CLIENT ALERT

SEC Division of Examinations Releases its 2021 Examination Priorities

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On March 3, 2021, the SEC's Division of Examinations (the "Division") released its 2021 examination priorities.[1] The priorities include thematic areas of focus on: (i) retail investors, including seniors and individuals saving for retirement; (ii) information security and operational resiliency; (iii) financial technology and innovation; (iv) anti-money laundering; and (v) LIBOR transition. In addition, the priorities include specific examination topics for registered investment advisers ("RIAs"), registered investment companies, broker-dealers, municipal advisors, clearing agencies, national securities exchanges, FINRA, and the MSRB. Below is a summary of highlights from the Division's release, which reflects a combination of long-standing areas of Division focus, new priorities of the Biden administration, and priorities arising out of recent market developments.

1. *Retail Investors, Including Seniors and Individuals Saving for Retirement*

The Division will continue to emphasize the protection of retail investors, with a specific emphasis on seniors and individuals saving for retirement. The Division aims to focus examinations on newly adopted standards of conduct, fraud, sales practices, conflicts, and retail-targeted investments.

[1] 2021 Examination Priorities, Division of Examinations, available here.

a. *Standards of Conduct*

i. *Regulation Best Interest*

The Division intends to prioritize examinations to assess compliance with Regulation Best Interest.[2] The initial round of examinations conducted in the months after the adoption of Regulation Best Interest focused on the processes broker-dealers relied on to implement the rule.[3] Moving forward, the Division will expand the scope of the examinations to assess whether broker-dealers are making recommendations that they have a reasonable basis to believe are in their retail customers' best interests and to evaluate processes for compliance and alterations to product offerings. As part of these examinations, the Division will conduct enhanced transaction testing and evaluate firm policies and procedures created to comply with elements of Regulation Best Interest, such as the recommendation of rollovers and complex products, assessment of costs and reasonably available alternatives, the impact of sales-based fees on recommendations, and conflicts of interest. While the release does not specify what the Division considers to be complex products, recent statements by SEC Commissioners and staff suggest that recommendations and sales of certain types of exchange-traded funds ("ETFs") and special purpose acquisition companies could be some of the products on which the Division focuses.

ii. *RIA Fiduciary Duty*

The Division will continue to assess whether RIAs have fulfilled their duties of care and loyalty in light of the SEC's 2019 Interpretation Regarding Standard of Conduct for Investment Advisers.[4] The Division will focus on risks associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed compensation arrangements.

iii. *Form CRS*

The Division intends to prioritize examinations of firms' compliance with Form CRS, including delivery and filing, content, formatting, and amendments.[5] The Division will focus on firms that service retail investors, have not filed a Form CRS, and failed to respond to inquiries about why they have not filed a Form CRS.[6] The Division's Director, Peter Driscoll, recently stated that Form CRS will be the "number one" document that examiners will read as they prepare for an examination.[7]

2 Regulation Best Interest: The Broker-Dealer Standard of Conduct, Rel. No. 34-86031 (June 5, 2019), available here.

3 *See* Examinations that Focus on Compliance with Regulation Best Interest, OCIE Risk Alert (April 7, 2020), available here.

4 Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Rel. No. IA-5248 (June 5, 2019), available here.

5 *See also* OCIE Risk Alert, Examinations that Focus on Compliance with Form CRS (April 7, 2020), available here.

6 *See* IAA Today, Form CRS, ESG Disclosure are Priorities for SEC Exams, Enforcement (Mar. 9, 2021), available here.

7 *Id.*

b. Fraud, Sales Practices, and Conflicts

The Division expressed concern that recent market volatility and industry pressures that have impacted fees and other revenues collected by firms may cause increased financial stress on firms and their personnel, which may, in turn, lead to increased instances of fraudulent conduct. In response, the Division will focus examinations on the appropriateness of recommendations and advice provided to retail investors, with particular emphasis on: (i) seniors, including recommendations targeting retirement communities; (ii) teachers; (iii) military personnel; and (iv) other individuals saving for retirement.

