



# Perspectives on SEC examination priorities

Prepared for asset management firms  
and private funds

Third Quarter 2023

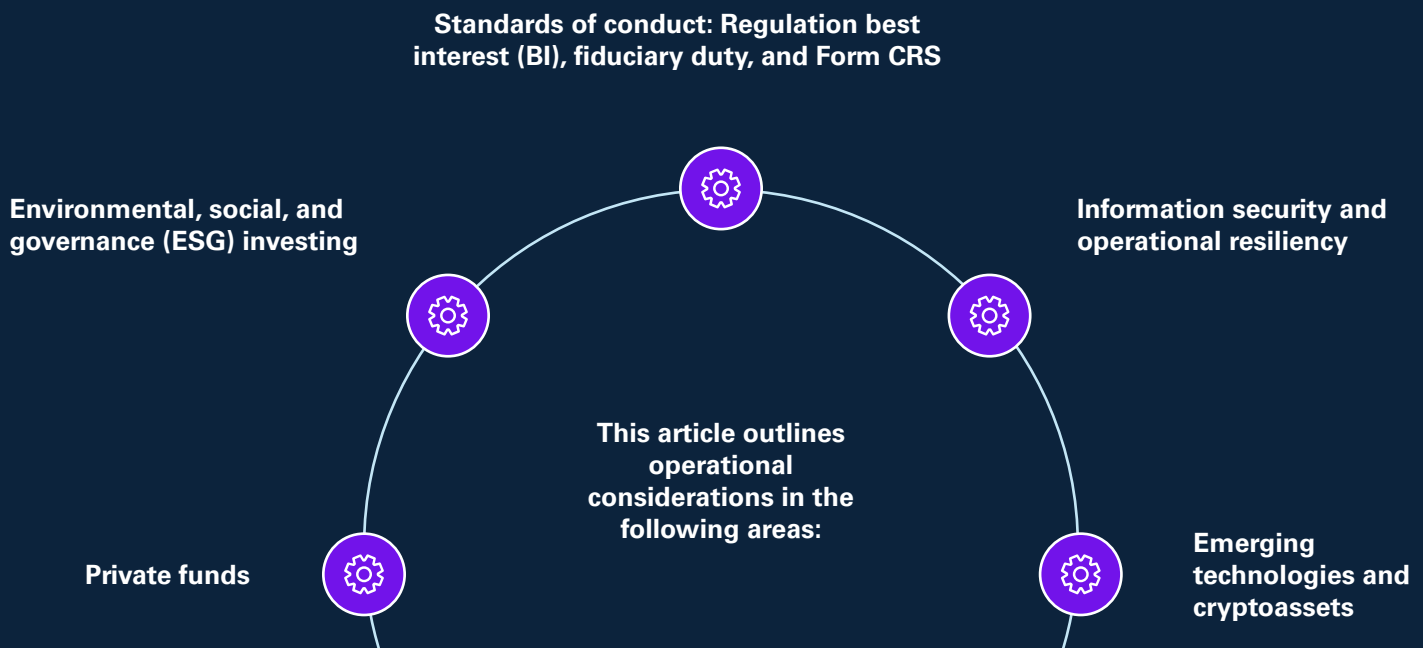
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# High-priority regulatory and risk topics

The asset and wealth management industry faces challenges that cut across all aspects of the business. Compliance programs must adapt and stay out front, partnering with the business to proactively identify and mitigate risk. **KPMG is highlighting six Securities and Exchange Commission (SEC) areas of focus to watch out for** and considerations for how asset and wealth management firms can navigate this newly energized regulatory environment.

Each of these high-priority regulatory and risk topics will impact board members, senior management, and employees in virtually every area of asset and wealth management activities, such as risk, compliance, product development, information technology, third-party risk management, portfolio management, trading, and regulatory reporting, among others.



## Regulatory priorities at a glance

Below are some high-priority topics anticipated to significantly impact the asset and wealth management industry.

