SEC’s Office of Compliance Inspections and Examinations announces 2019 examination priorities

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The Securities and Exchange Commission’s (SEC’s) Office of Compliance Inspections and Examinations (OCIE) has announced that it will focus its examination priorities in 2019 on retail investors, digital assets and cybersecurity, among other areas. The ultimate goal of its examinations are to help the SEC improve compliance, identify risks, prevent fraud and inform its rulemaking initiatives. Generally, OCIE’s duties include examination and oversight of registered investment advisers, exempt reporting advisers, municipal advisors, mutual funds, exchange-traded funds (ETFs), registered broker-dealers, transfer agents, securities exchanges and clearing agencies.

According to its 2019 Examination Priorities Report released last week, OCIE plans to focus on six general themes in the upcoming year: (i) retail investors, including seniors and those saving for retirement, particularly relating to fees, expenses and conflicts of interest; (ii) compliance and risk for critical market infrastructure; (iii) Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB) programs; (iv) digital assets, including cryptocurrencies and ICOs; (v) cybersecurity and (iv) anti-money laundering. As is typical, OCIE intends to utilize a risk-based approach. While these are likely to be the SEC’s primary areas of focus, other compliance issues may receive attention during the year.

Retail investors

A number of OCIE’s recent initiatives protected what the SEC deems to be retail investors. While private equity and other closed-end funds generally won’t have “typical” retail investors, the SEC views pension plans and other vehicles designed to save for retirement as retail investors, notwithstanding their level of sophistication. Thus, many items designed to protect retail investors will be, or will continue to be, applicable to the private funds industry as a whole. Retail investor protection initiatives include:

— **Fees and expenses**—Continued heavy focus on fees and expenses charged to advisory accounts to ensure they are fully disclosed to investors, particularly in respect of transparency in the disclosure of fees and expenses as either capital contributions or investor fees and disclosures relating to wrap fee programs that provide for the bundling of fees for both advisory and brokerage services.
— **Conflicts of interest**—Continuing to ensure that conflicts of investment advisers and broker-dealers are disclosed in sufficient detail and, where required, approved by investors; receiving approval from investors for all transactions. Of particular importance are OCIE’s plans to examine the use of the following:

  - Affiliated service providers and products, including portfolio management practices and compensation arrangements, including between general partners and limited partners.
  - Non-purpose loans or lines of credit which allow borrowers to use the securities in their brokerage or advisory accounts as collateral.
  - Borrowed funds from clients by investment advisers.

— **Senior investors and retirement accounts and products**—Eliminating exploitation of seniors and retirement investors by broker-dealers. Ensuring the appropriateness of compliance programs, supervision of employees and representatives and investment recommendations to seniors and those saving for retirement (including pension plans and pension systems themselves).

— **Portfolio management and trading**—Ongoing assessment of portfolio management by investment advisers and the allocation of investment opportunities and disclosure of information to clients, including a risk assessment of portfolio recommendations.

— **Never-before or not-recently examined investment advisers**—Continued increased likelihood of examinations of never-before or not-recently examined investment advisers, such as newly registered investment advisers and those that have changed their business models.

— **Mutual funds and exchange-traded funds**—Continued monitoring of activities and risks relating to mutual funds and exchange-traded funds (ETFs), including (i) custom-built or bespoke indexes, (ii) ETFs with little secondary trading or fewer assets under management, (iii) funds with high allocations to securitized assets, (iv) greatly underperforming (relative to peers) funds, (v) funds with advisers that have little experience with registered investment companies (RICs) and (vi) advisers that advise both RICs and private funds with similar investment strategies.

— **Municipal advisors**—Examination of municipal advisors that have never been examined, with focuses on compliance with registration requirements, professional qualifications, disclosure of conflicts of interests, fiduciary duties, continuing education requirements and recently effective MSRB rules, including advertising rules for municipal advisors.

