Client Update

What Will the "Eyes and Ears" of the SEC Choose to See and Hear this Year? OCIE Announces Examination Priorities for 2015

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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 "2015 Priorities Summary").[1] The examination priorities for 2015 appear to place particular emphasis on retail investors and investors saving for retirement and issues related to market-wide risks. The examination priorities also emphasize OCIE's evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity.

Of particular interest to private equity fund sponsors, the 2015 Priorities Summary indicates that the National Exam Program will continue to conduct examinations that focus on fees and expenses borne by investors in private equity funds. The summary also states that the National Exam Program will focus on risks related to cybersecurity. In view of these statements, recent public comments by OCIE officials (concerning, for example, presentation of performance data) and 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 and the areas of focus highlighted by the SEC in the past three years.

FOCUS ON RETAIL INVESTORS AND INVESTORS SAVING FOR RETIREMENT

The 2015 Priorities Summary reflects the SEC's concerns about the evolving breadth of investment options available to retail investors as well as investments that provide retail investors with increased access to alternative investment

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1 Available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

strategies, "including private funds, illiquid investments, and structured products." This set of examination priorities includes:

- *Fee Selection, Reverse Churning and Sales Practices*. Where an adviser offers a variety of fee arrangements, the SEC staff will "focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships."
- *Retirement Assets*. The SEC staff will also assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, especially when they pose greater risks and/or charge higher fees. The SEC staff will also evaluate recommendations to invest retirement assets into complex or structured products and higher yield securities, including whether the due diligence conducted, the disclosures made and the suitability of the recommendations or determinations are consistent with existing legal requirements.
- *Branch Office Supervision*. The SEC staff will focus on the supervision of registered representatives and financial adviser representatives in branch offices, including deviations from compliance practices of the firm's home office.
- *Mutual Fund Priorities*. The SEC staff will focus on mutual funds offering alternative investments and using alternative investment strategies, with a particular focus on: (i) leverage, liquidity and valuation policies and practices; (ii) factors relevant to the adequacy of the funds' internal controls; and (iii) the manner in which such funds are marketed to investors.

  The SEC staff will also review whether mutual funds with significant exposure to interest rate increases have implemented compliance policies and procedures and investment and trading controls sufficient to ensure that their funds' disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures.

ASSESSING MARKET-WIDE RISKS

Reflecting the SEC's increasing focus on systemic risks and in connection with an ongoing dialogue between regulators and market participants, the SEC staff intends to "examine the industry for structural risks and trends that may involve multiple firms or entire industries." OCIE plans to focus on the following initiatives:

- *Large Firm Monitoring*. The SEC staff will monitor the largest U.S. broker-dealers and asset managers for the purpose of assessing risks at individual firms and maintaining early awareness of developments industry-wide. This appears to be consistent with the SEC's plans to focus on the risks of the asset management industry and to develop appropriate regulatory responses.[2] The focus on firm risk is in contrast to a recent notice from the Financial Stability Oversight Council in which it appears that they will focus on potential systemic risks created by asset managers' products and activities, rather than the risks posed by individual asset managers.[3]
- *Clearing Agencies*. The SEC staff will conduct annual examinations of all clearing agencies designated systemically important.
- *Cybersecurity*. The SEC staff will examine broker-dealers' and investment advisers' cybersecurity compliance and controls and expand efforts to cover transfer agents.[4]
- *Potential Equity Order Routing Conflicts*. The SEC staff will assess whether firms are prioritizing trading venues based on payments or credits for order flow in conflict with their best execution duties.

USING DATA ANALYTICS TO IDENTIFY SIGNALS OF POTENTIAL ILLEGAL ACTIVITY

OCIE plans to utilize its data analytics capabilities to focus on registrants and firms 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 misconduct and the firms that employ them; (ii) pump and dump schemes or market manipulation by broker-dealers and transfer agents; (iii) excessive trading by brokers and registered representatives; and (iv) anti-money laundering programs.

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2 *See* our Client Update: "Planning for the Worst": The SEC Plans New Regulations for the Asset Management Industry, available at http://www.debevoise.com/insights/publications/2014/12/planning-for-the-worst.

3 *See* our Client Update: FSOC Gets Curious: Are Asset Managers' Products and Activities Creating Systemic Risk? available at http://www.debevoise.com/insights/publications/2015/01/financial-stability-oversight-council-gets-curious.

4 *See* our Client Update: SEC Releases Cybersecurity Examination Roadmap, available at http://www.debevoise.com/insights/publications/2014/04/sec-releases-cybersecurity-examination-roadmap. *See* also, two recent SEC releases relating to cybersecurity issues, available at http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf and http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-protecting-your-online-brokerage-accounts-fraud.

FEES AND EXPENSES IN PRIVATE EQUITY

Given the high rate of deficiencies that the SEC staff has observed among private equity fund sponsors in connection with fees and expenses, the SEC staff will continue to conduct thorough examinations in this area.[5]

OTHER INITIATIVES

OCIE expects to allocate examination resources to other priorities, including:
(i) conducting examinations of newly registered municipal advisors;
(ii) examining proxy advisory service firms, including their recommendation and conflict of interest policies, and investment advisers' compliance with their fiduciary duties in voting proxies on behalf of investors; (iii) conducting focused, risk-based examinations of select registered investment company complexes that have never before been examined; and (iv) examining transfer agents with a particular focus on those involved with microcap securities and private offerings.

CONCLUSION

OCIE's 2015 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 equity fund sponsors. As the 2015 National Exam Program progresses, we will all be looking to find out what OCIE chooses to see and hear while serving as the SEC's "eyes and ears."

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Please do not hesitate to contact us with any questions.

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[5] *See* our Client Update: Expense Allocation: The SEC Brings Down the Hammer, available at http://www.debevoise.com/insights/publications/2014/09/expense-allocation-the-sec-brings-down-the-hammer.