

# On the Radar for 2017 Exams of US-Regulated Investment Advisers and Broker-Dealers

Although the examination and enforcement priorities of the US Securities and Exchange Commission (“SEC”) may be in flux given imminent personnel changes under the Trump administration, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) announced examination priorities for 2017. We do not expect material changes to these areas of focus for OCIE staff during 2017 examinations of SEC-registered investment advisers and broker-dealers. The Financial Industry Regulatory Authority (“FINRA”) also released a list of examination priorities for 2017 for its broker-dealer member firms. This Legal Update explores OCIE and FINRA examination priorities, which advisers and broker-dealers should keep in mind now.

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## Introduction

Although the examination and enforcement priorities of the US Securities and Exchange Commission (“SEC”) may be in flux given imminent changes in key personnel of that agency under the Trump administration, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) announced examination priorities for 2017. We do not expect material changes to these areas of focus for OCIE staff during 2017 examinations of SEC-registered investment advisers and broker-dealers.<sup>1</sup> In a somewhat similar fashion, the Financial Industry Regulatory Authority (“FINRA”) released a list of examination priorities for its broker-dealer member firms.<sup>2</sup> As an independent, non-governmental, self-regulatory organization, FINRA is not managed by political appointees,<sup>3</sup> thus its examination priorities are less likely to change as a result of the new administration. Accordingly, it would be prudent for advisers and broker-dealers to be mindful of at least the major themes, if not the specific topics, that this Legal Update highlights from the OCIE and FINRA priorities lists.

## OCIE Examination Priorities

OCIE announced that, in 2017, it will continue to focus on the following thematic areas: protecting retail investors; protecting senior investors and retirement investments; and assessing market-wide risks.<sup>4</sup> OCIE’s announcement follows a new single fiscal year high for SEC enforcement actions, which included a record high number of cases involving advisers or investment companies (160) and a record high number of independent or standalone cases involving advisers or investment companies (98).<sup>5</sup> Overall, during fiscal year 2016, the SEC filed 868 enforcement actions, and brought a record 548 standalone or independent enforcement actions.<sup>6</sup> Although somewhat uncertain due to the new administration in Washington as well as the recently announced plan of OCIE Director Marc Wyatt to leave the SEC in late-February or early-March 2017,<sup>7</sup> enforcement and examination activity may well continue at a robust pace during 2017.

## SIX ACTIONS TO TAKE NOW

1. **Socialize** – Share this information with relevant internal and external legal and compliance resources.
2. **Review and Evaluate Relevance** – Legal and compliance resources should review OCIE’s examination priorities and evaluate whether and to what extent the priorities relate to the firm’s business operations.
3. **Identify Relevant Stakeholders to Evaluate Risk** – For each examination priority that relates to the firm’s business operations, identify relevant stakeholders that may be needed to conduct a risk assessment.
4. **Conduct a Risk Assessment** – Coordinating, as appropriate, with relevant stakeholders within the enterprise, conduct a risk assessment to identify potential areas of non-compliance or concern. *Note: OCIE’s continued focus on retail and senior investors serves as an important reminder to legal and compliance personnel alike that legal and regulatory risk assessments of a particular action, practice or product need to take into account the type of client or investor, as well as the nature and purpose of the investment.*
5. **Formulate Next Steps** – Identify and coordinate with (and seek approval from) relevant stakeholders that should be involved in determining what steps, if any, are necessary or appropriate to address the concern, and make such determinations.
6. **Implement Steps in Response** – Working with relevant stakeholders, implement the steps described above.

## PROTECTING RETAIL INVESTORS

OCIE announced that it will continue to prioritize the protection of retail investors, and highlighted the following seven related focus areas:

- **Electronic investment advice/robo-advisers (new exam priority).** For 2017, OCIE will focus on registered advisers and broker-dealers that provide investment advice through automated or digital mechanisms, including: (i) “robo-advisers” that primarily interact with clients online and (ii) firms that utilize automation as part of their services. OCIE said that examinations will likely focus on such firms’ compliance programs, marketing, formulation of investment recommendations, data protection, conflicts of interest disclosures and compliance practices for overseeing algorithms that generate recommendations.<sup>8</sup>

Although this area was not included as a 2016 examination priority,<sup>9</sup> the SEC has raised concerns about “robo-advisers” in the past few years<sup>10</sup> and has certainly been interested in quantitative strategies and related regulatory concerns for some time.<sup>11</sup> Notably, to date, neither OCIE nor the SEC’s Division of Investment Management has publicly issued any regulatory guidance pertaining to areas like the accuracy of algorithms, delivery of results relative to promised quant model capabilities and other quant-driven investment strategies, presumably placing that authority with OCIE and its staff.

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*Robo-advisers face specific regulatory challenges, such as those related to: investment company status and investment suitability (particularly with programs that have limited human interaction), quantitative models/algorithms, cybersecurity and data privacy, and digital/electronic business continuity.*

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- **Multi-branch adviser (continued focus from last year).** OCIE will continue to focus on advisers that provide advisory services from multiple locations. OCIE believes that branch office models can pose unique risks to advisers, particularly regarding the design and implementation of the compliance programs and oversight of the advisory services provided at their branch offices. This 2017 examination priority relates to a risk alert released by OCIE in December 2016.<sup>12</sup> In the risk alert, OCIE said that examination staff will assess, among others, the adviser’s compliance program and supervisory controls, particularly as they relate to branch offices.<sup>13</sup> In a change from last year, this year’s examination focus on multi-branch offices does not reference broker-dealers.<sup>14</sup>

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*Over the years, regulatory compliance and supervision have been ongoing challenges for multi-office advisers. However, these challenges can intensify with: (i) an adviser’s growth (not only in terms of employees and locations, but also with respect to lines of business), (ii) international and cross-border expansion and resource sharing, (iii) progressive telecommuting and other alternative work arrangements and (iv) a principal office compliance function.*

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- **Never-before examined advisers (expanded focus from prior years).** OCIE is expanding its never-before examined adviser initiative<sup>15</sup> to include focused, risk-based examinations of newly registered advisers, as well as certain advisers that have been registered for some time but have not been examined before.

We do not believe that the exam staff expects a full compliance program to be in place as of registrant status. Clearly, compliance policies and procedures should be created and evolve as assets arrive and begin to be managed. However, some policies and procedures must be in place as of the date of registration, such as an insider trading procedure and a code of ethics that includes personal securities trading reporting and related requirements of Investment Advisers Act of 1940 ("Advisers Act") Rule 204A-1. The exam staff would be concerned if, upon examination of a newly registered adviser, at least these policies and procedures were not adopted and in force. Better advice is to be able to show the exam staff drafts of more substantive policies and procedures to demonstrate an understanding of Advisers Act requirements under Rule 206(4)-7.

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*We have found that examinations of newly registered advisers can occur quickly, in some cases even before the registrant has begun advisory operations.*

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- **Wrap fee programs (renewed and expanded focus from last year).** OCIE is renewing and expanding this initiative from prior years, which focuses on advisers and broker-dealers that are associated with wrap fee programs.<sup>16</sup> OCIE likely will review whether advisers are acting consistent

with their fiduciary duties and meeting their contractual obligations to clients.<sup>17</sup> Additional areas of interest may include: (1) the suitability of wrap accounts,<sup>18</sup> (2) effectiveness of disclosures, (3) conflicts of interest and (4) brokerage practices (including best execution<sup>19</sup> and trading away<sup>20</sup>).

