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Legal Update

SEC's Division of Examinations 2021 Exam Priorities – Investment Advisers and Investment Companies

On March 3, 2021, the Division of Examinations of the US Securities and Exchange Commission (the "Examinations Division" and "SEC," respectively) announced its 2021 examination priorities, which, as in previous years, provide insight into its risk-based approach for the year with respect to the entities it examines.[1] This Legal Update focuses on the 2021 priorities applicable to investment advisers registered under the Investment Advisers Act of 1940 ("registered advisers") and investment companies registered under the Investment Company Act of 1940 ("registered funds").

While the announced priorities for 2021 contain certain priorities emphasized in previous years, they also include certain emerging risks, including those related to environmental, social, and governance matters ("ESG") and climate change. The 2021 examination priorities noted that registered advisers are increasingly offering investment strategies that focus on sustainability and may include registered fund products and services that are referred to by a variety of terms such as "sustainable," "socially responsible," "impact," and "ESG conscious." The Examinations Division indicated that they will focus on registered fund products in these areas that are widely available to investors such as open-end funds and ETFs. Acting SEC Chair Alison Herren Lee also noted that the Examinations Division is focusing on climate change-related risks "in light of intensifying physical risks associated with climate change."[2]

The new focus on ESG and climate change-related risks is consistent with recently announced initiatives from the SEC's staff that further integrate climate change and ESG considerations into the SEC's regulatory framework. For example, on March 4, 2021, the SEC's Division of Enforcement announced the creation of a Climate and ESG Task Force, which will develop initiatives to proactively identify ESG-related misconduct and whose initial focus will be to identify material gaps or misstatements in issuers' disclosure of climate risks under existing rules as well as analyze disclosure and compliance issues relating to investment advisers' and registered funds' ESG strategies.[3] This also follows Acting Chair Lee's appointment of a senior policy advisor for climate and ESG, who will advise the SEC on ESG matters and advance related new initiatives across its offices and divisions.[4]

2021 Examination Priorities for Investment Advisers and Registered Funds

The following briefly summarizes the aspects of the broader 2021 examination priorities relevant to registered advisers and registered funds, as well as the priorities specifically applicable to registered advisers and registered funds.

- **Retail Investors, Including Seniors and Those Saving for Retirement** – The Examinations Division will focus on compliance with Form CRS and whether investment advisers have fulfilled their fiduciary duties of care and loyalty. Specifically, the Examinations Division will examine whether registered advisers are appropriately mitigating conflicts of interest and, where necessary, providing disclosure of conflicts that is sufficient to enable informed consent by retail investors. With respect to those investments heavily used by retail investors or those that may present elevated risks, the Examinations Division will continue to prioritize these products, including mutual funds, exchange-traded funds (ETFs), municipal securities and other fixed income securities, variable annuities, private placements, and microcap securities. The Examinations Division also noted that examinations will review firms' disclosures related to fees and expenses as well as registered advisers that operate and utilize turnkey asset management platforms (and whether fees and revenue sharing arrangements in such platforms are adequately disclosed).

  Practice Point: The Examinations Division as in prior years will continue its focus on retail "main street" investors, which now includes review of the Form CRS of certain registered advisers (Form CRS came into effect last June 30, 2020). In light of the upcoming Form ADV annual update season, registered advisers should review their disclosures related to risks and conflicts of interest and whether they continue to remain accurate with respect to the prioritized products noted above and are consistent with their fiduciary obligations owed to advisory clients.[5] The Examinations Division stated that this will include assessing, among other things, whether registered advisers provide advice, including whether account or program types continue to be in the best interests of their clients, based on their clients' objectives, and eliminate or make full and fair disclosure of all conflicts of interest which might incline registered advisers—consciously or unconsciously—to render advice which is not disinterested such that their clients can provide informed consent to the conflict.

- **Information Security and Operational Resiliency (Business Continuity/Disaster Preparedness)**
  - **Information Security**: Building upon related information security priorities from earlier years, the Examinations Division will review whether registrants have taken appropriate measures to: safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; oversee vendors and service providers; address malicious email activities, such as phishing or account intrusions; respond to incidents, including those related to ransomware attacks; and manage operational risk as a result of dispersed employees in a work-from-home environment. These types of risks have increasing become important as more registered funds and registered advisers have adopted remote working environments in light of the COVID-19 pandemic. In particular, the Examinations Division noted that it will focus on controls surrounding online and mobile application access to investor account information, the controls surrounding the electronic storage of books and records and personally identifiable information maintained with third-party cloud service providers, and firms' policies and procedures to protect investor records and information.
  - **Operational Resiliency/Business Continuity:** Similar to prior years, the Examinations Division will continue to review business continuity and disaster recovery plans of registered advisers and registered funds, but for 2021 will shift its focus to whether such plans, particularly those of

systemically important registrants, are accounting for the growing physical and other relevant risks associated with climate change. As climate-related events become more frequent and more intense, the Examinations Division has stated that it will review whether such registrants are considering effective practices to help improve responses to large-scale events.

