

# SEC Division of Examinations Releases 2021 Examination Priorities

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The Securities and Exchange Commission's Division of Examinations (EXAMS) published its report on 2021 Examination Priorities<sup>1</sup> on March 3, 2021. The 2021 Examination Priorities cover eight broad topics

- The protection of retail investors, including seniors and those saving for retirement (with an emphasis on standards of conduct owed to retail investors);
- Information security and operational resiliency (with particular focus on cybersecurity in remote operations and climate change-related risks);
- Financial technology (Fintech) and innovation, including digital assets;
- Anti-money laundering (AML) programs;
- The London Inter-Bank Offered Rate (LIBOR) transition;
- Additional matters relating to investment advisers and investment companies;
- Additional matters relating to broker-dealers and municipal advisors; and
- Market infrastructure functions, including Regulation Systems Compliance and Integrity (SCI) and transfer agents.

While many of the above topics also were included in the 2020 OCIE Examination Priorities,<sup>2</sup> this year's examination priorities include three notable additions: new Regulation Best Interest (Reg BI) and Form CRS; the LIBOR transition; and the risks and market volatility associated with the COVID-19 coronavirus pandemic. EXAMS continues to emphasize vigilance in the consideration of environmental, social and governance matters, and continues to monitor activity surrounding "meme stocks."

The topics included in the 2021 Examination Priorities are a product of EXAMS' annual risk assessment process. Each year, the examination priorities incorporate views and information gathered from other SEC Offices and Divisions, including: the Division of Enforcement; the Division of Trading and Markets; and the Division of Investment Management. Internally, EXAMS relies on the expertise of its Asset Management Unit (which examines investment advisers and service providers to mutual funds, ETFs, retail client accounts and private funds) and its Broker-Dealer

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<sup>1</sup> [2021 Examination Priorities](#), SEC Division of Examinations (Mar. 3, 2021). All statements in this *OnPoint* as to the intent or plans of EXAMS are based on the text of the 2021 Examination Priorities. At times, this *OnPoint* tracks the 2021 Examination Priorities without the use of quotation marks.

<sup>2</sup> For further information regarding the 2020 examination priorities, please refer to *Dechert OnPoint*, [OCIE Releases 2020 Examination Priorities](#).

and Exchange (BDX) Unit (which examines broker-dealers, national securities exchanges, municipal advisors and transfer agents). In 2020, EXAMS established an Event and Emerging Risks Examination Team, in order to better respond to emerging and exigent risks.

The 2021 Examination Priorities provide insight as to how EXAMS: determines examination targets; prioritizes the time and resources of EXAMS' staff during the course of an examination; and, in certain instances, refers examination findings to the Division of Enforcement. The 2021 Examination Priorities provide important information regarding EXAMS' planned actions for this year, and can be predictive of potential enforcement activity involving participants in the financial services industry, including broker-dealers, investment advisers and investment companies. However, EXAMS' staff is not limited to items identified in the 2021 Examination Priorities; as in the past, examination and enforcement activities are based on a variety of factors, and the staff's approach can change at any time in response to changes in existing or emerging risks.

Additional statistical information regarding the examination program, compiled by Dechert from various SEC sources, is provided in the Appendix.

## Message from the Leadership Team of EXAMS

The 2021 Examination Priorities start with a message from EXAMS' leadership team, who use the 25th anniversary of the creation of the SEC Office of Compliance Inspections and Examinations (OCIE) to highlight its substantial growth and increase of examination responsibilities. Recognizing the increasing importance of SEC examinations, in December 2020, the SEC renamed OCIE as the Division of Examinations. The name change highlights the Division's role in the SEC, as well as within the financial services industry. The 14-page opening message in the 2021 Examination Priorities reflects the transformation of the examination priorities from a simple list to a larger statement of purpose and report on the status of the SEC's examination program. As recently as 2017, the examination priorities were presented in a five-page document in bullet point format, whereas the 2021 Examination Priorities constitute a 42-page narrative report.