### High-priority topics



#### Registered investment advisers (RIAs) to private funds

Private funds represent a significant portion of the asset allocations of pensions, charities, and endowments, hence the critical focus on private fund fee and expense arrangements, valuation practices, conflicts of interest, and fair and equal treatment and disclosures to all investors. Additionally, the SEC and Commodity Futures Trading Commission (CFTC) jointly propose to amend private fund reporting (Form PF) requirements to keep pace with evolving business practices and complexity of fund structures and investment strategies.

#### Emerging technologies and crypto assets

Heightened concerns around custody arrangements and firms' practices relating to the offer, sale, recommendation, advice, and trading of digital assets. Expected regulatory scrutiny will be around investment companies—including mutual funds and exchange traded funds (ETFs)—offering digital asset exposure and their practices for managing compliance and operational risks.

#### Information security and operational resilience

Information security and operational resilience are inextricably and increasingly linked as cybersecurity events become more frequent and more sophisticated. The SEC, through statements and proposed regulation, has signaled a strong focus on both cybersecurity and overall resilience concepts by expanding coverage and strengthening requirements of existing rules. Given these risks and concerns, cybersecurity remains a perennial focus area for registrants, including RIAs, broker-dealers, investment companies, municipal advisers, transfer agents, exchanges, and clearing agencies.

#### ESG investing

Continued focus on ESG-related products and services for asset management firms will be on (1) accurate disclosures of investment policies; (2) whether the funds are operating in the manner set forth in their disclosures; and (3) assessing whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in investors' best interests.

#### Regulation best interest (Reg BI)

The SEC expects Reg BI and fiduciary compliance programs to be robust. As such, the firms are expected to enhance their compliance frameworks, monitoring, and testing methodology and implement credible procedures to mitigate potential conflicts of interest. The SEC will focus on broker-dealers' recommendations involving complex products, advisers' recommendations in high-fee products, and where those activities may present conflicts of interest that interfere with their abilities to act in customers' best interests.

#### Compliance with recently adopted rules under the Investment Advisers Act and Investment Company Act

The SEC recently adopted several significant new rules. The SEC will prioritize examining for compliance with the "Marketing Rule," the "Derivatives Rule," and the "Fair Valuation Rule."



# KPMG insights into areas of regulatory focus

For each of the focus areas listed below, we would like to provide our perspectives on:

- 1 **Why these have become important areas of concern to the SEC**
- 2 **How each focus area presents new risks and challenges to investment management business models**
- 3 **Highlights on how these developments, risks, and challenges are impacting the compliance risk functions**
- 4 **What firms should focus on to address these industry dynamics, risks, and challenges.**

Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>Private fund market is growing</b></p> <ul style="list-style-type: none"> <li>The SEC noted that more than 5,500 RIAs, totaling over 35 percent of all RIAs, manage approximately 50,000 private funds with gross assets exceeding \$21 trillion.</li> </ul> <p><b>The SEC has finalized amendments to Form PF</b></p> <ul style="list-style-type: none"> <li>The SEC finalized Form PF requirements, expanding the data the SEC plans to collect from private fund advisers.</li> <li>The final rule includes investor reporting around fees and expenses, performance calculations, and disclosures; prohibitions on accelerated monitoring fees and non-pro rata allocations; all fund investors to be fully informed over any preferential terms offered to any investor(s); issuance of "Fairness Opinions" on certain affiliated fund transactions; and a requirement for a written annual compliance review.</li> <li>The SEC added it will be reviewing the risks associated with investing in SPACs.</li> </ul>	<p><b>Amendments to Form PF</b></p> <ul style="list-style-type: none"> <li>The SEC and CFTC jointly proposed amendments to Form PF that would expand reporting requirements for certain SEC-registered investment advisers to private funds that are also registered with CFTC as a commodity pool operator or commodity trading adviser, concerned with the growth and complexity of private fund structures and investment strategies and exposures.</li> <li>If adopted, regulators would have enhanced ability to monitor systemic risk and bolster the oversight of private fund advisers.</li> </ul> <p><b>Valuation vulnerabilities</b></p> <ul style="list-style-type: none"> <li>Private funds with large debt balances may be susceptible to correction if rising inflation sends interest rates sharply higher; even relatively small pullbacks could have outsized impacts on assets.</li> <li>The SEC's focus on principles of fairness and competition could separately impose impacts on valuations.</li> </ul>	<p><b>Review investor reporting</b></p> <ul style="list-style-type: none"> <li>Closely review disclosures to investors (via Form ADV or otherwise) regarding audit, auditors, risk management practices, and trading with large private fund counterparties.</li> <li>Test current reporting workflows.</li> <li>Consider opportunities for automation.</li> </ul> <p><b>Consider relationships with service providers</b></p> <ul style="list-style-type: none"> <li>Especially in light of the SEC's vendor oversight proposal, review third-party service providers.</li> <li>Review relationships that involve (1) conflicts of interest; (2) calculation and allocation of fees and expenses; (3) compliance with the new "Marketing Rule," including compensated testimonials and endorsements; (4) policies and practices regarding the use of alternative data; and (5) compliance with the Advisers Act Rule 206(4)-2 (Custody Rule), including selection of permissible auditors.</li> </ul>	<p><b>Improved reporting will assist with compliance with SEC focus</b></p> <ul style="list-style-type: none"> <li>The SEC's focus areas, understandably, are informed by recent events such as the rise (and fall) of special-purpose acquisition company (SPAC) issuance in 2021 and collapse of a large family office.</li> <li>Other focus areas, such as fee and expense allocation, may sound familiar, but the SEC is looking into new, specific subtopics, such as conflicts of interest when imposing gates or suspensions on fund withdrawals, and RIA-led fund restructurings.</li> </ul> <p><b>Fast-growing firms could be targeted</b></p> <ul style="list-style-type: none"> <li>The SEC alluded to the rate of growth of RIAs to private funds as a reason for focusing on such RIAs.</li> <li>RIAs that saw a rapid growth in AuM may want to conduct mock examinations in advance of SEC examinations.</li> </ul>

Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>ESG continues to increase for RIAs and registered funds</b></p> <ul style="list-style-type: none"> <li>Industry is trying to meet investor demand for ESG strategies and investments.</li> <li>Demand in ESG has created disclosures being materially false or misleading or omitted altogether.</li> </ul>	<p><b>The SEC will focus on ESG-related areas such as:</b></p> <ul style="list-style-type: none"> <li>Accurate disclosures around stated ESG investing approaches with adopted policies and procedures</li> </ul>	<p><b>Compliance programs should be consistent and integrated</b></p> <ul style="list-style-type: none"> <li>Policies and procedures must address how ESG is addressed and approached as a firm, including terms, disclosure, and investment usage.</li> </ul>	<p><b>Flexibility and industry practices will support ESG initiatives</b></p> <ul style="list-style-type: none"> <li>Compliance programs should be prepared for changing demands around ESG from internal business groups, investors, and regulators.</li> </ul>

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<p><b>Observations on how ESG investing is being incorporated include:</b></p> <ul style="list-style-type: none"> <li>Lack of standard ESG investing terminology</li> <li>Various approaches to ESG investing and the degree of focus on ESG factors</li> <li>Failure to address legal and compliance (i.e., are funds actually considering ESG factors the way they are disclosing?).</li> </ul> <p><b>The SEC is proposing new ESG disclosure requirements</b></p> <ul style="list-style-type: none"> <li>ESG funds would be required to make disclosures in fund governing documents and various investor reports.</li> <li>Funds would have to disclose portfolio company greenhouse gas emissions, and certain funds would have to disclose information about their proxy voting.</li> </ul>	<ul style="list-style-type: none"> <li>Related advisory services and fund offerings/whether the funds are operating in the manner set forth in their disclosures</li> <li>Assessing whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in investors' best interests.</li> </ul>	<ul style="list-style-type: none"> <li>Compliance should have periodic reviews, testing, and controls to monitor ESG across the firm.</li> <li>Business and compliance need to collaborate on new business initiatives and solutions in training and implementing ESG criteria as it evolves.</li> </ul>	<ul style="list-style-type: none"> <li>Large associations such as the Investment Company Institute will continue to urge the SEC to conform to a grassroots approach of leading practices around ESG.</li> </ul> <p>A minimal requirement for compliance is to meet SEC focus areas and build additional controls and processes around those that suit business and investor needs.</p>

