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Legal Update
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US Securities and Exchange Commission Announces 2015 Examination Priorities

The Office of Compliance Inspections and Examinations ("OCIE") of the US Securities and Exchange Commission ("SEC") has announced its 2015 examination priorities.[1] OCIE stated that, in 2015, it will focus on the following thematic areas: matters of importance to retiring or retired retail investors; structural risks and trends that are market wide; and data analytics to identify illegal activity. The priorities identified by OCIE, and those discussed herein, are merely intended to illustrate certain broader themes impacting the investment adviser and broker-dealer industries, they are not exhaustive of the issues that are important or are of concern, or that will be focused on during an examination.

Protecting Retail Investors and Investors Saving for Retirement

OCIE has indicated that it will be focusing on a number of initiatives to assess the risks to retail investors. It is doing this in recognition of: (i) the increasing variety of new products and services being offered to retail investors; (ii) retail investors' growing dependence on defined contribution ("DC") plans, such as 401(k) accounts, for their retirement; and (iii) the broad array of information, advice products, and services offered to retail investors to help them pay for, and live in, their retirement years. These initiatives, and OCIE's focus on these areas, build upon those first cited by OCIE as part of its 2014 exam priorities and should be considered by standalone investment advisory entities and dually registered broker-dealer/investment advisers. OCIE has designated the following six initiatives that will focus on protecting retiring or retired retail investors.

- **Fee arrangements and reverse churning.** Given the variety of account types and fee structures that are increasingly becoming available to investors, OCIE will be focusing extensively on the recommendation of account types and whether they are in the best interests of the investor, both at inception of the arrangement and going forward. For instance, investors may have options to choose among traditional commission-only brokerage accounts versus advisory accounts. Further, within the advisory account spectrum, investors may be able to select from traditional separate accounts managed by the adviser (or discrete teams within the adviser, which in the context of retail investors are more common at large financial service firms), separate account wrap accounts, mutual fund wrap accounts, unified fee overlay accounts, private fund allocation programs, and other programs.

  It is important to recognize that OCIE reviews may consider the suitability of the underlying products selected for the investor (e.g., mutual funds, ETFs versus alternatives, real estate, direct management strategies, and other programs), as well as the suitability of the fees assessed, including fees assessed by the advisory firm and fees that may be assessed by the underlying investment products utilized. Given OCIE's efforts to assess the suitability of such recommendations on an ongoing basis, registrants should consider the scope of their ongoing surveillance and testing of their recommended allocations. Importantly, OCIE's reference to "reverse churning" might suggest an effort to evaluate the ongoing level of services provided by the adviser with respect to each account.

- **Sales practices.** Increased scrutiny of advisers' sales practices when recommending that retail investors move their retirement assets from a DC plan into another investment account, especially when the risks and fees increase. For example, as noted in OCIE's 2014 examination priorities, recommendations to rollover employer-sponsored 401(k) plans into higher-cost investments remains a concern, including whether advisers are misrepresenting their credentials or the benefits and features of individual retirement account plans and other alternatives.
- **Recommendations to invest in structured products and higher-yielding investments.** Increased focus on the suitability of, due diligence conducted on, and disclosures made about recommendations to retail investors to move their retirement assets into structured, complex or high-yield products (e.g., leveraged ETFs and structured products). OCIE noted this initiative as part of its 2014 examination priorities, but specifically in respect of its broker-dealer examination program. These concerns continue to build upon results identified by the SEC in 2011 as a result of an industry-wide sweep of broker-dealer practices.[2] Among other things, the staff noted an ostensible lack of training requirements for supervisors and registered representatives that market structured products to their customers. These resulted, at times, in the making of unsuitable recommendations and the omission of materials facts about structured products offered to retail investors and raised a concern that certain questionable sales practices had been utilized. The staff report included a number of recommendations for registrants, including the maintenance of controls to independently review their desk prices of structured securities products in the secondary market; controls to adequately review the suitability of these products for customers; and controls to review customer concentrations in the structured securities products it sold.
- **Branch offices.** Expanded initiative that looks at firms' supervision of their branch offices and whether the branch office adheres to the firm's compliance practices.
- **"Alternative" registered investment companies.** Continued scrutiny of these funds' policies and procedures concerning valuation, leverage, and liquidity, as well as the adequacy of their internal controls (including staffing, funding, board authority, compliance personnel, and back-office support) and the manner in which such funds are marketed to investors. Liquidity management and the use of derivatives in mutual funds and ETFs continue to be two key areas of focus by the SEC staff. As indicated recently, the SEC staff has been considering whether broad risk-management programs should be required for mutual funds and ETFs to address the risks related to their liquidity and derivatives use, as well as measures to ensure the SEC's comprehensive oversight of those programs.[3] The staff has also been reviewing options for specific requirements, such as updated liquidity standards, disclosures of liquidity risks, or measures to appropriately limit the leverage created by a fund's use of derivatives.
- **Fixed-income investment companies.** Expanded review of funds with exposure to interest rate increases to determine whether