— **Broker-dealers**—Assessment of broker-dealers that hold customer cash and securities to ensure compliance with the Customer Protection Rule, which restricts the use of customer assets for working capital, among other things.

— **Microcap securities**—Monitoring broker-dealers selling microcap securities (stocks of companies with market capitalization under $250M) for compliance with various laws and regulations (including Regulation SHO and the Securities Exchange Act) and for fraud and risk.
Critical market infrastructure
OCIE will continue annual examinations of registrants responsible for critical market infrastructure (such as systemically important clearing agencies designated by the Financial Stability Oversight Council), entities subject to regulation systems compliance and integrity (SCI entities), transfer agents and national securities exchanges.

FINRA and MSRB
OCIE will continue to monitor FINRA and MSRB in 2019, particularly their operations and regulatory programs. OCIE will inspect both self-regulatory organizations to ensure the appropriateness of their procedures and controls.

Digital assets
OCIE will monitor and focus on risks pertaining to digital assets that are securities, particularly as related to portfolio management, trading, pricing, internal controls and ensuring the security of client funds.

Cybersecurity
Cybersecurity has been a longtime priority for OCIE, and it will continue focusing on network storage, information security governance, governance and risk assessment, access rights and controls, data loss prevention, retail trading and practices of multi-office investment advisers, among other areas. Policies and procedures should be updated for certain newer developments, such as fraudulent and fake capital call letters, increased protection of personally identifiable information under U.S. and European legal regimes and technological developments for device configurations. There will be particular focus on the cybersecurity practices of multi-office and recently merged advisers. Because no two cybersecurity protocols are the same, integration of these protocols when changed or added will be a hot topic. OCIE has also issued a risk alert relating to record-keeping for electronic communications that included recommendations for advisers texting clients and the use of alternative means of communications.

Anti-money laundering (AML) programs
In 2019, OCIE will focus AML examinations on the programs of broker-dealers, to ensure their compliance with the Bank Secrecy Act and other AML obligations, particularly the requirement to file suspicious activity reports (SARs) with the Financial Crimes Enforcement Network (FinCEN).

Takeaways
In general, there are a number of key takeaways from this alert that present a bit more nuance than OCIE’s examination priorities for previous years. First, the focus on conflicts disclosures (as between general partners and limited partners) may lead to increased disclosure where, for instance, a third party is invested both in a fund as well as its sponsor, or where the sponsor runs a parallel fund for specific investors that may have different financial terms than those of the main fund. Second, there may be greater disclosure regarding subscription facilities and termination facilities, particularly to the extent they are secured by portfolio assets or the fund’s bank accounts. We also believe the trend for higher thresholds to permit formation of successor funds will continue. We also think that more universal practices for custody, valuation, and internal controls will develop for funds that hold digital assets, particularly with respect to illiquid ICO or ITO.
tokens. As we’ve seen thus far while the SEC has been under Jay Clayton’s direction, we continue to expect vigorous enforcement of financial crimes and fiduciary duty violations as they are presently known. We do not, however, anticipate major expansions of the level of disclosure required for investment advisers to meet their fiduciary duties, as we saw in Mary Jo White’s SEC.

In addition, while not all of them are mentioned in the examination priorities, sponsors should also have heightened awareness of certain areas where the OCIE has issued risk alerts, including: (i) complying with the Investment Advisers Act recordkeeping rule where non-traditional methods of electronic communication, such as text messages, private messaging and phone apps, are used; (ii) risk-based examination initiatives for RICs; (iii) compliance with the Investment Advisers Act cash solicitation rule, which requires a number of conditions to be met for an adviser to pay cash fees to a solicitor; (iv) meeting best-execution obligations under the Investment Advisers Act and (v) adequate disclosure and approval practices for fees and expenses. To the extent advisers have not already done so, they should take a fresh look at their policies and procedures to ensure that these items, along with the areas of priority, are adequately addressed.

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