

SEC Is Ready To Execute Its 2019 Examination Priorities

By **Kelley Howes**

January 30, 2019, 11:42 AM EST

The U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations published its 2019 examination priorities[1] on Dec. 20, 2018. Since this occurred just prior to the implementation of a partial government shutdown, OCIE has had little chance to demonstrate how it will execute on these priorities.

With furloughed staff back in place, however, registered investment advisers, registered funds and broker-dealers can be certain that OCIE staff will quickly begin examinations focused on these identified priorities.



Kelley Howes

Equally important, however, registrants should not lose sight of OCIE's risk-based approach to selecting registered entities to examine and to determining the scope of risk areas to examine. OCIE's approach "remains flexible in order to cover emerging and exigent risks to investors and the marketplace as they arise. OCIE is continually evaluating changes in market conditions, industry practices and investor preferences to assess risks to both investors and the markets."

Registrants should take a similarly broad and flexible approach to the annual review of their compliance programs.

Six Themes and Related Focus Areas

OCIE's examination priorities address the following six themes related to "practices, products, and services that [OCIE] believes present potentially heightened risk to investors or the integrity of the U.S. capital markets."

Matters of Importance to Retail Investors, Including Seniors and Those Saving for Retirement

Consistent with the SEC's mission of protecting investors, OCIE has for several years focused on examinations related to retail and retirement products and investors. That focus will continue in 2019:

- ***Fees and Expenses:*** Given its risk-based approach to examinations, OCIE will select firms for examination that have business models that OCIE believes may create increased risks of inadequately disclosing the cost of investing, including fees, expenses and other charges. These

will include firms that incentivize financial professionals to select higher-fee mutual fund share classes, and advisers that participate in wrap-fee programs.

- *Conflicts of Interest:* A perennial area of focus for OCIE is ensuring that registered investment advisers operate in a manner consistent with their fiduciary duty, and that they adequately disclose conflicts of interest and the potential impact of such conflicts to their clients and potential clients. This year, OCIE intends to focus its attention on disclosure and controls related to conflicts of interest associated with the use of affiliated service providers and products, the availability of securities-backed nonpurpose loans or lines of credit, and borrowing funds from clients.
- *Senior Investors and Retirement Accounts:* OCIE plans to examine broker-dealers to determine if they are adequately supervising interactions between their registered representatives and senior investors. Examinations of registered investment advisers will focus on whether they are meeting their suitability obligations with respect to services and products offered to senior investors and those saving for retirement.
- *Portfolio Management and Trading:* Registered investment advisers should expect OCIE staff to review compliance and trading records. OCIE staff will evaluate whether advisers are fairly allocating investment opportunities among their clients and if they have policies in place to ensure that investments are consistent with each client's objectives and any applicable legal restrictions. OCIE will also review client disclosure documents to ensure that they adequately communicate critical information related to portfolio trades.
- *Never-Before- or Not-Recently-Examined Investment Advisers:* In 2019, OCIE will continue its initiative to review investment advisers that have never been examined, that have not been examined for a number of years, or that have substantially grown or changed business models.
- *Mutual Funds and ETFs:* Since mutual funds and exchange-traded funds are a primary investment vehicle for many retail investors, OCIE will prioritize examinations of registered funds, their advisers and their boards of directors. Consistent with a November 2018 risk alert^[2] that explained OCIE's risk-based initiatives focused on registered funds, in 2019 OCIE will examine industry practices and regulatory compliance related to:
 - Index funds that track custom-built or bespoke indexes;
 - ETFs with little secondary market trading volume or smaller assets under management;
 - Registered funds with higher allocations to certain securitized assets;
 - Registered funds with aberrational underperformance relative to their peer groups;
 - Registered funds managed by advisers who are relatively new to managing registered investment companies; and
 - Advisers that provide advice to both registered funds and private funds with similar investment strategies.
- *Municipal Advisers:* OCIE will continue to conduct examinations of never-before-examined municipal advisers, or MAs, concentrating on whether these MAs have satisfied their registration requirements, professional qualifications and continuing education requirements.

OCIE will also evaluate MAs' disclosures regarding their conflicts of interest to a municipal entity and whether MAs are complying with recently effective MSRB rules related to, among other things, advertisements by MAs and the standards of conduct for MAs obtaining Committee on Uniform Security Identification Procedures numbers on behalf of issuers.

- *Broker-Dealers Entrusted With Customer Assets:* Broker-dealers that hold customer cash and securities must ensure that such assets are safeguarded and accurately reported. OCIE therefore intends to examine select broker-dealers for compliance with the Customer Protection Rule (Exchange Act Rule 15c3-3).
- *Microcap Securities:* OCIE will continue to examine broker-dealers involved in selling stocks of companies with a market capitalization of under \$250 million. OCIE will focus on identifying pump-and-dump schemes, evaluating compliance with Regulation SHO (governing short sales), and reviewing compliance with Exchange Act Rule 15c2-11, which governs the submission and publication of quotations by broker-dealers for certain over-the-counter equity securities.

