2021 SEC Division of Examinations Priorities

March 8, 2021

On March 3, 2021, the U.S. Securities and Exchange Commission's ("SEC") newly-renamed Division of Examinations ("EXAMS" or "Division") released its 2021 Examination Priorities ("2021 Priorities").[1] While many of the priorities highlighted in this year's publication reflect classic areas of concern, the 2021 Priorities also reflect a clear focus on adaptations to processes necessitated by the COVID-19 pandemic. The 2021 Priorities also reflect new scrutiny of Environmental, Social, and Governance ("ESG") related matters, a policy priority for the SEC under the Biden Administration, as well as attention to Regulation Best Interest ("Reg BI") compliance and related scrutiny on complex products. Although the Division styles several topical areas as "priorities," the document actually provides a comprehensive overview of the full spectrum of topics that the Division plans to examine in the upcoming year.

General Themes

The 2021 Priorities reflect the Division's goal of proactively monitoring and engaging with registrants on the risks flowing from emerging market events, including "the wide-spread compromise of commonly used network management software" and the market impact of "meme stocks." To address these challenges, the 2021 Priorities highlight the recently formed Event and Emerging Risks Examination Team ("EERT"), which will be responsible for proactively engaging registrants and market participants about current market events and emerging threats with the goal of ensuring that firms are prepared to address "exigent threats, incidents, and emerging risks." The EERT intends to offer guidance to firms when these market events "could have a systemic impact" or "place investor assets at risk."

The Division also emphasizes its continued use of data analytics to identify examination candidates and to analyze data gathered during examinations. The 2021 Priorities discuss

[1] *2021 Examination Priorities*, Division of Examinations, U.S. Securities and Exchange Commission (Mar. 3, 2021), available here.

the specific use of predictive modeling and text-based analytics in conjunction with the Division of Economic and Risk Analysis ("DERA") to better focus examinations.

As in years past, the Division has emphasized the continuing importance of internal firm compliance. The 2021 Priorities note the need for the "active engagement" of internal compliance departments, especially with respect to new services and products that may create heightened regulatory risk. Mirroring the 2020 Priorities, the Division urges that Chief Compliance Officers be given the necessary resources and authority to adopt and implement policies and procedures.

Finally, the 2021 Priorities identify the following as types of firms on which the Division intends to focus its efforts:

- *Registered Investment Advisers ("RIAs") Not Recently Examined*. The Division will focus efforts on assessing the compliance of RIAs that have not undergone an examination for at least a few years. The rationale underlying this focus is the Division's need to assess compliance in light of firms' growth or other changes.

- *Dual Registrants*. Another area of focus will be on firms registered as both RIAs and broker-dealers. The Division will look at the risks inherent in each business model, such as conflicts of interest involving compensation and best execution.

- *"Robo-advisers" and RegTech*. The Division will look at firms using automated platforms to offer advice to clients, as the Division seeks to ensure compliance with external representations and regulatory requirements. Firms implementing technology to assist with regulatory compliance (*i.e.*, "RegTech") will also draw Division scrutiny. EXAMS will assess RegTech's implementation to ensure that the technology is actually improving compliance.

EXAMS referred approximately 4.4 percent of the 2,952 examinations conducted during FY2020 to the Division of Enforcement, reflecting the overall decrease in referrals from EXAMS to Enforcement during Chairman Clayton's tenure. Under the Biden Administration, we expect the referral percentage to rise to levels resembling those under the Obama Administration, which averaged over eleven percent from 2013 to 2016.

ESG Priorities

The 2021 Priorities make clear the prominent role that evaluation of ESG-related risks and disclosures will play in exams this year. In the Press Release accompanying the publication of the 2021 Priorities, Acting Chair Allison Lee stated that the Division is "enhancing its focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change," and noted how these efforts are "integrating climate and ESG considerations into the agency's broader regulatory framework."[2]

This focus will play out in the Registered Investment Adviser ("RIA") space, where the Division will examine ESG-conscious offerings to ensure RIAs' and funds' disclosures and proxy-voting policies reflect actual ESG-oriented strategies. In addition, as indicated by Acting Chair Lee and discussed in the 2021 Priorities, examinations assessing operational resiliency and cybersecurity will assess preparations for climate-related disruption.

