

Client Alert

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Another Bestseller: The SEC's Examination Priorities for 2014

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Following closely on the heels of FINRA's publication of its examination priorities for 2014 (see our recent [client alert](#)), OCIE's National Exam Program (NEP) released a [summary](#) of its 2014 priorities. OCIE's priorities represent a cross-divisional effort at the SEC and reflect the staff's assessment of information including:

- data from reports filed with the SEC;
- data gathered in the course of examinations;
- whistleblower tips;
- data retrieved from third-party databases;
- tips and communications from other regulators, including those outside the U.S.; and
- interactions with registrants, industry groups and service providers outside the examination process.

MARKET-WIDE PRIORITIES

Fraud Detection and Prevention: In 2013, the NEP expanded its Quantitative Analytics Unit. In 2014, this team of specialists – touted as having post-graduate degrees in computer science and mathematics – will continue to crunch data coming out of firms' algorithms, models and software in an effort to identify and mitigate potential fraud. The NEP's Risk Analysis Examinations will also continue to review transactions cleared through target clearing firms and large broker-dealers.

Our take: If the regulator is crunching data, you should be, too. Firms should use their intellectual capital as much to analyze their data and identify potential troubling trends as to develop new products and systems.

Conflicts of Interest: The NEP will continue its focus on conflicts of interest. Expect NEP staff to meet with registrants' senior management and boards this year as they try to better understand how firms identify and mitigate conflicts of interest and enterprise risk. This priority mirrors FINRA's current focus on conflicts of interest which is discussed in MoFo's related [client alert](#).

Our take: The NEP is looking at firms' overall control environment and their approach to conflicts and risk management. Firms should ensure that line management and senior executives understand the firm's key risks and regulatory requirements. OCIE will seek to ensure that firms make compliance the responsibility of the business, not just of the compliance team.

Client Alert

Technology: The NEP will evaluate governance and supervision of systems, operational capability, systems security and disaster preparedness.

Our take: Firms should revisit the joint report issued by the NEP, FINRA and the CFTC in August 2013 to ensure that their disaster recovery plans are consistent with the regulators' expectations (see MoFo's related [client alert](#)). Firms should also ensure that their data security systems and procedures are up to date in light of the increased frequency and sophistication of attacks on financial institutions (see MoFo's related [client alert](#)).

Dual Registrants: The NEP will continue to focus on the impact to investors of the different standards of conduct – suitability versus fiduciary duty – governing the provision of brokerage and investment advisory services. The NEP has identified the convergence of services offered by broker-dealer and investment advisory representatives as a significant risk because, among other things, these representatives can influence whether an investor establishes a brokerage or advisory account. The NEP is concerned that such recommendations might not be based entirely on the best interests of an investor but rather on the amount of revenue they could generate for a representative.

Our take: Dual registrants should evaluate their supervisory procedures to ensure that they include reviews of recommendations made to investors by representatives of a dually registered firm. Any such recommendations should be evaluated in light of the services offered to the investor and in the context of the documented risk profile and investment needs of a particular investor and not based upon any benefit to a representative.

New Laws and Regulation: The SEC adopted several new regulations in 2013, including Rule 506(c) under the Securities Act of 1933, allowing private funds to engage in general advertising and solicitation, and new registration requirements for municipal advisers. The NEP will test compliance with these rules during its 2014 exams.

Our take: Firms should review their due diligence procedures for offerings involving general solicitation to ensure they are adequately documenting their determinations that purchasers are accredited investors. Municipal advisers – or firms that may be municipal advisers – should review the SEC's recently released [interpretive guidance](#) regarding the new registration rules and work with experienced counsel to ensure that they act consistently with these regulations.

Retirement Vehicles and Rollovers: The NEP is concerned that investment advisers and broker-dealers might be motivated to recommend that investors move their rollover assets to an IRA or other retirement account. Accordingly, the staff intends to examine sales practices related to retirement accounts. FINRA also recently announced that it will focus on sales practices related to recommendations for rollover of retirement assets (for more on this, see our recent [client alert](#)).

Our take: The NEP staff's focus will presumably include whether supervisory and compliance procedures adequately address potential conflicts of interest inherent in making rollover recommendations. Firms should consider undertaking a comprehensive review of their sales and marketing materials related to retirement accounts to ensure they are fair, balanced and not misleading. Firms may also want to review compensation plans to ensure that they adequately mitigate conflicts of interests between investors and the representatives recommending retirement asset rollovers. Finally, firms might want to review the merits of a sample of their customers' rollovers of qualified retirement funds into IRA accounts.