Compliance and Risk in Registrants Responsible for Critical Market Infrastructure

A second mission of the SEC is to maintain fair, orderly and efficient markets. OCIE will therefore allocate time and attention to various entities that provide critical market services.

- *Clearing Agencies:* OCIE will conduct annual examinations of clearing agencies that the Financial Stability Oversight Council has designated as systemically important. In addition, consistent with its overall risk-based approach to examinations, OCIE will examine other registered clearing agencies for compliance with the SEC's Standards for Covered Clearing Agencies and whether such clearing agencies have taken timely corrective action in response to prior examinations. OCIE will continue to work collaboratively with staff of the SEC's Division of Trading and Markets and other regulators to identify new or emerging risk areas that warrant examination.
- *Entities Subject to Regulation SCI:* Regulation Systems Compliance and Integrity, or SCI, requires certain entities to "establish, maintain, and enforce policies and procedures designed to ensure that their systems' capacity, integrity, resiliency, availability, and security are adequate to maintain their operational capability and promote the maintenance of fair and orderly markets." Examinations of entities subject to Regulation SCI will focus on whether they have implemented the written policies and procedures required by Regulation SCI. OCIE will also evaluate whether these entities have adequate controls relating to software development life cycles, such as governance procedures, effective internal audit programs, inventory management, and threat-management capabilities.
- *Transfer Agents:* OCIE will examine registered transfer agents to ensure that they have adopted and implemented adequate policies and procedures related to share transfers, record-keeping, and safeguarding of client funds and securities. OCIE will consider whether transfer agents are annually filing with the SEC an internal accounting controls report issued by an independent accountant. Examinations will focus on transfer agents providing services to higher-risk issuers, including transfer agents developing blockchain technology and those providing services to issuers of microcap securities, private offerings, crowdfunded securities or digital assets.

Digital Assets (Including Cryptocurrencies, Coins and Tokens)

The SEC is focused on the risks digital assets present to retail investors, and OCIE's examinations of digital assets will follow suit.

- OCIE will continue to monitor the offer and sale, trading and management of digital assets and will examine digital asset market participants, such as broker-dealers, trading platforms and investment advisers. When digital assets are securities, OCIE will examine market participants for regulatory compliance, including portfolio management of digital assets, trading, safety of client funds and assets, pricing of client portfolios, compliance, and internal controls.

Cybersecurity

OCIE has previously conducted sweep examinations to evaluate market participants' cybersecurity policies. While OCIE has not announced any further sweep examinations, its examinations of individual registrants will nonetheless contain a cybersecurity component.

- OCIE's examinations will focus on, among other things, proper configuration of network storage devices, information security governance generally, and policies and procedures related to retail trading information security. OCIE will evaluate cybersecurity practices at investment advisers with multiple branch offices, and those that have recently merged with other investment advisers to evaluate governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

Anti-Money Laundering

In an effort to detect and combat terrorist financing, public corruption and other fraudulent behavior, broker-dealers are required to establish anti-money laundering programs. AML programs must include policies and procedures reasonably designed to "identify customers, perform customer due diligence, monitor for suspicious activity, and where appropriate, file suspicious activity reports, or SARs, with the Financial Crimes Enforcement Network."

- OCIE will evaluate whether broker-dealers have adopted and implemented policies and procedures that are reasonably designed to identify suspicious activity and illegal money laundering activities. Among other things, these policies and procedures should be implemented to ensure that broker-dealers meet their obligations to timely file SARs and to robustly and timely conduct independent tests of their AML program.

Select Areas and Programs of FINRA and MSRB

- *FINRA*: OCIE will focus its examinations of the Financial Industry Regulatory Authority on its operations and regulatory programs, as well as the quality of its examinations of broker-dealers and MAs that are also registered as broker-dealers.

- *MSRB*: OCIE will evaluate the effectiveness of the Municipal Securities Rulemaking Board’s policies, procedures and controls in light of MSRB’s broad mandate to regulate municipal securities transactions.

Conclusion

Many registered investment advisers, broker-dealers, registered funds and other market participants are currently engaged in an annual review of their compliance programs. While they should carefully consider OCIE’s identified 2019 examination priorities, they should also keep in mind that these priorities are not exhaustive. Regardless of its identified priorities, OCIE’s examination program remains “firmly grounded in its four pillars: promoting compliance, preventing fraud, identifying risk, and informing policy.”

“[T]he scope of any examination is determined through a risk-based approach that includes analysis of the registrant’s operations, products offered, and other factors. This risk-based approach often results in examinations that address key aspects of the SEC’s regulatory oversight, such as the disclosure of services, fees, expenses, conflicts of interest for investment advisers, and trading and execution quality issues for broker-dealers.”

Registrants must take the same broad, risk-based approach to evaluating their compliance programs in light of their regulatory obligations and the best interests of their investors and clients.

Kelley A. Howes is of counsel and vice chair of the investment management group at Morrison & Foerster LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] <https://www.sec.gov/files/OCIE%202019%20Priorities.pdf>

[2] https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20RIC%20Initiatives_0.pdf