

# PUBLICATION

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## SEC Office of Compliance Inspections and Examinations Issues 2013 Exam Priorities

March 12, 2013

On February 23, 2013, through the National Exam Program (NEP), the staff of the Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC) published the program's examination priorities for 2013.<sup>1</sup> The Priorities Release describes areas that are perceived by the staff to have heightened risk. Although set by the staff rather than by the Commission itself, the areas identified in the Priorities Release are intended to support the mission of the SEC by seeking to "improve compliance, prevent fraud, inform policy, and monitor firm-wide and systemic risk."<sup>2</sup> Perhaps of equal importance, the Priorities Release provides a roadmap for investment advisers and other market participants that are subject to oversight by the SEC as to segments of their compliance programs that may be subjected to additional scrutiny in the event of an SEC examination.

In addition to setting priorities for the NEP as a whole, the Priorities Release establishes priorities for each of the four distinct program areas of the NEP:

- Investment Advisers and Investment Companies,
- Broker-Dealers,
- Clearing and Transfer Agents and
- Market Oversight.<sup>3</sup>

Although the Priorities Release sets forth the areas in which the NEP expects to allocate a significant portion of its resources in 2013, the list is not exhaustive. The Priorities Release cautions that the NEP "will conduct additional examinations in 2013 focused on risks, issues, and policy matters that are not addressed . . ." in the Priorities Release.<sup>4</sup>

### Program-Wide Initiatives

The NEP has identified four topics that it believes apply to nearly all registrants. What is of note is that the four areas identified in the Priorities Release are the same areas in which the SEC has expressed concern for the past several years.

- ***Fraud Detection and Prevention*** – In order to facilitate trust in the marketplace, the NEP will continue to utilize and enhance the various analytical tools it uses to identify market participants engaged in fraudulent or unethical behavior. Interestingly, the Priorities Release also seeks to elicit "tips, complaints, and referrals from investors, registrants, and other parties . . ." to assist the NEP in identifying fraudulent activity.<sup>5</sup>
- ***Corporate Governance and Enterprise Risk Management*** – The Priorities Release makes it clear that the NEP will continue to focus on the sensitivity of registrants to enterprise risk and the manner in which such risks are managed. In that respect, the Priorities Release indicates that this topic is intended to:
  - Understand firms' approach to enterprise risk management;
  - Evaluate firms' tone at the top; and

- Initiate a dialogue on key risks and regulatory requirements.<sup>6</sup>

In addition to the foregoing, the OCIE staff will continue to engage in "discovery" reviews to inform both examination policy and rulemaking efforts.

- **Conflicts of Interest** – In the view of the staff, conflicts of interest, "when not eliminated or properly mitigated and managed, are a leading indicator and cause of significant regulatory issues for individuals, firms, and sometimes the entire market."<sup>7</sup> The NEP will focus on specific conflicts of interest, steps registrants have taken to mitigate conflicts and the sufficiency of disclosures made to investors. In addition, the staff will review the overall risk governance framework that firms have in place to manage conflicts on an ongoing basis.
- **Technology** – The ongoing revolution in technology, along with increasing complexity, interconnectedness and speed fostered by technology, is a continual challenge to market participants and regulators that has been highlighted by a number of events over the past several years. Thus, the NEP may conduct examinations on governance and supervision of information technology systems such as "operational capability, market access, and information security, including risks of systems outages, and data integrity compromises that may adversely affect investor confidence."<sup>8</sup>

### Areas of Focus for Investment Advisers and Investment Companies

The Priorities Release notes that the NEP has primary examination responsibility for 11,000 registered investment advisers and 800 registered investment company complexes. Each examination is conducted using a risk-based approach and generally is limited to the issues and business practices of each registrant that present the highest risks to investors and the integrity of the market. The foregoing notwithstanding, certain areas will be of ongoing focus during 2013.

#### *Ongoing Risks*

- **Safety of Assets.** The OCIE staff will use a risk-based asset verification process to confirm the safety of client assets and compliance with custody requirements. According to the Priorities Release, recent examinations have found a high frequency of issues regarding the custody and safety of client assets under Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the Custody Rule). Thus, examinations in this area will focus on such areas as:
  - Whether the adviser is appropriately recognizing situations in which they have custody as defined in the Custody Rule;
  - Whether the adviser is complying with the Custody Rule's "surprise exam" requirement;
  - Whether the adviser is satisfying the Custody Rule's "qualified custodian" provision; and
  - Whether the adviser is following the terms of the exception to the independent verification requirements for pooled investment vehicles.
- **Conflicts of Interest Related to Compensation Arrangements.** The OCIE staff will review financial and other records to ensure that all compensation arrangements and the potential conflicts of interest related to such arrangements are fully disclosed to investors.
- **Marketing/Performance.** As one might expect, marketing and performance is viewed as an inherently high-risk area. Thus, the staff will focus on policies and procedures that are intended to ensure, among other marketing activities, the integrity of advertised performance, including hypothetical and back-tested performance.
- **Conflicts of Interest Related to Allocation of Investment Opportunities.** Side-by-side management arrangements where the same manager oversees accounts that do not pay performance fees at the same time that they manage accounts that pay performance fees present the

potential for significant conflicts. Thus, during examinations in this area, the staff will review policies and procedures that are intended to monitor such side-by-side arrangements.

