**February 22, 2013**

# OCIE to Target Adviser Payments for Fund Distribution, Funds with "Alternative" Strategies and New Advisers

**By Kelley A. Howes and Jay G. Baris**

In an attempt to "increase transparency, strengthen compliance, and inform the public and the financial services industry about key risks," the SEC's Office of Compliance Inspections and Examinations (OCIE) published its 2013 examination priorities of its National Examination Program (NEP). While the announcement contained few surprises, OCIE's subtle shift of priorities may be a harbinger of enforcement cases to come. For example, OCIE said it will specifically focus on broker-dealer sales practices, newly registered advisers, and conflicts of interest. Perhaps most notably, OCIE will look at whether "revenue sharing" payments by investment advisers and payments by funds are really "payments for distribution in guise." OCIE's release states:

> The IA-IC Program is focusing on the wide variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments, and boards' oversight of the same. These payments go by many names and are purportedly made for a variety of services, most commonly revenue sharing, sub-TA, shareholder servicing, and conference support. The staff will assess whether such payments are made in compliance with regulations, including Investment Company Act Rule 12b-1, or whether they are instead payments for distribution and preferential treatment.

The list below describes "market-wide" areas of examination focus, then identifies specific areas of focus for investment advisers, investment companies, broker-dealers and transfer agents.

*Market-Wide Initiatives*

**Fraud Detection and Prevention.** Although the staff's focus on identification and mitigation of fraud is not new, OCIE said it will continue to utilize both quantitative and qualitative tools to seek out fraudulent or unethical behaviors. The NEP is actively soliciting whistleblower tips to help identify such schemes.

**Corporate Governance and Enterprise Risk Management.** Representatives of the NEP will continue to meet with registrants' senior management and boards to better understand how firms manage financial, legal, compliance, operational and reputational risks. This continues OCIE's focus on "tone at the top," and underscores its view that a compliance culture must permeate all areas of a firm. The staff said that it will continue to engage in "discovery" reviews to inform its examination program and rulemaking efforts.

**Conflicts of Interest.** OCIE identified conflicts of interest as a "leading indicator and cause of significant regulatory issues for individuals, firms, and sometimes the entire market." The identification of conflicts of interest

is and will continue to be a key factor in the staff's risk-based assessment of which firms to examine and what issues to focus on. Registrants should carefully consider their existing disclosures related to conflicts of interest and steps that they have taken to identify and mitigate potential conflicts of interest.

**Technology.** The staff noted that "the increasing complexity, interconnectedness, and speed fostered by technology is a continual challenge to market participants and regulators." Market events continue to make it clear that the SEC and other regulators must stay current with new trading technologies and the related market implications. In its release, the NEP said it "may conduct examinations on governance and supervision of information technology systems for topics such as operational capability, market access, and information security, including risks of system outages, and data integrity compromises that may adversely affect investor confidence."

*Program Area Specific Initiatives*

The NEP is divided into four specific program areas: (i) investment advisers and investment companies; (ii) broker-dealers; (iii) clearing and transfer agencies; and (iv) market oversight. Within each of these areas, the staff identified ongoing risks, new and emerging risks, and policy topics that are of interest to OCIE and thus may be subject to examination in 2013. Registrants should be aware of these areas of interest.

## INVESTMENT ADVISER – INVESTMENT COMPANY EXAM PROGRAM

The staff identified several on-going risks that will be of interest to the NEP staff in 2013, including:

- Custody and safety of client assets, particularly with respect to private funds;
- Conflicts of interest related to compensation arrangements such as solicitation agreements, referral arrangements and third party services;
- The use of performance advertising, particularly if such performance is identified in connection with the staff's aberrational performance initiative. The staff noted that aberrational performance can be an indicator not only of fraud but of weak valuation practices;
- Allocation of investment opportunities, particularly in the case of side-by-side management of accounts that do not pay performance fees (e.g., mutual funds) and those that do (e.g., hedge funds); and
- The quality and completeness of disclosure to fund boards, and whether the boards are conducting reasonable reviews of such information in connection with their responsibility for, among other things, contract approvals and valuation of fund assets.

The staff also noted several new and emerging issues that are likely to get attention in 2013, including:

- OCIE's clearly articulated intent to "establish a meaningful presence" with newly registered advisers, particularly in light of the fact that most of the newly registered advisers have never before been regulated or examined by the SEC. The staff said that new registrants can expect a two year program consisting of: (i) engagement; (ii) examination of a significant percentage of newly registered advisers; (iii) analysis; and (iv) reporting out to the industry. The staff said that it will "prioritize examinations of private fund advisers."