their policies and procedures, controls, and disclosures are sufficient. This follows on a Guidance Update addressing these issues released by the SEC's Division of Investment Management in January 2014[4] and the widely reported sweep of bond funds by OCIE in late 2014.

Assessing Market-Wide Risks

Focusing on the markets, OCIE stated that it will examine structural risks and trends across firms and the industry. OCIE announced the following initiatives targeted at the asset management industry to achieve this objective:

- **Monitoring of large broker-dealers and investment advisers.** Continued monitoring of the largest broker-dealers and investment advisers for individual risk and for early awareness of industry-wide developments. This follows on SEC Chair White's speech on this topic on December 11, 2014.[5]
- **Cybersecurity.** Continued focus on cybersecurity compliance and controls, and the expansion of this initiative to include transfer agents. This follows on OCIE's sweep exams of funds' cybersecurity preparedness, which was announced in April 2014.[6]
- **Order routing.** Initiative that focuses on whether firms are prioritizing trading venues based on payments or credits for order flow, in conflict with their best execution duties.

Data Analytics

OCIE expects to significantly expand its use of data analytics to review firms that appear to be engaged in illegal activity. OCIE's data analytics initiatives will include a focus on investment advisers that employ individuals with a history of misconduct. Further, as part of its Anti-Money Laundering initiative, OCIE will focus on firms that have not filed, or that have filed incomplete, suspicious activity reports.

Other Initiatives

In addition to the initiatives pertaining to the three themes for 2015, OCIE has announced the following four initiatives directed at the asset management industry:

- **Municipal advisers.** Continued examinations, industry outreach, and education of newly registered municipal advisers.
- **Proxy advisers.** New initiative that entails examinations of proxy advisory service firms, with a focus on the recommendation process and disclosures about potential conflicts, and of investment advisers for compliance with their fiduciary duties when voting proxies for clients.
- **Never-before-examined investment companies.** New initiative that consists of risk-based examinations of funds that have not been examined. This initiative should be distinguished from the 2014 initiative, which had focused on never-before-examined *advisers*.
- **Private equity ("PE") fund advisers' fees and expenses.** Continued focus on fees and expenses assessed by PE fund advisers. These issues have previously been discussed by the SEC on several occasions, perhaps most notably by OCIE Director Andrew Bowden in his May 2014 speech about the PE industry entitled "Spreading Sunshine in Private Equity."[7] More specifically, Director Bowden noted that when OCIE examined how fees and expenses were handled by advisers to PE funds, OCIE identified what it believed to be violations of law or material weaknesses in controls more than 50% of the time. Some of the more common areas of interest to OCIE are the use and disclosure of "operating partners," the misallocation of management company expenses, unfair allocation among side-by-side clients, as well as the use, disclosure, and reasonableness of fees paid to

related-party service providers. Fees and expenses, as well as conflicts of interest and other general disclosure issues will continue to be emphasized by OCIE during examinations.

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Endnotes

1 OCIE, National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015), http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

2 *See* OCIE, Staff Summary Report on Issues Identified in Examinations of Certain Structured Securities Products Sold to Retail Investors (July 27, 2011), *available at* https://www.sec.gov/news/studies/2011/ssp-study.pdf.

3 Chair Mary Jo White, Speech at the DealBook Conference at One World Trade Center: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543677722 [hereinafter Chair White's Speech at the DealBook Conference].

4 SEC, IM Guidance Update 2014-01 (Jan. 2014), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf.

5 See Chair White's Speech at the DealBook Conference.

6 SEC, National Exam Program Risk Alert: OCIE Cybersecurity Initiative (Apr. 15, 2014), *available at* http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf.

7 Andrew Bowden, Director, OCIE, Speech at the Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 6, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370541735361.