## Global Pandemic: Observations and Impacts

The opening message from the EXAMS leadership team reflects the unprecedented impact of the COVID-19 coronavirus pandemic on the financial markets; the leadership team noted that the markets' operations and services nonetheless have continued to work as designed, due to the industry's adaptability. The leadership team also noted how, early in the pandemic, EXAMS shifted its focus to the most pressing risks, such as those related to: remote supervision and business continuity efforts; the conduct of numerous examinations; and the publication of a COVID-19 Risk Alert to share OCIE's observations regarding pandemic responses by SEC-registered broker-dealers and investment advisers.<sup>3</sup> Since the beginning of the pandemic, EXAMS has continued to focus on cybersecurity, as reflected in its Ransomware Risk Alert and its Credential Compromise Risk Alert.<sup>4</sup>

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<sup>3</sup> For further information regarding the COVID-19 Risk Alert, please refer to *Dechert OnPoint*, [OCIE Publishes Risk Alert on COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers](#).

<sup>4</sup> For further information regarding the Credential Compromise Risk Alert, please refer to *Dechert OnPoint*, [OCIE Issues Cybersecurity Risk Alert on the Risk of Credential Stuffing Attacks](#). This risk alert, together with OCIE's Ransomware Risk Alert, build upon the Cybersecurity and Resiliency Observations that were published in 2020. For further information regarding the 2020 Cybersecurity Observations, please refer to *Dechert OnPoint*, [OCIE Releases 2020 Cybersecurity Observations](#).

## Reg BI and Form CRS

The leadership team also highlighted the implementation of Reg BI and Form CRS.<sup>5</sup> EXAMS published two risk alerts that: offer sample request lists to broker-dealers and their compliance professionals; and identify focus areas that EXAMS expects to review in examinations relating to Reg BI and Form CRS.<sup>6</sup> In October, the then-leadership team stated, at a roundtable to communicate EXAMS' initial observations about broker-dealers' compliance with Reg BI and Form CRS, that most broker-dealers had updated their written supervisory procedures and conducted compliance training. In December, EXAMS issued a Statement on Recent and Upcoming Regulation Best Interest Examinations (Statement),<sup>7</sup> which identifies likely areas of focus in upcoming examinations. The Statement sets forth EXAMS' intent to expand the scope of examinations to include compliance with Reg BI's requirement that broker-dealers have a reasonable basis to believe that recommendations are in the best interest of their retail customers. The Statement further indicates that Reg BI examinations will evaluate a broker-dealer's response to Reg BI, including: the broker-dealer's related policies and procedures; how it considers costs when making recommendations; and the processes used by registered representatives to make recommendations (including with respect to complex products) and to identify and address conflicts relating to recommendations.

The leadership team observed that broker-dealers and investment advisers generally have complied with Form CRS by avoiding "legalese" and boilerplate language, but noted that, in some instances, readability could be improved. The leadership team also observed that some broker-dealers and investment advisers did not adequately respond to the disciplinary disclosure requirements, and that hundreds of broker-dealers and investment advisers were notified they did not timely file a Form CRS, strongly implying that these firms could be subject to further scrutiny in examinations.

## Risk, Technology and Industry Trends

Continuing this examination priority from 2020, the leadership team stated that they will follow market events and adjust the Division's examination program accordingly. EXAMS will use its Event and Emerging Risks Examination Team to proactively engage with market participants, and to identify emerging threats and market events that could have a systemic impact on the industry.

Specific emphasis will be placed on compliance and operational challenges that arise from remote work. Globally, EXAMS plans to engage with broker-dealers and investment advisers on their Brexit and LIBOR transition preparedness. The leadership team further noted that EXAMS faces increasing challenges in its examinations of firms that are subject to non-U.S. data protection and privacy laws, recognizing the "particularly acute" challenges presented by registered investment advisers (RIAs) located outside the United States. To address these challenges, EXAMS will continue to work with the financial services industry and international regulators.

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<sup>5</sup> For further information, please refer to *Dechert OnPoint*, [SEC Adopts Enhanced Standard of Conduct for Broker-Dealers and Clarifies Fiduciary Duties of Investment Advisers](#).