Practice Point: This past year saw an increasing focus by the Examinations Division on registered adviser's business continuity and disaster recovery plans, particularly given COVID-19 and the resulting shift of many advisers to a remote working environment. Given the increasing number of climate-related events, such as the 2020 California wildfires and the most recent February 2021 winter storm in Texas and other regions in the US, it is unsurprising that the Examinations Division would focus on whether such plans take into consideration similar large-scale climate change-related events. Registered advisers and registered funds may consider reviewing the above factors as part of their 2021 annual compliance reviews of such policies. The Examinations Division noted that certain of these activities may result in conflicts of interest, which could require new disclosures and mitigation, and that launching new advisory products in this environment could involve new regulatory obligations or necessitate compliance enhancements to systems, including order and portfolio management frameworks.

- **Financial Technology (Fintech) and Innovation, Including Digital Assets** – As innovations in financial technology and capital formation continue at a rapid pace, the Examinations Division noted that this transformation has dramatically changed the way firms interact with their customers and clients. Specifically, the Examinations Division noted that some advisory firms (new and existing) are providing financial services to clients or customers in innovative and evolving ways, such as firms providing advice to clients through automated investment tools and platforms (often referred to as "robo-advisers") or firms offering automated asset allocation, fractional share purchases, customized portfolios, and mobile applications. As a result, the Examinations Division stated that examinations of market participants engaged with digital assets (including robo-advisory firms or traditional firms that rely on mobile or electronic platforms) will continue to assess the following: whether investments are in the best interests of investors; portfolio management and trading practices; safety of client funds and assets; pricing and valuation; effectiveness of compliance programs and controls; and supervision of representatives' outside business activities.

  Practice Point: In a recent risk alert, the Examinations Division warned registered investment advisers that it will be focusing its examinations on registered advisers that manage digital assets (e.g., asset that are issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins" and "tokens") for clients, given the unique risks, compliance considerations and disclosure obligations with respect to the management of these types of assets.[6] Notably, the custody issues related to these digital assets continue to be a significant area of interest.[7]

  In addition, registered advisers that continue to use electronic-based systems and platforms, particularly robo-advisers and advisers that utilize proprietary or third-party algorithms and other similar models as part of their advisory services, should continue to be mindful of their existing obligations as a registered investment adviser.[8]

- **Anti-Money Laundering Programs** – As was the case in prior years, the Examinations Division will continue to review for compliance with applicable anti-money laundering requirements, including evaluating whether registered funds have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

- **The London Inter-Bank Offered Rate ("LIBOR") Transition** – As was the case in the 2020 priorities, the Examinations Division will continue to engage with registrants through examinations to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR, and the transition to an alternative reference rate, in connection with registrants' own financial matters and those of their clients and customers. In June 2020, the Examinations Divisions issued a risk alert to provide registrants with additional information about the scope and content of these examinations.[9]

  Practice Point: Registered advisers should consider adding or updating existing LIBOR and alternative reference rate-related risks in their Form ADVs as well as those in the prospectuses of sponsored registered funds and private placement memoranda of sponsored private funds. Please also see Mayer Brown's LIBOR transition website at https://www.mayerbrown.com/en/capabilities/key-issues/ibor-transition for additional resources and information related to the LIBOR transition.

- **Focus Areas Relating Specifically to Registered Advisers and Registered Funds –**
  - **Registered Adviser Compliance Programs** – As in prior years, the Examinations Division will continue to review the compliance programs of registered advisers, including whether those programs and their policies and procedures are reasonably designed, implemented, and maintained in accordance with applicable federal securities laws. In evaluating the effectiveness of a compliance program, the Examinations Division stated that it frequently reviews whether registered advisers appear to have sufficient resources to perform core compliance responsibilities. This year, the Examinations Division noted that it is focusing on registered advisers that employ investment strategies related to ESG factors, particularly products in these areas that are widely available to investors, including open-end registered funds and ETFs, as well as those offered to accredited investors such as qualified opportunity funds. To that end, the Examinations Division stated that it will review the consistency and adequacy of the disclosures registered advisers and fund complexes provide to clients regarding their ESG strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.

    Practice Point: The emphasis on review of ESG-related issues with respect to proxy voting policies appears to be another example of the increasing focus on ESG considerations, which are also being reviewed by other regulatory bodies such as the Department of Labor with respect to the management of ERISA plans.[10] As a result, registered advisers and registered funds may consider reviewing the above products and related disclosures as part of their 2021 annual review cycles.

  - **Registered Funds, Including Mutual Funds and ETFs** – The Examinations Division stated that its examinations of registered funds will focus on disclosures to investors, valuation,[11] filings with the SEC, personal trading activities, contracts and agreements, and will include a review of fund governance practices and compliance programs.

    Similar to prior years, the Examinations Division noted that it will prioritize examinations of mutual funds or ETFs that have not previously been examined or have not been examined in a number of years, and will generally focus such examinations on fund compliance programs and financial condition, particularly where funds have instituted advisory fee waivers. In addition, the Examinations Division stated that it will focus on compliance with exemptive relief, including for the newly created non-transparent, actively managed ETFs, and will also review funds' and advisers' disclosures and practices related to securities lending.