In this regard, the Division will examine recommendations of account type, conversions and rollovers, and firm sales practices regarding structured products, exchange-traded products, real estate investment trusts, private placements, annuities, digital assets, municipal and other fixed income securities, and microcap securities. The Division will assess whether broker-dealers are meeting their legal and compliance obligations when providing retail customers access to complex strategies and products. The Division also will examine how firms are complying with the recent changes to the definition of "accredited investor" when recommending and selling certain private offerings, which is notably included in the section of the release focused on retail investors.[8]

The Division also will focus on disclosures concerning fee- and compensation-based conflicts of interest, including revenue sharing arrangements and direct or indirect compensation to personnel for executing transactions. In particular, the Division will prioritize examining RIAs that operate and utilize "turnkey" asset management platforms, which provide RIAs with technology, investment research, portfolio management, and other outsourcing services, and whether the fees and revenue sharing arrangements associated with such arrangements are adequately disclosed. The Division will assess whether RIAs aggregate certain accounts for purposes of calculating fee discounts consistent with their disclosures. The Division will review for advisory fee calculation errors, inaccurate calculations of tiered fees, and failures to refund prepaid fees for terminated accounts.

c. Retail-Targeted Investments

i. Mutual Funds and ETFs

In line with its past priorities, the Division will focus on recommendations and disclosures regarding ETFs, specifically the adequacy of risk disclosure and suitability for niche and complex products like leveraged/inverse ETFs. Incentives

[8] For a more in-depth summary on the changes to the definition of "accredited investor," please see Willkie's client alert from Sept. 2, 2020, available here.

provided to financial service firms and professionals will remain a priority for the Division as well—specifically whether these incentives influence the selection of higher cost mutual fund share classes when lower cost share classes are available.[9]

ii. Municipal Securities and Other Fixed Income Securities

With respect to municipal issuer disclosure, the Division believes that the importance of timely and accurate disclosures has increased due to the effects of the pandemic on the finances and operations of municipalities. In that regard, the Division intends to examine the activities of broker-dealers, underwriters, and municipal advisors to determine whether they are meeting their disclosure obligations. Division staff also will focus on trading activity in municipal and corporate bonds for compliance with best execution obligations, fairness of pricing, mark-ups, mark-downs, and commissions, and confirmation disclosure requirements.

iii. Microcap Securities

The Division remains focused on fraud involving securities of companies with a market capitalization under $250 million. In particular, the Division will examine transfer agent handling of microcap distributions and share transfers, the offer, sale, and distribution of microcap securities by broker-dealers for consistency with Regulation Best Interest, and other regulatory requirements, including the locate requirement of Regulation SHO, penny stock disclosures under Rules 15g-2 through 15g-6 of the Securities Exchange Act of 1934, and the obligation for broker-dealers to monitor for and report suspicious activity and other anti-money laundering ("AML") obligations.

2. Information Security and Operational Resiliency

The Division will continue to prioritize working with firms to identify and address information security risks, encouraging market participants to actively engage regulators and law enforcement. Given the increase in remote operations as a result of the pandemic, the Division will review whether firms have taken appropriate measures to: (i) safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (ii) oversee vendors and service providers; (iii) address malicious email activities, such as phishing or account intrusions; (iv) respond to incidents, including those related to ransomware attacks; and (v) manage operational risk resulting from dispersed employees in a work-from-home environment.[10] Examinations will focus on controls surrounding online and

9 In a recent interview, Peter Driscoll stated that the SEC's systems can review trade blotters and automatically flag specific trades that have a cheaper share class alternative. *See* SEC 2021 Examination Priorities, A Conversation with SEC Examinations Director Peter Driscoll (Mar. 4, 2021), available here.

