

SEC Publishes Inspection Priorities for 2018

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On February 7, the US Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) published its examination priorities for 2018 (the "2018 Priorities Report").¹ Given that OCIE's examination priorities for 2017 were published before the beginning of the Trump administration, differences between the 2017 and the 2018 priorities provide important insights into the focus of examinations under Chair Clayton.

What Is New?

- 1. Cryptocurrencies.** For the first time, cryptocurrencies are an examination priority for OCIE. We note that the Financial Industry Regulatory Authority (FINRA) also added this topic to its examination priorities for 2018.² As noted in the 2018 Priorities Report, OCIE will monitor the sale of products in the cryptocurrency and initial coin offering markets, and examine for regulatory compliance where products are securities. Among other things, OCIE will focus on whether sufficient safeguards are maintained to protect these assets from theft or misappropriation and whether financial professionals are adequately disclosing the risks associated with these products.
- 2. Higher Priority to Cybersecurity and Anti-Money Laundering.** Cybersecurity and anti-money laundering are given greater prominence than they were in previous exam priority reports.
 - **Cybersecurity.** Consistent with statements by SEC staff, cybersecurity has been assigned a greater priority, as evidenced by the creation of the Cyber Unit within the SEC's Division of Enforcement on September 25, 2017.³ The 2018 Priorities Report notes that examinations will continue to focus on areas such as "governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response."
 - **Anti-Money Laundering.** OCIE will continue to focus resources to ensure that firms have adapted their anti-money laundering (AML) programs to address their obligations. This effort focuses on broker-dealers and investment companies, as advisers are not required to adopt AML programs. OCIE examinations will cover the customer due diligence requirement and will seek to ascertain whether firms are taking reasonable steps both to understand the nature of customer relationships and to sufficiently address risks. OCIE also will verify that firms are filing timely, complete and accurate Suspicious Activity Reports with the Financial Crimes Enforcement Network where suspicious activity is detected. Finally, OCIE will confirm that firms are conducting sufficient independent reviews of their AML programs.
 - **Greater Focus on FINRA and MSRB.** OCIE's examinations of FINRA and the Municipal Securities Rulemaking Board will focus on the effectiveness of their operations and their examination and enforcement programs over member firms.

What Has Not Changed?

The 2018 Priorities Report begins with a set of principles that reflects a continuation of initiatives that have been

Katten
Katten Muchin Rosenman LLP

Article By [Wendy E. Cohen](#)
[Janet M. Angstadt](#)[David Y. Dickstein](#)
[Michael T. Foley](#)[Mark D. Goldstein](#)
[Richard D. Marshall](#)
[Katten Muchin Rosenman LLP](#)
[Advisories](#)
[Communications, Media & Internet](#)
[Financial Institutions & Banking](#)
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[All Federal](#)

pursued over several years.

1. **Risk-Based Examinations.** Unlike the approach of a decade ago, when there was an effort to examine all regulated entities on a periodic basis, the current examination program attempts to target higher risk firms for more frequent and more intensive examinations. OCIE does not detail how they will make their exam selections under the risk assessment program.

As OCIE's resources are limited, it endeavors to utilize those resources in a way that maximizes benefit to investors. Former Chair White shifted OCIE resources from broker-dealer examinations to adviser examinations, with the expectation that FINRA could fill in the gap created by OCIE's emphasis on adviser examinations. While the 2018 Priorities Report is silent on this shift in resources, it does emphasize OCIE's efforts to increase inspections of advisers, and SEC Chair Clayton has identified this as a priority. In 2017, OCIE examined approximately 15 percent of all investment advisers, up from 8 percent five years ago. Thus, it is likely that the shift in OCIE resources away from broker-dealer examinations and towards adviser examinations will continue.

2. **Big Data.** OCIE's commitment to employing technology and data analytics will continue. Former SEC Chair Mary Jo White committed the SEC to use data more effectively by: (1) more aggressive mining and analysis of data already in the possession of the SEC to identify possible violative conduct; and (2) using data analytic tools more often during examinations and investigations to enhance detection of violations and to improve the efficiency of the SEC's work.⁴
3. **Greater Transparency.** Since September 2011, OCIE has published "Risk Alerts," which report on findings from examinations and recommend changes in firms' compliance efforts. Five such reports were published in 2017. OCIE states they will make an effort to publish these alerts more frequently.

