

Client Update

The Shape of Things to Come: OCIE Announces Examination Priorities for 2016

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The staff of the Securities and Exchange Commission (the “SEC”) recently published a summary of the select priorities of the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) in connection with the National Exam Program (the “2016 Priorities Summary”).¹ The examination priorities for 2016 generally focus on the same themes as the 2015 priorities: (i) protecting retail investors; (ii) assessing market-wide risks; and (iii) using data analytics to identify signals of potential illegal activity.

Of particular interest to private equity fund sponsors, the 2016 priorities include: (i) a continued focus on fees and expenses; (ii) controls and disclosures associated with side-by-side management of clients with different fee structures; (iii) cybersecurity; (iv) private placements relying on Regulation D under the Securities Act of 1933; and (v) investment advisers who have not yet been examined. In view of the continued emphasis that the SEC is placing on private fund examinations and recent SEC enforcement actions involving private fund expense allocation issues and potential conflicts of interest—as well as our experience representing private equity firms being examined by OCIE—private equity fund sponsors should continue to be prepared for rigorous examinations on these issues.

¹ Available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf>. For a summary of the 2015 examination priorities, see our client update, “What Will the ‘Eyes and Ears’ of the SEC Choose to See and Hear this Year? OCIE Announces Examination Priorities for 2015” (Feb. 4, 2015), available at <http://www.debevoise.com/insights/publications/2015/02/what-will-the-eyes-and-ears-of-the-sec-choose>.

FOCUS ON RETAIL INVESTORS AND INVESTORS SAVING FOR RETIREMENT

The 2016 Priorities Summary reflects the SEC's concerns about the evolving breadth of investment options available to retail investors. This set of examination priorities includes:

- *ReTIRE*. OCIE launched a multiyear examination initiative in June 2015 that focuses on SEC-registered investment advisers and broker-dealers with respect to the services they offer to investors with retirement accounts, including examining the reasonable basis for recommendations to investors, conflicts of interest, supervision and compliance controls, and marketing and disclosure practices.
- *ETFs*. OCIE will review exchange-traded funds ("ETFs") for compliance with applicable exemptive relief, their unit creation and redemption process, sales strategies, trading practices and disclosures with respect to excessive portfolio concentration, primary and secondary market trading risks, and suitability.
- *Fee Selection and Reverse Churning*. Where an adviser or dually registered adviser/broker dealer offers a variety of fee arrangements (e.g., asset-based fees, hourly fees, wrap fees, commissions), OCIE will "focus on recommendations of account types and whether the recommendations are in the best interest of the retail investor at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such arrangements."
- *Branch Office Supervision*. OCIE will focus on the supervision of registered representatives and investment adviser representatives in branch offices, including using data analytics to identify potentially inappropriate trading.
- *Variable Annuities*. OCIE will be assessing the suitability of sales of variable annuities to investors and the adequacy of disclosure and supervision of such sales.
- *Public Pension Advisers*. With respect to advisers to municipalities and other government entities, OCIE will be focusing on pay-to-play and the identification of undisclosed gifts and entertainment.

ASSESSING MARKET-WIDE RISKS

With respect to structural risks and trends, OCIE plans to focus on the following initiatives:

- *Cybersecurity*. OCIE is in the middle of its second initiative, launched in September 2015, to examine broker-dealers' and investment advisers' cybersecurity compliance and controls. OCIE states that it expects that these exams will include testing and assessment of firms' implementation of procedures and controls.²
- *Regulation Systems Compliance and Integrity ("SCI")*. SCI entities (e.g., registered clearing agencies, alternative trading systems, plan processors and exempt clearing agencies) will be evaluated on whether they have "established, maintained, and enforced written policies and procedures reasonably designed to ensure the capacity, integrity, resiliency, availability, and security of their SCI systems."
- *Liquidity Controls*. OCIE expects to examine advisers to mutual funds, ETFs and hedge (and other private) funds with exposure to potentially illiquid fixed income securities and registered broker-dealers that have become new or expanding liquidity providers in the marketplace with respect to controls over market risk management, valuation, liquidity management, trading activity and regulatory capital.³
- *Clearing Agencies*. The SEC staff will conduct annual examinations of all clearing agencies that have been designated systemically important.

USING DATA ANALYTICS TO IDENTIFY SIGNALS OF POTENTIAL ILLEGAL ACTIVITY

OCIE plans to utilize its data analytics capabilities to focus on registrants that appear to be potentially engaged in fraudulent and/or other illegal activity. The examination initiatives will focus on: (i) individuals with a track record of

² See our prior client updates: "SEC Sanctions Investment Adviser for Failing to Adopt Cybersecurity Policies and Procedures" (Sept. 24, 2015), available at <http://www.debevoise.com/insights/publications/2015/09/sec-sanctions-investment-ad>; "SEC Release Updated Cybersecurity Examination Guidelines" (Sept. 18, 2015), available at <http://www.debevoise.com/insights/publications/2015/09/sec-releases-updated-cybersecurity-examinat>; "SEC Issues Cybersecurity Guidance for Registered Investment Advisers and Funds" (May 7, 2015), available at <http://www.debevoise.com/insights/publications/2015/05/sec-issues-cybersecurity-guidance>; "SEC Regulation of Cybersecurity and Tech Risk Coversges," *Law360* (Oct. 23, 2015), available at <http://www.law360.com/articles/718238/print?section=banking>.

³ This priority is likely linked to the SEC's focus on mutual fund liquidity, investments in derivatives and the challenges of managing a fixed income portfolio in a changing interest rate environment. See, e.g., "Use of Derivatives by Registered Investment Companies and Business Development Companies," SEC Release No. IC-31933 (Dec. 11, 2015); "Open-End Fund Liquidity Risk Management Programs," SEC Release No. 33-9922, IC-31835 (Sep. 22, 2015); "Risk Management in Changing Fixed Income Market Conditions," IM Guidance Update No. 2014-01 (January 2014).

misconduct and the firms that employ them; (ii) anti-money laundering programs of clearing and introducing broker-dealers (and whether the filing of the suspicious activity reports is consistent with their business models); (iii) pump and dump schemes and market manipulation by broker-dealers and transfer agents; (iv) excessive or otherwise inappropriate trading by brokers and registered representatives; and (v) the promotion of new, complex and high-risk products and the related sales practices that can raise issues relating to suitability and breaches of fiduciary obligations.

OTHER INITIATIVES

OCIE expects to allocate examination resources to other priorities, including: (i) conducting examinations of newly registered municipal advisors; (ii) reviewing private placements, including offerings involving Regulation D or the EB-5 Immigrant Investor Program; (iii) examination of “never-before-examined” investment advisers and investment company complexes; (iv) private fund advisers and, in particular, fees and expenses and controls and disclosures associated with side-by-side management of performance-based and purely asset-based fee accounts; and (v) examining transfer agents with a particular focus on transfer agents providing paying agent services for their issuers.

CONCLUSION

OCIE’s 2016 examination priorities cover a broad range of market participants and target a variety of their products, practices and procedures, including a continued focus on private fund sponsors. Registered investment advisers, including private fund sponsors—in particular, “never-before-examined” investment advisers—should be prepared for rigorous examinations that focus on these issues.

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Please do not hesitate to contact us with any questions.