10 *See also* Cybersecurity: Safeguarding Client Accounts against Credential Compromise, OCIE Risk Alert (Sept. 15, 2020), available here; Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers, OCIE Risk Alert (Aug. 12, 2020), available here; Cybersecurity: Ransomware Alert, OCIE Risk Alert (July 10, 2020), available here.

mobile application access, controls surrounding electronic storage of books and records and information maintained with third-party cloud service providers, and firms' policies and procedures designed to protect investor records and information. Additionally, the Division will continue reviewing business continuity and disaster recovery plans, shifting its focus to whether such plans have matured to account for the growing risks of climate change. The Division noted that the scope of these examinations will be similar to the work conducted by the Division post-Hurricane Sandy.[11]

3. Financial Technology ("FINTECH") and Innovation, Including Digital Assets

The Division will remain focused on the use of FINTECH, RegTech, alternative data (*i.e*., data gleaned from non-traditional sources), and digital assets by market participants.[12] In response to the rapid development of robo-advisers, automated asset allocation tools, and fractional share purchases, among other FINTECH developments, the Division intends to evaluate whether firms are operating consistently with their representations, whether firms are handling customer orders in accordance with customer instructions, and compliance surrounding trade recommendations made on mobile applications. The use of technology to facilitate compliance with regulatory requirements ("RegTech") is also a priority, with the Division examining the implementation and integration of RegTech in compliance programs for potential misapplication that causes compliance deficiencies. Examinations on alternative data will focus on whether firms are employing appropriate control mechanisms and compliance regarding the creation, receipt, and use of such information.

The Division will focus examinations of market participants engaged with digital assets on whether recommendations of digital asset investments are in the best interests of investors. In addition, the Division will review portfolio management and trading practices, safety of client funds and assets, pricing and valuation, effectiveness of compliance programs and controls, and supervision of representatives' outside business activities.

4. Anti-Money Laundering

The Division intends to prioritize examinations of broker-dealers and registered investment companies for compliance with AML obligations under the Bank Secrecy Act to determine whether firms have implemented appropriate programs and policies to, among other things, identify and verify the identities of customers, perform customer due diligence, monitor for suspicious activity, and file Suspicious Activity Reports with the Financial Crimes Enforcement Network.

5. The London Inter-Bank Offered Rate ("LIBOR") Transition

The Division believes the discontinuation of LIBOR could have a significant impact on financial markets and could present a material risk for certain market participants, both for clients of registered entities and for the entities themselves. The

11 *See* Joint SEC, FINRA, and CFTC Business Continuity Planning Observations (August 7, 2013), available here.

12 For an in-depth summary on the SEC's focus on digital assets, please see Willkie's client alert from Mar. 4, 2021, available here.

Division intends to examine registrants' awareness of their exposure to LIBOR and inspect preparations for the anticipated discontinuation of LIBOR and the transition to an alternative reference rate.[13]

6. Additional Focus Areas Involving RIAs and Investment Companies

a. RIA Compliance Programs

The Division will continue to evaluate RIA compliance programs, particularly with regard to whether compliance programs and policies are reasonably designed, implemented, and maintained, and whether RIAs have appropriately adapted their compliance programs in response to substantial changes to their business. The Division will prioritize RIAs that have not been examined for a number of years and RIAs that have never been examined, including new registrants.

The Division will increase its scrutiny of RIA investment strategies that incorporate sustainability and environmental, social, and governance factors ("ESG") including the use of mutual funds, ETFs, and privately offered products that pursue ESG strategies.[14] The Division intends to review the consistency and adequacy of disclosures that RIAs and fund complexes give to clients regarding these strategies, review whether the firms' practices are in line with these disclosures, and determine whether advertising is false or contains misleading statements.

RIAs that are dually registered as broker-dealers will remain a priority for the Division, as will RIAs that have supervised persons who are registered representatives of third-party broker-dealers. The Division will assess whether such firms have implemented effective compliance programs with a specific focus on conflicts of interest that arise from compensation arrangements and outside business activities.

b. Registered Funds, Including Mutual Funds and ETFs

The Division will review mutual fund filings and board reports for compliance with regulatory requirements and valuation issues and the impact that valuation can have on fund performance, liquidity, and risk. The Division will focus on investments in market sectors affected by the pandemic, such as energy and real estate, and will review disclosures and practices related to securities lending and liquidity risk management programs.

The Division will prioritize mutual funds or ETFs that have not been examined for many years or at all, focusing on compliance programs, financial condition, whether such funds have instituted advisory fee waivers, and compliance with exemptive relief, including for newly created non-transparent actively managed ETFs. In addition, the Division plans to review money-market fund compliance with stress-testing requirements, website disclosures, and board oversight.

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13 *See* Examination Initiative: LIBOR Transition Preparedness, OCIE Risk Alert (June 18, 2020), available here.

