

Private Capital Alert

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SEC releases 2023 examination priorities for investment advisers

On February 7, the Division of Examinations¹ within the U.S. Securities and Exchange Commission (the SEC) released its annual list of examination priorities for investment advisers regulated by the SEC under the U.S. Investment Advisers Act of 1940 (the “Advisers Act”), as well as investment companies under the U.S. Investment Company Act of 1940 and broker-dealers under the U.S. Securities Exchange Act of 1934. The 2023 priorities report follows one of the SEC’s most active years with respect to proposed rulemaking for private fund sponsors. Many of last year’s proposed rules are expected to become effective in some form later this year.

This year’s list represents more continuity than rupture with the 2022 list. Nonetheless, the SEC in 2023 is highlighting as a top priority the new marketing rule, which took effect for registered investment advisers (RIAs) in November 2022. As in past years, the Division expects to focus on RIAs to private funds, following a wide-ranging set of comprehensive [new rules for private funds](#) proposed last February, as well as adherence to applicable fiduciary duties. Priorities also include two perennial hot topics – environmental, social, and governance (ESG) standards and information security (especially cybersecurity). The SEC also last year proposed new rules for [cybersecurity](#) and [ESG](#) that will, upon finalization, impact private funds.

Notably, the priorities list is the first to be released under the Division’s new director, Richard R. Best, who was [appointed](#) in May 2022 and had served in an acting capacity since March 2022, previously serving as director of the SEC’s New York regional office. Under its new leadership, the Division elucidated “four pillars” for its long-standing mission: and change it to (i) promote compliance; (ii). prevent fraud; (iii). monitor risk; and (iv) inform policy.

Although the Division didn’t provide exact numbers as in years past, it examined 15% of all RIAs. The number of RIAs increased to over 15,000 for the first time in 2022, overseeing more than \$125 trillion in assets under management.

Marketing rule

The Division placed the marketing rule first among its compliance priorities list, reflecting both the rule’s relative novelty and the breadth of its impact on RIAs. Replacing both the old “advertising rule” and “cash solicitation rule,” the marketing rule² was adopted under the prior administration in 2020 and replaces a decades-long rules-based regulation with a principles-based regulation.

1. Formerly the Office of Compliance Inspections and Examinations (OCIE). In its 2022 priorities, the Division stated explicitly that the removal of the word “compliance” from the Division’s name is not intended to deemphasize the Division’s long-standing focus on, and commitment to, promoting compliance.

2. New Rule 206(4)-1, replacing the former Rule 206(4)-1 and Rule 206(4)-3 in their entirety.

In sum, the differences are summarized as follows:

Topic	Old 'Advertising Rule'	New 'Marketing Rule'
Applicability	Registered investment advisers or advisers required to be registered only	Exactly the same: registered investment advisers or advisers required to be registered only
Definition of "advertisement"	Developed over decades through SEC guidance and interpretation	Clear, two-pronged definition; evergreen definition designed to capture future technological changes
General approach	Many <i>per se</i> bright-line prohibitions	Seven, more flexible principles-based guidelines
One-on-one communications	Generally outside the scope of the rule	Outside the scope of the rule with exceptions (hypothetical information, testimonials)
Testimonials/endorsements	Prohibited	Permitted, with certain disclosures and restrictions
Solicitation	Previous cash solicitation rule prohibited cash fees to solicitors who are bad actors or without written agreement	No separate rule, but disclosure requirement now handled as part of rules permitting testimonials and endorsements; covers cash and non-cash compensation alike
Scope	Technically only to advisory clients (i.e. funds)	Expressly includes advisory clients and private fund investors
Use of performance data	Permitted under various SEC guidance and no-action letters	Permitted under the rule with established guidelines
Use of gross performance data	SEC guidance required side-by-side net performance data	Rule now expressly requires side-by-side net performance data with equal prominence (even, in many cases, on an investment-by-investment basis, pursuant to a recent FAQ interpretation provided by the SEC)
Use of hypothetical performance data	SEC guidance indicated that hypothetical data would in most cases be misleading	Permitted with certain disclosures and exclusions
Recordkeeping	Required only via books and records rule, SEC interpretations and Rule 10b-5	Express substantiation requirement and amended books and records rule for all marketing materials

As the Division notes in its 2023 exam priorities, the new marketing rule is a "significant change to a core examination review area for RIAs," and as such, the SEC will assess whether RIAs have adopted and implemented written policies and procedures that are reasonably designed to prevent violations. In particular, the Division said that it will review whether RIAs have complied with the substantive requirements of the Marketing Rule, including that RIAs have a reasonable basis for believing they will be able to substantiate material statements of fact and requirements for performance advertising, testimonials, endorsements, and third-party ratings.

RIAs to private funds

The Division continues to prioritize RIAs to private funds, which represent 35% of all RIAs and manage 50,000 private funds with gross assets exceeding \$21 trillion, marking an 80% increase in gross assets under management in the last five years.

In particular, the Division highlighted the following areas of focus:

- conflicts of interest;
- calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds;
- compliance with the new Marketing Rule, including performance advertising and compensated testimonials and endorsements, such as solicitations;
- policies and practices regarding the use of alternative data and compliance with Section 204A of the Advisers Act, i.e. dealing with the use (and misuse) of material non-public information (MNPI); and
- compliance with Rule 206(4)-2 (the “custody rule”), where applicable, including timely delivery of audited financials and selection of permissible auditors.

Three of the five areas generally align with the priorities that the Division highlighted last year. Emphasis on the Marketing Rule and MNPI displacing its stated emphasis on the following two areas:

- the potential preferential treatment by RIAs of certain investors to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; and
- the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales.

