

# OCIE Releases 2020 Examination Priorities

Authored by Catherine Botticelli, Brenden Carroll, Susan Grafton, Anthony Kelly, Mark Perlow, Mike Sherman, Paul Stevens, Eric Auslander, Kathleen Hyer, Nicholas Sanville

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The 2020 Examination Priorities of the Office of Compliance Inspections and Examinations (OCIE) of the U.S. Securities and Exchange Commission were announced on January 7, 2020, and cover eight broad topics:<sup>1</sup>

- Protection of retail investors, including seniors and those saving for retirement (with a focus on the standards of conduct owed to retail investors);
- Information security and cyber-security risks;
- Financial technology (fintech) and innovation, including digital assets and investment advisers that provide electronic investment advice (*i.e.*, “robo-advisers”);
- Focus areas for examinations of registered investment advisers (RIAs) and registered investment companies, including compliance programs, never-before and not-recently examined RIAs, mutual funds and ETFs, and RIAs to private funds;
- Focus areas for examinations of broker-dealers and municipal advisors;
- Anti-money laundering (AML) programs;
- Critical market infrastructure functions of entities such as clearing agencies, securities exchanges and transfer agents; and
- Quality and effectiveness of the operations and regulatory programs, policies, procedures and controls of the Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB).

While most of the above topics are the same as those included in the 2019 OCIE Examination Priorities, this year’s Examination Priorities include two notable additions: a focus on major rulemaking initiatives (including the 2019 rulemaking/guidance package consisting of Regulation Best Interest, the Form CRS Relationship Summary and two interpretations under the Investment Advisers Act of 1940 (collectively, Standard of Conduct Initiatives)<sup>2</sup>); and a focus on the accuracy and adequacy of disclosures relating to sustainable and responsible investment strategies, including strategies that incorporate environmental, social and governance (ESG) criteria.<sup>3</sup>

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<sup>1</sup> [2020 Examination Priorities](#), SEC Office of Compliance Inspections and Examinations (Jan. 7, 2020). All statements in this *OnPoint* as to the intent or plans of OCIE are based on the text of the 2020 Examination Priorities.

<sup>2</sup> For further information regarding the Standard of Conduct Initiatives, please refer to *Dechert OnPoint*, [SEC Adopts Enhanced Standard of Conduct for Broker-Dealers and Clarifies Fiduciary Duties of Investment Advisers](#).

<sup>3</sup> For further information regarding ESG investing, please refer to [Dechert on ESG: an Overview for Asset Managers](#); [Dechert on ESG: Diversity and Inclusion in Asset Management](#) and [ESG Investing: Considerations for U.S. Registered Investment Advisers](#).

The topics included in this year's Examination Priorities are a product of OCIE's annual wide-ranging risk assessment process. Each year, the Examination Priorities incorporate views and information gathered from other SEC Offices and Divisions, including the Division of Enforcement and the Asset Management Unit, which focuses on misconduct by investment advisers and service providers to mutual funds, ETFs, retail client accounts, and private funds.

Following their publication, the Examination Priorities are used to inform: the determination of examination targets; prioritization of the examination staff's time and resources during the course of an exam itself; and, in certain instances, referral of examination findings to the Division of Enforcement. The 2020 Examination Priorities accordingly provide important information about OCIE's planned actions for this year, as well as potential enforcement activity in the investment management and broker-dealer industries based on the close collaboration between OCIE and the Enforcement Division's Asset Management Unit. However, regulated firms should not expect examination or enforcement activity to be limited to the topics identified in this year's publication and should recognize that the staff's approach can change at any time in response to changes in existing or emerging risks.

