

# 2020 OCIE Priorities: Private Equity Remains Area of Interest, Focus on Retail and New SEC and Market-Wide Developments

January 15, 2020

The Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission (the “SEC”) recently published its 2020 examination priorities (the “2020 Priorities”).<sup>1</sup> While OCIE continues to focus on protecting retail investors and on assessing market-wide risks, unlike previous years, the 2020 Priorities specifically identify private funds as a priority and reflect recent SEC rules and interpretations affecting registered investment advisers (“RIAs”) and broker-dealers.

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## General Themes and Focus on Certain Targeted Firms

The 2020 Priorities emphasize, as an overall matter, “that compliance programs, chief compliance officers, and other compliance staff play critically important roles at firms” and discuss the attributes of an effective compliance program.

- It is key to have commitment “from C-level and similar executives to set a tone from the top that compliance is integral to the organization’s success.”
- Compliance should be actively engaged in most facets of a firm’s operations and should be an early area of focus in “important business developments, such as product innovation and new services.”
- A firm’s chief compliance officer (“CCO”) should be “knowledgeable and empowered . . . with full responsibility, authority, and resources to develop and enforce policies and procedures of the firm.”

The 2020 Priorities also identify the increased use of third-party service providers and other outside vendors by registrants as a source of additional challenges and risks to organizations. As such, OCIE will continue to focus on third-party risk management in 2020. Major risk themes include information security and resiliency risks, geopolitical

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<sup>1</sup> 2020 *Examination Priorities*, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (Jan. 7, 2020) available [here](#).

events and the industry's transition away from LIBOR. In connection with the latter, OCIE will be reviewing firms' preparations and disclosures regarding their readiness, particularly in relation to the transition's effects on investors including, among other areas, the use of LIBOR in benchmarks and indices, accounting systems, risk models and client reporting.

OCIE will continue to take a risk-based approach to targeting firms for examination. The 2020 Priorities note that potential risk factors can include: firms that offer certain products identified as higher risk; compensation and funding arrangements; prior examination observations and conduct; disciplinary history of associated individuals and affiliates of a firm; changes in a firm leadership or other personnel; and whether a firm has access to investor assets (*i.e.*, custody).

In addition, the 2020 Priorities identify certain types of firms that OCIE will focus on:

- *Never-Before and Not-Recently Examined RIAs.* OCIE will continue to focus on RIAs that are newly registered, that have been registered for several years but have never been examined and that were previously examined but have experienced a substantial growth or change in their business models to ensure that those firms have appropriately adapted their compliance programs.
- *Dual Registrants.* OCIE will continue to prioritize examinations of registered investment advisers that are also registered as, or affiliated with, broker-dealers or have supervised persons who are registered representatives of broker-dealers.
- *Third Party Asset Managers.* OCIE will prioritize firms that engage third-party asset managers that provide advice on investments and will examine those firms' due diligence practices, policies and procedures.
- *Robo Advisers.* OCIE will continue to focus on RIAs that provide services to clients automated investment tools and platforms. In particular, OCIE will review the firm's eligibility to register with the SEC, cybersecurity policies and procedures, marketing practices, adherence to fiduciary duty and adequacy of disclosures, and effectiveness of compliance programs.

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## Private Fund Priorities

- *General.* OCIE will focus on private fund sponsors that have a greater impact on retail investors such as firms that provide management to separately managed accounts side by side with private funds as well as private fund sponsors that also

manage registered investment companies with similar strategies. In addition, OCIE will review private fund sponsors to assess compliance risks, including controls to prevent the misuse of material, non-public information and conflicts of interest (including those relating to undisclosed or inadequately disclosed fees and expenses and the use of affiliates to provide services to clients).

- *Accuracy and Adequacy of Disclosures.* OCIE will continue to ensure that fees and expenses and compensation arrangements are actually and accurately disclosed. OCIE will also focus on registered investment advisers (“RIAs”) who offer emerging investment strategies like sustainable and responsible investment strategies that incorporate environmental, social, and governance (“ESG”) criteria.

