

## SEC 2023 Examination Priorities

February 27, 2023

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On February 7, the Securities and Exchange Commission's (SEC) Division of Examinations (Division) published its examination priorities for 2023.<sup>1</sup> According to this statement, the Division's mission is to promote compliance, prevent fraud, monitor risk and inform policy.

The Division noted that in fiscal year 2022, the Division examined approximately 15 percent of all registered investment advisers (RIAs). The Division stressed, that moving forward, increased examinations can only be achieved with "significant investments in human capital and technology resources." This statement raises the possibility that, in the future, the Division may recommend a significant increase in resources devoted to adviser inspections, such as through the creation of a self-regulatory organization.

This advisory provides an overview of some new areas the Division will prioritize, as well as highlights older areas that remain priorities.

### New Focus Areas

The following recently effective rules are the Division's priorities for examining for compliance:

#### 1. Marketing Rule<sup>2</sup>

November 4, 2022 was the compliance date for the new rule governing advertising and solicitation activities by investment advisers. The new rule substantially revised decades old authorities governing this activity.

The Division will examine firms to see whether firms have revised their policies and procedures to conform with the new rule. These examinations will include a focus on whether firms are collecting and retaining evidence substantiating factual statements in advertising; whether firms are changing performance presentations, including presenting all performance gross of fees and presenting multi-year historical performance for separately managed accounts; and, complying with numerous conditions on use of hypothetical performance.

#### 2. Derivatives Rule<sup>3</sup>

The Derivatives Rule provides a regulatory framework for derivative use by registered investment companies (RIC). The Derivatives Rule applies to mutual funds (other than money market funds), exchange-traded funds (ETFs), closed end funds and business development companies (BDCs), (collectively, Firms). The Division will assess whether Firms have adopted and implemented policies and procedures to prevent violation of the Derivatives Rule. The Division also will examine if Firms implemented a risk management program and whether disclosures concerning the Firms use of derivatives are accurate.

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<sup>1</sup> 2023 Examination Priorities, U.S. Securities and Exchange Commission, Division of Examinations, February 7, 2023, available [here](#).

<sup>2</sup> 17 CFR § 275.206(4)-1.

<sup>3</sup> 17 CFR § 270.18f-4.

### 3. Fair Valuation Rule<sup>4</sup>

The Fair Valuation Rule requires fund investments for which market quotations are readily available to be valued at their market value, and for all other securities for which market quotations are not readily available to be valued at their fair value as determined in good faith by the fund's board of directors. The Division will assess whether the funds' and the fund boards' are in compliance with the requirements.

### 4. RIAs to Private Funds

RIAs to private funds represent over 35 percent of all RIAs; managing assets exceeding \$21 trillion. The Division will focus on: conflicts of interest; calculation of fees and expenses; compliance with the new marketing rule; practices regarding the use of alternative data; and compliance with the custody rule,<sup>5</sup> which requires advisers that have custody of client assets to maintain those assets with a qualified custodian such as a bank, broker-dealer or futures commission merchant.

The Division stressed that it will focus on RIAs to private funds with specific risk characteristics, specifically: highly leveraged private funds; private funds managed side-by-side with BDCs; private equity funds that use affiliated companies and advisory personnel to provide services to their fund clients and underlying portfolio companies; private funds that hold certain hard-to-value investments, such as crypto assets and real estate-connected investments, with an emphasis on commercial real estate; private funds that invest in or sponsor special purpose acquisition companies (SPACs); and, private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds.

## Continued Areas of Focus

### 1. Regulation Best Interest (Regulation BI)<sup>6</sup>

In 2022, the Division prioritized reviewing standards of conduct issues for broker-dealers and RIAs, and how they are satisfying their obligations under Regulation BI which requires them to act in the best interests of retail investors.<sup>7</sup> In 2023, the Division will continue to examine broker-dealers and investment advisers to ensure that the policies and procedures they have in place are sufficient for investor protection. The Division will also examine broker-dealers and RIAs to make sure that they deliver their relationship summaries to investors, and file their relationship summaries with the SEC via Form CRS.<sup>8</sup>

### 2. Environmental, Social and Governance (ESG) Investing

Funds continue to offer investments that satisfy certain ESG criteria to meet the demand for ESG-related investments. The Division will focus on ESG fund offerings and whether the funds are operating consistent with their disclosures and whether the investments are made in the investor's best interest.

