Regulatory and Enforcement Alert

SEC Division of Examinations Releases Process-Focused Risk Alert—Exam Selection and Typical Categories of Document Requests

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On September 6, 2023, the SEC's Division of Examinations (the "Division") released a Risk Alert that (i) provides a high-level overview of its risk-based approach to selecting advisers for examination and (ii) lists certain categories of documents typically requested in examinations. While this is not a new internal SEC process, it is helpful, if unusual, for the Division to publish such information. The Risk Alert can serve as a helpful tool in an adviser's examination preparation toolkit, and it also serves as a reminder as to when an examination may be more imminent for an adviser based on particular circumstances. The Risk Alert is summarized below, with additional context embedded, followed by some practical considerations for an adviser's examination preparation.

Selecting Advisers for SEC Examination

As noted in the Risk Alert, the Division of Examinations has annually examined in recent years approximately 15% of all registered investment advisers. Given the large population of registered investment advisers (presently over 15,000), the Division employs a risk-based approach to selecting advisers for examination. As stated in the Risk Alert, the Division conducts examinations for several reasons, including the following: (i) to promote compliance; (ii) to prevent fraud; (iii) to monitor risk; and (iv) to inform policy (*i.e.*, the SEC's rule-making agenda).

The Risk Alert noted that its risk-based selection approach is dynamic, adapting to "changes in market conditions, industry practices, and investor preferences." The Risk Alert noted certain general factors in its risk-based selection process, as follows:

- Event-driven risks posing a risk to investors and the markets more broadly
- Risks related to how advisers are complying with new regulatory requirements
- The Division Staff's interest in particular compliance risk areas, for instance as noted in the Division's Examination Priorities published annually
    - For instance, with respect to advisers to private funds, the 2023 Examination Priorities identified the following focus areas: conflicts of interest; calculation and allocation of fees and expenses, with a focus on "the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds"; compliance with the New Marketing Rule; the use of alternative data; and compliance with the Custody Rule (including timely delivery of audited financials and selection of permissible auditors).

- Risks presented by the characteristics of types of firms
  - The 2023 Examination Priorities identified as of interest advisers to private funds with the following specific risk characteristics: highly leveraged private funds; private funds managed side by side with Business Development Companies; use of affiliated service providers; hard-to-value investments (such as crypto assets and commercial real estate); investments in SPACs; and adviser-led restructurings, including stapled transactions and continuation funds.
- Specific risks presented by a *particular* firm, including certain business activities, conflicts of interest, and regulatory history. In this regard, the Risk Alert outlined eleven categories of risk factors:
  1. "prior examination observations and conduct, such as when the staff has observed what it believes to be repetitive deficient practices during more than one review of a firm, significant fee- and expense-related issues, and significant compliance program concerns;
  2. supervisory concerns, such as disciplinary history of associated individuals or affiliates;
  3. tips, complaints, or referrals involving the firm;
  4. business activities of the firm or its personnel that may create conflicts of interest, such as outside business activities and the conflicts associated with advisers dually registered as, or affiliated with, brokers;
  5. the length of time since the firm's registration or last examination, such as advisers newly registered with the SEC;
  6. material changes in a firm's leadership or other personnel;
  7. indications that the adviser might be vulnerable to financial or market stresses;
  8. reporting by news and media that may involve or impact the firm;
  9. data provided by certain third-party data services;
  10. the disclosure history of the firm; and
  11. whether the firm has access to client and investor assets and/or presents certain gatekeeper or service provider compliance risks."

The Risk Alert also noted the vast amount of information the Division has at its fingertips as it seeks to identify general market risks and risks presented by particular firms. For instance, the Risk Alert referenced regulatory filings—such as Form ADV and Form PF—and noted that the Division leverages technology to gather and analyze large sets of data. While not noted in the Risk Alert, the Division's Office of Risk and Strategy assists with these efforts.

Categories of Documents Typically Requested in Standard SEC Examinations

As the Risk Alert noted, the scope of examinations is informed by additional risk assessment and will vary "depending on the firm's business model, associated risks, and the reason for conducting the examination."