- In light of the continuing convergence in the industry, the exam staff's intention to expand coordinated examinations of firms dually registered as investment advisers and broker-dealers. These exams will focus on areas such as suitability, financial incentives and disclosure of conflicts of interest.
- The staff's focus on "alternative" products, including the use of hedge fund strategies in open-end funds, ETFs, and variable annuity structures. In particular, the staff will be looking at compliance with regulations related to the use of leverage, liquidity, and valuation, whether the back office and the compliance department are adequately funded and empowered, and how these funds are marketed to investors.
- As noted above, payments made to distributors and intermediaries for distribution of fund shares, and the adequacy of the disclosure made to fund boards about such payments.

On the policy front, the staff will continue to evaluate the effect of the 2010 amendments to Rule 2a-7 under the Investment Company Act and whether money market funds are appropriately complying with the stress test requirements of the Rule. The staff will also look at compliance with existing exemptive orders and Rule 206(4)-5 under the Investment Advisers Act, the pay-to-play rule.

## BROKER-DEALER EXAM PROGRAM

The NEP staff will continue to focus on broker-dealers' sales practices and the opportunity for fraud inherent in such practices, particularly with respect to retail investors. Areas of particular focus include unsuitable recommendations of higher yielding products, improper supervision and due diligence processes regarding such products, and products "on the periphery." Other areas of on-going risk of interest to the NEP program staff are high frequency trading, algorithmic trading, alternative trading systems, order routing, management of intraday liquidity risks and net capital requirements, and the robustness of anti-money laundering programs.

The staff also identified the need to focus on broker-dealers' compliance with Exchange Act Rule 15c3-5 (Market Access Rule), particularly with respect to master/sub-account relations and controls regarding proprietary trading, as well as technology controls and supervision and a continued review (with the CFTC) of broker-dealers dually registered as futures commission merchants. The staff will also review ETFs' compliance with Regulation SHO and how geared ETFs are marketed to retail investors.

In the event of approval of a final rule under the JOBS Act related to the use of "crowd funding," the staff intends to promptly start its review of entities in this space.

## MARKET OVERSIGHT EXAM PROGRAM

The Market Oversight team will continue to conduct targeted, risk-focused examinations of self-regulatory organizations (SROs). In doing so, Market Oversight will be using a recently established baseline for comparing the effectiveness of compliance programs across the various SROs. In addition, the staff will "continue its efforts to enhance oversight of FINRA." In doing so, it will focus on issues specifically identified in Section 964 of the Dodd-Frank Act and areas not identified in the Dodd-Frank Act for potential oversight. The staff identified the review of security-based swap execution facilities (to the extent the Commission adopts final rules regarding registration), SROs' governance of their rulemaking initiatives and the real time monitoring of market events as areas of particular interest.

CLEARANCE AND SETTLEMENT EXAM PROGRAM

The Clearance and Settlement exam program looks at transfer agencies and clearing agencies. The review of transfer agencies is focused on their core functions (e.g., timely processing of transfers, recordkeeping, and safeguarding of funds and securities). Among other things, the NEP staff will consider whether transfer agents that offer purchase and sale services may be engaging in unregistered broker-dealer or investment adviser activity.

The staff said that it will carefully look at services offered to microcap securities, particularly those involved in private offerings. The staff is concerned that such offerings may facilitate the unregistered offering or restricted securities by allowing transfers that circumvent existing rules. In addition, the staff will consider whether a transfer agency's procedures adequately reflect in-depth understanding of transfer requirements related to hybrid securities.

Another area of concern is the use of outsourcing and the need to have adequate policies, service level agreements and testing protocols in place to help monitor and maintain appropriate processing environments. In addition, to the extent that transfer agents provide third party administration services (e.g., to a retirement plan), it is critical that transfer agents consider if and when they may be required to register as either a broker-dealer or an investment adviser.

Finally, the staff intends to perform its first annual examinations of clearing agencies as mandated by the Dodd-Frank Act. The staff acknowledged the need to continue to enhance and tailor its clearing agency exam procedures to reflect on-going rulemaking initiatives under the Dodd-Frank Act. Apparently, however, the fact that the regulatory framework may be shifting does not mean that clearing agencies get a pass on annual examinations.

* * *

Importantly, while OCIE is providing transparency in its anticipated examination priorities in 2013, the staff is keeping its options open: "this priority list is not exhaustive and priorities may be adjusted throughout the year in light of ongoing risk assessment activities."

When OCIE comes knocking on their door, investment advisers, funds, broker-dealers and transfer agents will have little ability to claim ignorance of the expectations of the regulator. OCIE can simply say, "we told you so."

**Contact:**

**Bradley Berman**
(212) 336-4177
bberman@mofo.com

**Kelley A. Howes**
(303) 592-2237
khowes@mofo.com

**Robert E. Putney, III**
(212) 336-4451
rputney@mofo.com

**Anna T. Pinedo**
(212) 468-8179
apinedo@mofo.com

**About Morrison & Foerster:**

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.*