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## Standards of conduct: Reg BI, fiduciary, and Form CRS

Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>Reg BI went into effect in June 2020</b></p> <p>The SEC's continuing focus on standards of conduct for broker-dealers and RIAs will address how broker-dealers and RIAs demonstrate acting in the best interests of retail investors through compliance with requirements under Reg BI and the Advisers Act fiduciary standard.</p> <p><b>Broker-dealers and RIAs must provide a relationship summary (Form CRS)</b></p> <p>The SEC is concerned with how disclosures are made to clients, and Form CRS is a critical component of those disclosures. The substance of the Form CRS, and delivery thereof, will be focus areas in 2023.</p>	<p><b>Risk complacency</b></p> <p>Firms are advised to demonstrate credible challenges, including the adequacy of risk assessments and the monitoring and adjustment, as needed, of internal controls related to Reg BI, including:</p> <ul style="list-style-type: none"> <li>Appropriate stature of risk, compliance, information security, and audit that is comparable to other strategic functions, including the quality of autonomy, empowerment, and visibility</li> <li>Dynamic, metric-driven risk models to determine technology, operational, and risk resources needed to keep pace with the changes in the business.</li> </ul>	<p><b>Compliance programs readiness for increased regulatory scrutiny</b></p> <ul style="list-style-type: none"> <li>Policy and procedure framework</li> <li>Evidencing cost analysis and alternative investment considerations to form "reasonableness basis" determinations</li> <li>Improved training of front-line staff</li> <li>Ensure that practices align via ongoing reviews, testing, and audits.</li> </ul>	<p><b>Designing the right tools for compliance</b></p> <p>Firms are evaluating introducing more innovative monitoring techniques and data analytics into Reg BI compliance program.</p> <p><b>Invest in data-driven risk automation, analytics, and process efficiency</b></p> <ul style="list-style-type: none"> <li>Firms require access to relevant sources of data to allow for effective monitoring and/or testing of policies, controls, and transactions.</li> <li>They can use data analytics flag potential issues.</li> </ul>



Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>The SEC brought its first Reg BI enforcement action in June 2022</b></p> <p>The SEC is detecting deficiencies in firms' Reg BI compliance programs and can be expected to apply lessons learned while conducting examinations going forward.</p>	<p><b>Difficult to demonstrate how complex products are in clients' best interests</b></p> <p>Many "complex" products can be difficult to analyze and, therefore, can be difficult to find reasonably available alternatives. Firms should have a reasonable framework for analyzing these products and documenting the rationale behind recommendations and comparison to alternatives.</p>		<p><b>Monitor and test new product onboarding, recommendations, and disclosures</b></p> <p>Well-designed monitoring and testing of Reg BI-related processes can be an effective tool in uncovering weaknesses in the firm's compliance program.</p>

Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>Cybersecurity and resilience take center stage</b></p> <ul style="list-style-type: none"> <li>Several high-profile disruptions to business activities caused by cybersecurity or operational issues, along with a heightened focus on investor protection, have put the spotlight on the programs that firms use to protect data and keep processes running smoothly.</li> <li>The current risk environment related to cybersecurity is considered elevated given the larger market events, geopolitical concerns, and the proliferation of cybersecurity attacks, particularly ransomware attacks.</li> </ul> <p><b>Regulators are proposing new rules</b></p> <ul style="list-style-type: none"> <li>The SEC has developed several proposed rules, including, but not limited to, (1) an expansion of the scope of Reg SCI to further strengthen resiliency of technology infrastructure in the U.S. securities markets; and (2) cybersecurity risk management rules for public companies, investment advisers, and funds.</li> <li>The SEC proposals will focus on new and expanded reporting of cybersecurity incidents and practices.</li> <li>Meanwhile, several regulators continue to develop operational resilience-related requirements to stem the tide of increasing operational risks.</li> </ul>	<p><b>Additional cybersecurity and resilience obligations create a need to balance compliance costs with return on investment</b></p> <ul style="list-style-type: none"> <li>Increased cybersecurity obligations, rather than guidance on cybersecurity leading practices, creates a pile-on effect by which firms not only face damaging cybersecurity breaches, but also a related enforcement action.</li> <li>Compliance costs continue to rise as prescriptive requirements obligate firms to develop additional processes to report incidents within certain timeframes, provide additional disclosures, modify books and records mechanisms, and perform additional assessments, among other requirements.</li> <li>An uneven global regulatory landscape governing resilience requirement as well as a lack of interconnected, automated systems and processes, creates resilience mapping and governance challenges.</li> </ul>	<p><b>Firms must continue to integrate risk and compliance concepts into everything they do</b></p> <ul style="list-style-type: none"> <li>Tailor cybersecurity and resilience programs to the specific needs of the firm; balance requirements with risk and compliance value.</li> <li>Identify impacted service providers and other parties who may be impacted by cybersecurity and resilience requirements and proposed rules.</li> <li>Build resilience concepts into the risk and compliance framework to provide an independent perspective of, and help drive an improvement in, the overall resilience of the firm.</li> <li>Review whether there has been an unauthorized use of third-party providers, particularly for transition assistance when departing RIA personnel attempt to migrate client information to another firm.</li> </ul>	<p><b>Take a holistic, tailored view of cybersecurity and resilience concepts</b></p> <ul style="list-style-type: none"> <li>Firms should take a fresh look at their overall resilience programs, including cybersecurity components, on a regular basis in an effort to incorporate emerging risks and threats, capture all business processes, and identify control weaknesses and gaps.</li> <li>It is important to take the time to thoughtfully map out business-critical services, understand risk points and mitigants, and understand the degree of resilience of a given critical service compared to risk appetite.</li> <li>Firms should educate their personnel relative to cybersecurity and operational risk concepts, risk points, roles and responsibilities, downstream impacts, and recovery processes.</li> <li>Firms should ensure strategic investments accommodate resilient-by-design principles.</li> </ul>

Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>Digital asset adoption continues its rapid expansion</b></p> <ul style="list-style-type: none"> <li>Faced with growing demand, more firms are beginning to offer direct and indirect exposure to cryptocurrency and other digital assets.</li> <li>States such as Wyoming and Colorado have created the designation of a special-purpose trust. Many firms have registered with hopes of being a digital asset custodian.</li> <li>Use of automated investing tools expands.</li> </ul>	<p><b>SEC expands jurisdiction, requires improved governance</b></p> <ul style="list-style-type: none"> <li>Proposed SEC Custody Rule would ensnare many state-chartered trusts.</li> <li>Private funds with crypto exposure need to assess risk management, disclosure protocols, and methodology for hard-to-value assets.</li> <li>Robo-advisers and digital engagement/promotion is under scrutiny.</li> </ul>	<p><b>SEC uses existing regulations to increase scrutiny of crypto, influencers, and robo-advisers</b></p> <ul style="list-style-type: none"> <li>State-chartered trusts holding crypto will be subject to SEC custody regulations and examination authority.</li> <li>Private funds with crypto exposure need to assess risk management, disclosure protocols, and methodology for hard-to-value assets.</li> <li>Funds using automated investing tools will have to demonstrate their recommendations meet the same standards for nonautomated investment recommendations.</li> </ul>	<p><b>Common sense approach aimed at protecting the individual investor</b></p> <ul style="list-style-type: none"> <li>The SEC's proposed crypto rule settles a long-standing debate about whether state-chartered trusts holding crypto are qualified custodians. Intentional or not, this is good for crypto asset markets.</li> <li>Crypto exposure is often hard to value as markets are illiquid and decentralized. An approach that emphasizes disclosure and a sound methodology for hard-to-value crypto assets is sensible.</li> <li>As robo-investing increases, the SEC seems to be trying to harmonize standards.</li> </ul>

