



## SEC³ 2024 Predictions

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We hope that everyone is enjoying the new year. As we witnessed last October, the SEC's Division of Examinations ("EXAMS") issued its [annual examination priorities](#). This was the earliest release in its 10-year history of publishing these priorities. The SEC continues to remind firms to prepare for upcoming examinations and shares focus area, but how will this play out in the year ahead? What will examiners expect specifically? With 2024 underway, we wanted to share our thoughts and predictions on regulatory matters for the year.

### **Regulation Best Interest**

For investment advisers, the SEC announced its intent to focus on an adviser's fiduciary obligations and the disclosure of conflicts of interest, as noted in its 2024 Examination Priorities ("Exam Priorities"). The SEC staff also issued a [Bulletin](#) discussing the care obligations of investment advisers and broker-dealers under the fiduciary standards and Regulation Best Interest, respectively. The first FAQ in that bulletin stressed the staff's belief that "[u]nder the care obligations, investment advisers, broker-dealers, and their financial professionals need to understand the investments and investment strategies on which they provide advice and recommendations before advising on or recommending them to retail investors." Advisers and broker-dealers should be prepared to document how they developed a sufficient understanding of the potential risks, rewards, and costs of an investment or investment strategy to back up their recommendations. The SEC will focus on investment advice provided to clients as it relates to products, investment strategies, and account types, such as the following:

- Complex products – derivatives and leveraged ETFs.
- High cost and illiquid products – variable annuities and non-traded REITs.
- Unconventional strategies – intended to address rising interest rates; and
- Investment advice to older investors and those saving for retirement.

Advisers should document their policies and procedures for determining investment advice in the client's best interest, including evidence that their financial professionals have received specialized training for more complex investments. Additionally, firms should have a documented process for making initial and ongoing suitability determinations.

EXAMS also noted in its Exam Priorities that it will continue to examine conflicts of interest. EXAMS staff will review advisers' economic incentives when recommending specific products, services, or account types. The SEC will also scrutinize advisers who are dually registered as broker-dealers, who use affiliated firms to perform client services, and who provide advice regarding proprietary products that result in additional or higher fees.

EXAMS will continue its focus on firms' policies and procedures. Specifically, EXAMS emphasized that it will be looking closely at whether firms have adopted appropriate written policies and procedures to address compensation structures, alternative ways advisers attempt to maximize revenue, and current market risks. Additionally, the SEC remains vigilant in reviewing valuation assessments by advisers making investment recommendations on illiquid and difficult-to-value assets. The SEC will also scrutinize advisers' controls to protect clients' material, non-public information. Predictably, the SEC will also closely examine the accuracy and completeness of regulatory filings.



Additional compliance program areas of focus from the SEC are the following:

- Firms' policies and procedures for selecting and using third-party and affiliated service providers.
- Overseeing branch offices; and
- Obtaining informed consent from clients when advisers implement material changes to their advisory agreements.

### ***SEC<sup>3</sup> Predictions and Recommendations***

1. The SEC Staff will expect that investment professional should develop a "sufficient understanding of the potential risks, rewards, and costs of the investment or investment strategy to have a reasonable basis to believe that the recommendation or advice could be in a retail investor's best interest."
2. The Staff will follow up during exams to ensure that investment professionals don't just rely on a firm's approved list. They are responsible for personally understanding the investment before making a recommendation. Factors to be considered include initial and ongoing costs, the investment's key characteristics and risks, including liquidity or volatility, the investment's performance under various market conditions, and the role of the investment as part of the retail investor's overall portfolio. Ensure these factors are part of the investment product and strategy approval process. Firms should also have evidence that investment professionals receive training, especially when offering more complex investments.
3. Although "no" may not be part of an investment professional's vocabulary, turning down clients who cannot provide the answers required to develop a full financial profile may be necessary. We predict the SEC will request lists of prospective clients that were turned away. Also don't worry, look how well it worked for Madoff when he turned away investors. If you turn some clients away, you may just get the answers you seek and grow your business faster.
4. We predict that the SEC will expect firms to consider a broad array of investments or investment strategies that are generally consistent with the client's investment profiles. Once this universe is identified, the firm should have a process to define the scope of alternatives that should be considered and the factors that should be weighed (e.g., costs, potential benefits, and risks, as well as compatibility with the retail investor's investment profile) in evaluating the available alternatives.

### **Private Fund Advisers**

Unsurprisingly, the SEC will continue its intensive examination of private fund advisers. The SEC has aligned its priorities with its rulemaking activity, as we witnessed from last year's adoption [of new rules and amendments to enhance the regulation of private fund advisers](#)<sup>1</sup>. As noted in the Exam Priorities, private funds advisers should address the following risk items and areas of concern:

- Portfolio management risks, when private funds experience poor performance, significant withdrawals, valuation issues, and funds with more leverage and illiquid assets.

