention of independent compliance consultants to oversee detailed remedial undertakings.[37]

The exam staff will remain a key part of the agencywide effort to root out broker-dealers and investment advisers that have not come into compliance with their respective obligations to maintain communications under the Exchange Act and the Advisers Act.

Cybersecurity

Cybersecurity is another perennial risk area for the exam program, and the 2024 priorities reiterate concerns from prior years, including "the proliferation of cybersecurity attacks, firms' dispersed operations, intense weather-related events, and geopolitical concerns."[38]

In describing likely areas of inquiry, the staff appear to be focused on operational resiliency, and compliance with Reg S-P, which requires firms to have policies and procedures addressing the protection of customer information, and Reg S-ID, which requires firms to develop and implement written identity theft prevention programs.[39]

Cryptocurrency

As part of Gensler's well-publicized crackdown on the cryptocurrency industry, the exam staff pointed to some specific areas of emphasis, including registrants' following their respective standard of care when recommending crypto products or strategies to retail investors, and compliance with Custody Rule and Bank Secrecy Act requirements.[40]

Other Relatively New Rules

Exam staff also made clear that they plan to review municipal advisers' compliance with new MSRB Rule G-46 after it becomes effective on March 1, 2024.[41]

Because MSRB Rule G-46 will require, among other things, disclosure of conflicts of interest and documentation of client relationships, this priority dovetails with the commission's continued focus on conflicts disclosures by all market participants.

The staff also plans to assess broker-dealers' preparations for the shortening of the trade settlement cycle to T+1, which has a compliance date of May 28, 2024.[42]

Operational Update and Recap of FY 2023

The 2024 priorities tout the SEC staff's nationwide return to office earlier this year, without mentioning that after difficult negotiations with the union, the agency's in-office requirement for line staff remains just one day per week.[43]

This minimal in-office requirement may be why the staff goes on to cite the efficiencies of providing "virtual options to both examiners and registrants."[44]

We suspect that in fiscal 2024, a majority of exams will remain virtual, including the traditional field work component.

In a departure from last year, the 2024 priorities do not cite the total number of exams completed in fiscal 2023, or the percentage of investment advisers examined.

The omission of these metrics likely was due to the early release of the 2024 priorities, so we'll have to wait for the agency's reporting to Congress for final statistics.

Conclusion

The SEC's Division of Examinations remains the agency's eyes and ears for the financial services industry because it conducts more than 3,000 examinations per year.

By paying close attention to the subtle shifts in the published 2024 examination priorities, and then reviewing the firm's observance of the rules and guidance in those areas, registrants can minimize the likelihood that an examination results in serious compliance deficiencies or a referral to the Division of Enforcement.

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Disclosure: During his tenure with the SEC, Gottschall supervised the early stages of the investigation of Classic Asset Management LLC, which is cited in Footnote 4.

[1] https://www.sec.gov/files/2024-exam-priorities.pdf at 1.

[2] Id. at 2.

[3] https://www.sec.gov/files/risk-alert-newly-registered-ias-032723.pdf.

[4] See, e.g. https://www.sec.gov/news/public-statement/gensler-statement-complex-exchange-traded-products-100421; https://www.sec.gov/news/statement/crenshaw-lizarraga-statement-classic-asset-management-050523.

[5] https://www.sec.gov/files/2024-exam-priorities.pdf at 1, 7, 13.

[6] Id. at 13.

[7] https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers.

[8] Id. at 7.

[9] In the Matter of American Infrastructure Funds, LLC at p. 5, paragraph 22.

[10] https://www.sec.gov/files/2024-exam-priorities.pdf at 7-8.

[11] Id. at 9.

[12] https://www.sec.gov/news/press-release/2023-173.

[13] https://www.sec.gov/files/2024-exam-priorities.pdf at 9.

[14] Id. at 10.

[15] Id.

[16] Id.

[17] Id.

[18] https://www.sec.gov/news/press-release/2023-155.

[19] https://www.sec.gov/files/2024-exam-priorities.pdf at 12.

[20] https://www.sec.gov/files/2024-exam-priorities.pdf at 21.

[21] In the Matter of DWS Investment Management Americas, Inc.

[22] https://www.sec.gov/files/2024-exam-priorities.pdf at 12.

[23] Id. at 13.

[24] Id.

[25] Id. at 14.

[26] Id.

[27] Id.

[28] Id.

[29] Id.

[30] https://www.sec.gov/news/speech/gensler-amac-2021-07-07.

[31] https://www.sec.gov/news/press-release/2023-188.

[32] See, e.g. https://www.sec.gov/files/litigation/admin/2023/ia-6432.pdf; https://www.sec.gov/files/litigation/admin/2022/ia-6189.pdf.

[33] https://www.sec.gov/files/2024-exam-priorities.pdf at 3.

[34] Id. at 7.

[35] Id. at 10.

[36] Id. at 9.

[37] https://www.sec.gov/news/press-release/2023-212; https://www.sec.gov/news/press-release/2023-149; https://www.sec.gov/news/press-release/2023-91.

[38] https://www.sec.gov/files/2024-exam-priorities.pdf at 18.

[39] Id.

[40] Id. at 20.

[41] Id. at 17.

[42] Id. at 19.

[43] Id. at 2.

[44] Id.