Recent enforcement actions brought against wrap fee sponsors provide fertile ground for wrap fee program exams, particularly programs in which frequent trading away practices occur.<sup>21</sup>

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*This examination focus has crystallized in recent years. In 2014, OCIE specifically called out wrap fee programs as an examination focus.<sup>22</sup> In 2015 and 2016, OCIE's interest in wrap fee programs was included in the more general subjects of fee selection and reverse churning. For 2017, OCIE returned to a specific focus on wrap fee programs. Undoubtedly, the 2016 enforcement actions involving active trading away in wrap fee programs have provoked examination interest.*

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- **Exchange-traded funds (continued focus from last year).** OCIE will continue its exchange-traded funds ("ETFs") initiative. Like last year, OCIE will continue to focus on compliance with applicable regulations and exemptive relief, and review unit creation and redemption processes. This year, OCIE's focus will also include: (1) sales practices and disclosures involving ETFs and (2) suitability of broker-dealers' recommendations to purchase ETFs with niche strategies, a somewhat more narrow focus as compared to last year.<sup>23</sup>

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*Regarding compliance with exemptive relief, in May 2013, the SEC's Division of Investment Management issued a Guidance Update encouraging funds to adopt policies and procedures designed to ensure ongoing **compliance with exemptive order conditions**.<sup>24</sup> Although not specified in the Guidance Update, those relying on exemptive orders also should be cognizant of changes to the facts or representations made to the SEC in seeking relief.*

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- **Employees with a history of misconduct (continued focus from last year)**. OCIE will continue last year's recidivist representative examination priority. OCIE will focus on individuals with a track record of misconduct and will examine the advisers that employ them (including, for example, an assessment of those advisers' compliance oversight and controls).

The announcement of last year's examination priority regarding recidivist representatives was followed by April 2016 SEC enforcement actions against an adviser and its regional director for, among other things, their failure to implement a heightened supervision plan for an employee who had a poor credit history and who was subject to a FINRA investigation.<sup>25</sup>

A few months later, OCIE published a risk alert regarding this subject.<sup>26</sup> In the risk alert, OCIE, referencing its 2016 examination priorities, stated that its examinations of these types of advisers would focus on the following key risk areas: compliance programs,<sup>27</sup> disclosures,<sup>28</sup> conflicts of interest<sup>29</sup> and marketing.<sup>30</sup>

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*This examination focus also raises important questions about the supervision, **management and control of "difficult" or uncooperative employees**, even those who may not have a disclosed disciplinary history or a history of compliance violations.*

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- **Share class selection (continued from related July 2016 risk alert)**. Referencing a related July 2016 risk alert,<sup>31</sup> OCIE stated that it will continue its focus on conflicts of interest or other factors that might affect registrants' mutual fund share class recommendations. As an example, OCIE stated that it will review conflicts that advisory personnel may have, such as those who are also registered representatives of a broker-dealer, which could influence share classes recommendations to favor classes with higher loads or distribution fees. OCIE will also assess how registrants are formulating investment recommendations and managing client portfolios.

In the July 2016 risk alert, OCIE stated that it is seeking to identify conflicts tied to advisers' compensation or financial incentives for recommending mutual fund or 529 Plan share classes that have substantial loads or distribution fees. As examples, OCIE cited situations where the adviser is a dual registrant or affiliated with a broker-dealer that receives fees from certain share classes, and situations where the adviser recommends that clients purchase more expensive share classes of funds for which it or an advisory affiliate receives more fees. Referencing a 2013 enforcement action, the risk alert warns that the SEC has taken the position that an investment adviser has failed to uphold its fiduciary duty when it causes a client

to purchase a more expensive share class of a fund when a less expensive class of that fund is available.<sup>32</sup> OCIE then discussed three high-risk areas that it will assess during an examination: fiduciary duty and best execution,<sup>33</sup> disclosures<sup>34</sup> and compliance programs.<sup>35</sup> Prior to issuing the risk alert, the SEC brought enforcement actions against advisers for placing advisory client assets in higher fee share classes that paid 12b-1 fees to advisory affiliates.<sup>36</sup>

In preparation for the effective date of the fiduciary duty rule adopted by the Department of Labor, many mutual fund organizations, including distributors, have designed new share classes, such as "T Shares," that are suitable for commission-based accounts. Although the fate of the rule is uncertain given recent Trump administration action, many organizations have spent considerable time and money in preparation for the rule. As such, these new shares, and enhanced compliance oversight of suitability, are very likely to remain part of product inventory regardless of the fate of the rule. We are likely to see an enhanced uptick in this examination priority, again, regardless of what ultimately happens to the rule.

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*This examination priority serves as a valuable reminder of the scope of an adviser's and broker-dealer's "best execution" and suitability obligations and the importance of disclosure regarding not only conflicts of interest themselves, but also the manner in which the adviser addresses them.*

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## PROTECTING SENIOR INVESTORS AND RETIREMENT INVESTMENTS

OCIE will continue to prioritize the protection of senior investors and those investing for retirement. OCIE stated that it has increased its attention to

these issues, due to an aging US population, and has set out the following three related focus areas:

- **Senior investors (new specific focus).** Although the general protection of senior investors was included in OCIE's 2016 examination priorities, OCIE said that, this year, it will focus specifically on advisers' and broker-dealers' management of their interactions with elderly investors, including their ability to identify financial exploitation. OCIE staff also will likely focus on registrants' supervisory programs and controls over products and services directed at senior investors.<sup>37</sup> Similarly, FINRA has designated as a 2017 priority the protection of senior investors; please see below.
- **Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative (continued focus).** OCIE has modified last year's initiative targeted at advisers and broker-dealers and the services they offer to investors with retirement accounts.<sup>38</sup> For 2017, OCIE will focus on firms' recommendations and sales of variable insurance products,<sup>39</sup> as well as the sale and management of "target date" funds. Additionally, OCIE will assess controls pertaining to cross-transactions, particularly with respect to fixed income securities. This examination priority relates to a risk alert released by OCIE in June 2015.<sup>40</sup> In the risk alert, OCIE said that examination staff will focus on the services offered by advisers and broker-dealers to investors with retirement accounts in the following areas: the reasonable basis for recommendations, conflicts of interest, supervision and compliance controls, and marketing materials and disclosures to retail investors saving for retirement.
- **Public pension advisers (modified focus).** OCIE has modified last year's initiative regarding public pension advisers (i.e., advisers to pension plans of government entities, such as states and municipalities).<sup>41</sup> For 2017, OCIE will focus on



how public pension advisers are managing conflicts of interest and fulfilling their fiduciary duty. OCIE will continue to review other risk areas related to public pension advisers, such as pay-to-play and undisclosed gifts and entertainment practices, both of which were included as 2016 examination priorities.