Client Alert

INVESTMENT ADVISER / INVESTMENT COMPANY PRIORITIES

Custody of Assets: Compliance with Rule 206(4)-2 under the Investment Advisers Act (the “custody rule”) continues to be a priority for the SEC, which brought several enforcement actions in 2013 based on violations of obligations in this area (see our [client alert](#) regarding several of these actions). In 2014, examinations will continue to focus on compliance with the custody rule, including verifying the existence of assets and failure to realize that an adviser has custody of assets.

Our take: Firms should revisit the NEP’s March 2013 [risk alert](#) that pointed out the most common issues of non-compliance with the custody rule and evaluate their custody procedures in light of the issues identified in that alert.

Conflicts of Interest in Adviser Business Models: The NEP is concerned about business practices that place the interests of investment advisers above those of their clients in contravention of the fiduciary duty owed to such clients. The staff is concerned that advisers may not perceive or properly mitigate the conflict. Thus, conflicts of interest will be an area of significant focus in the 2014 examination program.

Our take: Firms should review the following programs and ensure that they adequately address and mitigate conflicts of interest:

- compensation plans, particularly those that are not disclosed;
- investment allocation procedures;
- procedures for the side-by-side management of asset-based fee accounts and performance-based fee accounts (e.g., registered versus private funds);
- risk controls related to the use of leverage and illiquid investments; and
- the sale of higher risk products to retail investors (particularly retired or elderly investors).

Performance Marketing: The NEP staff will test performance calculations (including hypothetical performance, composite performance and back-tested performance), recordkeeping and compliance oversight of marketing initiatives.

Our take: Firms should audit performance calculations and ensure that they are consistent with existing guidance and that the firm maintains adequate records documenting the calculations. Firms should spot check marketing pieces to ensure that they have been reviewed and approved, as necessary, by compliance personnel prior to use with clients or potential clients.

Never-Before Examined Advisers: The NEP will focus on those advisers that are not part of the presence exam initiative (see below) and that have not previously been examined by the staff. These exams will be risk-based and focus on firms in existence for three years or more that have not yet been examined.

Our take: Firms that have never been examined should audit their compliance program before the staff does. Retaining experienced counsel or other outside advisers to help with a self-audit may help firms be prepared and avoid surprises when the SEC comes calling.

Client Alert

Presence Exams: The staff's presence exam initiative, focusing on those advisers that registered as a result of the Dodd-Frank Act, will continue in 2014. These exams prioritize examination of private fund advisers when data analytics undertaken by the SEC staff indicate higher risks to investors, broker-dealer status concerns or the possibility of fraud. Presence exams will continue to focus on:

- marketing;
- portfolio management;
- conflicts of interest;
- safety of client assets; and
- valuation.

Our take: Firms required to register under the Dodd-Frank Act should consider asking a third party to review their compliance program prior to a visit from the staff. In particular, these firms should ensure that their compliance program adequately addresses their specific business and that their records are up to date and easily accessible in a format that can be accessed by the staff.

Wrap Fee Programs: In 2014, the staff will review these programs to ensure that advisers are fulfilling their related fiduciary and contractual responsibilities.

Our take: Firms should review their compliance policies related to monitoring recommendations of wrap fee programs; how conflicts are addressed; best execution obligations; trading away from the sponsor of a wrap fee program and disclosure to investors. For more information related to concerns about fee-based accounts, firms should also review MoFo's recent [client alert](#) discussing the practice of "reverse churning."

Quantitative Trading Models: Firms that utilize proprietary quantitative portfolio management strategies will be a focus of the examination staff in 2014. In particular, the staff said it will seek to determine if these firms have implemented compliance policies tailored to the specific strategies utilized by a firm.

Our take: Firms should review their compliance policies in the following areas and ensure that they adequately address the specific quantitative programs used by a particular firm:

- evaluating models and ensuring that there is no market manipulation;
- testing models and their output over time;
- maintaining appropriate records; and
- maintaining an inventory of all firmwide proprietary models.

Payments for Distribution in Guise: This year, the NEP will continue to scrutinize payments by advisers and funds to intermediaries that may mask payments for distribution. The staff will look at how advisers disclose these payments to fund boards, and the boards' oversight of the payments.

