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SEC Provides Parameters on the Risk-Based Approach for Selecting Registered Investment Advisers for Examination

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On September 6, the Securities and Exchange Commission (SEC) issued a risk alert, which detailed the factors the division considers in its risk-based approach for selecting SEC-registered investment advisers (advisers) to examine. The SEC has highlighted that their risk-based approach is dynamic and regularly adapts to market shifts. This client alert is intended to summarize those risk factors in order for advisers to best prepare for an examination.

Selecting Firms to Examine

The SEC staff provided several factors that they use to determine how the division selects firms to examine, including the following:

- **The firm's risk characteristics.** An adviser may be selected in order for the division to evaluate the firm's specific risks, to respond to market changes and events that pose risks to specific investors affiliated with the firm, and to review advisers' compliance with new regulatory requirements.
- **A tip, complaint, or referral about the firm.**
- **The division's interest in a particular compliance area.** The SEC provides its priorities on an annual basis, which the division believes presents potential risks to investors and capital markets. These priorities can relate to certain products, business operations, services, or practices. In 2023, a few of the noteworthy SEC priorities, amongst others, included compliance with the new marketing rule (Advisers Act Rule 206(4)-(1)) and a review of ESG-related advisory services.
- **Firm-specific risk factors, including:**
 - A firm's prior examinations, such as its recurring deficiencies during exams or fee and expenses-related issues;
 - Disciplinary history of associated affiliates and individuals;

- Business activity of the firm that may result in conflicts of interest;
- The length of time since the firm’s registration or last examination (such as newly registered advisers);
- Material changes in a firm’s personnel or leadership;
- Indications that a firm may be particularly vulnerable to market stressors or financial strain;
- News and media reports concerning the firm;
- Data provided to the SEC by third-party data services;
- History of a firm’s disclosures; and
- Whether the firm has access to specific client and investor assets that present a compliance risk.

Selecting Examination Focus Areas and Documents

Once the SEC staff identifies which firms they will examine, the division will perform additional risk assessments to determine the particular areas the examiners will plan to review. The scope of a risk-based examination will vary from firm to firm, and the areas of examination will depend on the firm’s business model, affiliated risks, and the SEC’s reasoning for conducting the examination with the specific firm. Examinations typically include assessing advisers’ disclosures, conflicts of interest, compliance policies, operations, fees, expenses, and other related areas. Throughout the course of these examinations, the examiners are assessing an adviser’s risks, conflicts, and compliance. Once the examiners have determined the focus areas for an exam, the examiners will make an initial request list for information required for their review.

Should you have any questions related to the items discussed in this article or regarding your legal and compliance obligations, please do not hesitate to contact any of the authors listed. Our attorneys remain committed to assisting you with your legal needs.

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