To underscore the importance of examining public pension advisers, then-Director of Enforcement Andrew Ceresney said in May 2016:

“Now, why is the SEC spending its limited resources on the private equity industry given the sophistication of most investors? Because it is important to understand that retail investors are significantly invested in private equity. For example, public pension plans frequently invest the retirement savings of their plan beneficiaries — which include teachers, police officers and firefighters — in private equity funds. . . . the underlying victims [of fraud] frequently include retail investors . . . .”<sup>42</sup>

With vacancies at the Division of Enforcement and OCIE director levels, it is unclear if this perspective will follow with new SEC leadership. We believe there is a strong likelihood that it will.

## ASSESSING MARKET-WIDE RISKS

OCIE stated that it will continue to examine structural risks and trends across firms and the industry, announcing the following four initiatives that will affect advisers and/or broker-dealers<sup>43</sup>:

- **Money market funds (new focus).** OCIE will begin examining money market funds’ (“MMFs”) compliance with the 2014 reforms, which became effective in October 2016.<sup>44</sup> (Our summary of these reforms is available [here](#).) During an examination, OCIE staff will likely assess the MMF board’s oversight of the MMF’s compliance with

the 2014 reforms, as well as the MMF’s compliance policies and procedures related to stress testing and periodic reporting to the SEC.

- **Payment for order flow (renewed focus).** OCIE has renewed its focus on payment for order flow. OCIE will examine select broker-dealers (i.e., those who accept and/or process numerous customer orders in US exchange listed securities) to determine whether they are routing customer orders for execution in accordance with their respective duties of best execution. This initiative was previously announced in 2015.<sup>45</sup>
- **Anti-money laundering (continued focus).**<sup>46</sup> OCIE will continue to examine broker-dealers’ anti-money laundering (“AML”) programs to assess: (1) whether their AML programs are tailored to their specific risks (including whether they consider and adapt their programs to current laundering and terrorist financing risks), (2) how they are monitoring for suspicious activity, (3) the effectiveness of independent testing and (4) whether they are complying with the suspicious activity report (“SAR”) requirements (including the timeliness and completeness of SARs filed). This also is an examination priority for FINRA; please see below.
- **Cybersecurity (continued focus).** OCIE will continue to examine firms’ cybersecurity compliance procedures and controls, including testing the implementation of these procedures and controls. This matter has been a priority at the SEC over recent years.<sup>47</sup> This also is an examination priority for FINRA; please see below.

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*In our 2017 [outlook on cybersecurity and data privacy](#), we review the key issues that companies should consider as they continue to refine their cybersecurity and data privacy programs.*<sup>48</sup>

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## OTHER INITIATIVES ANNOUNCED BY OCIE

In addition to the above initiatives, OCIE announced the following two initiatives directed at the asset management industry<sup>49</sup>:

- **Private fund advisers (continued focus).** OCIE will continue to examine private fund advisers<sup>50</sup> and will focus on private fund advisers' conflicts of interest and the adequacy of their disclosures concerning such conflicts. OCIE staff will also look for actions and practices that appear to benefit the adviser at the expense of investors.

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*The SEC continues its intense focus on **expense allocations** in the private fund space, and has brought a number of enforcement actions in this area.<sup>51</sup>*

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- **Municipal advisors (expanded focus).** OCIE has expanded last year's initiative regarding municipal advisors to include examinations of municipal advisors in general (not just newly registered municipal advisors<sup>52</sup>) for compliance with SEC and Municipal Securities Rulemaking Board ("MSRB") rules. This initiative will continue to include industry outreach and education.

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*In August 2014, OCIE launched its **municipal advisor examination initiative** and made publicly available a letter to municipal advisors, which identified risk areas that examination staff may focus on during an exam.<sup>53</sup> Recently, the SEC has brought several enforcement actions in this area.<sup>54</sup>*

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## ADDITIONAL AREAS OF INTEREST

Although not mentioned in the 2017 examination priorities, there are a number of regulatory and compliance subjects that are likely to remain of interest to the SEC and its staff, as summarized below:

- **Protection of whistleblowers.** Whistleblower rule compliance is likely to remain a point of interest for the SEC. In October 2016, OCIE published a risk alert on this subject, announcing that OCIE is examining registered advisers and registered broker-dealers, reviewing, among other things, compliance manuals, codes of ethics, employment agreements, and severance agreements to determine whether provisions in those documents pertaining to confidentiality of information and reporting of possible securities law violations may raise concerns under the whistleblower rule.<sup>55</sup> OCIE cited as examples provisions that: (a) purport to limit the types of information that an employee may convey to the SEC or other authorities and (b) require departing employees to waive their rights to any individual monetary recovery in connection with reporting information to the government. OCIE warned that provisions requiring employees to represent that they either have or have not assisted in any investigation involving the registrant may also contribute to violations of the whistleblower rule. This risk alert followed a number of enforcement actions regarding whistleblower rule compliance against companies that retaliated against whistleblower employees or required employees to pre-clear with the company disclosures to government agencies, execute agreements with overly broad confidentiality provisions, and waive their right to recover financial whistleblower rewards for reporting misconduct to the SEC and other government agencies.<sup>56</sup>
- **Other areas.** Other areas that are likely to be of continued interest include: (1) performance-related due diligence, disclosures and recordkeeping,<sup>57</sup> (2) disclosures,<sup>58</sup> (3) conflicts of interest generally,<sup>59</sup> (4) personal trading and outside business activities,<sup>60</sup> (5) valuation,<sup>61</sup> (6) liquidity,<sup>62</sup> (7) best execution and trading

practices,<sup>63</sup> (8) custody,<sup>64</sup> (9) insider trading,<sup>65</sup> (10) “pay to play”,<sup>66</sup> (11) gifts and entertainment,<sup>67</sup> (12) business continuity<sup>68</sup> and (13) supervision.<sup>69</sup>

In a recent risk alert, OCIE reviewed the following five compliance topics most frequently identified in deficiency letters sent to advisers: compliance rule,<sup>70</sup> regulatory filings,<sup>71</sup> custody rule,<sup>72</sup> code of ethics rule,<sup>73</sup> and books and records rule.<sup>74</sup>

## FINRA Regulatory and Examination Priorities

As noted above, FINRA, the self-regulatory organization for broker-dealers (but not investment advisers), released its Annual Regulatory and Examination Priorities Letter for 2017 (the “Priorities Letter”).<sup>75</sup> Although a number of the topics listed in FINRA’s Priorities Letter overlap with OCIE’s, FINRA’s letter provides different details, and so we provide them separately below.

In planning and executing an examination, FINRA will consider, among other things, a broker-dealer’s business model, size and complexity of operations, and the nature and extent of a broker-dealer’s activities against the priorities outlined in its letter.<sup>76</sup> Thus, as always, the Priorities Letter can, and should, be used by broker-dealers to identify priorities applicable to their business units and to strengthen their compliance, supervisory and risk management controls.