### **Message from OCIE's Leadership Team**

The 2020 Examination Priorities begin with a message from OCIE's leadership team summarizing examination statistics and discussing major examination themes for this year. During 2019, OCIE completed 3,089 examinations and reviews of regulated firms, a decrease of 2.7% over 2018 with more than 150 of these examinations resulted in a referral to the Division of Enforcement for investigation.<sup>4</sup> The leadership team noted, however, that the decrease in number of examinations should be viewed in context of the nearly month-long government shutdown during which "virtually all examination activity" ceased, and the leadership team praised the OCIE staff's "hard work, continued improved efficiency, resiliency and dedication" during 2019. However, the leadership team also indicated that hard work and efficiency likely would not be enough "to keep pace with the continued growth in the population and complexity [of the RIA industry]" and that "the risks of diminished coverage, quality and effectiveness are possible without further support" in the form of increased staffing and resources.

### ***Anticipated Impact of Significant Rulemakings***

The OCIE leadership team notes that a major theme for this year will be the examination of market participants subject to new regulatory requirements, including compliance with the Standard of Conduct Initiatives. OCIE notes that "the SEC has established an inter-Divisional Standards of Conduct Implementation Committee – of which staff across OCIE are members."

Although not specified in the current Examination Priorities, OCIE's focus on the impact of significant rulemakings suggests that registered investment companies should prepare for greater OCIE attention to compliance with the SEC's liquidity risk management rule (Rule 22e-4 under the Investment Company Act of 1940), Form N-PORT and Form N-CEN and related reporting requirements. For Rule 22e-4, the final compliance date for larger entities was June 1, 2019.<sup>5</sup> For Form N-PORT, the compliance date for larger entities was June 1, 2018. For Form N-CEN, the compliance date was June 1, 2018.

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<sup>4</sup> Additional statistical information about OCIE's examination program, compiled by Dechert from various SEC sources, is provided in an Appendix.

<sup>5</sup> For further information regarding the liquidity rule, please refer to Dechert OnPoint, [SEC Amends Investment Company Liquidity Rule Disclosure Requirements](#).

## ***Risks, Technology and Industry Trends***

New to this year's Examination Priorities, the leadership team states that it will closely follow "major risk themes affecting its registrant population, including information security and resiliency risks, geopolitical events, and the industry's transition away from LIBOR." Consistent with the 2019 Examination Priorities, OCIE will continue to closely examine the use of third-party service providers by regulated firms and the potential risks of outsourcing.

In a recognition of industry concerns, the leadership team states that OCIE "is mindful of its responsibility to ensure that information requested during an examination is appropriately calibrated and, once information is provided, is protected." The leadership team states that it recognizes the sensitivity of staff requests for books and records that might contain customer transactions, communications and other personal data. If a regulated firm receives a request for books and records that might contain potentially sensitive information, the leadership team "encourages dialogue with staff where a registrant may have a preferred or alternative data solution that would meet examination objectives."

The leadership team further notes that OCIE faces increasing challenges in its examinations of regulated firms that are subject to non-U.S. data protection and privacy laws, recognizing the "particularly acute" challenges presented by RIAs located outside the United States.<sup>6</sup> To address these challenges, OCIE will seek additional information from non-U.S. persons applying to register with the SEC as investment advisers.

## ***Retail Investors, including Seniors and those Saving for Retirement***

OCIE reiterates its long-standing focus on protecting retail investors, including seniors and those saving for retirement. OCIE's efforts in this area are concentrated in its Investment Adviser-Investment Company (IAIC) and Broker-Dealer and Exchange programs, which examine intermediaries that serve, and investments marketed to or designed for, retail investors. Specifically, OCIE is prioritizing examinations of RIAs, broker-dealers and dually-registered firms, and will focus attention on mutual funds and ETFs, municipal securities and other fixed income securities, and microcap securities.

## ***Fraud, Sales Practices, and Conflicts***

OCIE emphasizes the importance of implementing and maintaining controls and systems to ensure that regulated firms disclose to retail investors required information relating to fees and expenses and conflicts of interest. Examinations will focus particularly on seniors, as well as recommendations and advice targeted to retirement communities, teachers and military personnel. OCIE also emphasizes the importance of such disclosures with respect to "higher risk products – including private placements and securities of issuers in new and emerging risk areas – such as those that are complex or non-transparent; have high fees and expenses; or where an issuer is affiliated with or related to the registered firm making the recommendation."