- **Fund Governance.** As with the program-wide initiative, the OCIE staff will look to evaluate the "tone at the top" in assessing risk during any investment company examination. Thus, the staff will review board-related disclosures and board oversight functions, including oversight of service providers, valuation of fund assets and assessment of expenses or viability.

### ***New and Emerging Issues***

- **New Registrants.** On October 9, 2012, OCIE launched a new initiative through the NEP to conduct "Presence Exams" of newly registered investment advisers. The initiative primarily is aimed at investment advisers to private investment funds, such as hedge funds and private equity funds, that were exempt from registration under the Advisers Act prior to the amendments to the Advisers Act brought about by the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Presence Exams Letter announcing the initiative was emailed to the chief compliance officers, other senior executives and principals of newly registered advisers. Click [here](#) for a copy of the letter, as posted on the SEC website.
- **Dually Registered Advisers and Broker-Dealers.** Firms that are dual registrants present unique risks and raise unique conflict of interest concerns. Among other things, the staff will review how financial professionals and firms satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations and whether all conflicts of interest are fully and accurately disclosed. In addition, the staff will review dually registered firms' policies and procedures to understand if such policies and procedures provide guidelines for when a financial professional makes a securities recommendation to a customer with a broker-dealer account versus an investment adviser account.
- **"Alternative" Investment Companies.** The Investment Adviser-Investment Company Program is focusing on the growing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds (ETFs) and variable annuity structures. During examinations, the OCIE staff will assess whether:
  - Leverage, liquidity and valuation policies and practices comply with regulations;
  - Boards, compliance personnel and back-offices are staffed, funded and empowered to handle the new strategies; and
  - The funds are being marketed to investors in compliance with regulations.
- **Distribution Payments.** The Investment Adviser-Investment Company Program is focusing on the wide variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments and boards' oversight of the same. Thus, the staff will assess whether such payments are made in compliance with regulations, including Rule 12b-1 under the 1940 Act, or whether they are instead payments for distribution and preferential treatment.

### ***Policy Topics***

- **Money Market Funds.** Recent amendments to Rule 2a-7 under the 1940 Act require money market funds to periodically stress-test their ability to maintain a stable share price based on hypothetical events, including changes in short-term interest rates, increased redemptions, downgrades and defaults and changes in spreads from selected benchmarks. Thus, during examinations, the staff will review whether firms are conducting stress testing, what factors they are considering in the stress testing and the results of the stress testing.

- **Compliance with Exemptive Orders.** Where applicable, the staff will focus on compliance with previously granted exemptive orders, such as those related to closed-end funds and managed distribution plans, employee securities companies, ETFs and the use of custom baskets and those granted to fund advisers and their affiliates permitting them to engage in co-investment opportunities with the funds.
- **Compliance with the Pay to Play Rule.** To prevent advisers from obtaining business from government entities in return for political "contributions" (i.e., engaging in pay to play practices), the SEC recently adopted and subsequently amended the Pay to Play Rule. The staff will review for compliance in this area, as well as assess the practical application of the rule.

### Areas of Focus for Broker-Dealers

The Broker-Dealer Program (the B-D Program) of the NEP is responsible for an examination program for more than "4,600 registered broker-dealers with approximately 111 million customer accounts, over 160,000 branch offices, and over 630,000 registered representatives." The B-D Program applies a risk-targeted focus to the program and also assists in selecting particular broker-dealers for examination, taking into account:

- The risks and activities associated with individual broker-dealers (or firms); and
- The risks identified in the course of regional risk assessment efforts.

Given the multiple layers of regulatory oversight, the priorities and activities of the B-D Program are closely coordinated with efforts of the Financial Industry Regulatory Authority (FINRA) and state regulators. Also, where a broker-dealer is part of an enterprise with related entities registered in multiple capacities (i.e., broker-dealer, investment adviser, transfer agent, etc.), the B-D Program will coordinate its review activity with relevant programs across the NEP.