<sup>6</sup> For further information regarding the Reg BI and Form CRS risk alerts, please refer to *Dechert OnPoint*, [OCIE Publishes Risk Alerts Providing Advance Information Regarding Inspections for Compliance with Reg BI and Form CRS](#).

<sup>7</sup> [Statement on Recent and Upcoming Reg BI Examinations from the SEC Division of Examinations](#), Division of Examinations (Dec. 21, 2020). Information pertaining to the Statement in this *OnPoint* is based on the text of the Statement. At times, this *OnPoint* tracks the Statement without the use of quotation marks.

## Retail Investors, including Seniors and those Saving for Retirement

The 2021 Examination Priorities focus on the protection of retail investors. In particular, EXAMS will focus its attention on seniors and those saving for retirement. In this regard, EXAMS will prioritize examinations of RIAs, broker-dealers and dually registered or affiliated firms, because individual investors often rely on these financial intermediaries. Additionally, examinations will focus on investments and services marketed to retail investors.

### *Standards of Conduct*

Adopted in 2019, Reg BI established a best interest standard of conduct for broker-dealers and their associated persons, when making recommendations to retail investors about transactions in securities and investment strategies involving securities. Reg BI imposes four obligations on broker-dealers: a care obligation; a disclosure obligation; a conflicts of interest obligation; and a compliance obligation. In examinations of broker-dealers, EXAMS will prioritize: reviews of the adequacy of policies and procedures to meet the requirements of Reg BI; evaluations of the availability and costs of alternative securities recommendations in response to conflicts of interest; and assessments of fee structures that may impact recommendations. In its December Statement, EXAMS noted its intent to move away from reviewing for compliance with suitability obligations, and indicated that it now will “require broker-dealers to have a reasonable basis to believe that recommendations are in retail customers’ best interests.”

The 2021 Examination Priorities recap the SEC’s 2019 Interpretation Regarding Standard of Conduct for Investment Advisers, which states that RIAs owe fiduciary duties to their clients, which include a duty of care and a duty of loyalty.<sup>8</sup> The 2021 Examination Priorities state that EXAMS will continue to assess RIAs to determine whether they have fulfilled their fiduciary duties, including whether RIAs are providing advice in the best interest of their clients and have eliminated or disclosed conflicts of interest. EXAMS stated that it will continue to focus on: fees and expenses; complex products; best execution; and undisclosed or inadequately disclosed compensation arrangements.

Both broker-dealers and RIAs must complete, file and deliver to retail investors Form CRS – a short disclosure document intended for retail investors.

### *Fraud, Sales Practices and Conflicts*

In the 2021 Examination Priorities, EXAMS noted the significant impact that disclosures and compliance with federal securities laws have on helping investors to make informed decisions, as well as protecting the financial needs of the public. The SEC stressed that it is imperative for broker-dealers, investment advisers and investment companies to implement policies and procedures to ensure that adequate and fair disclosures are provided to customers and clients. Accordingly, examinations will focus on advice and recommendations given to retail investors and the satisfaction of conflict-of-interest obligations.

Examinations of the recommendations provided to retail investors will pay special attention to teachers, military personnel, seniors and those saving for retirement. EXAMS also will review the appropriateness of recommended investment strategies, as well as recommendations of product and account types made to retail investors by broker-dealers.

EXAMS will continue its evaluation of conflict-of-interest policies and procedures of RIAs and will pay special attention to fee calculations, including: calculation errors; proper application of fee discounts; and failure to exclude

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<sup>8</sup> Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Rel. No. IA-5248 (June 5, 2019).

fees or provide refunds when necessary. EXAMS noted that RIAs should disclose revenue sharing arrangements that create a conflict of interest with clients (e.g., where compensation is provided for executing transactions). The 2021 Examination Priorities also state that EXAMS will prioritize RIAs that operate or use a turnkey asset management platform (TAMP). This is the first time that the examination priorities include TAMPs.