Accordingly, the documents requested will vary across examinations. While examinations will vary, the Risk Alert noted commonalities among tested areas: “reviewing advisers’ operations, disclosures, conflicts of interest, and compliance practices with respect to certain core areas, including but not limited to, custody and safekeeping of client assets, valuation, portfolio management, fees and expenses, and brokerage and best execution.”

The Risk Alert included as an attachment a chart of typical information requested during an examination, though the information is not comprehensive and, as noted in the Risk Alert, the chart does not include information requested particular to advisers to private funds or certain other advisers with additional characteristics. Highlights from the chart are as follows:

- **General Information**
  - Organizational Information (such as organizational structure, affiliations, branch locations, and supervised persons)
  - Business and Operations (such as committees, advisory contracts, fees, and service providers)
  - Disclosures and Filings (such as Form ADV and Form CRS)
  - Legal and Disciplinary (such as litigation and remedial action against supervised persons)
- **Information Regarding the Compliance Program, Risk Management, and Internal Controls**
  - Compliance Program and Oversight Process (such as compliance policies, compliance testing, annual reviews, client complaints, and compliance training)
  - Valuation (such as valuation process, advisory fee calculations, and pricing overrides)
  - Information Processing, Reporting, and Protection (such as safeguards for the protection of customer information, business continuity plan, and cybersecurity incidents)
- **Information to Facilitate Testing with Respect to Advisory Trading Activities**
  - Information About Advisory Clients and Accounts (such as client account information, custodial arrangements, and clients lost during the review period)
  - Portfolio Management (such as securities held, outside compensation to supervised persons, and client portfolio profile information)
  - Brokerage and Trading (such as trade blotter, soft dollar arrangements, affiliated broker-dealers, principal trades and cross transactions, and trade allocation information)
  - Conflicts of Interest and Insider Trading (such as Code of Ethics, insider trading policies, and reports of securities transactions)
- **Information to Perform Testing for Compliance in Various Areas**
  - Marketing and Advertising (such as marketing materials, performance information, composites, DDQ, testimonials and endorsements, and third-party ratings and rankings)

  - Financial Records (such as balance sheet and general ledger)
  - Custody (such as custodian identification, surprise examination documentation, and auditor engagement information)

Risk Alert Takeaways and General Considerations

- While advisers may perpetually be in examination preparation mode, advisers should be aware when certain risk characteristics or other events are present that may make an examination more imminent, and be sure to prioritize examination preparation at that time. For example, in periods of market stress affecting certain sectors of the economy (*e.g.*, commercial real estate or distressed debt), advisers with flagship or large strategies in those sectors should be prepared for Staff outreach (which can take the form of an examination or more informal requests).
- Given the Risk Alert's specific itemization of certain of interest risk characteristics potentially relevant to *individual* firms, advisers should consider reviewing those items and ensuring relevant policies and practices are sound. Indeed, given the Risk Alert's pointed observation that adverse findings (*e.g.*, material amounts of misallocated expenses) in a prior examination can be a plus factor for a follow-up examination, the stakes of managing examinations smoothly and efficiently are high and can have enduring effects.
- As noted in the Risk Alert, the Division is keen to test advisers' compliance with new rules. Accordingly, advisers should be prepared to be examined shortly after the effective date for new rules (such as the New Marketing Rule, which compliance date went into effect on November 4, 2022).
- Finally, advisers should pay particular attention to substantive areas the SEC has identified. The topics of fees and expenses, in particular, continues to be a focus in examinations, SEC publications, and in SEC Enforcement actions (see for example the recent Insight Partners settlement on the topic of fee calculations as impacted by valuation and the corresponding press release).

Conclusion

The information in the Risk Alert should be incorporated into advisers' processes for examination preparation, as applicable. The SEC has indicated that certain items can prompt an examination, so managers should be mindful of these areas as they develop their business. And it is clear that, as the registered investment adviser population continues to grow in size and complexity, the Division is keen to keep pace in examining a significant number of advisers each year through its sophisticated and coordinated examination program.

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