

Legal Update

OCIE's 2020 Examination Priorities: Variations on Recurring Themes

The US Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") released its [2020 examination priorities](#) on January 7, 2020. A number of the 2020 priorities are continuations from the exam priorities for 2019 (some of which have been enhanced for 2020), and others have been informed by OCIE Risk Alerts or significant regulatory initiatives during 2019, such as the SEC's [investment adviser fiduciary duty interpretation](#) (see our [2019 Legal Update](#) on this topic). As was the case in prior years, OCIE's examination priorities cover a broad array of SEC registrants, including investment advisers and registered investment companies, broker-dealers and transfer agents. However, this Legal Update focuses on the examination priorities for investment advisers and registered investment companies.

Before we turn to specific adviser and investment company examination priorities for 2020, we begin with a review of OCIE's approach in implementing its examination program, which itself indirectly includes guidance and warnings for registrants.

[A Primer on OCIE's Examination Approach](#)

Although OCIE's examination priorities often drive the scope and focus of its examinations as well as the registrants selected for examination, OCIE, overall, uses a risk-based approach to determine exam scope and focus as well as registrant selection. OCIE considers numerous factors in this approach, which may include:

- the products and services offered (including those products identified as being higher risk);
- compensation and funding arrangements;
- prior examination observations and conduct;
- disciplinary history of associated individuals and affiliates of a registered firm;
- changes in firm leadership or other personnel; and
- whether the firm has custody of client assets. In this regard, OCIE noted that in exams of registered investment advisers ("RIAs") that have custody of client funds or assets, OCIE prioritizes examination of the RIA's compliance with the custody rule.

Registrants should review these factors carefully in light of their own facts and circumstances, not only to evaluate their likelihood of examination, but also to evaluate their compliance programs and related policies and procedures for possible modifications. Registrants that have not been examined in the last few years or that have had a negative examination history, whose personnel have significant disciplinary histories, or that have had any enforcement history should be all the more prepared for an examination.

OCIE further identified certain key aspects of regulatory oversight for RIAs:

- the adequacy of the adviser's disclosures concerning services, fees and expenses, and
- the adviser's management and handling of conflicts of interest.

Notably, both of these subjects directly relate to the SEC's 2019 fiduciary interpretation and receive additional attention from OCIE in the specific exam priorities described below.

A Word About LIBOR

As an example of OCIE's ability to quickly pivot its exam focus to cover emerging and exigent risks, OCIE specifically called out the transition away from LIBOR. In this regard, OCIE warned that it will be reviewing firms' preparations and disclosures regarding their

readiness and the transition's effects on investors. OCIE specifically encouraged registrants to evaluate their use of, and operational exposure to, LIBOR and their clients' exposure thereto, not just in contracts, but also in benchmarks and indices; accounting systems; risk models; and client reporting, among other areas. OCIE also warned that insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants. OCIE will also closely track and evaluate the impact of the industry's transition away from LIBOR, which it calls a major risk theme affecting registrants.

In July 2019, SEC staff issued a joint statement regarding the LIBOR transition, providing guidance and expectations for registrants. Other federal and state regulators are asking questions about how their regulated entities are managing the transition and associated risks. UK regulators have been doing the same.

Examination Themes for 2020

Use of Third-Party Service Providers – OCIE observed that as registered entities' businesses have become more global, often this is coupled with an increased use of services and operations in the United States and abroad. OCIE also observed that registrants' use of third-party service providers and other vendors continues to increase, which can bring additional challenges and risks. OCIE will continue to focus on third-party risk management in FY 2020.

Enhanced risk in this respect raises the expectation that advisers have detailed due diligence procedures and use them to fully vet outsourced service providers, both at inception and as an ongoing proposition. Also, note that this examination focus is echoed a number of times in connection with other, more specific exam priorities, described below.

The importance of this examination focus is underscored not only by the recent adoption of [Reg. BI](#) (see our [2019 Legal Update](#)), the [Customer Relationship Summary](#) and the fiduciary interpretation, but also the fact that disclosure generally and these specific disclosure subjects have served as the basis for numerous enforcement actions over the years.

Foreign Registrants and Foreign Privacy Laws – OCIE admits that it has experienced challenges in examining non-US registrants due to local data protection and privacy laws. These challenges are growing along with the growing number of “off-shore” RIAs. Local privacy laws might conflict with US securities laws, SEC rules and registration forms, which require non-US RIAs to provide records to the SEC for inspection. In light of this conflict of law, OCIE is: (i) seeking additional information from non-US applicants for RIA registration to ensure that they can comply with these inspection requirements and (ii) continuing to work with both industry and regulatory counterparts in other countries.