Background	Risks and challenges	Impact to compliance	KPMG perspective
<p><b>Three major rules were passed, affecting the Advisers Act and Investment Company Act:</b></p> <ul style="list-style-type: none"> <li>The "Marketing Rule" or Advisers Act Rule 206(4)-1</li> <li>The "Derivatives Rule" or Investment Company Act Rule 18f-4</li> <li>The "Fair Valuation Rule" or Investment Company Act Fair Valuation Rule 2a-5.</li> </ul> <p><b>Firms must adopt effective policies and procedures</b></p> <ul style="list-style-type: none"> <li>Policies and procedures related to these rules must be tailored to the firms' business for them to be effective.</li> <li>Firms should carefully review their entire policy, procedure, and control inventories for impacted policies, procedures, and controls.</li> </ul> <p><b>Monitor marketing material</b></p> <ul style="list-style-type: none"> <li>Firms must ensure they have a reasonable basis for believing they will be able to substantiate claims made in their marketing materials.</li> <li>Testimonial, third-party ratings, and performance will also be in focus.</li> </ul>	<p><b>Marketing Rule sweeps are expected to begin shortly</b></p> <p>The Division stated they would begin sweeps shortly after the November 2022 compliance date.</p> <p><b>Monitoring and testing these new rules can be an effective means of preparing for an SEC examination</b></p> <ul style="list-style-type: none"> <li>Thorough, independent monitoring and testing can proactively detect program deficiencies.</li> <li>Monitoring and testing staff must first be sufficiently knowledgeable about these new rules.</li> </ul> <p><b>Board involvement is key to achieving compliance</b></p> <ul style="list-style-type: none"> <li>Fund boards must be involved in overseeing compliance with the Derivatives and Fair Valuation Rules (e.g., fund derivative practices and whether disclosures of each fund's use of derivatives are potentially misleading).</li> <li>Legal and compliance teams can help fund boards understand the obligations.</li> <li>Clear board reporting can help demonstrate their oversight of these activities.</li> </ul>	<p><b>Lack of SEC guidance, no-action letters, and enforcement data</b></p> <ul style="list-style-type: none"> <li>Because these are new rules, firms do not have much regulatory guidance to use when designing their compliance target operating model(s)</li> <li>Division of Investment Management (the Division) FAQ states that gross performance advertisements must also show net performance.</li> </ul>	



# SEC enforcement overview

The SEC brought 760 new enforcement actions in FY 2022 (9 percent higher than the previous year), resulting in \$6.4 billion in disgorgement and penalties (the most in SEC history).

The Division of Enforcement continues to prioritize identifying misconduct with registered investment advisers, especially with respect to their interactions with retail investors.

The Division of Enforcement believes that investment professionals occupy positions of tremendous responsibility by being entrusted with retirement funds, college funds, and other savings.

Below are recent enforcement activities related to investment advisers sourced from the Division of Enforcement's 2021 and 2022 Annual Reports.

## Digital assets

**Heightened concerns around custody arrangements and firms' practices relate to the offer that covers investment advice and brokerage services, including trade execution.**

The SEC ordered a digital asset exchange operator to pay more than **\$10 million to settle charges for operating an unregistered online digital asset exchange** in connection with its operation of a trading platform that facilitated buying and selling of digital asset securities.

The online digital asset exchange **did not register as a national securities exchange, nor did it operate pursuant to an exemption from registration at any time**, and its failure to do so was a violation of Section 5 of the Exchange Act.

## ESG

The SEC has been warning for a long time that "greenwashing" is a focus area. In 2022, the SEC brought notable cases against a public fund adviser, a robo-adviser, and a commodity producer regarding their ESG claims.