While most of the topics addressed in the 2017 Priorities Letter have been a focus in prior years, it appears that the priorities for 2017 are fundamental compliance areas where FINRA has observed common weaknesses. As Robert Cook, FINRA’s Chief Executive Officer, stated, the common thread for 2017 is a focus on “core ‘blocking and tackling’ issues of compliance supervision and risk management.”<sup>77</sup>

## HIGH-RISK AND RECIDIVIST BROKERS

Similar to OCIE, in 2017, FINRA will continue its focus on broker-dealers’ hiring and monitoring of high risk and recidivist associated persons. FINRA launched its “High Risk Broker” initiative in 2013 to identify individual brokers that display a pattern of complaints or disclosures for sales practice abuses.<sup>78</sup> In particular, FINRA was concerned with the potential harm to investors as well as the reputation of the securities industry and financial markets.<sup>79</sup>

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*In 2014, FINRA expanded the **High Risk Broker** program and created an Enforcement unit dedicated to the prosecution of cases against high-risk brokers.*<sup>80</sup>

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## SALES PRACTICES

- **Excessive and short-term trading of long-term products (new focus).** A new area of focus for FINRA will be instances of brokers recommending that their clients trade long-term products (*e.g.*, open- and closed-end mutual funds, variable annuities and unit investment trusts (“UITs”)) on a short-term basis. Accordingly, in 2017, FINRA will evaluate broker-dealers’ ability to monitor for such trading patterns. In addition, FINRA urges broker-dealers to review their supervisory systems and ensure that the systems can detect activity intended to evade automated surveillance for excessive switching activities.

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*It appears that this focus stems from FINRA’s 2016 targeted exam that focused on **UIT rollovers** during which it observed, for example, that some brokers were using early UIT rollovers to increase their sales credit to the detriment of their clients.*<sup>81</sup>

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- **Social media and electronic communications retention and supervision (expanded focus).**

FINRA will expand its focus of technology management, and will pay particular attention to broker-dealers' compliance with their supervisory and record-retention obligations regarding social media and other electronic communications based on the increasingly important role they play in the securities business.

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*Regardless of the devices or networks used, SEC and FINRA record-retention requirements require broker-dealers to capture and maintain business-related communications, and broker-dealers must do so in such a way that the broker-dealer can review them for inappropriate business conduct.*

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- **Senior investors (continued focus).** Similar to OCIE, the protection of senior investors will also remain a top priority for FINRA in 2017. FINRA will evaluate the controls that broker-dealers implement in order to protect senior investors from fraud, abuse and improper advice. Specifically, FINRA will assess whether investments intended to obtain a higher yield, such as speculative or complex products, were suitable given the investor's investment profile and risk tolerance. Like OCIE, FINRA will focus on whether broker-dealers have the appropriate supervisory systems in place to detect and prevent problematic sales practices. Finally, FINRA will focus on microcap schemes targeted at the elderly.

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*FINRA noted an increase in 2015 and 2016 in the use of aggressive sales practices by unregistered persons in sales schemes targeted at the elderly, and noted that there are a number of controls that broker-dealers can implement to enhance protection of elderly clients from financial exploitation.*

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- **Product suitability and concentration (continued focus).** Suitability will remain an area of focus for FINRA in 2017. FINRA will assess how broker-dealers conduct reasonable-basis and customer-specific suitability reviews. These assessments may include examination of broker-dealers' product vetting process, supervisory systems and controls to review specific recommendations. In 2017, it appears that FINRA will pay specific attention to the adequacy of broker-dealers' supervision and training when new products are introduced, new features of existing products are introduced, or market conditions change in ways that could affect product performance.

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*FINRA will increase its focus on the controls broker-dealers use to monitor recommendations that could result in over-concentration in customers' accounts. This could include excessive concentration in a particular type of product (e.g., long-duration fixed income instruments) or excessive concentration in securities exposed to an industry sector.*

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- **Outside business activities and private securities transactions (continued focus).** Outside business activities ("OBAs") and private securities transactions will continue to be an area of focus for FINRA. As it has previously done, FINRA will evaluate broker-dealers' procedures to review registered persons' written notifications of proposed OBAs. FINRA will also focus on broker-dealers' procedures for handling associated

persons' notifications of proposed private securities transactions and any ongoing supervision over associated persons' approved private securities transactions for compensation.

## OPERATIONAL RISKS

- **Supervisory controls testing (new focus).** In 2017, FINRA will assess broker-dealers' testing of their internal supervisory controls. FINRA believes that regular testing is critical to enabling broker-dealers to identify and mitigate gaps or inadequate controls that, left undetected, may lead to systemic control breakdowns. In light of this concern, FINRA reminds broker-dealers of the obligations with respect to supervisory controls testing (Rule 3120) and CEO certifications (Rule 3130).
- **Cybersecurity (expanded focus).** According to FINRA, cybersecurity threats are one of the most significant risks many broker-dealers face. Thus, as with OCIE, in 2017, FINRA will continue to assess broker-dealers' programs to mitigate those risks. FINRA's assessments will be tailored to each broker-dealer's program based on a variety of factors, including its business model, size and risk profile. Among the areas that FINRA may review are broker-dealers' methods for preventing data loss, controls broker-dealers use to monitor and protect data, how broker-dealers manage their vendor relationships, and controls to prevent sensitive information from insider threats. As part of the Priorities Letter, FINRA draws broker-dealers' attention to two areas in which it has observed repeated shortcomings in control: (1) cybersecurity controls at branch offices; and (2) fulfillment of obligations under Exchange Act Rule 17a-4(f) that requires broker-dealers to, among other things, preserve certain records in a non-rewritable, non-erasable format (commonly known as "write once read many" format).
- **Customer protection/segregation of client assets (expanded focus).** FINRA will evaluate whether broker-dealers have implemented adequate controls and supervision to protect customer assets pursuant to Exchange Act Rule 15c3-3. For example, FINRA will assess whether broker-dealers properly include customer securities positions and money balances in multiple platforms in the reserve formula and in the possession or control calculations. In addition, FINRA will review whether broker-dealers maintain sufficient documentation to demonstrate that securities are held free of liens and encumbrances. FINRA will also assess whether broker-dealers' possession or control processes are sufficient to identify securities held in custody, clearance, dealer or custodial agent locations. Broker-dealers should also expect an evaluation of the adequacy of its supervision and controls to identify, and where appropriate prevent, manual overrides of automated possession or control calculations. Finally, FINRA will evaluate whether broker-dealers are engaging in transactions with little or no economic substance designed primarily (or solely) to reduce their reserve or segregation requirements. This evaluation will include a focus on the mechanisms used to identify, review and approve/disapprove transactions that may have such an effect, as well as a review of client transactions that result in outsized profit for a client when compared to transactions of similar risk.
- **Municipal advisor registration (renewed focus).** In 2014, the SEC's municipal advisor registration rules became effective, and FINRA observed that some broker-dealers did not realize that certain types of activities in which they engaged subjected them to registration requirements.<sup>82</sup> Since that time, FINRA has found that some broker-dealers are not registering correctly with both the SEC and MSRB or are not properly updating their registration information as it changes. For these

reasons, it appears that FINRA has renewed its focus in municipal advisor registration and, in 2017, will specifically assess whether broker-dealers are properly registered or whether broker-dealers properly apply the exemptions and exclusions to municipal advisor registration requirements under SEC rules. This is also an examination priority for OCIE; please see the above discussion.

