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Securities and Exchange Commission (SEC) Staff Releases 2014 Examination Priorities

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On January 9, 2014, the SEC staff released its examination priorities for 2014. The examination priorities address the entire market, including investment advisers, investment companies and broker-dealers, and are meant to communicate areas that the staff perceives to have heightened risk. The staff disclosed several market-wide examination initiatives, including fraud detection and prevention; corporate governance, conflicts of interest and enterprise risk management; technology controls; issues posed by the convergence of broker-dealer and investment adviser businesses; compliance with new rules and regulations, including solicitation practices under Rule 506(c) under the 1933 Act; and examinations of sales practices related to retirement investments and rollovers. The SEC staff also highlighted examination priorities specific to investment advisers, investment companies and broker-dealers.

For investment advisers and investment companies, the staff identified the following ongoing risks and new and emerging issues as examination priorities for 2014:

Ongoing Risks

- Safety of Assets and Custody . Examinations will continue to include asset verifications to confirm the safety of client assets and compliance with custody requirements, paying particular attention to those instances where advisers fail to realize they have custody.
- Conflicts of Interest Related to Certain Investment Adviser Business Models . Examinations will focus on conflicts of interest inherent in certain investment adviser business models, including the following:
- Adviser compensation arrangements, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients;
- Allocation of investment opportunities;
- Controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts;
- Risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies; and
- Higher risk products of strategies targeted to retail (and especially retired or elderly) investors.
- Marketing/Performance . Examinations will focus on the accuracy of investment objectives and performance, compliance oversight of marketing, and, where applicable, marketing efforts related to the JOBS Act.

New and Emerging Issues

- Never-Before Examined Advisers. Examinations will conduct focused, risk-based examinations of advisers that have been registered for more than three years but have not yet been examined.

- Wrap Fee Programs. Examinations will focus on whether advisers are fulfilling their fiduciary and contractual obligations to clients and will review the processes in place for monitoring wrap fee programs recommended to advisory clients, related conflicts of interest, best execution, trading away from the sponsor and disclosures.
- Quantitative Trading Models. The staff will examine advisers with substantial reliance on quantitative portfolio management and trading strategies and assess, among other things, whether these firms have adopted and implemented compliance policies and procedures tailored to the performance and maintenance of their proprietary models.
- Presence Exams. The staff will continue the 2012 initiative to examine a significant percentage of the advisers registered since the effective date of Section 402 of the Dodd-Frank Act. The five key focus areas of these examinations are marketing, portfolio management, conflicts of interest, safety of client assets and valuation.
- Payments for Distribution in Guise. Examinations will continue to focus on the variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments and fund boards' oversight of the same.
- Fixed Income Investment Companies. The staff will monitor the risks associated with a changing interest rate environment and the impact this may have on bond funds and related disclosures of risks to investors.

For broker-dealers, the staff identified the following ongoing risks and new and emerging issues as examination priorities for 2014:

Ongoing Risks

- Examinations will continue to focus on identifying fraud in connection with sales practices, supervision issues, trading risk areas, internal controls, customer protection and net capital rules and anti-money laundering compliance.

New and Emerging Issues

- The staff continued to identify appropriate application of the Market Access Rule as a priority in 2014 as well as the suitability of variable annuity buybacks. Examinations will also focus on a number of issues in the fixed income market, including factors that may impact the quality of execution in the fixed income market, such as market structure and the use of alternative trading systems.