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## Other RIA Examination Priorities

- *Compliance Programs.* OCIE will continue to review RIA’s compliance programs, including whether these programs and their policies and procedures “are reasonably designed, implemented and maintained.” The 2020 Priorities notes that OCIE typically assesses compliance programs of RIAs in one or more core areas: portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, and valuation of client assets. OCIE will often assess the adequacy of disclosures and governance practices in the core areas reviewed.
- *Supervision of Employees.* OCIE will review firms’ supervision of employees and associated persons’ outside business activities including disclosures of conflicts of interest that may arise from these activities.
- *Material, Nonpublic Information.* OCIE will assess controls to prevent misuse of material, nonpublic information.
- *Alternative Data.* OCIE will focus on firms’ use of alternative data sources to drive investment decisions, in particular, firms’ arrangements with data vendors and service providers and the effectiveness of compliance and control functions related to the sourcing of and use of alternative data sets.
- *Information Security.* OCIE will focus on proper configuration of network storage devices, information security governance, retail trading information security, proper disposal of retired hardware and network intrusion vulnerabilities. To ensure adequate protection of clients’ personal financial information, OCIE will evaluate governance and risk management, access controls, data loss prevention, vendor

management, training, incident response and resiliency, and use and oversight of third-party vendors.

- *AML Programs.* OCIE will continue to assess compliance with AML obligations, including whether firms have established appropriate customer identification controls, conduct due diligence on customers, comply with beneficial ownership requirements, conduct robust and timely independent tests on AML programs and satisfy SAR filing obligations.

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## Continued Focus on Retail

OCIE will again emphasize the protection of retail investors, particularly seniors and those saving for retirement. OCIE will prioritize examinations of (i) intermediaries that serve retail investors, namely RIAs, broker-dealers, and dually registered firms and (ii) investments marketed to, or designed for, retail investors such as mutual funds and exchange-traded funds (“ETF”), municipal securities and other fixed income securities, and microcap securities. Examinations will focus on recommendations and advice given to retail investors, with a particular focus on: (a) seniors including recommendations and advice made by entities and individuals targeting retirement communities; and (b) teachers and military personnel. Related priorities include the following:

- *High-Risk Products.* OCIE will evaluate, in particular, high-risk products targeted at retail investors including private placements in new and emerging risk areas and investment products that are complex or non-transparent or have high fees and expenses.
- *Fiduciary Duties.* OCIE will assess whether RIAs have fulfilled their duties of care and loyalty, in particular whether they have provided advice that is disinterested and in the best interests of their clients.<sup>2</sup>
- *Mutual Funds and ETFs.* OCIE will continue assessing financial incentives that may influence the selection of a particular mutual fund share class, paying particular attention to reviewing mutual fund fee discounts that should be provided to clients as a result of policies and contractual obligations. OCIE will also focus on RIAs that use third-party administrators to sponsor mutual funds.

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<sup>2</sup> In June 2019, the SEC released a final interpretation that “reaffirms—and in some cases clarifies—certain aspects of the fiduciary duty” that an investment adviser owes to its client, specifically discussing how this duty may differ depending on the sophistication of the client. For a summary of this final interpretation, please see our prior client update available [here](#).

- *Municipal Securities and Other Fixed Income Securities.* OCIE will examine broker-dealer activity including compliance with best execution, fair pricing and retail disclosures. For municipal advisers, OCIE will prioritize the review of their adherence to fiduciary obligations to municipal entity clients, fair dealing with market participant requirements and disclosure of conflicts of interests.
- *Microcap Securities.* Focused on identifying broker-dealers and transfer agents that may be engaged in, or aiding and abetting, pump-and-dump schemes, market manipulation and illegal distribution of securities of smaller market cap companies, OCIE will evaluate transfer agents' handling of microcap distributions and share transfers as well as broker-dealer sales practices and supervision of high risk registered representatives.
- *Digital Assets.* OCIE will continue to focus on investment suitability, portfolio management and trading practices, safety of client funds and assets, pricing and valuation, effectiveness of compliance program and controls, and supervision of employees' outside business activities.
- *Other Risks.* OCIE will evaluate the use of affiliates that provide services to retail clients.