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<sup>1</sup> "SEC Enhances the Regulation of Private Fund Advisers"



- Adherence to investment management agreements, including requirements to consult a Limited Partner Advisory Committee (“LPAC”) and any contractual notification and consent processes.
- Calculation and allocation of private fund fees and expenses, including valuation of illiquid assets, calculation of post-commitment period management fees, adequacy of disclosures, and potential offsetting of such fees and expenses.
- Adherence to due diligence practices and consistency with policies, procedures and disclosures.
- Monitoring conflicts, controls, and disclosures for funds managed side-by-side with Registered Investment Companies and the use of affiliated service providers.
- Compliance with custody requirements, including accurate Form ADV reporting, timely completion of private fund audits, and distribution of audited financial statements; and
- Adoption of policies and procedures for reporting on Form PF.

### ***SEC³ Predictions and Recommendations***

1. The SEC will continue to look for areas where private fund managers fail to treat investors fairly. Therefore, you should up your game. EXAMS staff will look at the above-referenced areas with a microscope, so make sure you have policies and procedures to address them.
2. We predict that examiners will ask where you are with regard to your preparation for upcoming rules. Get ready for the new rules. Advisers Act Rule 211(h)(2)-3, the Preferential Treatment Rule and Rule 211(h)(2), the Adviser-led Secondaries Rule, go into effect for larger private fund advisers in September 2024. Ensure you have policies and procedures in place before the deadline.
3. We predict that exams will include reviewing new Form PF triggering events. Required Reporting for Hedge Fund Managers. Large hedge fund advisers must report certain events on Section 5 of Form PF within 72 hours of their occurrence, including extraordinary investment losses, margin defaults, significant disruption or degradation of a fund’s critical operations, and large withdrawal and redemption requests. (See [Adopting Release](#) for details.) This requirement went into effect on December 11, 2023. Large hedge fund advisers should develop processes for monitoring these triggering events and be ready to make the required filings.
4. We predict that the SEC will be on the lookout for compliance with reportable event requirements. Private Fund Managers have new Quarterly Report Obligations. Private fund managers must file quarterly reports if “Reportable Events” occur on new Section 6 of Form PF within 60 days of a fund’s fiscal quarter end, starting with the first quarterly filing due after December 11, 2023 (February 29, 2024). Reportable events include adviser-led secondary transactions and situations where the limited partners vote to (i) remove the fund’s adviser or affiliate as the general partner, (ii) terminate the fund’s investment period, or (iii) terminate the fund during the preceding quarter.

### **Marketing Rule**

Last year, investment advisers endured the first full-year implementation of the new Marketing Rule. Unsurprisingly, the SEC will continue to prioritize assessing advisers’ adherence to the rule through routine compliance examinations and limited sweep examinations. We predict that the SEC will continue to



proceed with their examination efforts similar to what we learned last September when EXAMS announced [sweep exams that resulted in Marketing Rule violations against nine investment advisers](#)<sup>2</sup>.

To avoid a similar fate, advisers should adopt and implement written policies and procedures for compliance with the rule. Additionally, with Form ADV season underway, advisers should determine whether they have appropriately disclosed all information related to their marketing efforts. Lastly, advisers should maintain substantiation and documentation of their processes and other required books and records.

### ***SEC<sup>3</sup> Predictions and Recommendations***

1. We predict that examiners will conduct testing in line with EXAMS risk alerts on Marketing Rule focus so you should too. EXAMS issued two risk alerts highlighting the areas under the Marketing Rule that will receive extra attention; see [Risk Alert: Examinations Focused on the New Investment Adviser Marketing Rule](#) and [Risk Alert: Examinations Focused on Additional Areas of the Adviser Marketing Rule](#). Firms should review these risk alerts carefully and compare their current policies and procedures to the SEC's expectations.
2. The SEC has set the bar high for investment advisers and we predict examiners will expect firms to have evidence to support their advertising claims. The SEC will review and ask who is responsible for maintaining backup for "statements of fact" and then test to ensure that information is being maintained.  
Maintain evidence. The Marketing Rule includes seven prohibitions on distributing advertising materials that use words like "untrue statement and omissions," "unsubstantiated material statement of fact," and "untrue or misleading implications or inferences."
3. We predict that the SEC will review to ensure firms include information on risks and limitations of investment strategies in advertisements and take special care when targeting retail investors.

Confirm that marketing materials include information on risks and limitations. The SEC repeated "fair and balanced" three times in the Marketing rule, which is important. The SEC will review to ensure firms include information on risks and limitations of investment strategies in advertisements and take special care when targeting retail investors.

### **Cybersecurity**

The SEC has been worried about investment adviser cybersecurity compliance and controls since 2014, and this year is no different. The Commission continues highlighting the importance of cybersecurity, information security, and operational resiliency. Nearly two years ago, the SEC released a new rule proposal for [Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies](#)<sup>3</sup>. The rule was subject to two comment periods, and final action on the proposal was supposed to be announced in April of last year. Then, based on updates to its rulemaking agenda announced in July, the SEC delayed the approval of the Cybersecurity Risk

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<sup>2</sup> "SEC Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisers"

<sup>3</sup> "Cybersecurity Risk Management for Investment Advisers, Registered investment Companies, and Business Development Companies"



Management Rule until October of last year. However, October came and went, and the Commission remained silent on adopting the Cybersecurity Risk Management Rule. The SEC intends to adopt the rule in April based on the latest regulatory agenda.

