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SEC Division of Examinations Announces 2021 Examination Priorities

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On March 3, 2021, the SEC's Division of Examinations[1] announced its examination priorities for 2021. Noting the effects of the global COVID-19 pandemic, the Division of Examinations reported that during the agency's 2020 fiscal year it examined 15% of registered advisers and over 330 registered broker-dealers. While the registered adviser examination coverage was equivalent to the percentage for fiscal year 2019, it was also recently reported that Pete Driscoll, director of the Division of Examinations, expressed concern as to whether a 15% coverage rate could be continued without additional resources in the current environment.

The 2021 examination priorities are divided into the following eight general categories:

- Retail investors, including seniors and those saving for retirement, through Regulation BI and fiduciary duty compliance;
- Information security and operational resiliency;
- Financial technology (fintech) and innovation, including digital assets;
- Anti-money laundering programs;
- The London Inter-Bank Offered Rate (LIBOR) transition;
- Focus areas relating to investment advisers and investment companies;
- Focus areas involving broker-dealers and municipal advisors; and
- Market infrastructure.

Although many of this year's priorities are similar to topics identified in past years, there are a few new items which stand out:

- Greater focus on issues arising from events in the past year, such as the LIBOR transition, cybersecurity, business continuity and operational risk issues, particularly in light of a primarily remote workforce resulting from the COVID-19 pandemic;

- Implementation and integration of technology used to facilitate regulatory compliance (RegTech);
- Consistency between procedures and disclosures regarding environmental, social, and governance (ESG) products and strategies; and
- For managers to private funds, an expanded list of key risk areas.

While the priorities will drive many of the examinations, the Division of Examinations selects firms for examination and the areas of focus covered during examinations, according to a risk-based analysis, which varies depending on the type of firm and its business activities. For registered advisers and broker-dealers, the Division of Examinations considers dozens of risk factors, which include:

- Products and services offered, including certain products identified as having higher risk characteristics;
- Compensation and funding arrangements;
- Disclosures and representations made to customers; prior examination observations and regulatory history;
- Whether the firm has never been examined, is newly registered, or has not been examined in many years;
- Material changes in firm leadership or other key personnel; and
- Whether a firm has access to investor assets, i.e., custody.

This year marks the ninth straight year of this particular publication and, at 42 pages, is the most expansive version published to date. Given the breadth of the topics addressed in the publication, this alert focuses on several issues likely to be most relevant to registered advisers, registered investment companies, and registered broker-dealers.

Registered Advisers and Registered Investment Companies

Compliance Programs – The Division of Examinations typically assesses compliance programs of registered advisers in one or more core areas, including the appropriateness of account selection, portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, business continuity plans, and valuation of client assets for consistency and appropriateness of methodology. In evaluating the effectiveness of a compliance program, the Division of Examinations frequently reviews whether registered advisers appear to have sufficient resources to perform core compliance responsibilities.

The Division of Examinations will continue to review the compliance programs of registered advisers, including whether those programs and their policies and procedures are reasonably designed, implemented, and maintained. The Division of Examinations will continue to prioritize examinations of registered advisers that have not been examined for a number of years to focus on whether the compliance programs of registered advisers have been appropriately adapted in light of any substantial growth or change in their business models. As part of its risk-based examination approach, the Division of Examinations will also continue to conduct examinations of registered advisers that have never been examined, including newly registered advisers and advisers registered for several years that have yet to be examined, with a particular focus on firms' compliance programs.

Registered Advisers to Private Funds – Noting that over 36% of registered advisers reported managing one or more private funds, the Division of Examinations will continue to focus on advisers to private funds and will assess compliance risks, including a focus on liquidity and disclosures of investment risks and conflicts of interest.

Specifically, the Division of Examinations will review for, among other things:

- Preferential treatment of certain investors by advisers to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals;
- Portfolio valuations and the resulting impact on management fees;
- Adequacy of disclosure and compliance with any regulatory requirements relating to cross trades, principal investments, or distressed sales; and
- Conflicts around liquidity, such as adviser-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of investors in, or assets of, an existing fund while also agreeing to invest in a new fund.

The Division of Examinations will also focus on advisers to private funds that have a higher concentration of structured products, such as collateralized loan obligations and mortgage-backed securities, to assess whether the funds are at a higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors. In addition, the Division of Examinations will examine advisers to private funds where there may have been material impacts on portfolio companies owned by the private fund (e.g., real estate-related investments) due to recent economic conditions.