### 3. Information Security

The Division will continue to review broker-dealers cybersecurity systems to make sure investor information is protected. The Division stressed that the cybersecurity risks are elevated given larger market events, geopolitical concerns and the proliferation of ransomware attacks.<sup>9</sup>

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<sup>4</sup> 17 CFR § 270.2a-5.

<sup>5</sup> 117 CFR § 275.206(4)-2. It is unsurprising that the Division will be focused on the custody rule as on March 30, 2022, the SEC settled charges against a RIA for violating the custody rules. The order is available [here](#).

<sup>6</sup> 117 CFR § 240.15l-1.

<sup>7</sup> 12022 Examination Priorities, U.S. Securities and Exchange Commission, Division of Examinations, March 30, 2022, available [here](#).

<sup>8</sup> See also Risk Alert: Observations from Broker-Dealer Examinations Related to Regulation Best Interest, U.S. Securities and Exchange Commission, Division of Examinations, January 30, 2023 available [here](#).

<sup>9</sup> For more information on cybersecurity requirements for RIAs, see Katten Client Alert: Proposed SEC Rules for Investment Advisers and Regulated Funds, and New FTC Safeguard Rule Applicable to Private Funds available [here](#).

## 4. Crypto Assets

The Division pointed out that given the recent disruptions caused by the financial distress among crypto asset market participants, the Division will continue to monitor registrants to ensure they meet and follow their respective standards of care when making investment recommendations. The Division also will be inspecting market participants to make sure they are routinely reviewing, updating and enhancing their disclosure and risk management practices relating to crypto assets.

## Other New Areas of Focus

The Division also noted that it will review hedge clauses and use of personal devices by personnel to communicate about firm business. Both of these areas have been the subjects of recent enforcement cases and pronouncements by senior SEC officials.

## Risk Alerts

In the past few months, the Division released two risk alerts highlighting deficiencies the Division identified in recent examinations. These risk alerts also serve as indicators in which areas the Division will focus on in the coming year.

### 1. Regulation NMS<sup>10</sup>

Regulation NMS requires broker-dealers to provide publicly available quarterly reports on its routing of customer orders. This provides insight into factors that may influence a broker-dealer's order routing decisions. The Division observed among other things, that firms were not creating Rule 606 reports; inaccurately classifying order percentages among the four order type categories (market orders, marketable limit orders, non-marketable limit orders and other orders); and, disclosing inaccurate amounts of net aggregate rebates received for each of the four order types.<sup>11</sup>

### 2. Regulation S-ID<sup>12</sup>

Regulation S-ID requires certain RIA, broker-dealers and investment companies to determine if they offer or maintain covered accounts.<sup>13</sup> If a firm determines that it has such accounts, it must establish a program that is designed to detect, prevent and mitigate identity theft in connection with covered accounts. The Division observed that many firms failed to identify covered accounts and failed to establish and administer appropriate identity theft programs.<sup>14</sup>

## Conclusion

The above description of the 2023 Priorities Report is not exhaustive, and regulated entities should carefully review the report as it gives important insight into the likely focus of future examinations.

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<sup>10</sup> 17 CFR § 242.600

<sup>11</sup> See, Risk Alert: Observations Related to Regulation NMS Rule 606 Disclosures, U.S. Securities and Exchange Commission, Division of Examinations, November 10, 2022 available [here](#).

<sup>12</sup> 17 CFR § 282.201

<sup>13</sup> Under 17 CFR § 248.201(b)(3), a covered account is "(i) an account that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions; and (ii) any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation, or litigation risks."

<sup>14</sup> See, Risk Alert: Observations From Broker-Dealer and Investment Adviser Compliance Examinations Related to Prevention of Identity Theft Under Regulation S-ID available [here](#).

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## CONTACTS

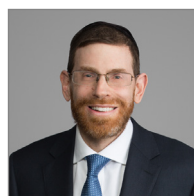
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2/27/23