

Legal Risk Management Tip September 2023

What We Learned from the SEC's Recent *Risk Alert* on Investment Adviser Examinations

Preparing for an SEC examination can be a daunting experience. The regulatory environment has never been tougher than it is today. During examinations, the SEC staff is asking for more information to substantiate responses, evaluating business risks, assessing conflicts of interest (especially those related to outside business activities), and mapping those areas to an adviser's internal control system. To prepare, it is critical for advisers to be proactive and keep up to date with the latest regulatory guidance.

This month, the SEC issued a new [Risk Alert](#) which focuses on how the SEC assesses risks, scopes examinations and requests documents. In addition, the Division of Examinations ("EXAMS") provided guidance on typical information requested to assist advisers in preparing for an SEC examination.

In this month's Jacko Law Group, PC ("JLG") Risk Management Tip, we will provide a summary of the 2023 SEC Examination priorities which highlight those particular areas of focus by EXAMS this year. We will then explore the most recent SEC *Risk Alert* and discuss recent SEC guidance on how to better understand the SEC's risk-based approach to examinations. Finally, we will also consider steps you can take to help prepare for and achieve a positive SEC examination experience.

Recap of 2023 SEC Examination Priorities

Each year the EXAMS releases the SEC's [Examination Priorities Report](#) which provides tremendous insight into those significant areas of focus. With the goals of preventing fraud, monitoring risk, and informing policy, the SEC staff prioritizes examination of areas it believes provide "heightened risks to investors or compromises the integrity of the U.S. capital markets."¹

In 2023, there were six (6) critical areas identified by EXAMS, including:

- Compliance with recently adopted rules under the Investment Advisers Act of 1940, including the Marketing Rule (Rule 206(4)-1);
- Compliance programs of investment advisers to private funds;
- Standards of conduct related to fiduciary duties of investment advisers involving conflicts of interest, revenue sharing, use of hedge clauses in contracts and disclosures in Form CRS;
- Environmental, social and governance investing;
- Information security and operational resiliency, including compliance with safeguards outlined in Regulation SP and S-ID and protections against cyber-attacks; and
- Crypto assets and emerging financial technology and whether standards of care owed by an adviser are being considered when deploying such products and services.

In addition, EXAMS cautioned that examination of investment advisers will focus on operational practices of the registrant, including policies and procedures "for retaining and monitoring electronic communications and selecting and using third-party service providers."² We have seen this most recently reflected with the SEC's recent charges against various firms for failing to maintain and preserve business electronic communications, including text messages of employees.³

¹ See <https://www.sec.gov/files/2023-exam-priorities.pdf> at page 9.

² *Id.* at page 16.

³ See <https://www.sec.gov/news/press-release/2023-149>, <https://www.sec.gov/news/press-release/2023-91>, and <https://www.sec.gov/news/press-release/2022-174>.

Recent SEC Guidance on Investment Adviser Examinations

The September 6, 2023 [Risk Alert](#) provides critical guidance about the approach EXAMS takes on the selection and scope of examinations of investment advisers. Generally, the SEC uses a risk-based approach when it is examining its registrants. This may involve evaluation of how that registrant responds to risks associated with new product and service offerings, conflicts of interest, adaptation to new regulatory requirements and disclosures to clients.

The selection process used by EXAMS considers the risk profile of that firm, based upon data analytics used by the SEC. Firm risks include, among other things, tips, referrals, and complaints received by the SEC related to the registrant; business operations and practices (with higher risk profiles associated with advisers who have custody of client assets, advisers of private funds and advisers to crypto assets); advisers with recidivist deficiencies of compliance program concerns; associated persons' disciplinary histories; conflicts of interest due to outside business activities, including advisors dually registered or affiliated with a broker-dealer; length of time between exams; and disclosure history of the registrant.

When the SEC examinations team arrives, you can anticipate that they will review the firm's operations, compliance program and higher risk areas, including those listed in the 2023 [Examination Priorities Report](#) as well as core areas of the registrant's business. This may include fees and expenses, portfolio management, brokerage and best execution, as well as safekeeping of client assets.

Finally, once the examination is announced, the staff will send an initial document request list to the adviser. Dependent upon whether or not it is a sweep or focus exam or "routine" examination, the SEC staff will generally request information related to the firm's business model, compliance risks identified (through the Annual Review process and risk assessments), internal controls (including those written policies and procedures adopted by the firm), trade information and related information to facilitate testing with respect to the adviser's trading activities, custody, conflicts of interest, marketing and advertising, and financial records.

Steps to Take to Have a Positive SEC Examination Experience

Now that you have a better understanding of the SEC's examination priorities and the staff's guidance on how they conduct SEC investment adviser examinations, it is important to take critical steps to prepare for the regulatory exam.

Step 1 – Review Lessons Learned

Before an exam, it is prudent to take a step back and review what lessons were learned in past examinations and discuss takeaways and actions that were taken historically to move the compliance program forward.

Review compliance program records, such as your Annual Review report, risk assessment and mock SEC examination results to identify higher risk areas that may still require attention.

Assess prior responses that were provided to the staff, and to senior management, as to steps that would be taken by the investment adviser to enhance internal controls or take corrective actions as

needed. Be prepared to discuss this during the examination and emphasize the steps you continue to take to address the areas of concern to create a more robust compliance environment.

Step 2 – Create a PowerPoint for the Initial Interview with the Staff

Consider the benefits of creating a PowerPoint to use during the initial interview with the Staff. This document can summarize where the firm is today, how the business has evolved since the last SEC examination and emphasize the attributes of your compliance program. At the commencement of the onsite or interview portion of the examination, examiners typically will ask to speak with members of senior management. A carefully and well-designed PowerPoint presentation to the Staff often is welcomed as it will allow the examination team to better understand your current business model. It also helps your senior management team to stay on message to deliver meaningful information to the examiners, which may in turn help facilitate a more streamlined examination process.

Topics to include in the PowerPoint could include evolutions to your business model, information on advancements in your compliance program, key members of your compliance staff and highlights of compliance initiatives taken, training of associated persons and implementation of new policies and procedures.

Step 3: Help Key Personnel Prepare

It is likely that the SEC will want to interview certain supervisory personnel on various compliance matters. Help personnel to prepare by conducting mock interviews, highlighting important disclosures and policies to review related to their supervisory area and discuss how to best provide dialogue related to advancements in internal controls deployed.

Conclusion

The SEC examination process is critical both to the protection of investors, and to advance the investment advisory industry and their compliance with rules and regulations. By taking proactive measures to understand the SEC's current risk priorities and examination program, investment advisers are well equipped to self-evaluate their current risks within their organization. Once such risks are identified, they should be mapped to supervisory and internal controls, which then are shared through training and education to associated persons directly impacted by such policies and procedures. Conducting mock SEC examinations by an independent third-party can also help to further prepare investment advisers for the inevitable examination.

For more information on how JLG can assist with your SEC investment adviser examination preparations, please contact us at (619) 298-2880.

Author: Michelle L. Jacko, Managing Partner, Jacko Law Group, PC (“JLG”). JLG works extensively with investment advisers, broker-dealers, investment companies, private equity and hedge funds, banks and corporate clients on securities and corporate counsel matters. For more information, please visit <https://www.jackolg.com/>.

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