OCIE also intends to continue examinations focused on the fiduciary duties of RIAs, probing whether RIAs are satisfying their duties of care and loyalty. OCIE plans to examine whether RIAs provide advice in the best interests of their clients, and eliminate or disclose conflicts of interest, including conflicts associated with revenue-sharing

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<sup>6</sup> In recent years, the SEC staff has taken various steps to address its significant concern for investment advisers subject to non-U.S. data protection and privacy laws, including refusing to declare effective registrations of certain RIA-applicants located outside the United States. The leadership team notes that the "SEC continues to work with both industry and its counterparts in other countries to address this challenge" but does not provide any indication that such applicants will be able to be declared effective in the near term.

arrangements and outside service providers. OCIE also will emphasize conflicts of interest associated with fees and expenses, as well as inadequately disclosed compensation arrangements.<sup>7</sup>

### ***Retail-Targeted Investments***

OCIE examinations will prioritize investments that pose “elevated risks” when they are marketed or sold to retail investors. Specifically, OCIE will focus on:

- *Mutual Funds and ETFs*: OCIE will prioritize examination of financial incentives received by financial services firms and professionals that “may influence the selection” of mutual fund share classes.<sup>8</sup> OCIE also will focus on mutual fund fee discounts owed to investors.
- *Municipal Securities and Other Fixed Income Securities*: OCIE will examine broker-dealer trading activity in the bond markets, to ensure compliance with “best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements.”
- *Microcap Securities*: OCIE also will focus on broker-dealers’ and transfer agents’ activities relating to companies with market capitalizations of less than \$250 million, by examining broker-dealers and transfer agents to determine whether they are “engaged in or aiding and abetting pump and dump schemes, market manipulation, and illegal distributions of securities of small companies.” OCIE’s selection of broker-dealers for examination will focus on whether an entity: employs registered representatives with a disciplinary history; engages in significant trading in unlisted securities; and makes markets in unlisted securities.

### ***Standards of Care***

OCIE intends to focus on the Standard of Conduct Initiatives in examinations during 2020, particularly as they relate to standards of care owed to advisory clients and brokerage customers, as well as related disclosures. Regulation Best Interest created a new standard of conduct for broker-dealers under the Securities Exchange Act of 1934, requiring broker-dealers to act in the best interest of retail customers at the time of making recommendations, and not to put broker-dealers’ and their associated persons’ interests ahead of those of the retail customers. Similarly, the Interpretation Regarding Standard of Conduct for Investment Advisers (IA Standards Interpretation) sets forth the SEC’s views as to the fiduciary duties of care and loyalty owed by investment advisers to their clients and how advisers discharge those duties to various types of clients. Form CRS requires broker-dealers and RIAs to deliver to retail investors a brief relationship summary that provides certain key information about the firm. Finally, the Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser (Solely Incidental Interpretation) clarifies the SEC’s views as to when advisory services are “solely incidental” to a broker-dealer’s business for purposes of the “broker’s exclusion” from the definition of “investment adviser” under the Advisers Act.<sup>9</sup>

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<sup>7</sup> The SEC staff has recently discussed, in response to frequently asked questions, certain compensation arrangements and related disclosure obligations arising from an RIA’s fiduciary duty as well as Form ADV. See [Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation](#).

<sup>8</sup> This represents a continuation of the staff’s Share Class Disclosure Initiative. For further information, please refer to *Dechert OnPoint*, [SEC Announces Results of Share Class Selection Disclosure Initiative](#).

<sup>9</sup> This exclusion, set forth in Section 202(a)(11)(C) of the Advisers Act, also requires that the broker-dealer not receive “special compensation” for any advice provided.

