



January 2019

## **2019 SEC Exam Priorities for Securities Industry Registrants**

The Office of Compliance Inspections and Examinations (OCIE) of the U.S. Securities and Exchange Commission (SEC) released its annual list of **Examination Priorities for 2019** on Dec. 20, 2018.

The 2019 examination priorities are a combination of risk areas that have been previously identified in prior iterations of the letter as well as new initiatives. Most securities industry participants (registered investment advisers, broker-dealers, registered investment companies, municipal advisors, and transfer agents) are subject to examination. Therefore, securities industry participants will benefit from reviewing the 2019 priorities to assess the impact on their business and take proactive measures to strengthen their compliance programs.

As this summary is being written (mid-January 2019), the SEC is still impacted by the partial government shutdown. As a result, it is uncertain what effect this will have on the ability of OCIE to successfully complete the goals set forth in its release.

### **Purpose and Thematic Focus**

On a general level, OCIE notes that the purpose of its program continues to be promoting compliance with rules and policies, preventing fraud, identifying risks, and focusing SEC attention on matters that impact its policy decisions. To that end, OCIE has continued its practice of organizing its priorities around thematic areas. This year's areas are:

1. Retail Investors, including seniors and those saving for retirement;
2. Registrants responsible for critical market infrastructure;
3. FINRA and MSRB;
4. Digital Assets;
5. Cybersecurity; and
6. Anti-Money Laundering (AML) Programs.

This GT Alert summarizes key points in each of these thematic areas.

## **I. PROTECTING RETAIL INVESTORS, INCLUDING SENIORS AND THOSE SAVING FOR RETIREMENT**

OCIE's examination priorities connected to protecting retail investors are each described below. To protect retail investors, OCIE will review retail fees and expenses paid by investors, conflicts of interest of industry personnel, treatment of senior investors, and the advertising and suitability of retirement products, portfolio management and trading, operations of and selection of mutual funds and ETFs, procedures of municipal advisors, procedures for broker-dealers entrusted with customer assets, and microcap securities.

### *Retail Fees and Expenses Paid by Investors*

OCIE will particularly examine whether investors are provided with proper disclosures of the fees and expenses they pay, and OCIE will attempt to examine firms that have practices that may increase the risks of inadequately disclosed fees or expenses.

OCIE will continue to focus on financial professionals' selection of mutual fund share classes, and on reviewing investment advisers participating in wrap fee programs.

### *Conflicts of Interest of Industry Personnel*

Investment advisers have the duty to act in the best interests of their clients. However, because of economic or business factors that create conflicts of interest, financial professionals may recommend certain types of products and services that are not consistent with this duty. Therefore, OCIE examinations will review policies and procedures that address:

- The Use of Affiliated Service Providers and Products. Decisions of advisers that use affiliated service providers and products may face conflicts of interest related to portfolio-management practices and compensation arrangements. OCIE will examine the disclosure of these arrangements and the corresponding impact on clients.
- Securities-Backed Non-Purpose Loans and Lines of Credit. OCIE has observed that advisers, broker-dealers, and their employees may receive certain financial incentives to recommend non-purpose loans or lines of credit to borrowers who use the securities in their brokerage or advisory accounts as collateral to obtain a loan. OCIE will review the disclosures of the risks to clients posed by such arrangements, including any conflicts of interest present by recommending such loans.

- Borrowing Funds from Clients. When observing this practice, OCIE will examine whether adequate disclosures (such as the financial condition of the investment adviser) are given to the client and whether the investment adviser has acted consistently with such disclosures.

#### *Senior Investors and Retirement Accounts and Products*

In examinations of broker-dealers, OCIE will review how broker-dealers oversee their interactions with senior investors (including their ability to identify financial exploitation). In examinations of investment advisers, OCIE will continue reviewing the services and products offered to seniors and those saving for retirement, with a specific focus on compliance programs, the appropriateness of investment recommendations, and the supervision of firm employees and independent representatives.

#### *Portfolio Management and Trading*

OCIE will continue reviewing firms' practices for:

- executing transactions on behalf of clients;
- allocating investment opportunities among clients;
- ensuring consistency of investments with the objectives obtained from clients;
- disclosing critical information to clients; and
- complying with other legal restrictions.

OCIE will also examine investment adviser portfolio recommendations to assess whether investment strategies of advisers are:

1. in the best interests of investors based on their investment objectives and risk tolerance;
2. contrary to, or have drifted from, disclosures to investors;
3. venturing into new, risky investments or products without adequate risk disclosure; and
4. appropriately monitored for attendant risks.

#### *Never-Before or Not-Recently-Examined Investment Advisers*

OCIE will continue to examine certain investment advisers that have never been examined, including newly-registered investment advisers and advisers registered for several years that have not yet been examined, and firms that have recently changed their business models.

#### *Mutual Funds and Exchange Traded Funds (ETFs)*

Since these are the primary investment vehicles for many retail investors, OCIE will continue to prioritize examinations of these funds, their advisers, and oversight practices of their boards of directors.

