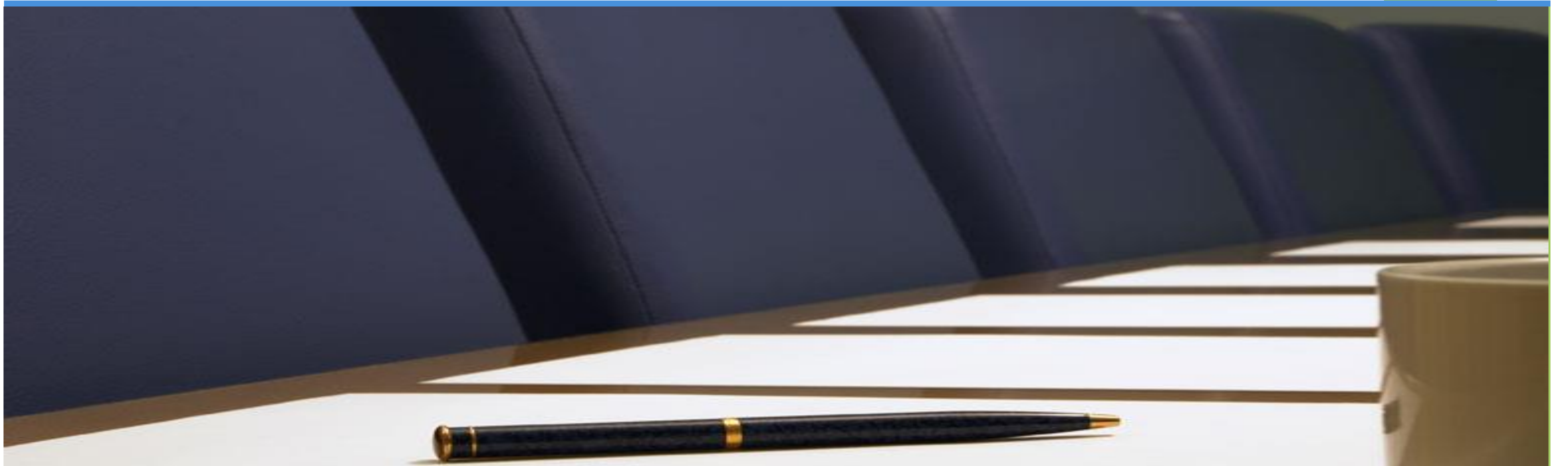

Investment Regulation/Financial Regulatory & Compliance | Alert

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2016 SEC Exam Priorities

On Jan. 11, 2016, 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 2016, which was previously summarized in the Greenberg Traurig *Financial Services Observer*, available here. A copy of the examination priorities letter is available here. The examination priorities are a mixture of OCIE's examination priorities and risk areas first identified in 2015 (or before), and new initiatives. Most securities industry participants -- registered investment advisers, broker-dealers, registered investment companies and transfer agents -- are impacted. The 2016 examination priorities letter does not address the examination priorities for the national securities exchanges, which the letter indicates will be addressed separately.

Purpose and Thematic Focus

The 2016 examination letter reiterates OCIE's role as the "eyes and ears" of the SEC and notes that OCIE's examinations of registered entities are designed to promote compliance and inform policy, in addition to preventing fraud and identifying risk. In the 2015 examination priorities letter (available here), OCIE for the first time identified three thematic areas around which the examination priorities were organized; and this year's priorities continue to be organized around the same three thematic areas:

1. Examining matters of importance to retail investors and those investing for retirement (a priority OCIE expects to continue to be a focus for the foreseeable future);
2. Assessing market-wide risks; and
3. Utilizing OCIE's data analytics abilities to identify signals of potential illegal activity.

In this GT Alert, we've summarized the items addressed by OCIE, sorted by registrant type.

Investment Advisers and Broker-Dealers

A significant percentage of the 2016 examination priorities (well more than half) focus on the activities of investment advisers, broker-dealers, and their personnel. The following are the areas of focus:

OCIE's "ReTIRE" Initiative. An acronym for OCIE's "Retirement-Targeted Industry Reviews and Examinations Initiative," which launched in June 2015 (OCIE's Risk Alert on this initiative is available here), this is a multi-year examination initiative that is an outgrowth of the first thematic area noted above. In this initiative, OCIE intends to conduct risk-based examinations of investment advisers and broker-dealers (and their personnel) identified through the use data analytics, information from prior examinations, and examiner-driven due diligence, focusing on the services offered to investors with retirement accounts. Specifically, the ReTIRE Initiative intends to focus on these registrants': (i) obligations to have a reasonable basis for the recommendation of investment products, (ii) conflicts of interest inherent in their operations and disclosure thereof, (iii) supervision and compliance controls, and (iv) marketing and disclosure materials to ensure they are neither deceptive nor misleading.