Further reflecting the Commission's focus on ESG, on March 4 the Commission announced the creation of a new Climate and ESG Task Force in the Division of Enforcement.[3] The Press Release announcing the Task Force's creation noted that the group will collaborate across the agency, including with EXAMS.

Continued Focus on Retail Investors

In line with previous years, EXAMS will prioritize retail investor protection, with a specific focus on senior citizens, retirement savers, teachers, and the military. The advice offered to these investor classes will be examined for conflicts of interest and possible fraudulent conduct, risks heightened by recent market volatility and industry pressures. Beyond this entity-level focus, EXAMS intends to look at particular products that present an elevated risk of harm. Examples include:

- *Mutual Funds and Exchange-Traded Funds ("ETFs")*. As these are the "primary investment vehicle for many retail investors," EXAMS will focus on recommendations and disclosures involving mutual funds and ETFs. EXAMS also plans to continue looking at incentives offered to financial services firms and their impact on the share class selection process.
- *Municipal Securities and Other Fixed Income Securities*. The 2021 Priorities note the increased importance of timely and accurate municipal issuer disclosures in light of

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2 See Press Release, U.S. Securities and Exchange Commission, SEC Division of Examinations Announces 2021 Examination Priorities (Mar. 3, 2021), https://www.sec.gov/news/press-release/2021-39.

3 See Press Release, U.S. Securities and Exchange Commission, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

the financial impact of the pandemic. The Division plans to examine the activities of intermediaries to ensure that these firms are "meeting their respective obligations" with regard to these disclosures. In addition, the Division will examine broker-dealer trading in municipal and fixed income securities for issues relating to pricing, commissions, and best execution.

- *Microcap Securities*. In light of volatility and specific instances of fraud during the pandemic, the Division plans to examine broker-dealers' and transfer agents' compliance with their obligations in the offer, sale, and distribution of microcap securities. The Division will focus on transfer agent handling of microcap distributions and share transfers; broker-dealer sales practices and consistency with Reg BI; and broker-dealer compliance with other regulatory requirements, including the locate requirement of Reg SHO as well as anti-money laundering obligations.

Broker-Dealer Priorities

The 2021 Priorities contain numerous items related to broker-dealer operations. Reg BI examinations are front and center for retail broker-dealers. Other priorities of interest include custody and capital requirements, as well as timely topics such as best execution and payment for order flow.

Regulation Best Interest

Following an initial 2020 examination cycle focusing on reasonable efforts to implement policies and procedures, the 2021 Priorities signal an expanded focus on substantive compliance with the Reg's requirements, including:[4]

- Whether broker-dealers have a "reasonable basis" to believe their recommendations to retail clients are in the specific client's best interest. Specifically, the Division will look at the "recommendation of rollovers and alternatives considered, assessment of costs and reasonably available alternatives, how sales-based fees paid to broker-dealers and representatives impact recommendations."

- Evaluating processes for compliance and making changes to product offerings available to clients. The Division will also conduct "enhanced transaction testing" to determine compliance with the above requirements.

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4 For more in-depth commentary on the Division's December 2020 announcement on this topic, please see our prior client update available here.

Custody and Capital Requirements

EXAMS will evaluate broker-dealers' practices in handling cash and securities held on clients' behalf. The 2021 Priorities flag compliance with the Customer Protection Rule in borrowing customer securities and the Net Capital Rule. The Division acknowledges market volatility during the COVID-19 pandemic, stating that EXAMS may look at risk management designed to ensure sufficient liquidity in the face of significant market events.

Best Execution and Payment for Order Flow

EXAMS plans to assess best execution obligations in the "zero commission environment," including any effect of payment for order flow on those obligations. Under the new Commission, payment for order flow and best execution are likely to face increased examination and investigative scrutiny, particularly given recent public interest in these subjects. The 2021 Priorities also specifically mention a focus on compliance with Rule 606 of Regulation NMS's reporting requirements.