New Focus on Well-Established Themes

Previous examination priorities focused on protecting retail investors and monitoring market infrastructure issues. The 2018 Priorities Report continues to emphasize these themes, but with some shifts in focus.

1. **Retail Investors.** OCIE will focus on the disclosure of costs to retail investors and whether fees and expenses paid by retail investors are consistent with such disclosures. Examinations also will review fees charged to advisory accounts including assessing whether assets upon which fees are based are valued in a manner that conforms to agreements, disclosures, and policies and procedures. An emphasis also will be placed on situations in which there may be an incentive to fail to properly disclose costs. Such situations include those in which:

- advisory personnel are given incentives to recommend that investors invest in share classes of mutual funds where the investors may pay higher fees and the conflict of interest is not disclosed;
- accounts have not been assigned a new representative after an investment advisory representative has left a firm;
- advisers change the way fees are calculated from a commission to a percentage of client assets under management; and
- private fund advisers manage funds with a high proportion of investors investing for the benefit of retail clients.

Examinations focused on the protection of retail investors will continue themes from prior examination priorities reports with respect to robo-advisers, wrap fee programs, retirement products, mutual funds and exchange-traded funds (ETFs), municipal advisors, and fixed income executions:

- **Robo-Advisers.** Examinations will focus on regulated entities' marketing materials, investor data protection and disclosure of conflicts of interest with respect to entities that offer investment recommendations through automated platforms. OCIE also will examine compliance programs related to such automated platforms including the oversight of algorithms that generate recommendations.

- **Wrap Fee Programs.** OCIE will continue to focus on advisers and broker-dealers associated with wrap fee programs, and will evaluate whether advisers are operating in a manner conforming to their fiduciary duties.
 - **Retirement Products.** As those saving for retirement become more dependent on investment returns, OCIE examinations will center on investment recommendations, sales of variable insurance products and sales and management of target date funds.
 - **Mutual Funds and ETFs.** OCIE will pay particular attention to mutual funds that have experienced poor performance or liquidity, that are managed by advisers with little experience, and that hold securities that are difficult to value during market stress. OCIE also will focus on ETFs and mutual funds that seek to track custom-built indexes.
 - **Municipal Advisors.** Examination of municipal advisors will review their compliance with registration, recordkeeping and supervision requirements. OCIE will continue to prioritize examination of municipal advisors that are not registered as broker-dealers.
 - **Fixed Income Order Execution.** OCIE will evaluate whether broker-dealers have implemented best execution policies and procedures for municipal bond and corporate bond transactions.
2. **Market Infrastructure.** Focus, as in prior years, will be on clearing agencies, exchanges, transfer agents and SCI entities (which include clearing agencies, exchanges and alternative trading systems):

- **Clearing Agencies.** OCIE will continue to annually examine clearing agencies that the Financial Stability Oversight Council has identified as systemically important, and examinations will evaluate compliance with the Commission's Standards for Covered Clearing Agencies.
- **Exchanges.** Examinations of national securities exchanges will focus on, among other things, internal audits conducted by the exchanges and the governance of certain National Market System plans.
- **Transfer Agents.** OCIE will examine transfer agents that serve as paying agents or that service microcap or crowdfunding issuers, and examinations will concentrate on transfers, recordkeeping and safeguarding of funds and securities.
- **SCI Entities.** Examinations of SCI entities will continue to focus on whether they have implemented certain required written policies and procedures, business continuity plan effectiveness, vendor risk management and enterprise risk management.

Conclusion

The above description of the 2018 Priorities Report is not exhaustive, and regulated entities should carefully review the report as it gives important insight into the likely focus of future OCIE examinations.

¹ 2018 National Exam Program Examination Priorities, U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, February 7, 2018, available [here](#).

² Cook, Robert, "Cover Letter From FINRA President and CEO," January 8, 2018, available [here](#).

3 SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors, U.S. Securities and Exchange Commission, September 25, 2017, available [here](#).

4 White, Mary Jo, "The SEC in 2014," January 27, 2014, available [here](#).

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