14 For an in-depth summary on the SEC's focus on ESG, please see Willkie's client alert from March 17, 2021, available here. Additionally, Peter Driscoll indicated that the Division plans to issue a risk alert on ESG in the next few weeks. *See* supra note 9.

c. RIAs to Private Funds

The Division reiterated its commitment to examine private fund managers, with a focus on compliance risks, including liquidity and disclosures of investment risks and conflicts of interest. Specifically, the Division will review advisers of funds that have provided preferential liquidity rights to certain investors, including gates and suspensions (with a particular emphasis on funds that have faced liquidity challenges). The Division also will review advisers' portfolio valuations and the resulting impact on management fees, adequacy of disclosure and compliance related to cross trades and principal investments, and conflicts surrounding liquidity.

The Division also will focus on advisers to private funds with a higher concentration of structured products, such as collateralized loan obligations and mortgage-backed securities, to determine whether such funds are at a higher risk for holding non-performing loans and having loans with a higher default risk than what is disclosed to investors. Additionally, the Division will review material impacts on portfolio companies owned by private funds as a result of recent economic conditions.

7. Additional Focus Areas Involving Broker-Dealers

a. Broker-Dealer Financial Responsibility

The Division will continue to focus on broker-dealers that hold customer cash and securities, to ensure that cash and securities are properly safeguarded in accordance with the Customer Protection Rule and the Net Capital Rule. Specifically, the Division will focus on adequacy of internal processes, procedures, and controls, and compliance with requirements for borrowing securities from customers. The Division may also assess funding and liquidity management practices in light of the effects of the pandemic.

b. Broker-Dealer Trading Practices

The Division will continue to focus on broker-dealer compliance with best execution obligations in a zero-commission environment, compliance with order routing disclosure rules, payment for order flow (and related disclosures) and its effect on order routing, and best execution obligations. Additionally, examinations will assess market-maker compliance with Regulation SHO and the operations of specific alternative trading systems for consistency with Form ATS-N disclosures.

8. Market Infrastructure

a. Clearing Agencies

As required by law, the Division will perform risk-based examinations of clearing agencies that are deemed systemically important. Such examinations will cover core risks, processes, and controls, as well as financial and operational risk assessments. The Division also plans on examining compliance with the Standards for Covered Clearing Agencies. Specific focus areas include compliance, legal, recovery and wind-down, margin, back-testing, settlement and operations, liquidity risk management, effect of the LIBOR transition, and cybersecurity and resiliency.

Examinations also will include looking into clearing agencies' responses to deficiencies identified by the Division and internal auditors and whether the actions taken were timely and appropriate to correct and mitigate any risks associated with identified deficiencies.

b. National Securities Exchanges

The Division intends to examine whether national securities exchanges are meeting their obligations, focusing on operations to monitor, investigate, and enforce member and listed company compliance with applicable exchange rules and federal securities laws.

c. Regulation Systems Compliance and Integrity ("SCI")

The Division will evaluate whether entities subject to Regulation SCI have established, maintained, and enforced required written policies and procedures, specifically focusing on IT governance, IT asset management, cyber threat management and incident response, business continuity planning, and third-party vendor management. In addition, the Division may focus on whether the SCI entities have appropriately responded to past examination findings.

d. Transfer Agents

The Division plans to continue to examine transfer agents' performance relating to timely turnaround of items and transfers, recordkeeping and record retention, and safeguarding of funds and securities. Transfer agent examinations also will consider a firm's business continuity and disaster recovery programs, as well as their cybersecurity measures and account takeover precautions, given the recent developments of the pandemic. The Division intends to focus on transfer agents that present the greatest possible risks to investors and investment channels, including those that service microcap or municipal bond issues, use novel technological applications, or engage in significant paying agent activity.

Conclusion

The Division's 2021 examination priorities reflect a continued focus on risks facing retail investors, a growing emphasis on ESG products and disclosures, and an assessment of the effects of the pandemic on the financial industry. All SEC-regulated market participants should remain vigilant with respect to these priorities in light of what is anticipated to be a more aggressive regulatory, examination, and enforcement environment during the Biden administration.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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