

CLIENT ALERT

SEC Provides Further Transparency on Investment Adviser Examination Process

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Introduction

On September 6, 2023, the Division of Examinations (“Division”) of the U.S. Securities and Exchange Commission (“SEC”) published a Risk Alert discussing its process for selecting investment advisers for examination and determining the scope of the examination.¹ According to the Division, given the size and variety of the registered investment adviser population, the Division uses a risk-based approach for both selecting advisers to examine and determining the scope of the examinations.² This risk-based approach can generally consider “three buckets,” external inputs, internal inputs, and the Division’s own internal research.³ As discussed in more detail below, the Division leverages industry- and firm-level data and reviews disclosures and various regulatory filings such as Form ADV and Form PF to identify risks and better understand advisory businesses during examinations.

¹ See Risk Alert, [Investment Advisers: Assessing Risks, Scoping Examinations, and Requesting Documents](#), Securities and Exchange Commission Division of Examinations (Sept. 6, 2023) (the “Risk Alert”).

² The Division notes that its risk-based approach is dynamic and adapts to changes in market conditions, industry practices, and investor preferences. Investment advisers may be selected for an examination in order for the Division to evaluate risks relevant to the particular adviser, to respond to events that pose risks to investors and the broader market, and/or to assess how registrants are adapting to new regulatory requirements. See Risk Alert, at 1.

³ See Investment Management 2023: Current Issues & Trends, SEC Compliance and Examination Issues for Advisers and Funds, Practising Law Institute (July 25, 2023). In this PLI panel, Maryellen Maurer, a Senior Compliance Examiner at the SEC, discussed the Division’s risk-based approach to selecting advisers for examination. First, the Division considers “inputs from people other than [registrants].” Second, the Division considers “inputs from [the registrant].” Finally, the Division considers its “own internal research.”

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I. Assessing Risks and Scoping Examinations

A. Selecting Firms to Examine

When selecting advisers to examine, the Division considers whether advisers provide services, recommend products, or otherwise meet criteria relevant to focus areas described in the Division's annual publication of priorities.⁴ Additional reasons an adviser may be selected for examination include, but are not limited to, tips, complaints, referrals, or the Division's interest in a particular compliance risk area.

The Division also considers firm-specific risk factors, such as those related to an adviser's business activities, conflicts of interest, and regulatory history. For example, Division staff may consider the following when selecting an adviser for examination:

1. Prior examination deficiencies;
2. Supervisory concerns, such as disciplinary history of associated individuals or affiliates;
3. Conflicts of interest, such as outside business activities and the conflicts associated with advisers dually registered as, or affiliated with, broker-dealers;
4. Length of time since the firm's registration or last examination, such as advisers newly registered with the SEC;⁵
5. Material changes to an adviser's leadership or other personnel;
6. The adviser's vulnerability to financial or market stresses;
7. Reporting by news and media that may involve or impact the adviser;
8. Data provided by certain third-party data services;
9. Disclosure history of the firm; and
10. Whether the firm has access to client and investor assets and/or presents certain gatekeeper or service provider compliance risks.

⁴ See [FY 2023 Examinations Priorities](#), Securities and Exchange Commission, Division of Examinations (Feb. 7, 2023). For a discussion on the Division's 2023 priorities, please see our memo, [SEC Division of Examinations Releases Its 2023 Examination Priorities](#).

⁵ See Risk Alert, [Observations from Examinations of Newly-Registered Advisers](#), Securities and Exchange Commission Division of Examinations (Mar. 27, 2023) (discussing the typical focus areas reviewed during examinations of newly registered advisers and observations regarding compliance policies and procedures, disclosures, and marketing practices).