Client Alert

Our take: Fund boards should continue to ask questions about payments made to intermediaries and seek assurances that these payments are not primarily intended for distribution or for obtaining preferential distribution treatment. Boards should seek documentation of the shareholder or administrative services provided by intermediaries and be satisfied that they are an appropriate use of fund assets.

Fixed Income and Money Market Funds: The staff said that in 2014 it will evaluate fixed-income funds in light of changing interest rates and will consider how money market funds handle potential market stress. Money market funds with outlier performance will be a particular area of interest.

Our take: Firms should review their disclosure related to these types of investment companies to ensure that they are adequately disclosing the risks inherent in investing in such funds in a changing market environment. Particular disclosure may warrant close scrutiny, including:

- the effect of changing interest rates on fixed-income investing;
- how money market funds may handle market stress events; and
- why a particular money market fund may have a higher yield than its peers.

Alternative Investment Companies: The NEP is concerned about funds' use of "alternative" investment approaches. In particular, the staff intends to focus on whether investments in these funds are suitable for the investors to whom they are being marketed.

Our take: Firms should evaluate their disclosure, compliance policies and marketing practices related to these funds. Such evaluations should focus on:

- policies regarding the use of leverage and liquidity requirements;
- valuation policies;
- the empowerment of boards, compliance personnel and operational teams; and
- how these funds are marketed to investors.

BROKER-DEALER PRIORITIES

Sales Practices: Broker-dealer sales practices, and detecting and preventing fraud in connection with sales to retail investors, are an area of perennial interest to the examination staff. 2014 will be no exception. The NEP said it will focus on sales to the elderly; micro-cap fraud and pump-and-dump schemes; suitability of recommendations of complex products; and unusual capital-raising activities.

Our take: Although sales practices are an area that the broker-dealer examination program continually focuses on, firms should carefully evaluate their sales practices as they relate to the sales of complex products to retail investors, suitability obligations in general and mitigation of conflicts of interest.

Supervision: The supervision of registered representatives and others involved in the brokerage business is a key responsibility of broker-dealers. The staff said it will focus on supervision of:

Client Alert

- independent contractors and financial advisers in remote offices;
- registered representatives with significant disciplinary histories; and
- private securities transactions.

Our take: The staff said that these three areas, in particular, present challenges to the ability of a broker-dealer to adequately supervise and prevent violation of securities laws. Broker-dealers should carefully review their supervisory procedures with that in mind. In addition, firms should remain cognizant of FINRA's increasing focus on recidivist brokers.

Trading: The NEP will look at controls related to market access with a focus on technology, cyber security and market manipulation. These initiatives are consistent with initiatives recently announced by FINRA, and registrants should expect cooperation between the SEC and FINRA. (For more information on FINRA's approach to cyber security, see our recent [client alert](#).)

Our take: Broker-dealers should ensure that their policies and procedures are consistent with existing guidance from both the SEC and FINRA in the following specific areas:

- algorithmic and high frequency trading;
- erroneous orders;
- cyber security;
- market manipulation practices, including marking the close, parking, spoofing and excessive markups or markdowns; and
- the relationship between broker-dealers and alternative trading systems.

Anti-Money Laundering: The NEP will review clearing and introducing firms to assess their AML programs. This was also a priority identified by FINRA (see our [client alert](#) regarding FINRA's 2014 exam priorities).

Our take: Firms should revisit their AML procedures in light of both FINRA and the SEC's identified concerns in this area.

Suitability of Variable Annuity Buybacks: The staff said that it will evaluate whether representatives are recommending that investors accept offers from insurance companies to repurchase variable annuity products with guaranteed benefits and, if so, whether those recommendations are suitable for the investors.

Our take: If a firm's representatives sell variable annuity products, the firm should carefully evaluate recent data to determine if buybacks have occurred. If so, firms should determine whether an investor was placed into another variable annuity product with less favorable terms and the disclosure made to the investor in connection with that change. Firms may also want to review training related to the sale of variable annuity products.

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Client Alert

The NEP's 2014 Examination Priorities also include various initiatives related to oversight of SROs and exchanges, clearance and settlement of securities and transfer agents outside the scope of this client alert. Across the board, however, it is clear that the examination staff will be focusing on conflicts of interest and registrants' controls designed to identify and mitigate such conflicts. Broker-dealers and investment advisers should carefully evaluate their compliance programs through that prism and ensure that they have adopted compliance programs designed to ensure that transactions occur in the best interests of investors.

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