

Client Update

OCIE 2018 Examination Priorities Focus on Retail, but Private Fund Sponsors Still in Crosshairs

The Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission recently published its 2018 examination priorities.¹ Consistent with Chairman Jay Clayton’s priorities, the 2018 priorities focus on (i) protecting retail investors, especially seniors and those saving for retirement, and (ii) continuing current initiatives to reduce market-wide risks and improve market-wide infrastructure. However, private fund sponsors will likely continue to receive OCIE’s attention.

PRIORITIES OF INTEREST TO PRIVATE FUNDS

OCIE will continue to concentrate on disclosures to investors regarding fees and expenses. In particular, the 2018 priorities state that OCIE will “focus on firms that have practices or business models that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges.” This category of firms includes private fund advisers that manage funds with a high concentration of investors investing for the benefit of retail clients--which OCIE views as including clients historically considered institutional, such as non-profit organizations and pension plans.

As in the past, OCIE will continue its scrutiny of never-before-examined investment advisers with higher risk profiles. Additional specific target areas relevant to private fund sponsors include:

- *Cybersecurity.* OCIE will examine for “governance, risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.”
- *Anti-money laundering.* OCIE will evaluate whether firms are “taking reasonable steps to understand the nature and purpose of customer relationships.” OCIE will also assess whether firms are evaluating the robustness of their programs and filing Suspicious Activity Reports when appropriate.

¹ Available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf>.

- *Cryptocurrency, Initial Coin Offerings, and Blockchain.* OCIE will review safeguards against theft and misappropriation, and will focus on risk disclosures, including those associated with risk of loss, liquidity, price volatility, and fraud.

SENIOR RETAIL INVESTORS AND THOSE SAVING FOR RETIREMENT

OCIE will examine firms providing products and services directly to senior retail investors and retail investors saving for retirement, with particular focus on firms advising non-profit organizations, pension plans, and state, local and non-profit employees. OCIE will assess (i) compliance with disclosures, investor agreements, and internal policies that describe costs of investing, fees, expenses, and valuation, (ii) internal procedures used to supervise investment representatives to ensure that firms can identify manipulation of senior investors, and (iii) products and technological changes that pose a higher risk or that influence how advice is delivered. Other areas of focus include:

- *Wrap Fee Programs.* OCIE will examine (i) whether recommendations to invest or stay in wrap fee programs are reasonable, (ii) whether conflicts of interest are being disclosed, and (iii) whether investment advisers are seeking and disclosing best execution costs.
- *Electronic Investment Advice.* OCIE will assess compliance programs with a special focus on computer algorithms that generate “recommendations, marketing materials, investor data protection, and disclosure of conflicts of interest” -- in other words, “robo-advisers” and other online advisers.
- *Fixed Income Order Execution.* OCIE will evaluate whether broker-dealers have implemented best execution policies and procedures for municipal bond and corporate bond transactions.

EVALUATING MARKET-WIDE RISKS AND INFRASTRUCTURE

With respect to structural risks, OCIE notes its continued emphasis on existing initiatives regarding (i) clearing agencies, (ii) national securities exchanges, (iii) transfer agents, (iv) SCI entities (e.g., registered clearing agencies, alternative trading systems, plan processors and exempt clearing agencies), and (v) oversight of regulated entities by FINRA and the Municipal Securities Rulemaking Board (“MSRB”). Other target areas include:

- *Mutual Funds and Exchange Traded Funds.* OCIE will focus on mutual funds that (i) show poor performance or liquidity, (ii) are managed by advisers with limited experience, or (iii) hold securities that are difficult to mark to market (e.g., collateralized securities). Similarly, OCIE will scrutinize ETFs that (i) show poor secondary trading volume, (ii) risk being delisted, and (iii) may have to liquidate assets. In reviewing disclosures, OCIE will review conflicts of interest between advisers and index providers in instances where mutual funds and ETFs track customized indices.

- *Municipal Advisors and Underwriters.* OCIE will assess compliance with (i) qualification and continuing education requirements, and (ii) standards of conduct and duties as enacted by the MSRB.

CONCLUSION

- Private fund sponsors should continue to (i) review disclosures concerning fees, expenses and valuation, (ii) assess cybersecurity and anti-money laundering programs, (iii) update internal controls, and (iv) consider risks associated with cryptocurrency and blockchain.
- In addition to assessing the adequacy of disclosures concerning fees, expenses and valuation, firms providing products and services to retail investors should review disclosures concerning conflicts of interest and the costs of investing, provide reasonable investment recommendations, and look out for the protection of retail investors.
- OCIE will continue to evaluate market-wide risks and infrastructure and will assess regulatory compliance and corrective actions taken with a specific focus on market participants showing higher risk profiles.

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Please do not hesitate to contact us with any questions.

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