

Investment Management & Funds Regulatory Update - October 2023

October 31, 2023 | Client Update | 7-minute read

In this issue, we discuss the 2024 examination priorities for the SEC's Division of Examinations.

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Rules and regulations

The Internal Revenue Service and Treasury Department propose digital asset tax reporting regulations

In August, the Internal Revenue Service and the Treasury Department proposed regulations expanding the scope of the tax reporting requirements for brokers to apply to sales of digital assets, including cryptocurrency. The proposed regulations include an expansive definition of “broker” that covers a wide range of entities, including DeFi platforms, and a similarly broad definition of “digital asset.” Please see our recent [client update](#), which explores the potential impact on participants in digital asset markets.

Industry update

SEC Division of Examinations releases examination priorities for 2024

On October 16, 2023, the SEC's Division of Examinations (Division) published its [examination priorities for 2024](#) (Exam Priorities). The Exam Priorities fall into the following seven categories: (1) Investment Advisers, (2) Investment Companies, (3) Broker Dealers, (4) Self-Regulatory Organizations, (5) Clearing Agencies, (6) Other Market Participants and (7) Risk Areas Impacting Various Market Participants. Highlighted below are some of the key priorities noted in the Exam Priorities for investment advisers and investment companies. For a discussion of the 2023 Exam Priorities, please see our February 27, 2023 [Investment Management Regulatory Update](#).

Investment advisers

According to the Exam Priorities, the Division will continue to prioritize investment advisers' adherence to their fiduciary duty of care and loyalty to their clients, along with advisers' compliance programs.

With respect to investment advisers' fiduciary duty of care and loyalty, examinations will focus on, among other things, investment advice provided to clients regarding complex products (e.g., derivatives and leverage exchange-traded funds), high cost illiquid products (e.g., variable annuities and non-traded real estate investment trusts) and unconventional investment strategies such as those that aim to address rising interest rates, with particular focus on advice provided to older clients and those saving for retirement.

The Division will also focus on investment advisers' processes for determining that their investment advice is in the client's best interest, such as making suitability determinations, seeking best execution, evaluating costs and risks. According to the Exam Priorities, examinations will review how advisers address conflicts of interest, including how advisers mitigate or eliminate conflicts of interest and how they allocate investments to accounts when investors have more than one account (e.g., allocation among accounts that are adviser fee-based, brokerage commission-based and wrap fee-based, and among taxable and non-taxable accounts). This will also include a focus on the disclosures made to investors and whether all material facts regarding conflicts of interest are disclosed so that client is able to give informed consent.

Relatedly, the Division will continue to focus on the economic incentives that advisers and other related financial professionals may have in recommending products, services, or account types. To examine this, the Division will evaluate the economic incentives and conflicts of interest associated with advisers that are dually registered as broker-dealers, use affiliated firms for client services, and have professionals that serve both brokerage customers and advisory clients, to identify, among other things, investment advice to purchase or hold onto certain types of investments when other lower-cost options are available for investors or investment advice regarding proprietary products and affiliated service providers that result in increased fees for investors. The Exam Priorities also noted that the Division will focus on disclosures to investors regarding conflicts of interest, and whether the disclosure includes all material facts sufficient to allow a client to provide informed consent to the conflict.

According to the Exam Priorities, an examination of an adviser's compliance policies and procedures may 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; and (10) business continuity plans." A review of an adviser's compliance program will also assess whether the policies and procedures are sufficient to support the adviser's compliance with its fiduciary obligations.

With respect to advisers' compliance programs, examinations will include, among other things, marketing practice assessments to identify whether advisers have policies and procedures in place to comply with the Advisers Act and Rule 206(4)-1 thereunder (Marketing Rule), made appropriate disclosures of marketing information on Form ADV, and maintained substantiation of their processes and related books and records. The Division will also review whether disseminated advertisements include untrue statements of material fact, are materially misleading or otherwise deceptive, and comply with the requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements.

As noted in the Exam Priorities, compensation arrangement assessments will focus on: (1) fiduciary obligations of advisers to their clients, including registered investment companies, particularly with respect to the advisers' receipt of compensation for services or other material payments made by clients and others; (2) alternative ways that advisers try to maximize revenue (e.g., revenue earned on clients' bank deposit sweep programs); and (3) fee breakpoint calculation processes (e.g., when fee billing systems are not automated).

Additional examination priorities include valuation assessments where investment advisers' have recommended to clients to invest in illiquid or otherwise difficult to value assets (e.g. commercial real estate or private placements), safeguarding assessments to ensure advisers have measures in place to protect clients' material non-public information, especially where advisers share office locations or use expert networks, and other disclosure assessments to review the accuracy and completeness of an adviser's regulatory filings, including Form CRS.

According to the Exam Priorities, the Division is also focused on advisers' policies and procedures for: "(1) selecting and using third-party and affiliated service providers; (2) overseeing branch offices when advisers operate from numerous or

geographically dispersed offices; and (3) obtaining informed consent from clients when advisers implement material changes to their advisory agreements. Such reviews will assess, among other things, whether the advisers' policies and procedures are reasonably designed and implemented and whether the procedures prevent the advisers from placing their interests ahead of clients' interests."

The Exam Priorities noted that Division will also continue to focus on advisers that manage private funds. Examinations will review portfolio management risks during exposure to recent market volatility and higher interest rates (e.g., poor performance, significant withdrawals and valuation issues and private funds with more leverage and illiquid assets), adherence to contractual agreements regarding limited partnership advisory committees and other structures (e.g., compliance with contractual notification and consent processes), accurate calculation and allocation of fees and expenses (e.g., valuation of illiquid assets, calculation of post commitment period management fees, adequacy of disclosures, and potential offsetting of such fees and expenses), and due diligence practices to ensure consistency with policies, procedures and disclosures, such as with respect to private equity and venture capital fund assessments of prospective portfolio companies. The Exam Priorities further notes a focus on conflicts, controls and disclosures for private funds managed parallel to registered investment companies, use of affiliated services providers, compliance with Advisers Act custody rule requirements (e.g., accurate Form ADV reporting, timely completion of private fund audits by a qualified auditor and distribution of private fund audited financial statements), and policies and procedures for reporting on Form PF.

Investment companies

The Division will continue to prioritize examinations of registered investment companies, including mutual funds and exchange-traded funds (ETFs). According to the Exam Priorities, examinations will focus on the written compliance policies and procedures of registered investment companies with respect to oversight of advisory fees and any fee waivers or reimbursements. The Division will review whether there have been different advisory fees charged to different share classes of the same fund, identical strategies offered by the same sponsor through different distribution channels for different fee structures, high advisory fees, and high registered investment company fees and expenses, especially for those registered investment companies with lower performance. The Division will also review the boards' approval of the advisory contract and registered investment company fees.

Other examination areas include derivatives risk management assessments to review whether written policies and procedures have been adopted to prevent violations of Investment Company Act Rule 18f-4. To effectuate this, examinations may review the adoption and implementation of derivatives risk management programs, board oversight, the completeness and accuracy of disclosures regarding the use of derivatives, and derivative valuations.

According to the Exam Priorities, the Division will also review compliance with the terms of exemptive order conditions and issues relating to recent market volatility, such as compliance with liquidation procedures for registered investment companies in liquidation.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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