- **Regulation SHO – close out and easy to borrow (continued focus).** FINRA will continue to focus on broker-dealers' compliance with SEC Regulation SHO. In particular, FINRA will focus on the locate process to ensure broker-dealers have reasonable grounds to believe securities are available for borrowing prior to accepting a short sale. FINRA will assess broker-dealers' preparation and use of the easy-to-borrow list and evaluate the adequacy of broker-dealers' automated locate models.
- **Anti-money laundering and suspicious activity monitoring (continued focus).** AML programs have been an area of focus for FINRA and OCIE (see above) for several years, and in 2017, FINRA will be attentive to those areas where it has observed shortcomings in the past. These shortcomings include gaps in broker-dealers' automated trading and money movement surveillance systems caused by data integrity problems, poorly set parameters or surveillance patterns that do not capture problematic behavior. Further, with respect to suspicious activity monitoring, FINRA understands that broker-dealers may perform AML suspicious activity monitoring using the same trading surveillance they use for supervisory purposes; however, FINRA expects that the surveillance also includes alerts tailored to the broker-dealer's AML red flags. Finally, FINRA will continue to focus on broker-dealers' controls around accounts held by nominee companies.

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## Endnotes

- <sup>1</sup> See OCIE, National Exam Program, Examination Priorities for 2017 (Jan. 12, 2017) [hereinafter OCIE 2017 Exam Priorities], available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf>. The regulated entities subject to OCIE exams include broker-dealers, investment advisers, registered investment companies, transfer agents, municipal advisors, and certain self-regulatory organizations like FINRA. *Id.* at 1 n.2.
- <sup>2</sup> See FINRA, 2017 Annual Regulatory and Examination Priorities Letter (Jan. 4, 2017) [hereinafter FINRA 2017 Exam Priorities], available at <http://www.finra.org/industry/2017-regulatory-and-examination-priorities-letter>.
- <sup>3</sup> FINRA is the only national securities association registered with the SEC under section 15A of the Securities Exchange Act of 1934 (“Exchange Act”). Under Exchange Act section 15(b)(8), SEC-registered broker-dealers are generally required to be members of a registered national securities association. While broker-dealers are subject to examination by both OCIE and FINRA, OCIE has suggested a reallocation of its exam staff away from broker-dealers to investment advisers, thus effectively shifting greater examination responsibility for broker-dealers to FINRA. See Mary Jo White, Chair, SEC, Testimony on Examining the SEC’s Agenda, Operations, and FY 2018 Budget Request Before the Committee on Financial Services United States of the House of Representatives (Nov. 15, 2016), <https://www.sec.gov/news/testimony/white-testimony-sec-agenda-fy2018-budget-request.html> (“[E]ffective October 1, 2016, OCIE has transitioned resources from its broker-dealer examination program to its program for investment advisers and investment companies.”).
- <sup>4</sup> OCIE no longer identifies the use of data analytics to detect illegal activity as a separate thematic area, which it had done in its 2015 and 2016 exam priorities announcements. OCIE explained that this is because the vast majority of its initiatives now incorporate data analytics, which OCIE uses to identify elevated risks at the registrant and industry levels.
- <sup>5</sup> Press Release, SEC, SEC Announces Enforcement Results for FY 2016 (Oct. 11, 2016), <https://www.sec.gov/news/pressrelease/2016-212.html>.
- <sup>6</sup> *Id.*
- <sup>7</sup> Press Release, SEC, OCIE Director Marc Wyatt to Leave SEC (Jan. 30, 2017), available at <https://www.sec.gov/news/pressrelease/2017-38.html>.
- <sup>8</sup> See OCIE 2017 Exam Priorities, *supra*. Robo-advisers was a topic at the SEC’s Fintech Forum. In a November 2016 speech at the Forum, Chair White stated that the SEC is focusing on how robo-advisers: (1) provide appropriate disclosures to clients concerning their services; (2) obtain information to support their duty to provide suitable advice; (3) design their compliance programs to address the particular challenges relevant to providing automated advice; and (4) safeguard client data and address business continuity. See Mary Jo White, Chair, SEC, Opening Remarks at the Fintech Forum (Nov. 14, 2016), <https://www.sec.gov/news/statement/white-opening-remarks-fintech-forum.html>.
- <sup>9</sup> See OCIE, National Exam Program, Examination Priorities for 2016 (Jan. 11, 2016) [hereinafter OCIE 2016 Exam Priorities], available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf>.
- <sup>10</sup> OIEA, SEC, Investor Alert: Automated Investment Tools (May 8, 2015), <https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtml> (providing investors with a general overview of automated investor tools); see also Mary Jo White, Chair, SEC, Opening Remarks at the Fintech Forum (Nov. 14, 2016), <https://www.sec.gov/news/statement/white-opening-remarks-fintech-forum.html>; Mary Jo White, Chair, SEC, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), <https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html>.
- <sup>11</sup> See OCIE, National Exam Program, Examination Priorities for 2014, at 5 (Jan. 9, 2014) [hereinafter OCIE 2014 Exam Priorities], available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>; see also Release No. IA-3285 (Sept. 22, 2011), available at <https://www.sec.gov/litigation/admin/2011/ia-3285.pdf>; Release No. IA-3149 (Feb. 3, 2011), available at <https://www.sec.gov/litigation/admin/2011/33-9181.pdf>.
- <sup>12</sup> OCIE, National Exam Program, Risk Alert: Multi-Branch Adviser Initiative (Dec. 12, 2016), available at <https://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf>.
- <sup>13</sup> *Id.*
- <sup>14</sup> OCIE’s 2016 branch office examination priority included both advisers and broker-dealers. See OCIE 2016 Exam Priorities, *supra*.
- <sup>15</sup> The 2016 priorities focused on advisers and investment companies that were never examined by OCIE. See *id.*; see also Letter from Jane E. Jarcho, National Associate Director of IAIC Examinations, OCIE, SEC, to Senior Executive or Principal of a Registered Investment Adviser (Feb. 20, 2014), available at <https://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf>.
- <sup>16</sup> By “wrap fee program,” OCIE means those programs that charge investors a single bundled fee for advisory and brokerage services. See OCIE 2017 Exam Priorities, *supra*.
- <sup>17</sup> See, e.g., Release No. IA-4626 (Jan. 26, 2017), available at <https://www.sec.gov/litigation/admin/2017/34-79882.pdf>; Release No. IA-4441 (June 28, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78189.pdf>.
- <sup>18</sup> Release No. IA-4351 (Mar. 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77362.pdf>.
- <sup>19</sup> See, e.g., Release No. IA-4453 (July 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4453.pdf>.
- <sup>20</sup> See, e.g., Release No. IA-4526 (Sept. 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4526.pdf>; Release No. IA-4525 (Sept. 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4525.pdf>.