Branch Offices. The 2016 examination priorities letter indicates that OCIE intends to continue to focus on branch office supervision of investment adviser representatives and registered representatives, and specifically cites the use of data analytics to identify registered representatives in branches that appear to be engaged in potentially inappropriate trading.

Fee Selection and Reverse Churning. In another example of a priority that is being continued from 2015, OCIE intends to focus on investment advisers (including those dually-registered as broker-dealers) offering various fee arrangements (*e.g.*, asset-based fees, hourly fees, wrap fees, commissions). Specifically, OCIE intends to focus on recommendations of investor account types, whether they are in the best interest of the client – both at inception and thereafter – and the fees charged, services provided and disclosures made.

Variable Annuities. Despite being a specialized product, the 2016 examination priorities letter specifically notes the presence of these contracts as a part of the investment and retirement plan of many Americans. OCIE has expressed its intent to assess the suitability of variable annuity sales to investors – specifically including, as an example, exchange recommendations and product classes – and the adequacy of disclosure and supervision of such sales. This focus will be relevant to those investment advisers and broker-dealers who are involved in the sale of these products, although this priority likely will be broader than applying just to those registrants.

Public Pension Advisers. The 2016 examination priorities letter highlights that OCIE specifically intends to examine advisers to municipalities and other government entities, focusing on issues involving pay-to-play and the identification of undisclosed gifts and entertainment, among other undefined "key risk areas," particularly for advisers to public pensions.

Cybersecurity. As we summarized in a prior *GT Alert* (available here), OCIE launched its second round of cybersecurity examinations in September 2015. The 2016 examination priorities letter indicates OCIE's intent to continue and advance those examination efforts, including testing (in addition to assessment) of registrants' implementation of cybersecurity procedures and controls.

Exchange-traded funds (ETFs). As discussed more fully below, the 2016 examination priorities letter expresses a focus on various matters regarding ETFs. To the extent that investment advisers or broker-dealers are engaged in the purchase and sale of ETFs by client or customer accounts, OCIE's focus may also involve such determinations by investment advisers and/or broker-dealers.

Liquidity Controls. In 2015, one of OCIE's focus areas was on fixed income investment companies. In the 2016 examination priorities, OCIE has expanded this focus area, indicating that OCIE intends to examine investment advisers to mutual funds, ETFs and private funds that have exposure to potentially illiquid fixed income securities, as well as on broker-dealers that have become new or expanding liquidity providers in the marketplace. Reviews of controls over risk management, valuation, liquidity management, trading activity and regulatory capital, among other controls, are expected to be a part of these exams.

Recidivist Representatives and their Employers. The SEC has always been concerned with recidivist conduct, and the 2016 examination priorities letter highlights that OCIE intends to use its analytic capabilities to identify individuals with a track record of misconduct and examine the firms that employ those individuals – including when the misconduct occurred at a prior firm or in a different capacity (such as an investment adviser employing a person who had been disciplined or barred from a broker-dealer). Compliance oversight and controls of the employing firm are expected to be focus areas in such examinations.

Municipal Advisors. OCIE intends to both continue to conduct examinations of newly-registered municipal advisors and their compliance with the recently-adopted rules and industry outreach and education.

Never-Before-Examined Investment Advisers. As with new investment company complexes (discussed below), OCIE intends to use a risk-based approach to examine registered investment advisers that have not yet been examined by OCIE.

Private Fund Advisers. Continuing a priority from 2015, OCIE intends to continue to conduct examinations focused on fees and expenses charged by private fund advisers, including evaluating the controls and disclosure of side-by-side management of performance-based and purely asset-based fee accounts.

Data Analytics – The 2016 examination priorities letter indicates OCIE continuing utilization of data analytics to focus on a number of specific issues, including:

- the examination of clearing and introducing broker-dealers' AML programs, focusing on firms identified as having filed incomplete or late suspicious activity reports (SARs) or that have not filed the number SARs that would be consistent with their business models;
- an assessment of broker-dealers' independent testing of their AML programs and consideration and adapting their programs to current AML risks;
- an examination of the operations of broker-dealers and transfer agents for signs they are engaged in or are aiding and abetting pump-and-dump schemes or other market manipulation and assessing broker-dealers' compliance with OTC market regulations;
- identification of broker-dealers and registered representatives that appear to be engaged in excessive or other inappropriate trading; and
- detection of potential suitability issues and potential fiduciary duty breaches with respect to the promotion of new, complex and high-risk products.