## Material nonpublic information

A critical element in preventing **illegal trading** is robust corporate controls and compliance policies around the use and safeguarding of **material nonpublic information**. The importance of such policies was central to the Co-Directors' Statement of March 23, 2020, referenced above, and it also animated the SEC's enforcement action against a prominent **private equity firm** registered with the SEC as an investment adviser. In that matter, the SEC found that the firm's **compliance policies failed** to account for the special circumstances presented by having an **employee serve on the portfolio company's board while that employee continued to participate in trading decisions regarding the portfolio company**.

## Form CRS and disclosure

SEC requires RIAs and registered broker-dealers to **file their respective Forms CRS with the SEC**. The SEC also requires firms to prominently post their current Form CRS on their website. **SEC ordered about a dozen firms to pay penalties ranging from \$10,000 to \$100,000 in civil penalties for failure to file, deliver, and post this form, because this failure deprived these firms' clients and customers of critical disclosures and information.**

# How can we help?

KPMG understands where the regulators tend to focus and the challenges the industry is facing due to these significant regulatory developments and rapidly changing industry dynamics. We bring practical advice and services to help our clients work through those challenges. We are listing a number of our services below based on what we believe to be the most relevant.

How KPMG can help	
RIAs to private funds	<ul style="list-style-type: none"> <li>• Perform 206(4)-7 compliance program assessments and targeted risk assessments in key areas of high vulnerability to alternative firms such as valuations, fee and expenses, operational due diligence, conflicts assessment, disclosures versus actual practices, etc.</li> <li>• Assist in the development of fee and expense validation programs for large institutional fund investors and pension plan investors in private funds.</li> </ul>
ESG	<ul style="list-style-type: none"> <li>• Design and help implement strategies to standardize terminology used in ESG areas.</li> <li>• Recommend effective practices around process implementation across trading, compliance, and operations related to ESG.</li> <li>• Devise and help implement an ESG framework to respond to rapid changes quickly and effectively.</li> <li>• Draft recommended policies and procedures with ESG integrated in any documents impacted.</li> <li>• Recommend testing, reviews, and monitoring techniques to oversee ESG processes.</li> </ul>
Reg BI	<ul style="list-style-type: none"> <li>• Assist with current-state assessments in identifying when potential exceptions to meeting the best interest standard for a customer occur and recommend a process to systematically capture any supporting evidence and disclosures made.</li> <li>• Develop advanced surveillance analytics by bringing together information from customer demographics, portfolio holdings, and security master to capture anomalies related to a customer's cost/risk profile changes relative to peers in the same segment.</li> <li>• Assist with the development of tailored monitoring and testing scripts and procedures to drive consistency and accuracy across the compliance function.</li> </ul>

## How KPMG can help

### Information security and operational resiliency

- Design and help implement strategies to improve operational, technology, and cyber resilience.
- Devise and help implement a business resilience management framework to respond to changes more quickly and effectively.
- Converge the resilience framework into existing operational risk management and recovery and resolution frameworks.
- Perform implementation readiness assessments and gap analyses of current practices compared to existing or proposed requirements.

### Emerging technologies and crypto assets

- Educate staff on digital asset products and help tailor their risk and compliance programs accordingly.
- Factor unique risks into suitability analyses and disclosure practices.
- Recommend a robust regulatory change management program for identifying and responding to new rules and regulations.
- Help implement technology, business continuity, and third-party risk management programs for managing the inherent risks of digital assets (e.g., custody considerations).

### Compliance with recently adopted rules under the Advisers Act and Investment Company Act

- Assess firm's business model, product offerings, marketing materials, regulatory filings, and existing policies and procedures to identify high-risk activities.
- Prepare an SEC-style document request list covering the major components of a compliance program considering the requirements of Rule 206 (4)-7 (the Compliance Rule) of the Advisers Act to assess exam readiness.
- Conduct targeted interviews, similar to an SEC exam, to assess a firm's understanding of its obligations under the Advisers Act and the culture of compliance.
- Incorporate our understanding of your firm's unique risks, recent guidance provided by the SEC, lessons learned from recent enforcement activity, and our understanding of prevailing industry practices in making recommendations for enhancements.

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