The 2020 Examination Priorities note that OCIE will engage with broker-dealers preparing to comply with Regulation Best Interest and broker-dealers and RIAs preparing their initial Forms CRS in advance of the compliance date, and that OCIE already has integrated the IA Standards Interpretation into the IAIC examination program. Although not specified in the 2020 Priorities, OCIE's focus on the standards of conduct indicates that broker-dealers should prepare for greater OCIE attention, including with respect to the Solely Incidental Interpretation. OCIE states that, following the compliance date for Regulation Best Interest and Form CRS, OCIE will assess implementation of Regulation Best Interest for broker-dealers as part of OCIE examinations, and will assess the content and delivery of Form CRS for broker-dealers and RIAs.

## **Information Security**

OCIE is working with entities to anticipate and mitigate information security risks (including cyber-security risks) and is encouraging market participants to engage with regulators and law enforcement to assist these efforts. The information security aspects of OCIE examinations will continue to focus on RIAs' efforts to protect client information, specifically by assessing firms' governance and risk management, access controls, data loss prevention, vendor management, training, and incident response and resiliency. OCIE also notes that it will look to oversight practices related to service providers and network solutions as part of its examination of third-party and vendor risk management. OCIE also will conduct examinations to ensure compliance with Regulations S-P and S-ID, ensure secure online and mobile access to customer account information, and assess procedures for safe disposal of hardware containing client data.

## **Financial Technology and Innovation, including Digital Assets and Electronic Investment Advice**

New in this year's Examination Priorities, OCIE identifies the use of so-called "alternative data" by firms in investment decision-making as an area of focus. OCIE also states that it sees greater potential risks in the market for "digital assets." In examinations related to digital assets, OCIE states that it intends to assess questions of investment suitability, portfolio management and trading practices, custody, pricing and valuation, compliance programs and controls, and supervision of outside business activities by employees. Also, although robo-advisers (providers of digital investment advice) were included in both the 2017 and 2018 Examination Priorities, they were dropped from the 2019 Examination Priorities but have now re-emerged as an examination topic. New this year, OCIE states that it will focus robo-adviser examinations on, among other things, a firm's eligibility for SEC registration.

## **Additional Focus Areas involving RIAs and Investment Companies**

For RIAs and investment companies, OCIE's efforts will continue to focus on risk-based examinations. Consistent with prior years, OCIE will prioritize examinations of: RIAs that are dually registered as broker-dealers; RIAs that have never been examined; RIAs that have not been examined for a number of years; mutual funds and ETFs; and RIAs to private funds, including their controls to prevent the misuse of material, non-public information. New to the current Examination Priorities, OCIE indicates that it will focus on RIAs that use third-party administrators to sponsor mutual funds, and mutual funds or ETFs that have not been examined.

Also new to the current Examination Priorities is a focus on "the accuracy and adequacy of disclosures provided by RIAs offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria." While OCIE has conducted a number of ESG-focused examinations of regulated firms in recent years, the inclusion of ESG in the

2020 Examination Priorities indicates that ESG strategies almost certainly will receive greater attention from OCIE examiners this year.

## **Additional Focus Areas Involving Broker-Dealers and Municipal Advisors**

Consistent with the theme of protecting retail investors, in conducting broker-dealer examinations OCIE will focus on: the safety of customer cash and securities; risk management; trading activities; commissions and cost structures; best execution; and order flow arrangements. OCIE emphasizes broker-dealers' financial responsibility, particularly with respect to: internal processes; procedures; and controls and compliance with the Customer Protection Rule and the Net Capital Rule. OCIE also will examine broker-dealers' involvement in "odd lot"<sup>10</sup> trading and supervision, as well as broker-dealers' development, testing, implementation, maintenance and modification of automated trading algorithms that present risks to retail investors and market stability.

OCIE will focus on whether municipal advisors have satisfied internal registration, professional qualification and continuing education requirements. OCIE will prioritize: the review of fiduciary duty obligations; fair dealing with market participant requirements; and the disclosure of and conduct surrounding conflicts of interest. In doing so, OCIE will emphasize compliance with MSRB Rule G-40 on advertisements.