### ***Retail-Targeted Investments***

In the 2021 Examination Priorities, EXAMS noted three securities products that “can pose elevated risks” when marketed or sold to retail investors, whether due to the nature of the security, market dynamics or retail investor asset concentration in the security or product:

- **Mutual Funds and ETFs:** Examinations will prioritize incentives provided to firms when clients select a more expensive mutual fund share class over an available lower-cost class. EXAMS also will review recommendations and risk disclosures involving ETFs, particularly “niche” or leveraged/inverse ETFs.
- **Municipal Securities and Other Fixed-Income Securities:** EXAMS will evaluate the timeliness and adequacy of disclosures, noting the substantial impact from the pandemic on the operations of issuers of municipal securities. Examinations will look to “broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs and commissions; and confirmation disclosure requirements, including disclosures relating to mark-ups and mark-downs.”
- **Microcap Securities:** EXAMS will continue to monitor fraudulent activity in microcap securities (market capitalization of less than \$250 million). During the COVID-19 coronavirus pandemic, a number of fraudulent claims and misrepresentations were made by microcap issuers regarding vaccines, treatments and testing capabilities. EXAMS will focus on reviewing the accuracy of public statements and representations made by microcap issuers, in addition to their compliance with regulatory requirements.

### **Information Security and Operational Resiliency**

EXAMS will continue to review security measures, noting security concerns related to the increase in remote operations as a result of the COVID-19 coronavirus pandemic. Accordingly, EXAMS will assess measures taken by firms to address these risks, including: safeguarding customer accounts and verification of investor identity; oversight of vendors and service providers; monitoring suspicious email activities, including phishing attempts; responding to incidents and ransomware attacks; and general management of risks associated with remote/work-from-home operations. The 2021 Examination Priorities state that, in particular, EXAMS will focus on: controls surrounding online and mobile application access to investor account information; controls surrounding the electronic storage of books, records and personally identifiable information maintained with third-party cloud service providers; and firms’ policies and procedures to protect investor records and information.

EXAMS also renewed its commitment to reviewing business continuity and disaster recovery plans, as well as risks related to climate change, noting an ever-growing need to prepare as climate-related incidents rise in frequency and intensity. EXAMS will review the effectiveness of registered firms’ responses to such events.

## Financial Technology (Fintech) and Innovation, including Digital Assets

EXAMS will continue its efforts to assess the use of technology to provide advice to clients, including firms that use or provide automated investment tools and platforms (also referred to as “robo-advisers”). Examiners will evaluate whether firms are: acting consistently with any representations made to their clients; following client instructions; and providing compliant trade recommendations in mobile applications. EXAMS renewed its commitment to continue examinations related to digital assets to include: whether investments are in an investor’s best interest; portfolio management and trading practices; safeguarding client funds and assets; pricing and valuation; compliance programs and controls; and supervision of employees outside of their business activities.

This year, EXAMS also will focus on the use of technology by registered firms to comply with regulations and rules (also referred to as “RegTech”). Examinations will assess procedures and controls in place to monitor the use of RegTech, as well as the capability of any implemented RegTech to follow compliance requirements.

The 2021 Examination Priorities also state that EXAMS will review firms’ use of alternative data, including examining whether firms are implementing appropriate controls and compliance regarding the creation, receipt and use of such information.

## Anti-Money Laundering Programs

EXAMS will continue to: review compliance with AML requirements; and prioritize examinations of broker-dealers and registered investment companies. EXAMS will focus on evaluations of firms’ AML policies and procedures, including firms’: establishment of customer identification programs; thorough due diligence on customers; compliance with beneficial ownership requirements; and routine, independent testing.

## The London Inter-Bank Offered Rate (LIBOR) Transition

As the discontinuation of LIBOR approaches, EXAMS will focus on the effect this discontinuation will have on firms. EXAMS acknowledges the risks and impact that this discontinuation and the transition to an alternative reference rate may present to market participants, and will use examinations to engage with firms to assess their exposure to LIBOR, as well as the adequacy of their preparation for the transition.

