

Memorandum

SEC Announces Examination Priorities for 2019

January 4, 2019

The Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission (“SEC”) recently released its “2019 Examination Priorities,” which serve to highlight the key focus areas for examinations during 2019. OCIE publishes its examination priorities annually to promote transparency of its examination program and provide insights into the areas it believes present potentially heightened risk to investors or the integrity of U.S. capital markets. Below is a high-level summary of those areas discussed in the “2019 Examination Priorities” relevant to investment advisers that manage private funds and registered funds.¹

Notably, the OCIE 2019 priorities do not specifically identify private fund advisers as a stand-alone OCIE priority, likely reflecting the SEC staff’s view that the steady stream of examinations and enforcement actions against private fund advisers over the past several years has appropriately sensitized the industry to OCIE’s recurring focus areas.

Advisers to private funds and registered funds should review their policies, procedures, and practices relating to the OCIE examination priorities discussed below and consider whether any enhancements to such policies, procedures, and practices should be made in response.

Retail Investors, Including Seniors and Those Saving for Retirement

In line with the retail-centric approach favored by SEC Chairman Jay Clayton, OCIE continues to prioritize the protection of retail investors, particularly seniors and those saving for retirement, and examines advisers that provide products and services to these investors. In furtherance of this commitment to retail investors, examinations in 2019 will focus on the following areas:

¹ For a complete list of the “2019 Examination Priorities,” see *2019 Examination Priorities*, SEC OCIE (Dec. 20, 2018), available at <https://www.sec.gov/files/OCIE%202019%20Priorities.pdf>.

Fees and Expenses: OCIE will continue to review fees charged to clients to ensure such fees are assessed in accordance with client agreements and adviser disclosures. For these examinations, OCIE will select advisers with practices or business models that may create increased risks of inadequately disclosed fees, expenses, or other charges.² For example, OCIE will continue to evaluate financial incentives for financial professionals that may influence their selection of particular mutual fund share classes. In addition, the adequacy of disclosures regarding fees and expenses continues to be an area of interest for OCIE.

Conflicts of Interest: OCIE will review policies and procedures that address (i) the utilization of services or products provided by affiliated service providers, (ii) arrangements where advisers and their employees have certain financial incentives to recommend securities-backed non-purpose loans and lines of credit³ to clients, and (iii) arrangements where advisers borrow funds from clients. Where OCIE examiners observe any of these arrangements, emphasis will be on whether the risks and conflicts of interest presented by such arrangements are adequately disclosed to clients.

Registered Funds: OCIE will continue to prioritize examinations of registered funds, the activities of their advisers, and oversight practices of their boards of directors. The OCIE priorities emphasize several areas implicated by the side-by-side management of private funds and registered funds. Specifically, OCIE will focus on the risks associated with (i) advisers that provide advice to both registered funds and private funds with similar investment strategies, (ii) funds managed by advisers that are relatively new to managing registered funds, (iii) funds with higher allocations to certain securitized assets, (iv) funds with aberrational underperformance relative to their peer groups, (v) index funds that track custom-built or bespoke indexes, and (vi) exchange-traded funds with little secondary market trading volume and smaller assets under management. Although not specifically referenced in OCIE's examination priorities, many of these focus areas are equally relevant to advisers of business development companies.

Portfolio Management and Trading: OCIE will review advisory firm practices for executing investment transactions on behalf of clients, fairly allocating investment opportunities among clients, and ensuring investments are consistent with disclosures, clients' objectives, and other legal restrictions. OCIE will also examine adviser portfolio recommendations to assess whether investment or trading strategies are (i) suitable for, and in the best interests of, investors based on their objectives and risk tolerance levels, (ii)

² OCIE indicated in its "2018 National Exam Program Examination Priorities" that in connection with its priority to protect retail investors, OCIE would focus on advisory firms that have practices or business models that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges, including, among other types of firms, private fund advisers that manage funds with a high concentration of investors investing for the benefit of retail clients, including non-profit organizations and pension plans. See *2018 National Exam Program Examination Priorities*, SEC OCIE (Feb. 7, 2018), available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf>.

³ OCIE explained that a non-purpose loan or line of credit allows borrowers to use the securities in their brokerage or advisory accounts as collateral to obtain a loan, the proceeds of which cannot be used for purchasing or trading securities.

consistent with disclosures to investors, (iii) venturing into new, risky investments or products without adequate risk disclosure, and (iv) appropriately monitored for attendant risks.

Never-Before or Not Recently-Examined Advisers: OCIE will continue to conduct risk-based examinations of certain advisers that have never been examined, including newly-registered advisers and those registered for several years but that have yet to be examined. OCIE will also prioritize examinations of certain advisers that have not been examined for a number of years and may have since substantially grown or changed business models.

Senior Investors and Retirement Accounts and Products: In investment adviser examinations, OCIE will continue to review the services and products offered to seniors and those saving for retirement. These examinations will focus on, among other things, the compliance programs of advisers, the appropriateness of certain investment recommendations to seniors, and the supervision by advisory firms of their employees and independent representatives.

Digital Assets

OCIE will examine firms actively engaged in the digital asset market, focusing on, among other things, portfolio management of digital assets, trading, safety of client assets, pricing of client portfolios, compliance, and internal controls.

Cybersecurity

OCIE will continue to prioritize cybersecurity in its examinations of investment advisers. Examinations relating to cybersecurity will focus on, among other areas, proper configuration of network storage devices, information security governance and risk assessment, policies and procedures related to retail trading information security, access rights and controls, data loss prevention, vendor management, training, and incident response. OCIE will focus on cybersecurity practices at advisory firms with multiple branch offices, including those that have recently merged with other advisory firms.

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