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## Priorities of Interest to Broker-Dealers

- *Regulation Best Interest.* In light of the SEC's 2019 adoption of Regulation Best Interest, OCIE will evaluate the progress toward readiness prior to the compliance date (June 30, 2020). After the compliance date, OCIE will assess actual implementation including policies and procedures regarding conflict disclosures and the content and delivery of Form CRS.<sup>3</sup>
- *Custody and Risk.* A perennial area of attention, OCIE will continue to focus on broker-dealer compliance with the Customer Protection Rule (Rule 15c3-3) and the Net Capital Rule (Rule 15c3-1). Focus on this area will include adequacy of internal processes, procedures and controls.
- *Automated Trading.* For broker-dealers that use automated trading algorithms, OCIE will examine how those firms assess their trading programs including the development, testing, implementation, maintenance and modification of any

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<sup>3</sup> For a summary of Regulation Best Interest, please see our prior client update available [here](#).

computer programs used. OCIE will also assess how broker-dealers control access to the computer code.

- *Compliance Programs of Dual Registrants.* For broker-dealers that are dually registered as, or affiliated with, RIAs, OCIE will focus on how such RIA's compliance programs address the risks associated with best execution, prohibited transactions, fiduciary advice and disclosure of conflicts.
- *Other Themes.* The 2020 focus on information security will also apply to the broker-dealer program, and OCIE will also continue to assess issues relating to digital assets, including suitability, custody, pricing and valuation, effectiveness of compliance programs and outside business activities.

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## Market-Wide Risks and Infrastructure

- *Clearing Agencies.* OCIE will examine for compliance with the SEC's Standards for Covered Clearing Agencies and applicable federal securities laws, timely corrective actions in response to prior examinations and internal audit reports, risk management (including with respect to liquidity, default and collateral), cybersecurity and resiliency, and recovery and wind-down procedures.
- *National Securities Exchanges.* OCIE will assess how exchanges address market disruptions and how they monitor member activity for compliance with the federal securities laws, particularly their efforts to protect the integrity of the markets from abusive, manipulative and illegal trading practices.
- *Regulation Systems Compliance and Integrity (SCI).* OCIE will evaluate IT inventory management, IT governance, incident response, third-party vendor management, and establishment and adequacy of required policies and procedures.
- *Transfer Agents.* OCIE will examine whether transfer agents are in compliance with their annual obligation to file a report by an independent accountant concerning such transfer agent's internal accounting controls as well as evaluating its compliance with obligations to search for lost security holders and provide notice to unresponsive payees.
- *FINRA and MSRB.* OCIE will continue its oversight examinations of FINRA, making recommendations to improve FINRA's programs, risk assessment and future examinations. Partnering with FINRA, OCIE will also continue examining registered

firms to ensure compliance with MSRB regulations and will evaluate the effectiveness of MSRB’s policies, procedures and controls.

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Private fund sponsors should be wary of the increased focus of OCIE in the coming year and continue monitoring SEC developments, including proposed amendments to the Investment Advisers Act of 1940 and the expansion of access to private securities offerings, as these rulemakings may become new areas of focus in future examinations as OCIE assesses compliance.<sup>4</sup>

Please do not hesitate to contact us with any questions.

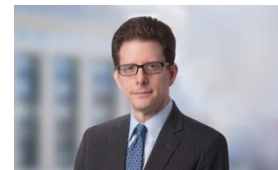
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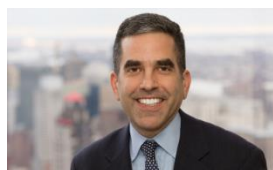


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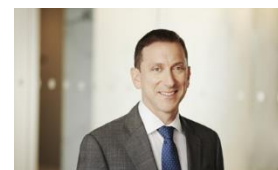
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<sup>4</sup> See, e.g., *Investment Adviser Advertisements; Compensation for Solicitations*, Release No. IA-5407; File No. S7-21-19 (Nov. 4, 2019); *Amending the “Accredited Investor” Definition*, SEC Release Nos. 33-10734; 34-87784 (Dec. 18, 2019).



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