- <sup>21</sup> See, e.g., Release No. IA-4526 (Sept. 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4526.pdf>; Release No. IA-4525 (Sept. 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4525.pdf>; Release No. IA-4453 (July 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4453.pdf>.
- <sup>22</sup> Wrap account suitability was not identified in OCIE's 2014 announcement, although OCIE did identify best execution and trading away as areas of interest. See OCIE 2014 Exam Priorities, *supra*.
- <sup>23</sup> Last year, OCIE was focused on: sales strategies, trading practices, and disclosures involving ETFs, including excessive portfolio concentration; primary and secondary market trading risks; adequacy of risk disclosure and suitability, particularly in niche or leveraged/inverse ETFs.
- <sup>24</sup> Division of Investment Management, SEC, Guidance Update No. 2013-02, Compliance with Exemptive Orders (May 2013), available at <https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-02.pdf>.
- <sup>25</sup> Release No. IA-4361 (Apr. 5, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4361.pdf> (enforcement action against the advisory firm); Release No. IA-4362 (Apr. 5, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4362.pdf> (enforcement action against the firm's regional director); see also Press Release, SEC, Iowa-based Investment Adviser and Supervisor Charged with Supervisory Failures (Apr. 5, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4361-s.pdf>.
- <sup>26</sup> OCIE, National Exam Program, Risk Alert: Examinations of Supervision Practices at Registered Investment Advisers (Sept. 12, 2016), available at <https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf>.
- <sup>27</sup> In this regard, examiners will likely review advisers' practices surrounding their hiring processes, ongoing reporting obligations, employee oversight practices, complaint handling processes, and, importantly, the compliance culture and "tone at the top."
- <sup>28</sup> Examiners will likely review advisers' practices regarding disclosures of regulatory, disciplinary, or other actions, with a focus on assessing the accuracy, adequacy, and effectiveness of these disclosures.
- <sup>29</sup> Examiners will likely review the conflicts of interest that an adviser or its supervised persons may have, particularly conflicts that may exist with respect to financial arrangements (e.g., unique products, services, or discounts) initiated by supervised persons with disciplinary events.
- <sup>30</sup> Examiners will likely review advisers' advertisements, including pitch-books, website postings, and public statements, to identify any conflicts of interest or risks associated with supervised persons with a history of disciplinary events.
- <sup>31</sup> OCIE, National Exam Program, Risk Alert: Share Class Examination Initiative (July 13, 2016), available at <https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf>.
- <sup>32</sup> *Id.*; see also Release No. IA-3686 (Oct. 2, 2013), available at <https://www.sec.gov/litigation/admin/2013/33-9462.pdf>.
- <sup>33</sup> In this regard, examiners will likely review advisers' practices to determine whether they are acting in their clients' best interests and seeking best execution when recommending or selecting mutual fund and 529 Plan investments to clients.
- <sup>34</sup> Examiners will likely review the adequacy of advisers' disclosures regarding whether they or their supervised persons accept compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds. Additionally, examiners will likely review the adequacy of advisers' disclosures explaining the conflicts of interest such compensation creates and how advisers address the conflicts, including advisers' procedures for disclosing the conflicts to their clients.
- <sup>35</sup> Examiners will likely review advisers' practices surrounding their selection of mutual fund and 529 Plan share class investments in clients' accounts.
- <sup>36</sup> See, e.g., Release No. IA-4351 (Mar. 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77362.pdf>; Release No. IA-4314 (Jan. 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-76897.pdf>.
- <sup>37</sup> In 2013, as part of the National Senior Investor Initiative, OCIE and FINRA conducted 44 examinations of broker-dealers reviewing, among other things, their supervision of registered representatives as they interact with senior investors. See OCIE & FINRA, Report on National Senior Investor Initiative (Apr. 15, 2015), available at <https://www.sec.gov/ocie/reportspubs/sec-finra-national-senior-investor-initiative-report.pdf>; see also OIEA, SEC, Investor Alert: Five Red Flags of Investment Fraud (July 18, 2016), available at [https://www.sec.gov/oiea/investor-alerts-bulletins/ia\\_fraud5redflags.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ia_fraud5redflags.html).
- <sup>38</sup> In 2016, as part of the ReTIRE initiative, OCIE focused on examining the basis for recommendations made to investors, conflicts of interest, supervision and compliance controls, and marketing and disclosure practices. OCIE 2016 Exam Priorities, *supra*.
- <sup>39</sup> This initiative follows on OCIE's 2016 initiative focused on the suitability of the sales of variable annuities to investors, including the adequacy of the disclosures about and the supervision of such sales. See *id.* at 2.
- <sup>40</sup> OCIE, National Exam Program, Risk Alert: Retirement-Targeted Industry Reviews and Examinations Initiative (June 22, 2015), available at <https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf>.
- <sup>41</sup> In 2016, OCIE's priorities announcement did not identify conflicts management or fiduciary duties as areas to be assessed, as part of the public pension adviser initiative. See OCIE 2016 Exam Priorities, *supra*.
- <sup>42</sup> Andrew Ceresney, Director, Division of Enforcement, SEC, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016), <https://www.sec.gov/news/speech/private-equity-enforcement.html>.
- <sup>43</sup> Other initiatives announced by OCIE as part of its 2017 theme focused on assessing market-wide risks, which were not



covered here, are the following: examinations of systemically important clearing agencies, oversight of FINRA, examinations of Systems Compliance and Integrity entities, and risk-based inspections of national securities exchanges.