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B. Selecting Examination Focus Area

Once an adviser is selected for examination, additional risk assessment occurs to determine the scope of the examination by selecting particular areas of the business that examiners will review. The Division utilizes its “Strategy and Risk Team,” “Events in Emerging Markets Risk Team,” as well as other “Specialized Working Groups” to help the Division identify particular concerns and emerging issues in the market and to direct the focus of the exam.⁶ Accordingly, the scope of an examination and the documents requested will vary depending on the adviser’s business model, associated risks, and the reason for conducting the examination.⁷ However, examinations typically include reviewing an adviser’s operations, disclosures, conflicts of interest, and compliance practices for certain core areas, including custody and safekeeping of client assets, valuation, portfolio management, fees and expenses, and brokerage and best execution.

II. Selecting Documents to Request – Typical Information Requested

As part of the examination process, an adviser will typically receive a letter notifying the firm of the upcoming examination. The letter often contains an initial request list identifying certain information, including:

1. General information to provide the staff of the Division with an understanding of the adviser’s business and investment activities;
2. Information about the compliance risks that the adviser has identified and the written policies and procedures the firm has adopted and implemented to address each of those risks;
3. Information to facilitate testing with respect to advisory trading activities; and
4. Information for the Division staff to perform its own testing for compliance in various areas.

To assist advisers further, the Division provided the “Typical Initial Information Examiners Request of Investment Advisers” table, which is attached as Appendix A.

⁶ See Investment Management 2023: Current Issues & Trends, SEC Compliance and Examination Issues for Advisers and Funds, Practising Law Institute (July 25, 2023). During the panel, Maryellen Maurer noted that these specialized teams will help to recommend areas for the Division to examine, such as “artificial intelligence” or “firms [that] may have had exposure to regional banks in their custody filings.”

⁷ Requests for documents relating to background information, such as organizational charts, will be made in most examinations. See Risk Alert, at n.6.

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Conclusion

The Division's Risk Alert provides advisers with valuable insight into the examination process, beginning with an overview of the Division's risk-based approach to the selection of advisers and the scope of examinations, and ending with an overview of the typical initial information requests advisers may be subject to during the course of an examination. In light of the information detailed in the Risk Alert, SEC-registered advisers, including advisers that are newly registered, should be proactive in assessing their supervisory, compliance, and other risk management systems related to the risk considerations discussed to address and strengthen those systems ahead of future examinations.

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Appendix A: Typical Information Examiners Request of Investment Advisers

Described below are the types of initial information, including documents, that the Division staff may request and review during a typical examination of an adviser that does not engage in additional activities and/or have additional relationships (e.g., manage private funds).

| General Information | |
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| Organizational Information | <ul style="list-style-type: none">• Organizational structure, affiliations, and control persons.• Remote offices and branch locations.• Joint ventures or other businesses (including those with respect to the firm or any officer, director, portfolio manager, or trader).• Current and former supervised persons, officers, and/or directors. |
| Business and Operations | <ul style="list-style-type: none">• Committees (e.g., responsibilities, members, meeting frequency, and meeting minutes).• Client advisory contracts or agreements.• Agreements and arrangements with third parties associated with the management of client accounts (e.g., sub-advisers, third-party managers, referrals, wrap fee programs, and third-party investment platforms used for clients).• Fees and payments for services rendered.• Power of attorney obtained from clients.• Service providers and the services they perform. |
| Disclosures and Filings | <ul style="list-style-type: none">• Disclosure documents and filings with regulators (e.g., Form ADV, including the brochure, and Form CRS). |
| Legal and Disciplinary | <ul style="list-style-type: none">• Threatened, pending and settled litigation, arbitration, or administrative proceeding involving the adviser or any supervised person.• Remedial actions taken against supervised persons. |

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| Information Regarding the Compliance Program, Risk Management, and Internal Controls | |
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| Compliance Program and Oversight Process | <ul style="list-style-type: none">• Compliance policies and procedures in effect during the examination period.• Tests performed (i.e., compliance reviews, quality control analyses, surveillance, and/or forensic or transactional tests performed by the firm).• Compliance consultant reports resulting from a review of compliance policies and procedures, operations, or books and records.• Annual and/or interim reviews of policies and procedures, including any reports prepared.• Record of compliance exceptions.• Remote office and/or independent advisory contractor oversight process.• Client complaints and correspondence and the process for monitoring such communications, including electronic communication.• Inventory of compliance risks and conflicts of interest that forms the basis for policies and procedures, and notations regarding changes made to the inventory.• Written guidance and training provided to employees regarding compliance program and documentation of attendance. |
| Valuation | <ul style="list-style-type: none">• Valuation process.• Pricing services, quotation services, and externally acquired portfolio accounting systems used in the valuation process and payment information.• Fair-valued and illiquid securities held by clients.• Advisory fee calculations.• Pricing overrides. |

