

OCIE's 2019 Priorities Focus on Retail, but PE Managers Remain in Examiners' Sights

January 9, 2019

The Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission (the “SEC”) recently published its 2019 examination priorities (the “2019 Priorities”).¹ Consistent with the 2018 OCIE examination priorities,² the 2019 Priorities focus on protecting retail investors, especially seniors and those saving for retirement, and on assessing market-wide risks. We believe, however, that private fund sponsors will continue to be a significant focus of OCIE in the coming year—if for no other reason than these exams continue to provide the SEC’s Division of Enforcement with a steady source of referrals.

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Priorities of Interest to Private Funds

- *Disclosure of Fees and Expenses.* OCIE continues to review disclosures of fees and expenses for completeness and to ensure that advisers “accurately calculate and charge fees in accordance with these disclosures.” OCIE will focus on “firms with practices or business models that may create increased risks of inadequately disclosed fees, expenses, or other charges” including those that offer wrap fee programs, further highlighting the SEC’s focus on retail. Even so, recent enforcement actions have highlighted the importance of private equity fund sponsors clearly disclosing the allocation of compensation of internal employees and of consultant expenses to fund clients:
- The SEC took action against Yucaipa Master Manager, LLC for charging the funds it advised a portion of the cost of Yucaipa’s in-house tax partner and in-house tax manager for preparing the fund’s tax returns while failing to charge the adviser, its affiliates and its principals their attributable share of the expense for the same service.³ The SEC also highlighted the failure to allocate expenses incurred by third-party service providers who were working on simultaneous

¹ Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (Dec. 20, 2018), available [here](#).

² For a summary of the 2018 examination priorities, please see our prior client update [here](#).

³ In the Matter of Yucaipa Master Manager, LLC, Investment Adviser Release No. 5074 (Dec. 13, 2018), available [here](#) (referred to herein as “Yucaipa”). See also our prior client update [here](#).

projects for the adviser, the funds, the funds' portfolio companies and the principals, some of which did not bear their attributable share of the expenses.

- Similarly, the SEC found that NB Alternative Advisers charged the funds it advised for employee compensation associated with activities that fell outside of the allowable expenses outlined in the limited partnership agreement such as raising capital and identifying and meeting with alternative asset management companies.⁴ The SEC noted that, to the extent employees spent time on services that did not involve providing services to the minority stake advisory business, the employees' compensation should have been borne by the adviser.
- *Conflicts of Interest.* OCIE will focus on policies and procedures addressing (i) the use of affiliated service providers and products and (ii) the practice of recommending non-purpose loans or lines of credit where clients may use their brokerage or advisory accounts as collateral—especially where the adviser receives a financial incentive for such recommendations. Additionally, OCIE will assess the related disclosures and financial condition of advisers who borrow funds from fund clients. While recent enforcement actions have focused on undisclosed conflicts of interest with service providers, conflicts of interest may arise in other situations including secondary transactions.⁵
- *Cybersecurity.* OCIE will examine “proper configuration of network storage devices, information security governance generally, and policies and procedures related to retail trading information security” with a particular focus on advisers with multiple branch offices.⁶
- *Anti-Money Laundering Programs (“AML”).* OCIE will continue to prioritize compliance with AML obligations including robust testing and meeting SAR filing obligations.
- *Never-Before or Not Recently Examined Investment Advisers.* OCIE will continue to prioritize investment advisers that have not been examined and that may have experienced substantial growth or a change in business model.
- *Portfolio Management and Trading.* OCIE will review business practices to ensure fair execution of investment transactions on behalf of clients, fair allocation of

⁴ In the Matter of NB Alternatives Advisers LLC, Investment Adviser Release No. 5079 (Dec. 17, 2018), available [here](#) (referred to herein as “NB Alternative Advisers”).

⁵ For more information, please see our prior client updates [here](#) (discussing the conflicts of interest in Yucaipa) and [here](#) (discussing potential conflicts of interest in recent secondary transactions).

⁶ For recent OCIE guidance on the preservation of electronic communications and best practices with respect to electronic messaging, please see our prior client update [here](#).

investment opportunities among clients and consistency of investments with client objectives. Advisers should review recent risk alerts on the most common best execution deficiencies for further insight.⁷

- *Digital Assets.* OCIE expects to continue monitoring the offer, sale and management of digital assets (e.g., cryptocurrency and tokens). OCIE will examine “portfolio management of digital assets, trading, safety of client funds and assets, pricing of client portfolios, compliance, and internal controls.”⁸

Retail, Retail, Retail

- *Senior Investors and Retirement Accounts.* OCIE will continue to focus on the suitability of investment recommendations and the supervision of employees.
- *Mutual Funds and Exchange Traded Funds.* OCIE will assess risks associated with bespoke indices, underperforming funds, funds with small secondary trading volume and high securitized assets allocations, and advisers new to managing registered investment companies or who also advise private funds with similar investment strategies.
- *Other.* OCIE will prioritize examination of municipal advisors who have never been examined and review compliance with MSRB rules. OCIE will also assess broker-dealers who sell stock of companies with a market capitalization of less than \$250 million and on compliance with, among other things, the Customer Protection Rule, Regulation SHO and Exchange Act Rule 15c2-11.

Critical Market Infrastructure

OCIE will continue to focus on examinations of clearing agencies that have been designated as systemically important by the Financial Stability Oversight Council and for which the SEC has supervisory authority under the Dodd-Frank Act. OCIE will also focus on entities subject to Regulation Systems Compliance and Integrity to ensure compliance and implementation of policies and procedures. For transfer agents, OCIE will examine, among other things, transfers, recordkeeping and safeguarding of funds and securities. Lastly, for national securities exchanges, OCIE will review internal audit and surveillance programs and funding for regulatory programs.

⁷ For a summary of OCIE’s risk alert on the most common best execution deficiencies, please see our prior client update [here](#).

⁸ For more information on the custody of digital assets, please see our prior client update [here](#).

FINRA and MSRB

OCIE will continue to focus on FINRA's operations and regulatory programs and the quality of FINRA's examinations of broker dealers and municipal advisors. OCIE will also continue to review MSRB to ensure effective policies, procedures and controls.

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While the 2019 Priorities preview OCIE's key focus areas, the actual scope of examinations is determined through a risk-based approach which includes an analysis of an adviser's operations, products offered and other relevant factors. We believe that this means that private equity managers will continue to be a focus of OCIE.

Please do not hesitate to contact us with any questions.

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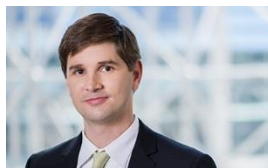
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