- <sup>44</sup> See Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47736 (July 23, 2014).
- <sup>45</sup> OCIE, National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf>.
- <sup>46</sup> In August 2015, the Department of the Treasury's Financial Crimes Enforcement Network proposed rules requiring registered advisers to establish AML programs and to file suspicious activity reports. See Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52680 (Aug. 31, 2015). These rules have not been adopted to date.
- <sup>47</sup> See, e.g., Release No. IA-4415 (June 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78021.pdf>; Division of Investment Management, SEC, Guidance Update No. 2015-02, Cybersecurity Guidance (Apr. 2015), available at <https://www.sec.gov/investment/im-guidance-2015-02.pdf>.
- <sup>48</sup> See Mayer Brown, 2017 Outlook on Cybersecurity and Data Privacy (Jan. 2017), available at [https://www.mayerbrown.com/files/Publication/fdbc78d7-a5f5-4719-9783-d701eaf54476/Presentation/PublicationAttachment/4efb468c-dba2-4d9f-9689-c69071b33678/2017\\_Outlook-Cybersecurity.pdf](https://www.mayerbrown.com/files/Publication/fdbc78d7-a5f5-4719-9783-d701eaf54476/Presentation/PublicationAttachment/4efb468c-dba2-4d9f-9689-c69071b33678/2017_Outlook-Cybersecurity.pdf).
- <sup>49</sup> OCIE also announced a 2017 initiative focused on transfer agents. See OCIE 2017 Exam Priorities, *supra*.
- <sup>50</sup> In 2016, OCIE's private fund adviser priority focused on advisers' fees and expenses, and assessed the controls and disclosures regarding the side-by-side management of performance-based and purely asset-based fee accounts. See OCIE 2016 Exam Priorities, *supra*.
- <sup>51</sup> See, e.g., Release No. IA-4604 (Jan. 10, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4604.pdf>; Release No. IA-4529 (Sept. 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4529.pdf>; Release No. IA-4494 (Aug. 24, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4494.pdf>; Release No. IA-4493 (Aug. 23, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4493.pdf>; Release No. IA-4411 (June 1, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77959.pdf>; Complaint, No. 1:16-cv-01752-LMM (May 31, 2016), available at <https://www.sec.gov/litigation/complaints/2016/comp-pr2016-98.pdf>; Release No. IA-4276 (Nov. 23, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4276.pdf>; Release No. IA-4258 (Nov. 5, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4258.pdf>; Release No. IA-4253 (Nov. 3, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4253.pdf>; Release No. IA-4219 (Oct. 7, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4219.pdf>; Release No. IA-4131 (June 29, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4131.pdf>; Release No. IA-3927 (Sept. 22, 2014), available at <https://www.sec.gov/litigation/admin/2014/ia-3927.pdf>.
- During a speech in May 2016, Enforcement Division Director Andrew Ceresney discussed the Enforcement Division's focus on fees and expenses in the private equity industry. See Andrew Ceresney, Director, Division of Enforcement, SEC, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016), <https://www.sec.gov/news/speech/private-equity-enforcement.html>.
- <sup>52</sup> See OCIE 2016 Exam Priorities, *supra*.
- <sup>53</sup> Letter from Kevin W. Goodman, National Associate Director of the Broker-Dealer Examination Program, OCIE, SEC, to Senior Executive or Principal of a Newly Registered Municipal Advisor (Aug. 19, 2014), available at <https://www.sec.gov/about/offices/ocie/muni-advisor-letter-081914.pdf>; see also Press Release, SEC, SEC Announces Municipal Advisor Exam Initiative (Aug. 19, 2014), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542678782> (announcing the municipal advisor initiative).
- <sup>54</sup> See, e.g., Release No. 34-78053 (June 13, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78053.pdf>; Release No. 34-78054 (June 13, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78054.pdf>; Release No. IA-4352 (Mar. 15, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77369.pdf>.
- <sup>55</sup> OCIE, National Exam Program, Risk Alert: Examinations of Registrants' Compliance with Whistleblower Rules (Oct. 24, 2016), available at <https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf>.
- <sup>56</sup> See, e.g., Release No. 34-78957 (Sept. 28, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78957.pdf>; Release No. 34-78590 (Aug. 16, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78590.pdf>; Release No. 34-78528 (Aug. 10, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78528.pdf>; Release No. 34-78141, (June 23, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78141.pdf>; Release No. 34-74619 (Apr. 1, 2015), available at <https://www.sec.gov/litigation/admin/2015/34-74619.pdf>.
- <sup>57</sup> See, e.g., Release No. IA-4508 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4508.pdf>; Release No. IA-4506 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4506.pdf>; Release No. IA-4499 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4499.pdf>; Release No. IA-4507 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4507.pdf>; Release No. IA-4505 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4505.pdf>; Release No. IA-4503 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4503.pdf>; Release No. IA-4500 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4500.pdf>; Release No. IA-4502 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4502.pdf>; Release No. IA-4501 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4501.pdf>; Release No. IA-4498 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4498.pdf>; Release No. IA-4504 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4504.pdf>;

Release No. IA-4497 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4497.pdf>;  
Release No. IA-4496 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4496.pdf>;  
Release No. IA-4349 (Mar. 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10051.pdf>;  
Release No. IA-3988 (Dec. 22, 2014), available at <https://www.sec.gov/litigation/admin/2014/ia-3988.pdf>.

<sup>58</sup> See, e.g., Release No. IA-4513 (Aug. 25, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4513.pdf>;  
Release No. IA-4460 (July 21, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10114.pdf>;  
Complaint, No. 1:16-cv-02572-LMM (N.D. Ga. July 15, 2016), available at <https://www.sec.gov/litigation/complaints/2016/comp23597.pdf>; Initial Decision Release No. 1033 (July 11, 2016), available at <https://www.sec.gov/alj/aljdec/2016/id1033jeg.pdf>; Release No. IA-4420 (June 13, 2016), available at <https://www.sec.gov/litigation/opinions/2016/34-78049.pdf>;  
Release No. IA-4367 (Apr. 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77618.pdf>;  
Complaint, No. 3:16-cv-00438-PK (D. Or. Mar. 10, 2016), available at <https://www.sec.gov/litigation/complaints/2016/comp23485.pdf>; Initial Decision Release No. 941 (Jan. 11, 2016), available at <https://www.sec.gov/alj/aljdec/2016/id941tjisp.pdf>.

<sup>59</sup> See, e.g., Release No. IA-4567 (Nov. 10, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10250.pdf>;  
Initial Decision Release No. 1079 (Nov. 9, 2016), available at <https://www.sec.gov/alj/aljdec/2016/id1079jeg.pdf>; Release No. IA-4566 (Nov. 7, 2016), available at <https://www.sec.gov/litigation/opinions/2016/ia-4566.pdf>;  
Release No. IA-4557 (Oct. 20, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-79126.pdf>;  
Release No. IA-4543 (Sept. 30, 2016), available at <https://www.sec.gov/litigation/opinions/2016/33-10227.pdf>;  
Release No. IA-4537 (Sept. 28, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4537.pdf>;  
Release No. IA-4463 (July 27, 2016), available at <https://www.sec.gov/litigation/opinions/2016/33-10115.pdf>;  
Release No. IA-4455 (July 18, 2016), <https://www.sec.gov/litigation/admin/2016/ia-4455.pdf>;  
Release No. IA-4431 (June 17, 2016), available at <https://www.sec.gov/litigation/opinions/2016/33-10100.pdf>;  
Release No. IA-4423 (June 15, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4423.pdf>;  
Release No. IA-4399 (May 27, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4399.pdf>;  
Release No. IA-4400 (May 27, 2016), available at <https://www.sec.gov/litigation/opinions/2016/ia-4400.pdf>;  
Release No. IA-4389 (May 19, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10080.pdf>;  
Initial Decision Release No. 973 (Mar. 2, 2016), available at <https://www.sec.gov/alj/aljdec/2016/id973bpm.pdf>; Release No. IA-4323 (Jan. 28, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10009.pdf>.  
The SEC has also commenced litigations against advisers for failing to disclose conflicts of interest. See, e.g., Complaint, No. 1:16-cv-01950 (D.D.C. Sept. 30, 2016), available at <https://www.sec.gov/litigation/complaints/2016/comp23670.pdf>; Complaint, No. 1:16-cv-02572-LMM (N.D. Ga. July 15, 2016), available at

<https://www.sec.gov/litigation/complaints/2016/comp23597.pdf>.

<sup>60</sup> See, e.g., Release No. IA-4545 (Oct. 4, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10228.pdf> (alleging that the advisory firm's founder and sole owner had cherry-picked profitable trades for his own account and allocated unprofitable trades to his client accounts).