Investment Companies (including ETFs)

According to the Investment Company Institute's official survey of the mutual fund industry, as of December 2015, the U.S. mutual fund industry has $15.7 trillion of assets under management. The ICI also estimated that, as of Sept. 30, 2015, total U.S. retirement assets were $23.5 trillion, accounting for 34 percent of all household financial assets in the U.S. as of such date (the foregoing information is available here), and that 401(k) plan assets, as of such date, were estimated to be $4.5 trillion (or over 19 percent) of such total retirement assets (such ICI estimate is available here). In addition, according to the ICI's monthly ETF report, as of December 2015 the combined assets of U.S. ETFs were approximately $2.1 trillion, reflecting a year-to-date net issuance of over $230.9 billion of ETF shares.

The 2016 examination priorities letter has identified the following as priorities for investment company registrants:

ETFs. While ETFs are registered investment companies, they differ in a number of respects from traditional mutual funds, including the manner in which ETF shares are sold and redeemed by ETFs. In order to operate as designed, ETFs are required to be granted and comply with certain exemptive relief from the Securities Exchange Act of 1934, the Investment Company Act of 1940, and certain other regulatory requirements. In the 2016 examination priorities letter, OCIE indicates that it will focus on examining ETFs for compliance with such exemptive relief and review unit creation and redemption by ETFs. OCIE also intends to focus on sales strategies, trading practices and disclosures involving ETFs, and has highlighted excessive portfolio concentration, primary and secondary market trading risks, adequacy of risk disclosure and investor suitability, particularly in niche or leveraged/inverse ETFs, as areas of particular concern.

Never-Before-Examined Investment Companies. The 2016 examination priorities letter continues to express that OCIE intends to use a risk-based approach to examine registered investment company complexes that have not yet been examined by OCIE.

Transfer Agents, Clearing Agencies and Other Industry Participants

In November 2014, the SEC adopted Regulation Systems Compliance and Integrity (SCI), with the intent of strengthening the technology infrastructure of the U.S. securities markets, with rules specifically intended to reduce the occurrence of systems issues, improve resiliency when systems issues occur and enhance SEC oversight and enforcement of securities market technology infrastructure. Regulation SCI applies to various securities industry participants (SCI entities), specifically including self-regulatory organizations (including exchanges), registered (and certain exempt) clearing agencies, FINRA and the MSRB and alternative trading systems (under certain conditions), among others. OCIE intends to examine SCI entities to evaluate whether they have established, maintained and enforced written policies and procedures designed to ensure the capacity, integrity, resiliency, availability and security of their SCI systems. Resiliency of SCI entities' primary and backup data centers, evaluating whether computing infrastructure components are geographically diverse and assessing the risk-tailoring of security operations are identified as a nonexhaustive list of OCIE's examination focuses.

As summarized in the Greenberg Traurig *Financial Services Observer*, available here, OCIE intends to review private placements (including Regulation D and EB-5 offerings) for compliance with various legal requirements.

Finally, the 2016 examination priorities letter indicates that OCIE intends to focus examinations on transfer agents, and specifically their turnaround of transfers, recordkeeping and record retention, and various asset safeguarding matters.

This *GT Alert* was prepared by **Richard M. Cutshall** and **Arthur Don.** Questions about this information can be directed to:

- Richard M. Cutshall | +1 312.476.5121 | cutshallr@gtlaw.com
- Arthur Don | +1 312.456.8438 | dona@gtlaw.com
- Or your Greenberg Traurig attorney

Albany
+1 518.689.1400

Amsterdam
+ 31 20 301 7300

Atlanta
+1 678.553.2100

Austin
+1 512.320.7200

Berlin¬
+49 (0) 30 700 171 100

Berlin-GT Restructuring¯
+49 (0) 30 700 171 100

Boca Raton
+1 561.955.7600

Boston
+1 617.310.6000

Chicago
+1 312.456.8400

Dallas
+1 214.665.3600

Delaware
+1 302.661.7000

Denver
+1 303.572.6500

Fort Lauderdale
+1 954.765.0500

Houston
+1 713.374.3500

Las Vegas
+1 702.792.3773

London*
+44 (0)203 349 8700

Los Angeles
+1 310.586.7700

Mexico City+
+52 55 5029.0000

Miami
+1 305.579.0500

New Jersey
+1 973.360.7900

New York
+1 212.801.9200

Northern Virginia
+1 703.749.1300

Orange County
+1 949.732.6500

Orlando
+1 407.420.1000

Philadelphia
+1 215.988.7800

Phoenix
+1 602.445.8000

Sacramento
+1 916.442.1111

San Francisco
+1 415.655.1300

Seoul∞
+1 82-2-369-1000

Shanghai
+86 21 6391 6633

Silicon Valley
+1 650.328.8500

Tallahassee
+1 850.222.6891

Tampa
+1 813.318.5700

Tel Aviv^
+03.636.6000

Tokyo¤
+81 (0)3 4510 2200

Warsaw~
+48 22 690 6100

Washington, D.C.
+1 202.331.3100

Westchester County
+1 914.286.2900

West Palm Beach
+1 561.650.7900