Practice Point: The Examinations Division also noted that it would focus on the liquidity risk management programs of mutual fund complexes, particularly to evaluate whether the programs are reasonably designed to assess and manage the funds' liquidity risk, and to evaluate the implementation of required liquidity classifications given the recent market stresses and volatility (such as those caused by the COVID-19 pandemic).

- **Registered Advisers to Private Funds** – Consistent with prior years, the Examinations Division will continue to focus on advisers to private funds, and will assess compliance risks, including a focus on liquidity and disclosures of investment risks and conflicts of interest. The 2021 examination priorities noted that over 36 percent of registered advisers manage private funds, and that the Examinations Division staff will continue to focus on advisers to private funds, and will assess compliance risks, including a focus on liquidity and disclosures of investment risks and conflicts of interest. For 2021, the Examinations Division stated that it will also focus on advisers to private funds that have a higher concentration of structured products, such as collateralized loan obligations and mortgage backed securities, to assess whether the private funds are at a higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors.

Practice Point: In light of recent economic conditions and market volatility following the onset of the COVID-19 pandemic, the Examinations Division also stated that it would examine advisers to private funds where such conditions may have resulted in material impacts on portfolio companies owned by the private fund (such as, for example, real estate-related investments).

Concluding Thoughts

The 2021 examination priorities offer key insights to registered advisers and registered funds, particularly their compliance personnel, as to regulatory and compliance matters on which the Examinations Division expects to focus as part of the 2021 examinations cycle. Registered funds and registered advisers may consider the 2021 examination priorities as "fair warning" of areas that are being emphasized this year and should consider addressing topics applicable to their business as part of their overall risk and compliance management process. That being said, the announced priorities do not represent an exhaustive list of the areas the Examinations Division will focus on with respect to registrants, so registered advisers and registered funds should continue to adopt a comprehensive, risk-based approach with respect to their compliance programs.

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Endnotes

1 SEC Division of Examinations: 2021 Examination Priorities (March 3, 2021), *available at* https://www.sec.gov/files/2021-exam-priorities.pdf

2 Press Release: SEC Division of Examinations Announces 2021 Examination Priorities (March 3, 2021), *available at* https://www.sec.gov/news/press-release/2021-39

3 Press Release: SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (March 4, 2021), *available at* https://www.sec.gov/news/press-release/2021-42

4 Press Release: Satyam Khanna Named Senior Policy Advisor for Climate and ESG (March 4, 2021), *available at* https://www.sec.gov/news/press-release/2021-20

5 *See also* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, IA Release No. 4889 (April 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf (the "Fiduciary Interpretation").

6 SEC Division of Examinations Risk Alert: The Division of Examinations' Continued Focus on Digital Asset Securities (Feb. 26, 2021), *available at* https://www.sec.gov/files/digital-assets-risk-alert.pdf. A Mayer Brown Legal Update on this risk alert with respect to investment advisers is available at https://www.mayerbrown.com/en/perspectives-events/publications/2021/03/sec-examinations-division-issues-risk-alert-regarding-digital-assets

7 *See* SEC Division of Investment Management, Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), *available at* https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm ; SEC Division of Investment Management, Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019), *available at* https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206 ; and SEC Division of Investment Management, Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), *available at* https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets

8 *See*, e.g., SEC Division of Investment Management IM Guidance Update No. 2017-02: Roboadvisers (February 2017), *available at* https://www.sec.gov/investment/im-guidance-2017-02.pdf See also the Fiduciary Interpretation.

9 SEC Division of Examinations Risk Alert: Examination Initiative: LIBOR Transition Preparedness (June 18, 2020), *available at* https://www.sec.gov/ocie/announcement/risk-alert-libor-initiative

10 On March 10, 2021, the Department of Labor (now under the Biden administration) announced that it would not enforce previously published final rules on "Financial Factors in Selecting Plan Investments" and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," which were published in November and December 2020, respectively, during the Trump administration. In a press release related to the announcement explaining why the Department of Labor was not enforcing these previously published rules, Principal Deputy Assistant Secretary for the Employee Benefits Security Administration Ali Khawar stated that "these rules have created a perception that fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments, and that they may need to have special justifications for even ordinary exercises of shareholder rights." He also stated that the Department of Labor "intend[s] to conduct significantly more stakeholder outreach to determine how to craft rules that better recognize the important role that ESG integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations." US Department of Labor, Press Release: US Department of Labor releases statement on enforcement of its final rules on ESG investments, proxy voting by employee benefit plans (Mar. 10, 2021), *available at* https://www.dol.gov/newsroom/releases/ebsa/ebsa20210310

11 On December 3, 2020, the SEC adopted a new rule under the Investment Company Act of 1940 that addresses valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered fund. *See* Good Faith Determinations of Fair Value, Investment Company Act Release No. 34128 (Dec. 3, 2020), *available at* https://www.sec.gov/rules/final/2020/ic-34128.pdf