## Additional Focus Areas Involving RIAs and Investment Companies

### *RIA Compliance Programs*

EXAMS will concentrate on the appropriateness of: account selection; portfolio management practices; custody and safekeeping of client assets; best execution; fees and expenses; business continuity plans; and valuation of client assets for consistency and appropriateness of methodology. EXAMS will review whether RIAs appear to have sufficient resources to perform their core compliance responsibilities. In selecting RIAs for examination, as has been the case in recent years, EXAMS will prioritize those that: have not been examined for a number of years; have never been examined; or are dually registered as, or affiliated with, broker-dealers.

The 2021 Examination Priorities continue the SEC’s emphasis on investments that focus on environmental, social and governance (ESG) factors. EXAMS observed that RIAs increasingly are offering investment strategies that focus on sustainability; these include products and services that may be referred to by a variety of terms, such as “sustainable,” “socially responsible,” “impact” and “ESG conscious.” Continuing and deepening its approach in recent



examinations, EXAMS will: review disclosures related to these strategies for consistency and adequacy; determine whether processes and practices match disclosures; review fund advertising for false or misleading statements; and review proxy voting policies and procedures and votes cast, to assess whether they align with the strategies.

### ***Registered Funds, including Mutual Funds and ETFs***

In examining the compliance programs and governance practices of registered investment companies, EXAMS will focus on: disclosures to investors; valuation; filings with the SEC; personal trading activities; and contracts and agreements. EXAMS will check mutual fund filings and board reports for compliance with regulatory requirements and for valuation issues. When considering valuation and its impact on fund performance, liquidity and risk disclosures, EXAMS will focus on market sectors that have experienced, or continue to experience, stress due to the pandemic, which the 2021 Examination Priorities note include “energy, real estate, or products such as bank loans and high yield corporate and municipal bonds.” EXAMS also will review securities lending disclosures and practices. EXAMS will prioritize the examinations of mutual funds and ETFs that have never been examined and those that have not been examined for a number of years. In particular, EXAMS will concentrate on funds that have instituted advisory fee waivers. Furthermore, EXAMS will focus on the compliance by non-transparent actively managed ETFs with exemptive relief.

EXAMS will continue to focus on funds’ liquidity risk management programs (LRMPs), and will assess whether LRMPs are reasonably designed to assess and manage a fund’s liquidity risk. EXAMS also will review funds’ implementation of the liquidity classification requirements, particularly in light of the recent pandemic-driven market stresses.

EXAMS plans to review money market funds’ compliance with: stress-testing requirements; website disclosures; and board oversight.

### ***RIAs to Private Funds***

The 2021 Examination Priorities state that examinations of RIAs to private funds will focus on: liquidity; disclosure of investment risks; and conflicts of interest. As part of its examinations, EXAMS will review preferential treatment of certain investors by advisers to private funds that have experienced issues with liquidity (e.g., imposition of gates or suspensions on fund withdrawals; portfolio valuations and the resulting impact on management fees; adequacy of disclosure; compliance with any regulatory requirements relating to cross trades, principal investments or distressed sales; and conflicts involving liquidity).

EXAMS also will concentrate on RIAs to private funds that have a higher concentration of structured products, as well as private funds that may have experienced material impacts to their portfolio companies as a result of economic conditions (for example, pertaining to real estate).

### ***Additional Focus Areas involving Broker-Dealers and Municipal Advisors***

In conducting broker-dealer examinations, EXAMS will focus on financial responsibility and trading practices. With respect to financial responsibility, examinations will focus on: the safety of customer cash and securities; commissions and cost structures; trading activities; and alternative trading systems. The 2021 Examination Priorities emphasize financial responsibility, and EXAMS will continue to focus on compliance with the Customer Protection Rule (Rule 15c3-3 under the Securities Exchange Act of 1934) and the Net Capital Rule (Rule 15c3-1 under the Exchange Act). In particular, examinations of broker-dealers will focus on: internal processes, procedures and

controls; borrowing securities from customers; and funding and liquidity risk management practices (with an emphasis on the COVID-19 coronavirus pandemic). EXAMS' trading practice examinations will focus on: best execution obligations in a zero-commission environment; Rule 606 order routing disclosures; payment for order flow; Regulation SHO compliance by market makers; and alternative trading systems' operations and corresponding Form ATS-N disclosures.