## **Anti-Money Laundering Programs**

OCIE notes that examiners will continue to prioritize broker-dealer and investment company compliance with applicable AML requirements, including: proper filing of suspicious activity reports; adequacy of customer identification programs; compliance with beneficial ownership requirements; and robust and independent testing of AML programs.

## **Market Infrastructure**

OCIE will continue to prioritize compliance and risks related to critical market infrastructure. Examinations will focus on:

- Clearing agencies designated to be "systematically important" by the Financial Stability Oversight Council;
- National securities exchanges, including how they react to disruptions in the market;
- Entities (including alternative trading systems) that are subject to Regulations Systems Compliance and Integrity (SCI), with a focus on such entities' information technology (IT) inventory management, "IT governance, incident response, and third party vendor management;" and
- Transfer agents, including those that are: (i) acting as paying agents for issuers; (ii) developing blockchain technology; and (iii) "provid[ing] services to issuers of microcap securities, private offerings, crowdfunded securities, or digital assets."

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<sup>10</sup> Odd lots are orders under 100 shares. Orders of this size are often placed by retail investors.

## Focus on FINRA and MSRB

As with last year, OCIE will examine FINRA's operations and regulatory programs and the quality of its examinations of broker-dealers, by collecting and analyzing information and data, as well as conducting outreach programs. OCIE will apply a risk assessment process to identify areas to examine at MSRB, and will examine broker-dealers' compliance with MSRB rules to evaluate the effectiveness of MSRB's policies, procedures and controls. With OCIE's continued focus on FINRA and MSRB, there may be greater pressure on self-regulatory organizations to conduct examinations of broker-dealers and municipal advisors.

## Conclusion

In its eighth consecutive year of publication, the 2020 Examination Priorities are an important tool for regulated firms assessing their compliance programs and preparing for OCIE examinations. The topics identified in these Examination Priorities illustrate the evolution of the SEC's national examination program to meet existing and emerging risks. Regulated firms should carefully consider these Examination Priorities in assessing their readiness for potential document requests or examinations by OCIE in the coming year.



## Appendix

### OCIE Examination Statistics 2017-2019<sup>11</sup>

	2019 <sup>12</sup>	2018	2017
Total Number of Exams	3,089	3,175	2,873
Number of Broker-Dealer Exams	350	329	325
Broker-Dealer Exams as % of Total Exams	11%	10%	11%
Broker-Dealer Exams as % of Broker-Dealer Population	45%	48%	48%
Number of Investment Adviser Exams	2,180	2,312	2,114
Investment Adviser Exams as % of Total Exams	71%	73%	74%
Investment Adviser Exams as % of SEC-Registered Investment Adviser Population	15%	17%	15%
Investment Company Exams	150	138	95
Investment Company Exams as % of Total Exams	5%	4%	3%
Investment Company Exams as % of IC Population	11%	~11%	11%
Total Amount of \$ Returned to Investors	\$70 million	\$35 million	Not available <sup>13</sup>
Number of Exams Referred to Enforcement (and as % of Exams Conducted)	Over 150 (5%)	Over 160 (6%)	~200 (7%)

<sup>11</sup> The data contained in this chart was compiled using the following SEC sources: [OCIE National Examination Program, 2020 Examination Priorities](#); [OCIE National Examination Program, 2019 Examination Priorities](#); [OCIE National Examination Program, 2018 National Exam Program Examination Priorities](#); [Fiscal Year 2020 Congressional Budget Justification Annual Performance Plan & Fiscal Year 2018 Annual Performance Report](#); and [Fiscal Year 2019 Congressional Budget Justification Annual Performance Plan & Fiscal Year 2017 Annual Performance Report](#).

<sup>12</sup> Several 2019 figures are estimates subject to change when the SEC has finalized the data from FY 2019. Moreover, please note that fiscal year 2019 was likely impacted by the government shutdown.

<sup>13</sup> The total amount of money returned to investors resulting from OCIE examinations in FY 2017 has not been published.

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