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| Information Processing, Reporting, and Protection | <ul style="list-style-type: none"> • Safeguards for the protection of customer records and information. • Electronic access controls. • Business continuity plan. • Cybersecurity incidents or breaches (e.g., incident description, impact, and remediation). |
| Information to Facilitate Testing with Respect to Advisory Trading Activities | |
| Information About Advisory Clients and Accounts | <ul style="list-style-type: none"> • Current advisory client account information regarding: account inception, type, balance, and management discretion; client demographic information; client affiliation with the firm; custodial arrangements; firm authority with respect to the account (e.g., trading authority, custody, and trustee); services provided; investment strategy and investment objectives; portfolio manager; fee computation; fee payment arrangements; and consultant related to obtaining the client, if any. • Advisory clients lost during review period. |
| Portfolio Management | <ul style="list-style-type: none"> • Securities held in all client portfolios, including information identifying each client holding an interest, the amount owned by each client, the aggregate number of shares or principal and/or notional amount held and total market value of the position. • Information about certain types of client investments (e.g., private investments and initial public offerings). • Publicly traded companies for which employees of the adviser or its affiliates serve as officers and/or directors. • Companies for which employees of the adviser or its affiliates serve on creditors' committees. • Outside compensation to supervised persons, including compensation related to client's transactions or investments. |

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| | <ul style="list-style-type: none"> • Client portfolio profile information (e.g., investment objectives, investment strategy, risk tolerance, suitability, and mandates). |
| Brokerage and Trading | <ul style="list-style-type: none"> • Trade blotter. • Brokerage arrangements and best execution evaluation documentation. • Soft dollar budget and products and services obtained using clients' brokerage commissions. • Commission-sharing arrangements. • Affiliated broker-dealers. • Principal trades and cross-transactions. • Wrap fee programs. • Trade errors and related information. • Trade allocation information regarding initial public offerings and secondary offerings in which clients, proprietary accounts or access persons participated. |
| Conflicts of Interest and Insider Trading | <ul style="list-style-type: none"> • Code of Ethics and insider trading policies and procedures for the firm and its affiliates. • Code of Ethics attestations. • Exemptions from Code of Ethics for supervised persons. • Reports of securities transactions reported by access persons. • Fee splitting or revenue-sharing arrangements. |
| Information to Perform Testing for Compliance in Various Areas | |
| Marketing and Advertising | <ul style="list-style-type: none"> • Advertisements and marketing materials disseminated, including newsletters, public audio and video programs, pitch books, pamphlets, brochures, |

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| | <p>websites, blogs, social media, and other promotional and/or marketing materials used.</p> <ul style="list-style-type: none">• Client or investor meeting materials and presentations.• Sponsored and attended seminars or events.• Client performance information.• Composite performance information, including current and terminated composites and composite returns.• Requests for proposal, due diligence questionnaires, and any other questionnaire (e.g., third-party consultant database or other performance database).• Testimonials and endorsements, including payments made and compensation received.• Third-party ratings and rankings. |
| Financial Records | <ul style="list-style-type: none">• Balance sheet, trial balance, income statement, and cash flow statements.• Cash receipts and disbursements journal.• General ledger and chart of accounts.• Loans and sales of firm or affiliate's stock. |
| Custody | <ul style="list-style-type: none">• Custodian identification and contact information for entities that maintain custody of client assets.• Surprise examination documentation, such as engagement letters, client account lists, and reports, results, and recommendations.• Auditor engagement letters, opinions, and findings.• Custodial confirmation of positions for specific clients. |

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