In response to COVID-19, EXAMS' review of municipal advisors will focus on such advisors': fiduciary duty obligations to municipal entity clients; requirements regarding registration, professional qualification, continuing education and supervision; and reliance on relief from Form MA annual update filing requirements or reliance on the temporary exemptive order permitting brokers to engage in certain activities in connection with the direct placement of municipal securities.

## Market Infrastructure

EXAMS will continue to prioritize compliance and risks related to critical market infrastructure. Examinations will focus on:

- Clearing agencies designated to be "systematically important" by the Financial Stability Oversight Council (with an emphasis on core risks, processes and controls);
- National securities exchanges, including how they monitor, investigate and enforce applicable exchange rules and securities laws;
- Regulation Systems Compliance and Integrity (SCI) designated entities, with a focus on: information technology (IT) governance; IT asset management; cybersecurity; business continuity; and third-party vendors;
- Transfer agents, focusing on: timely turnaround; recordkeeping and retention; safeguarding securities; and business continuity. Examination candidates will focus on those that present the greatest risk to investors and investment channels.

## Focus on FINRA and MSRB

The Financial Industry Regulatory Authority uses examinations, enforcement and surveillance to supervise approximately 3,600 brokerage firms and 630,000 registered representatives.<sup>9</sup> EXAMS selects areas within FINRA to examine and then conducts risk-based oversight examinations. EXAMS uses the results of these examinations to conduct inspections of FINRA's major regulatory programs.

The Municipal Securities Rulemaking Board oversees: broker-dealers that buy, sell and underwrite municipal securities; and municipal advisors. EXAMS looks at registered firms to check compliance with MSRB rules. EXAMS also conducts examinations of the MSRB itself.

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<sup>9</sup> For information regarding FINRA examination priorities, please refer to *Dechert OnPoint*, [FINRA Issues 2020 Examination Priorities](#).

## Conclusion

In its ninth consecutive year of publication, the 2021 Examination Priorities continue to be an important tool for registered firms when assessing compliance programs and preparing for examinations. The topics identified in the 2021 Examination Priorities illustrate the evolution of the SEC's national examination program to meet existing and emerging risks. Moreover, the development of the examination priorities into a statement of purpose, as well as a larger report on the status of the examination program, provides important information about the evolution of the SEC's examination program. Firms may want to consider carefully the 2021 Examination Priorities in assessing their readiness for potential document requests or examinations by EXAMS in the coming year.

## Appendix – EXAMS Examination Statistics 2018-2020<sup>10</sup>

	2020 <sup>11</sup>	2019	2018
<b>TOTAL NUMBER OF EXAMS</b>	3,134	3,089	3,175
<b>NUMBER OF BROKER-DEALER EXAMS</b>	332	361	329
<b>BROKER-DEALER EXAMS AS % OF TOTAL EXAMS</b>	11%	12%	10%
<b>NUMBER OF INVESTMENT ADVISER EXAMS</b>	2,316	2,188	2,312
<b>INVESTMENT ADVISER EXAMS AS % OF TOTAL EXAMS</b>	74%	71%	73%
<b>INVESTMENT COMPANY EXAMS</b>	102	153	138
<b>NUMBER OF INVESTMENT COMPANY EXAMS AS % OF TOTAL EXAMS</b>	3%	5%	4%

<sup>10</sup> The data contained in this chart was compiled using the following SEC sources: Fiscal Year 2021 Congressional Budget Justification Annual Performance Plan & Fiscal Year 2019 Annual Performance Report; and Fiscal Year 2020 Congressional Budget Justification Annual Performance Plan & Fiscal Year 2018 Annual Performance Report.

<sup>11</sup> Several 2020 figures are estimates subject to change when the SEC has finalized the data from FY 2020. Please note that fiscal year 2020 likely was impacted by the COVID-19 coronavirus pandemic.

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