<sup>61</sup> See, e.g., Release No. IA-4577 (Dec. 1, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4577.pdf>;  
Release No. IA-4554 (Oct. 18, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4554.pdf>;  
Release No. IA-4323 (Jan. 28, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10009.pdf>;  
Release No. IA-4315 (Jan. 19, 2016), available at <https://www.sec.gov/litigation/admin/2016/33-10004.pdf>.  
In March 2016, Chair White discussed the importance of the accurate valuation of securities. See Mary Jo White, Chair, SEC, Keynote Address at the Investment Company Institute 2016 General Meeting – “The Future of Investment Company Regulation” (May 20, 2016), <https://www.sec.gov/news/speech/white-speech-keynote-address-ici-052016.html>. Also, in 2016, the SEC filed a complaint against two portfolio managers who allegedly used sham broker quotes to inflate the value of securities held by the fund, which led the fund to pay inflated management and performance fees to the investment adviser. See Complaint (S.D.N.Y. June 15, 2016), available at <https://www.sec.gov/litigation/complaints/2016/comp-pr2016-119-plaford.pdf>; Press Release, SEC, Hedge Fund Managers and Former Government Official Charged in \$32 Million Insider Trading Scheme (June 15, 2016), <https://www.sec.gov/news/pressrelease/2016-119.html>.

<sup>62</sup> While not identified as a 2017 examination priority, this subject will likely be of continued interest to the staff. Liquidity controls were included in the 2016 examination priorities. In addition, in October 2016, the SEC adopted liquidity risk management requirements for open-end registered investment companies, including ETFs organized as open-end funds. See Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82142 (Oct. 13, 2016).

<sup>63</sup> See, e.g., Release No. IA-4542 (Sept. 30, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-79003.pdf>;  
Release No. IA-4534 (Sept. 23, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4534.pdf>;  
Release No. IA-4463 (July 27, 2016), available at <https://www.sec.gov/litigation/opinions/2016/33-10115.pdf>;  
Release No. IA-4441 (June 28, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78189.pdf>;  
Release No. IA-4433 (June 22, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78128.pdf>;  
Release No. IA-4431 (June 17, 2016), available at <https://www.sec.gov/litigation/opinions/2016/33-10100.pdf>;  
Release No. IA-4413 (June 2, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4413.pdf>;  
Release No. IA-4371 (Apr. 19, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77648.pdf>;  
Release No. IA-4372 (Apr. 19, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77649.pdf>.

<sup>64</sup> See, e.g., Release No. IA-4607 (Jan. 13, 2017), available at <https://www.sec.gov/litigation/admin/2017/34-79794.pdf>;  
Release No. IA-4483 (Aug. 15, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4483.pdf>;  
Release No. IA-4389 (May 19, 2016), available at

<https://www.sec.gov/litigation/admin/2016/33-10080.pdf>; Release No. IA-4368 (Apr. 14, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77625.pdf>; Release No. IA-4273 (Nov. 19, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4273.pdf>.

- <sup>65</sup> See, e.g., Press Release, SEC, SEC Charges Hedge Fund Manager with Insider Trading (Sept. 21, 2016), <https://www.sec.gov/news/pressrelease/2016-189.html> (including a link to the copy of the complaint filed by the SEC in connection with this matter); Press Release, SEC, Hedge Fund Managers and Former Government Official Charged in \$32 Million Insider Trading Scheme (June 15, 2016), <https://www.sec.gov/news/pressrelease/2016-119.html> (providing a link to the three complaints filed by the SEC in connection with this matter).
- <sup>66</sup> See, e.g., Release No. IA-4608 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4608.pdf>; Release No. IA-4609 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4609.pdf>; Release No. IA-4610 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4610.pdf>; Release No. IA-4611 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4611.pdf>; Release No. IA-4612 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4612.pdf>; Release No. IA-4613 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4613.pdf>; Release No. IA-4614 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4614.pdf>; Release No. IA-4615 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4615.pdf>; Release No. IA-4616 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4616.pdf>; Release No. IA-4617 (Jan. 17, 2017), available at <https://www.sec.gov/litigation/admin/2017/ia-4617.pdf>.
- <sup>67</sup> Division of Investment Management, SEC, Guidance Update No. 2015-01, Acceptance of Gifts or Entertainment by Fund Advisory Personnel – Section 17(e)(1) of the Investment Company Act (Feb. 2015), available at <https://www.sec.gov/investment/im-guidance-2015-01.pdf>.
- <sup>68</sup> See Adviser Business Continuity and Transition Plans, 81 Fed. Reg. 43530 (proposed June 28, 2016).
- <sup>69</sup> See, e.g., Release No. IA-4550 (Oct. 13, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4550.pdf>; Release No. IA-4483 (Aug. 15, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4483.pdf>; Release No. IA-4362 (Apr. 5, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77528.pdf>; Release No. IA-4307 (Jan. 8, 2016), available at <https://www.sec.gov/litigation/admin/2016/ia-4307.pdf>. See the above section regarding OCIE's recidivist representative examination priority, which includes a discussion of the heightened supervision requirements of advisers and their personnel when employing individuals with a history of misconduct.
- <sup>70</sup> Typical deficiencies or weaknesses identified by examiners in connection with the compliance rule, Advisers Act Rule 206(4)-7, include: compliance manuals are not reasonably tailored to the adviser's business practices; annual reviews are not performed or did not address the adequacy of the adviser's policies and procedures; compliance policies and procedures are not followed; and compliance manuals are not current. OCIE, National Exam Program, Risk Alert: The Five Most

Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017), available at <https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf>.

- <sup>71</sup> Common deficiencies or weaknesses in adviser regulatory filing obligations identified by examiners include: inaccurate disclosures; untimely amendments to Form ADVs; incorrect and untimely Form PF filings; and incorrect and untimely Form D filings. *Id.*
- <sup>72</sup> Examiners have commonly identified the following deficiencies or weaknesses with respect to the custody rule, Advisers Act Rule 206(4)-2: advisers did not recognize that they may have custody due to online access to client accounts; advisers with custody obtained surprise examinations that did not meet the requirements of the custody rule; and advisers did not recognize that they may have custody as a result of certain authority over client accounts. *Id.*
- <sup>73</sup> Typical deficiencies or weaknesses with respect to the code of ethics rule, Advisers Act Rule 204A-1, identified by examiners include: failure to identify access persons; required information missing in code of ethics; untimely submission of transactions and holdings; and no description of code of ethics in Form ADVs. *Id.*
- <sup>74</sup> Examiners have commonly identified the following deficiencies or weaknesses with respect to the books and records rule, Advisers Act Rule 204-2: failure to maintain all required records; books and records are inaccurate or not updated; and inconsistent recordkeeping. *Id.*
- <sup>75</sup> FINRA 2017 Exam Priorities, *supra*.
- <sup>76</sup> *Id.*
- <sup>77</sup> *Id.*
- <sup>78</sup> FINRA, 2014 Regulatory and Examination Priorities Letter (Jan. 2, 2014), available at <https://www.finra.org/sites/default/files/Industry/p419710.pdf>.
- <sup>79</sup> *Id.*
- <sup>80</sup> *Id.*
- <sup>81</sup> FINRA, Targeted Exam Letters, Unit Investment Trust Rollover Review (Sept. 2016), available at <http://www.finra.org/industry/unit-investment-trust-rollover-review>.
- <sup>82</sup> FINRA, 2015 Regulatory and Examinations Priorities Letter (Jan. 6, 2015), available at <http://www.finra.org/industry/2015-exam-priorities-letter>.

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