Registered Investment Advisers

In addition to the generally applicable retail investor protection goals, with respect to RIAs the Division will focus on:

Standards of Conduct–Fiduciary Duties

In line with 2019's Interpretation Regarding Standard of Conduct for RIAs, the Division will evaluate whether advisers have satisfied their duties of care and loyalty based on the content of proffered advice, the client's goals and best interest, and the elimination or disclosure of conflicts of interest.[5] EXAMS will pay close attention to risks "associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed, compensation arrangements."

RIA Compliance Programs

The Division will assess RIA compliance programs to determine whether the "programs and their policies and procedures are reasonably designed, implemented, and maintained."

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5 *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248 (June 5, 2019) available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

Demand for ESG-Conscious Investments

Consistent with the SEC's new focus on ESG concerns more broadly, EXAMS also intends to scrutinize the investments offered by RIAs in response to the demand for ESG-conscious investments. The Division plans to examine RIA disclosures and proxy voting policies regarding ESG to assess how these items align with actual practices, and to evaluate fund advertising for misleading statements concerning ESG investments.

Pandemic-Related Valuation Risks

The Division will review mutual fund filings for regulatory compliance and for valuation issues. The 2021 Priorities note that when considering valuation and fund performance, EXAMS will focus on investments in sectors particularly affected by the pandemic, including energy and real estate.

Private Fund Priorities

Last year, the Division articulated a renewed emphasis on private funds and their advisers. The 2021 Priorities contain an expanded discussion of topics involving advisers to private funds, signaling the Division's increased focus on these areas. The 2021 Priorities mention:

Liquidity Issues

EXAMS will target advisers to private funds giving preferential treatment to certain investors when the adviser has a history of liquidity issues leading to RIAs restricting withdrawals or imposing gates.

Disclosures and Compliance

Adequate disclosure of investment risks and conflicts of interest will be a priority. The Division will look at advisers to private funds with portfolios consisting of a "higher concentration of structured products, such as collateralized loan obligations mortgage backed securities," aiming to compare the actual default risks against the contents of their disclosures.

Cybersecurity Priorities

The COVID-19 Pandemic

EXAMS also plans to examine issues and risks that have emerged due to the unprecedented shift to a remote work environment during the pandemic. The Division plans to examine steps taken to address the operational risk stemming from "dispersed employees in a work-from-home environment." Further recognizing the disruptions of the pandemic, the Division will evaluate regulated-entities' business continuity and disaster recovery plans. The emphasis on business continuity and disaster recovery also reflects the Commission's concern with registrants' ability to manage and address environmental risks, given the increased frequency of large-scale climate events.

General Cybersecurity Priorities

The Division's cybersecurity priorities are largely consistent with those articulated last year. The 2021 Priorities include a focus on preventing account takeovers, phishing and ransomware attacks, and sufficient attention to vendor management.

Market Infrastructure

The Division plans to examine entities with important market infrastructure roles, like clearing agencies, national securities exchanges, entities covered under Regulation SCI, and transfer agents. These examinations will focus on compliance with the federal securities laws and the core areas of risk specific to the type of entity.

The Division has taken a broad approach to the 2021 Priorities. As with most years, it is the slight differences from prior years that likely indicate the areas of that will receive most attention. For 2021, we expect that particular emphasis to include ESG-related risks and disclosures, as well as the liquidity and disclosure issues specific to advisers to private funds. In addition, as Reg BI takes center stage as the SEC's newest and arguably most important retail investor protection tool, broker-dealers should gear up for fairly intensive and extensive examinations.

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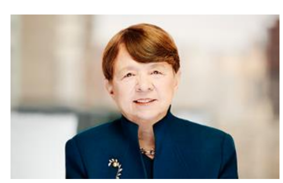

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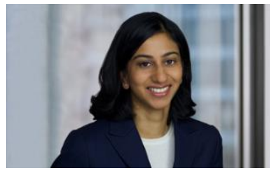

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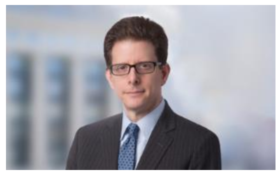

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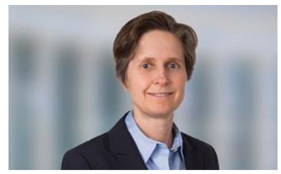

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