Disclosures – OCIE emphasized the importance of disclosures, specifically those regarding: (i) fees and expenses; and (ii) conflicts of interest. OCIE also commented that registrants must effectively implement controls and systems to ensure that disclosures are made as required *and that a firm’s actions match those disclosures (emphasis added).*

Retail Investors: A Continued Focus

Generally – As in past years, OCIE will continue to focus on protecting retail investors, specifically seniors and investors who are saving for retirement. In this regard, OCIE stated that it will emphasize examinations of: retail investor intermediaries, such as RIAs and dual-registrants; and (ii) investments that are intended (whether by design or marketing) for retail investors, such as mutual funds and exchange-traded funds (ETFs), municipal securities, other fixed-income securities, and microcap securities.

OCIE stated that its examinations will focus on recommendations and advice given to retail investors, particularly: (1) seniors and (2) new for this year, teachers and military personnel. This focus will specifically include recommendations and advice made by entities and individuals that target retirement communities.

Higher-Risk Products – In addition, OCIE will focus on higher-risk products, such as securities issued in private placements and securities that involve new and emerging risk areas. In this regard, OCIE specifically cited securities that are complex or non-transparent, or that have high fees and expenses. OCIE also specifically referenced

securities that are issued by an entity that is related to the registrant that is making the recommendation. In this regard, OCIE stated that its examinations will also focus on registrants' disclosures; supervision of outside business activities of its employees and associated persons; and related conflicts.

Mutual Funds, ETFs and Other Retail-Oriented Products – As retail assets continue to flow into investment companies, OCIE stated that it will prioritize examinations of mutual funds and ETFs (particularly those that have not been previously examined), as well as the activities of their RIAs (particularly those that use third-party administrators to sponsor the mutual funds they advise or with which they are affiliated), and fund board oversight practices.

The reference to third-party administrators/sponsors is presumably a reference to so-called “docking stations” or “turnkey” mutual fund platforms.

In addition, OCIE will continue to focus on mutual fund share class selection, which has been the subject of numerous enforcement actions in recent years. OCIE also will focus on the application of mutual fund fee discounts.

Registered funds were the subject of a fairly lengthy [November 2019 OCIE Risk Alert](#), outlining OCIE observations and concerns with: the fund compliance rule (Rule 38a-1); disclosures to investors; the annual advisory agreement approval process under Section 15(c); fund codes of ethics; money market funds; and target date funds. This Risk Alert provides a helpful road map for review and consideration.

An Adviser's Fiduciary Duty – Continued but New

OCIE will also continue to focus on an RIA's fiduciary duty, including whether RIAs: (i) provide advice that is in their clients' best interests; and (ii) eliminate, or at least fully and fairly disclose, conflicts of interest. In this regard, OCIE will continue to focus on risks associated with fees and expenses, and undisclosed or inadequately disclosed compensation arrangements.

OCIE noted that fee- and compensation-based conflicts of interest can take different forms, such as revenue sharing arrangements with various entities and direct or indirect compensation paid to advisory personnel for executing client transactions. OCIE also stated that duty of care concerns may arise if an RIA does not aggregate accounts for fee discounts in accordance with its disclosures.

The above examination priority likely will now be evaluated through the lens of the recent fiduciary interpretation, which OCIE has already integrated into the examination program.

On a related note, after the June 30, 2020, compliance date, OCIE also intends to assess the content and delivery of Form CRS.

RIA Compliance Programs

RIA compliance programs will continue to be an examination focus, as will examinations of dual registrants, RIAs that are affiliated with broker-dealers and RIAs that have supervised persons who are registered representatives of unaffiliated broker-dealers. RIA examinations will focus on: best execution, prohibited transactions, fiduciary advice and disclosure of conflicts regarding such arrangements.

In addition, OCIE will prioritize examinations of RIAs that use third-party asset managers to advise clients' investments and in this regard will assess, among other things, the RIAs' due diligence protocols and procedures.

Lastly, OCIE voiced a specific interest in the quality of disclosures from RIAs regarding new or emerging investment strategies and called out as an example strategies focused on sustainable and responsible investing (i.e., environmental, social and governance or "ESG" criteria).

In the wake of increased investments in ESG funds and strategies: (i) recent SEC examinations have included inquiries about ESG strategies and adherence to related criteria; and (ii) Commissioner Hester Pierce has called for greater oversight of ESG products and strategies.