### *Ongoing Risks*

- **Sales Practices/Fraud.** The B-D Program frequently finds fraud in connection with sales practices regarding retail investors, including:
  - Affinity fraud or fraud targeting seniors;
  - Unsuitable recommendations of higher yield products (e.g., unsuitable recommendations of municipal or corporate bonds), as well as improper supervision and due diligence processes regarding those recommendations or those products;
  - Activities and products on the periphery of certain registered entities, such as outside business activities or an affiliated entity that the registrant claims is beyond the SEC's jurisdiction;
  - Conflicts of interest that are not appropriately mitigated and are not clearly disclosed in an understandable and timely manner; and
  - Certain firms identified as recidivist or high-risk for potential misconduct.
- **Trading.** The Priorities Release describes concerns with the ongoing evolution of trading activity, especially as it relates to the implementation of technology to facilitate trading activity, including, but not limited to, high-speed and algorithmic trading activity.
- **Capital.** The B-D Program intends to conduct exams of clearing firms with multiple correspondents engaging in high frequency/high volume trading, focusing on the clearing firms' internal controls for managing intraday liquidity risk, as well as assessing intraday net capital and other financial risks.
- **AML.** The B-D Program will seek to identify firms with weak Anti-Money Laundering (AML) programs, especially customer identification programs. It is worth noting that AML programs and suspicious activity monitoring have been areas of focus for the SEC and FINRA since the adoption of the USA PATRIOT Act in 2001.

## New and Emerging Issues

- **Exchange Act Rule 15c3-5.** Given the increase in alternative trading and market access models, compliance with Rule 15c3-5 under the Securities Exchange Act of 1934 as amended (the Market Access Rule) has taken on more importance for both the SEC and FINRA.
  - *Master/Sub-Accounts.* Given the ability of the master/sub-account structure to conceal trading activity, the staff will look closely at this sort of structure in an effort to identify "money laundering activity, market manipulation, unregistered broker-dealers, excessive margin, and inadequate minimum equity for pattern day traders."
  - *Proprietary Trading.* The Priorities Release notes that, in the estimation of the staff, firms may be unaware that the Market Access Rule also applies to proprietary trading activity. Thus, the B-D Program will examine the degree to which firms have developed appropriate policies and procedures related to their proprietary trading activity to meet the requirements of the Market Access Rule.
  - *Supervision of Registrants' Technology System Controls and Governance.* As noted above, the increased reliance on technology in securities has posed unique concerns to the staff. Given recent events, the staff will look to examine the degree to which broker-dealers have sufficient "controls and oversight over technology systems and supervision of personnel, as well as the adequacy of firms' protocols to address systems that are acting counter to expectations, and the robustness of firms' risk management procedures."
  - *Dual Registrants/Regulatory Coordination.* In addition to the concerns described above with respect to broker-dealers that also are registered as investments advisers, the B-D Program will look closely at firms that also are registered as futures commission merchants with the Commodities and Futures Trading Commission (CFTC). In particular, the B-D Program will look to coordinate its efforts with the CFTC and "Designated Examination Authorities" (i.e., a self-regulatory organization with oversight responsibilities for a specific broker-dealer).
- **Exchange Traded Funds.** Given the increased popularity of ETFs, the B-D Program will look closely at compliance by broker-dealers selling such products with applicable rules, including Regulation SHO and suitability determinations by broker-dealers in connection with ETFs generally and leveraged or inverse ETFs in particular.

## Policy Topics

- **JOBS Act.** Once rulemaking is completed with regard to the various exemptions and other provisions of the Jumpstart Our Business Start-Ups Act of 2012 (the JOBS Act), the B-D Program will look closely at firms engaged in "crowd-funding" and other activity. As an aside, it is reasonable to assume that the B-D Program also will review the degree to which broker-dealers engage in crowd-funding and general solicitations in advance of final JOBS Act rulemaking in violation of existing rules.
- **Other Regulatory Requirements.** In addition to recent rulemaking related to municipal securities advisors and incentive-based compensation, the staff intends to focus on compliance with various rulemaking related to the Dodd-Frank Act, including compliance with "Security-Based Swap Dealers rules pending the final adoption or compliance effective date for such rules."

The Priorities Release is an important reminder that a compliance program is intended to be dynamic and evolving to meet developments in the marketplace, as well as regulatory developments. An effective compliance program is the best way to minimize regulatory and reputational risk. Waiting for the OCIE to send you notice of an examination is not an effective review program. If you would like to discuss ways in which your compliance program can be strengthened or enhanced to meet these challenges, please contact any member of our [Broker-Dealer/Registered Investment Adviser](#) group.

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<sup>1</sup>*National Exam Program, Office of Compliance Inspections and Examinations, Examination Priorities for 2013*, SEC Rel. (Feb. 21, 2013) (the Priorities Release).

<sup>2</sup>*Id.*

<sup>3</sup>*Id.* This client alert will focus on those portions of the Priorities Release that are applicable to investment advisers, investment companies and broker-dealers.

<sup>4</sup>*Id.*

<sup>5</sup>*Id.* at 2.

<sup>6</sup>*Id.*

<sup>7</sup>*Id.*

<sup>8</sup>*Id.* at 3.