In particular, OCIE will focus on the following:

1. index funds that track custom-built indexes;
2. ETFs with little secondary-market trading volume and fewer assets under management;

3. funds with higher allocations to certain securitized assets;
4. funds with aberrational underperformance or overperformance relative to their peer groups;
5. funds managed by advisers who are relatively new to managing public funds; and
6. advisers who provide advice to both public and private funds with similar investment strategies.

#### *Municipal Advisors*

OCIE will continue to conduct select examinations of municipal advisors (MAs) that have never been examined, concentrating on whether these MAs have satisfied their registration requirements and professional qualifications. Further, OCIE will review MA compliance with recently effective MSRB rules.

#### *Broker-Dealers Entrusted with Customer Assets*

Examinations of select broker-dealers will focus on compliance with the Customer Protection Rule (Exchange Act Rule 15c3-3), as well as procedures and controls to promote compliance to ensure customer assets are safeguarded and accurately reported.

#### *Microcap Securities*

OCIE will look at broker-dealers involved in selling stocks of companies with market capitalizations under \$250 million, specifically searching for manipulative schemes (such as pump and dump schemes), compliance with Regulation SHO (which governs short sales), and compliance with Exchange Act Rule 15c2-11 (which governs the submission and publication of quotations by broker-dealers for certain over-the-counter equity securities).

## **II. COMPLIANCE AND RISK IN REGISTRANTS RESPONSIBLE FOR CRITICAL MARKET INFRASTRUCTURE**

OCIE will continue examining (1) clearing agencies, (2) entities subject to Regulation SCI, governing systems compliance and integrity, (3) transfer agents, and (4) national securities exchanges as described below.

#### *Clearing Agencies*

OCIE will continue to examine clearing agencies that the Financial Stability Oversight Council has designated as systemically important. Examinations will focus on compliance across three areas:

- conformity with the SEC's Standards for Covered Clearing Agencies, and other federal securities laws applicable to registered clearing agencies;
- whether clearing agencies have taken timely corrective action in response to prior examinations; and
- other issues identified in collaboration with the SEC's Division of Trading and Markets and other regulators.

*Entities Subject to Regulation Systems Compliance and Integrity (Regulation SCI)*

In examinations of such entities, OCIE will evaluate whether they effectively implement written policies and procedures required by Regulation SCI, whether they have controls in place relating to software development life cycles, and the effectiveness of internal audit programs, inventory management, and threat management capabilities.

*Transfer Agents*

OCIE will prioritize transfers, recordkeeping, the safeguarding of funds and securities, and the transfer agent's duty to annually file a report by an independent accountant concerning the transfer agency's system of internal accounting controls.

*National Securities Exchanges*

OCIE will examine internal audit and surveillance programs and funding for regulatory programs.

**III. FOCUS ON FINRA AND MSRB**

*Financial Industry Regulatory Authority (FINRA)*

Examinations of FINRA will continue to focus on FINRA's operations, regulatory programs, and the quality of FINRA's examinations of broker-dealers and municipal advisors.

*Municipal Securities Rulemaking Board (MSRB)*

OCIE will continue to inspect the MSRB and evaluate the effectiveness of MSRB's policies, procedures, and controls.

**IV. DIGITAL ASSETS**

OCIE will continue to monitor the offer and sale, trading, and management of digital assets. In cases where the products are securities, OCIE will conduct examinations focused on portfolio management of digital assets, trading, safety of client funds and assets, pricing of client portfolios, compliance, and internal controls. Given the continuing developments in these areas, information gathered by OCIE in these examinations can be expected to influence continuing SEC policy decisions.

**V. CYBERSECURITY**

With regard to cybersecurity, and faced with continuing noteworthy cybersecurity breaches impacting significant financial records, OCIE will continue to prioritize a focus on proper configuration of network storage devices, information-security governance generally, and policies and procedures related to retail trading information security. For investment advisers with multiple branch offices, OCIE will emphasize governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

**V. ANTI-MONEY LAUNDERING PROGRAMS**

OCIE examinations will continue to ensure that broker-dealers have policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities, and that such policies and procedures are kept up-to-date in light of current developments. Their examinations

will prioritize whether broker-dealers and other financial entities are effectively fulfilling these policies, including meeting their SAR filing obligations, implementing all elements of their AML program, and robustly and timely conducting independent tests of their AML program.

## Conclusion

OCIE's 2019 priorities are by no means exhaustive; examinations will include inquiries into a variety of other areas based upon changes in market conditions, industry practice, and investor protection. OCIE also can be expected to conduct additional "for cause" examinations where specific matters come to light. Developments during the 2019 calendar year may prompt OCIE to expand or modify its focus on these and other issues facing the securities industry, and it remains unclear and difficult to assess what the government shutdown and its ripple effects may have on these priorities and their implementation.

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