### ***SEC³ Predictions and Recommendations***

- 1- The SEC will continue to focus on the firm's cybersecurity policies and procedures, internal controls, governance practices, and responses to cyber-related incidents. Exams will include questions related to how firms identify and assess risks essential to business operations from third-party vendors and service providers.
- 2- Lastly, in the continued remote work environment, the SEC will continue to examine how firms protect their data from cyber-attacks and safeguard client information, especially firms with multiple branch offices.
- 3- We predict the roll-out period to be like the new Marketing Rule implementation, allowing several months for firms to implement the requirements fully. We also expect that the SEC will assume that advisers do not have to start from scratch, as advisers should already have adequate Cybersecurity programs.

### **Electronic Communications**

Maintaining and preserving electronic communications continues to be a hot topic for the SEC. We have witnessed many cases involving large firms being cited for widespread recordkeeping failures with electronic communications. In August 2023, the [SEC charged 11 firms with widespread recordkeeping failures related to electronic communications](#)<sup>4</sup>. With average penalties exceeding \$48 million, the SEC is sending a message.

### ***SEC³ Predictions and Recommendations***

1. We predict that the SEC will continue to prioritize [Rule 204-2\(a\)\(7\)](#), which requires advisers to retain certain records of written communications. Unlike broker-dealers, however, advisers' record-keeping obligations are limited to communications relating to (i) investment advice, (ii) receipt, disbursement or delivery of funds and securities, (iii) securities orders, and (iv) predecessor performance. In addition to ensuring required communications are being retained and archived, advisers must also stay current on the ever-changing landscape of technology and communication. Advisers must ensure that employees are not communicating securities-related business matters on unofficial channels where the records are not archived. Furthermore, advisers must also conduct reviews to identify potential violations of securities laws and the firm's policies and procedures. As we continue to witness case after case from the SEC, firms need to have a handle on how their employees communicate firm-related business.
2. We predict that the SEC will review your employee inquiries. Find out what apps your employees are using. Firms should know what apps their employees are using and why. With that information, they can decide what they can reasonably expect to monitor and retain with their

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<sup>4</sup> "SEC Charges 11 Wall Street Firms with Widespread Recordkeeping Failures"



available resources. **Find out where your gaps are.** Firms should be capturing all electronic communications channels employees use for official business. If the firm uses instant messaging apps, are they being captured and monitored?

3. We predict the SEC will ask about your training in this area. It is essential to educate employees about the firm's electronic communications policy and the potential penalties for non-compliance.
4. We predict the SEC will look for potential "off-channel" communications during exams. If emails or other electronic messages indicate employees are communicating firm business outside of the regular channels, the compliance team should investigate. As many recent cases have shown, annual employee certifications using approved communication channels are insufficient.

### **Crypto and Emerging Financial Technologies**

According to the Exam Priorities, EXAMS will focus on firms that offer crypto assets or related products. Specifically, the SEC will ensure that firms meet respective standards and suitability requirements when recommending or advising clients on crypto assets.

### **SEC<sup>3</sup> Predictions and Recommendations**

- 1- We predict that the SEC will remain vigilant on crypto securities and financial technology tools. Firms making recommendations in crypto assets should ensure that they maintain and document initial and ongoing monitoring of applicable products. In addition, advisers should routinely review, update, and enhance their compliance practices, risk disclosures, and operational resiliency practices.
- 2- The SEC will monitor the increased use of technological and automated online solutions. Advisers using automated investment tools, artificial intelligence, and trading algorithms or platforms should be ready to provide evidence that their use of such technology meets the fiduciary standard, especially when used with retail and retirement investors.
- 3- EXAMS will prioritize assessing the technological risks associated with using blockchain and distributed ledger technology. Advisers have been warned and should ensure that they have adopted and implemented appropriate written policies, procedures, and risk disclosures.
- 4- The SEC will remain hostile toward crypto assets, so firms offering these investments to their clients should review [EXAMS Risk Alert: The Division of Examinations' Continued Focus on Digital Asset Securities](#). Although issued in 2021, the advice remains sound and reminds advisers to fully understand and evaluate digital assets before recommending them to clients.

2024 proves to be another busy year for the SEC. It's hard to imagine this administration slowing down compared to the previous years, especially during an election year. We predict more rule proposals, adoptions, and, of course, a steady drumbeat of cases referred to enforcement.

SEC<sup>3</sup> can assist investment advisers with managing their compliance programs. SEC<sup>3</sup> works with clients to develop a tailored partnership that meets all needs. Additionally, SEC<sup>3</sup> is the first step towards a headache-free examination.

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