Sponsors should understand that these additional two areas of focus, both of which represent specific conflicts areas, may be especially important in SEC exams, among other areas.

In particular, the Division said it will focus on RIAs to private funds with specific risk characteristics, including:

- highly-leveraged private funds;
- private funds managed side-by-side with business development corporations;
- 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.

Advisers that manage funds with these features should be especially prepared for SEC scrutiny.

As always, SEC examinations of RIAs will examine three areas (whether advisers to private funds or not):

- the calculation of fees;
- alternative ways that RIAs may try to maximize revenue, including revenue earned on clients’ bank deposit sweep programs; and
- excessive fees.

Despite what appears to be a record-setting seven enforcement actions against exempt reporting advisers (ERAs) in 2022, six of which were venture capital fund advisers, the Division doesn't list ERAs (neither venture capital fund advisers nor private fund advisers with under \$150 million in assets under management) as a priority area for 2023. Nevertheless, ERAs remain subject to examination by the SEC and subject to several rules and regulations, as well as the broader anti-fraud provision of Section 206 of the Advisers Act. Several of the 2022 proposed rules would affect ERAs and RIAs alike.

Fiduciary duty

As in 2022, the SEC is prioritizing the fiduciary duty that investment advisers owe to their clients. In June 2019, the SEC adopted an [interpretive release](#) detailing the duty of care and loyalty and outlining its view on what that duty constitutes.

The Division also emphasized the standard of conduct under the fiduciary standard to act in the best interests of retail investors and not to place their own interests ahead to retail investors' interests. Examinations for RIAs will focus on, in particular:

- investment advice and recommendations with regard to products, investment strategies, and account types;
- disclosures made to investors and whether such disclosures include all material facts relating to the conflicts of interest associated with the advice and recommendations;
- processes for making best interest evaluations, including those for reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest;
- factors considered in light of the investor's investment profile, including investment goals and account characteristics; and
- whether RIA conflicts of interest disclosures are sufficient such that a client can provide informed consent to the conflict, whether express or implied.

Again, while the Division will focus on RIAs to private funds, all investment advisers, including those exempt from registration, have a duty of care and loyalty to their clients.

ESG strategies

Not unexpectedly, the SEC highlighted its continual interest in ESG standards, given that RIAs and funds are competing for rising demand for ESG-related investments and strategies that incorporate certain ESG criteria, and, thus are increasingly offering and evaluating investments that employ ESG strategies and investments. The Division will continue its focus on ESG-related advisory services, including whether the funds are operating in the manner set forth in their disclosures. The SEC will also assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in investors' best interest.

Information security

Since its initial emphasis on cybersecurity in 2014, the Division continues to emphasize information security as a leading priority. In particular, the SEC said that the current risk environment related to cybersecurity is considered "elevated" given larger market events, geopolitical concerns, and the proliferation of cybersecurity attacks, particularly ransomware attacks.

As in prior years, the Division stated that it will review RIA practices to prevent interruptions to mission-critical services and to protect investor information, records and assets. In language echoing the 2022 priorities list, the SEC's examination will continue to review measures designed to safeguard customer records and information, including personally identifiable information, as well as review the cybersecurity issues associate with the use of third-party vendors, including registrant visibility into the security and integrity of third-party products and services (which may continue to have implications for law firms as RIA service providers). The Division will also continue to assess systemically significant operational resiliency planning, such as efforts to consider and/or address climate-related risks.

Crypto-assets

Nodding to recent disruptions in the crypto asset market, the Division said it will continue to observe the proliferation of certain types of investments (e.g., crypto assets and their associated products and services) and emerging financial technology (e.g., RIAs choosing to provide automated digital investment advice to their clients). The SEC will examine RIAs, in particular, that are offering new products and services or employing new practices, such as including technological and on-line solutions to meet the demands of compliance and marketing and to service investor accounts (e.g., online brokerage services, internet advisers, and automated investment tools and trading platforms, including RIAs referred to as “robo-advisers”).

In examinations, the SEC will assess whether RIAs involved with crypto or crypto-related assets (i) met and followed their respective standards of care when making recommendations, referrals, or providing investment advice, to the extent required; and (ii) routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices.

Finally, RIA examinations will focus on firms that employ digital engagement practices and the related tools and methods to assess whether:

- recommendations were made or advice was provided (e.g., through the use of social media marketing and social trading platforms);
- representations are fair and accurate;
- operations and controls in place are consistent with disclosures made to investors;
- any advice or recommendations are in the best interest of the investor taking into account the investor’s financial situation and investment objectives; and
- risks associated with such practices are considered, including the impact these practices may have on certain investors, such as seniors.

It would be sound for all advisers, however, to ensure that all of their policies and practices, even beyond digital engagement practices, generally take into consideration the above-mentioned principles.

Conclusion

In summary, the SEC will continue to focus on many of the areas it has emphasized for years in its examinations. In addition, it will initiate a fresh focus on compliance with the new Marketing Rule, as RIAs continue to adjust to the new regime, and it will also focus on compliance with Section 204A and MNPI protections.

Hogan Lovells regularly represents RIAs who are subject to SEC examinations, as well as exempt reporting advisers who are also obligated to comply with certain aspects of the Advisers Act. We also have very active regulatory, cybersecurity, international sanctions and compliance, employment, public company, M&A and ESG practices, among others, that provide counsel to clients who deploy private capital across a broad range of regulated industries through a broad range of investment strategies. We are happy to discuss any aspects of the Division’s 2023 examination priorities or other regulatory actions in respect of private funds under the Advisers Act or otherwise within the broader securities regulatory matrix to which private capital is subject.

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