RIAs to Private Funds

OCIE will continue to focus on private fund RIAs that manage separately managed accounts side-by-side with their private funds. Relatedly, OCIE will focus on private fund RIAs that also manage one or more registered investment companies with similar investment strategies.

This latter topic was included in a 2019 OCIE Risk Alert: [Risk-Based Examination Initiatives Focused on Registered Investment Companies](#).

OCIE also will review private fund RIAs to assess compliance risks. In that regard, OCIE identified the following areas of focus: insider trading; conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses (a recurring theme in this year's examination priorities); and the use of RIA affiliates to provide services to clients.

Robo-Advisers

As in prior years, OCIE will continue to focus on "robo-advisers", including such advisers': (1) SEC registration eligibility, (2) cybersecurity policies and procedures, (3) marketing practices, (4) adherence to fiduciary duty (and

adequacy of disclosures); and (5) effectiveness of compliance programs.

Information Security

OCIE stated that it will continue to prioritize information security in its examinations, focusing in particular on proper configuration of network storage devices, the security of retail trading information and information security governance generally. In addition, for RIA examinations specifically, OCIE will continue to assess RIAs' protection of clients' personal financial information, particularly: (1) governance and risk management; (2) access controls; (3) data loss prevention; (4) vendor management; (5) training; and (6) incident response and resiliency.

This year, however, OCIE added more detail regarding third-party and vendor risk management, stating that it will also focus on oversight practices related to service providers and network solutions, including cloud-based storage. OCIE also stated that it will examine for compliance with Regulations S-P and S-ID; focus on the controls surrounding online access and mobile application access to customer brokerage account information (presumably, OCIE could be equally focused on such access to advisory client account information); and review the safeguards in place for disposing retired hardware that may contain client information and potential network information.

Network storage was a topic of an OCIE Risk Alert in 2019:

[Safeguarding Customer Records and Information in Network Storage—Use of Third Party Security Features](#). In addition, in 2019, OCIE issued a Risk Alert covering investment adviser compliance issues related to Regulation S-P: [Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P—Privacy Notices and Safeguard Policies](#).

Fintech and Innovation

Generally – For 2020, examinations in this area will focus on registrants' use of the technologies and new ("alternative") data sets to interact with or provide services to clients, investors, service providers and others, and will assess the effectiveness of registrants' compliance and control functions related thereto.

Digital Assets – Noting that the digital asset market has expanded quickly and poses a number of risks (including for retail investors who may not understand that there are important differences between digital assets and other types of investments), OCIE make clear that its examinations will assess: (1) investment suitability, (2) portfolio management and trading practices, (3) safety of client funds and assets, (4) pricing and valuation, (5) effectiveness of compliance programs and controls, and (6) supervision of employee outside business activities.

RIAs and registered funds that plan to have exposure to or otherwise participate in this market should “look before leaping” and review the above assessment areas carefully, and modify compliance policies and internal controls accordingly, before doing so.

For an RIA, growth is desired and expected. But OCIE looks at growth in regulatory assets under management, particularly material changes, and expects budgets and personnel involved in compliance programs to grow commensurately.

Anti-Money Laundering

OCIE will continue to prioritize examining investment companies for compliance with their anti-money laundering obligations. The examinations will assess, among other things, whether the investment company has established an appropriate customer identification program and whether it is satisfying applicable SAR filing obligations, conducting due diligence on investors, complying with beneficial ownership requirements, and conducting robust and timely independent tests of the AML program.

Never-Before- or Not-Recently-Examined Advisers

OCIE will continue to examine RIAs that have never been examined, including new RIAs and RIAs that have been registered for a number of years but have not yet been examined. OCIE will also prioritize examinations of RIAs that were previously examined but have not been examined for a number of years. In this regard, the examination focus will be on whether the RIAs’ compliance programs have been appropriately modified in response to significant growth or changes to their business models.

Concluding Thoughts

OCIE’s examination activities continue to be robust. In the SEC’s fiscal year 2019, examinations of registered funds increased by about 12 percent, with RIA examinations during the same period continuing at a strong pace relative to 2018. Further, OCIE has made over 150 enforcement referrals from fiscal year 2019 examinations, and it anticipates making even more. The SEC’s enforcement activity during fiscal year 2019 showed an uptick from 2018.

In light of the foregoing as well as the above OCIE examination priorities for 2020, it would be very wise for RIAs and registered funds to:

- carefully review their compliance programs and related policies, procedures, practices and internal controls, as well as their examination, enforcement and disciplinary histories;
- thoughtfully evaluate whether enhancements or revisions may be warranted; and
- promptly implement those enhancements or revisions.

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