Registered Funds, Including Mutual Funds and ETFs – Examinations of registered funds will focus on disclosures to investors, valuations, filings with the SEC, personal trading activities, and contracts and agreements, and will include a review of fund governance practices and compliance programs. The Division of Examinations will prioritize examinations of mutual funds or ETFs that have not previously been examined or have not been examined in a number of years, and will generally focus on fund compliance programs and financial condition, particularly where funds have instituted advisory fee waivers. In addition, the Division of Examinations will focus on compliance with exemptive relief, including for the newly created non-transparent, actively managed ETFs. The Division of Examinations will also review funds' and advisers' disclosures and practices related to securities lending.

Registered Broker-Dealers

The Division of Examination's broker-dealer examinations will focus on the safety of customer cash and securities, best execution in light of the effects of evolving commissions and other cost structures, certain types of trading activity, and the operations of alternative trading systems.

Broker-Dealer Financial Responsibility

Broker-dealers that hold customer cash and securities have a responsibility to ensure that those assets are safeguarded in accordance with the Customer Protection Rule and the Net Capital Rule. Examinations of broker-dealers will continue to focus on compliance with these rules, including the adequacy of internal processes, procedures, and controls, and compliance with requirements for borrowing securities from customers. In light of the COVID-19 pandemic, examiners may also assess broker-dealer funding and liquidity risk management practices to assess whether firms have sufficient liquidity to manage stress events.

Broker-Dealer Trading Practices

The Division of Examinations will continue to examine broker-dealer trading practices. Examinations will focus on broker-dealer compliance with best execution obligations in a zero commission environment and compliance with the recently amended Rule 606 order routing disclosure rule. The Division of Examinations will continue its prior initiative in the area of payment for order flow and its possible effect on order routing and best execution obligations. Examinations will also focus on market maker compliance with Regulation SHO, including the rules regarding aggregation units and locate requirements. The Division of Examinations will also examine the operations of certain alternative trading systems for consistency with their disclosures provided in Form ATS-N.

Other Areas of Focus

ESG

Due to investor demand, registered advisers are increasingly offering investment strategies that focus on sustainability. These strategies may include products and services that are referred to by a variety of terms such as sustainable, socially responsible, impact, and environmental, social, and governance conscious. The Division of Examinations will focus on products in these areas that are widely available to investors, such as open-end funds and ETFs, as well as those offered to accredited investors, such as qualified opportunity funds. The Division of Examinations will review the consistency and adequacy of the disclosures that registered advisers and fund complexes provide to clients regarding these strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.

AML

The Division of Examinations will continue to prioritize examinations of broker-dealers and registered investment companies for compliance with their anti-money-laundering (AML) obligations in order to assess, among other things, whether firms have established appropriate customer identification programs, and whether they are satisfying their Suspicious Activity Report filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs. The goal of these examinations is to evaluate whether broker-dealers and registered investment companies have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

Digital Assets

The Division of Examinations noted that examinations of market participants engaged with digital assets will continue to assess the following:

- Whether investments are in the best interests of investors;
- Portfolio management and trading practices;
- Safety of client funds and assets;
- Pricing and valuation;
- Effectiveness of compliance programs and controls; and
- Supervision of employees' outside business activities.

Take-Aways

As with prior years, firms can expect the Division of Examinations' program to generally reflect the priorities articulated in the announcement. However, given the continued implementation and evolution of the Division of Examinations' risk-based program, firms can expect more targeted and modular examinations focused on either specific areas of firms' operational compliance or more global advancements in product or service offerings about which the SEC staff seeks to obtain further information. Recent examples of document request letters also reflect an ever-increasing sophistication of examinations staff in areas involving complex products or intra-industry arrangements.

Finally, it is expected that the Division of Examinations will continue to administer its examinations program on a remote basis for the foreseeable future. Nonetheless, registered entities should expect no reprieve in the scope or amount of documents and requests made should they be selected for an SEC examination in 2021. Accordingly, firms should have access to required records and be able to document their compliance processes in the same manner as examinations conducted in an onsite setting.

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[1] The unit formerly known as the Office of Compliance Inspections and Examinations (OCIE) was renamed the Division of Examinations effective December 17, 2020.

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