

IAWatch

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THE **SEC** EXAMINATIONS PRIORITIES HANDBOOK 2019 EDITION

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The companion CD features the tools printed in this handbook.

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Introduction

All-time highs have been set by the SEC with respect to the percentage of the registered investment adviser population that it is examining. The Commission's Office of Compliance Inspections and Examinations chalked up more than 2,000 IA exams in FY 2018, visiting 17% of all SEC-registered investment advisory firms.

However, these numbers may be out of reach in fiscal year 2019. "This year will likely take a hit" on total exams due to the five-week government shutdown, said OCIE Deputy Director **Dan Kahl** March 7 at **IA Watch's** 21st annual IA compliance conference in Washington, D.C.

It was the day before the 35-day government shutdown that OCIE released its 2019 exam priorities. Interestingly, the priorities don't vary dramatically from the exam division's 2018 list.

Perennial risk areas

The 2019 exam priorities return to some "perennial risk areas," such as how advisers handle senior clients and those nearing retirement and cybersecurity, but there are some nuances. Scrutiny of private fund advisers gets only a scant mention and there's a new slant on conflicts of interest, among other tweaks.

Six categories bridge OCIE's priorities:

1. Compliance and risk at registrants responsible for critical market infrastructure;
2. Matters of importance to retail investors, including seniors and those saving for retirement;
3. FINRA and MSRB;
4. Digital assets;
5. Cybersecurity; and
6. AML programs.

Conflicts of interest

Areas of focus when it comes to conflicts of interest are use of affiliated service providers and products; securities-backed non-purpose loans and lines of credit (advisers may have financial incentives to recommend certain products) and borrowing from clients.

Fees and expenses makes a return appearance. "OCIE will select firms with practices or business models that may create increased risks of inadequately disclosed fees, expenses, or other charges," according to the priorities.

Topics examiners will delve into around portfolio management and trading include the “consistency of investments with the objectives obtained from clients,” suitability and putting clients in new and risky investments.

Mutual funds and ETFs make another appearance but with a new OCIE hint, that examiners will look at “funds with aberrational underperformance relative to their peer groups.”

Cybersecurity

OCIE provides insight into what examiners will be interested in with cybersecurity: “proper configuration of network storage devices, information security governance generally, and policies and procedures related to retail trading information security. Specific to investment advisers, OCIE will emphasize cybersecurity practices at investment advisers with multiple branch offices, including those that have recently merged with other investment advisers.”

“We’re kicking off cybersecurity three,” said **Mark Dowdell**, assistant regional director in the SEC’s Philadelphia Regional Office, referring to OCIE’s third sweep exam related to the topic. He added that this sweep will focus on IAs with five or more branch offices, he added.

Cybersecurity is an issue where OCIE may be lenient. “IT is tough,” conceded Kahl. OCIE recognizes the challenges cybersecurity poses to small- and medium-sized advisers and examiners won’t play “gotcha” with the topic, he added.

But examiners will be interested in seeing how advisers melded different systems following a merger or acquisition, Kahl continued.

Additional ‘hot topics’

Kahl detailed some hot exam topics. These included fees and expenses, suitability of wrap fee programs, rollovers, seniors and retail clients, share class allocations and breakpoints. Dowdell also revealed that an OCIE initiative will look at security-based loans and credit, as well as RICs that advisers manage alongside a private fund. “We consider that high risk,” he said.

Laura Grossman, associate general counsel at the **Investment Adviser Association** in Washington, D.C., said OCIE told the association last fall that custody and compliance with the agency’s 2017 guidance “is fair game” on exams.

However, examiners shouldn’t be writing deficiencies related to the inadvertent custody issue until the SEC resolves continuing concerns about the topic, she added. Examiners in at least two unidentified regional offices are “commenting” on the issue in exam letters, Grossman noted.

“Don’t panic if you get a deficiency” on custody because enforcement will pursue only “egregious” custody violations, said **Dabney O’Riordan**, chief of the SEC Enforcement

Division's Asset Management Unit. This is no doubt a recognition of the continuing confusion surrounding the custody rule.

Of course, OCIE cautions that the priorities are not inclusive in that they “will not be the only issues OCIE addresses in its examinations.”

Privacy

OCIE has released one risk alert already this year and published five risk alerts in 2018. Kahl signaled that OCIE's next risk alert could cover Reg S-P. He suggested advisers take a fresh look at their firm's Reg S-P policies. “We found lots of deficiencies” in exams around Reg S-P, he said.

OCIE is also working on a risk alert on conflicts of interest, Kahl divulged. This year's and last year's OCIE risk alerts can all be found here in *The SEC Examinations Priorities Handbook 2019 Edition*.

The process

It's always nice to know who will be at your office should you get a call that examiners will be visiting. “It will never be hidden from you” when someone from enforcement accompanies OCIE examiners, said O'Riordan. Ninety-nine percent of the time the enforcement staff tags along for educational purposes only, she added.

That exam visit would be preceded by a document request letter. Dowdell mentioned that OCIE now has a process in place whereby should an adviser submit exam documents that it didn't recognize might be protected by an attorney-client privilege, OCIE would segregate the materials, notify the adviser and ask how the adviser would like to handle the documents.

The SEC Examinations Priorities Handbook 2019 Edition contains nearly 20 different SEC document request letters that will afford you the opportunity to see what examiners are seeking in different contexts and in different regions.

Additional documents contained in the handbook also will aid you in your exam preparation efforts. An example of this is an Excel file demonstrating the trade blotter format OCIE would like firms to submit during an SEC exam.

The new format features 24 fields ranging from account ID to strategy. This number is three fewer fields than a trade blotter format OCIE circulated a few years ago. The new format also differs from the older model in that it contains more detailed descriptions for each field.

“I think they're comparing the trade blotters in examinations to market data,” says **Ellen Bruno**, a consultant with **Compliance Advisor Professionals** in Berkley, Mass.

Bruno reports recent OCIE exams involving clients have varied, from a routine inquiry to a blisteringly detailed exam to one focused on an adviser's wrap fee program to another looking into mutual fund share class allocations.

Exam insight

*IA Watch's **The SEC Examinations Priorities Handbook 2019 Edition*** is designed to provide you with insight on the current SEC exams landscape, exam best practices and guidance, as well as sample document request letters and other pertinent documents. The coverage is indicative of what can be found at *IA Watch*, the most authoritative source and all-in-one regulatory compliance service offering best practices, guidance and tools to help advisory firms keep in compliance.

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