THE SEC'S 2017 PRIORITIES: WHAT COMPLIANCE PROFESSIONALS NEED TO KNOW

As we all have anticipated, the SEC has released its 2017 Examination Priorities Letter ("Letter") from the Office of Compliance Inspections and Examinations ("OCIE"). The Letter is broken down into three main categories:

1. Examination of matters of importance to retail investors;
2. Focusing on risks specific to elderly and retiring investors; and
3. Assessing market-wide risks.

The Letter states that the SEC staff has incorporated data analytics to identify elevated risk profiles and analyze complex products. [1] The timing of the Letter comes right as a new presidential administration is coming into office. It remains to be seen if these priorities will shift.

A. PROTECTING RETAIL INVESTORS

Electronic Investment Advice. Regulators are taking a closer look at electronic investment advice. The SEC hosted its first FinTech Forum in November 2016 and one of the focus areas was electronic (or digital) investment advice. FINRA published its Report on Digital Investment Advice in March 2016. According to the report, FINRA is concerned about investment recommendations made without any personal contact. The SEC permits this type of advice; however, firms should carefully manage their onboarding process. Firms and compliance officers should also remember it does not matter that the business model is new; the same old requirements and regulations apply to innovative businesses.

Firms offering electronic investment advice are now taking various forms and are offering services at different levels. Initially, robo-advisers provided advisory services to their own clients, using unaffiliated clearing firms as custodians. More recently, those same industry pioneers are creating affiliated broker-dealers, often acting as custodian on an omnibus clearing basis. Other, more recently established firms offer digital investment advice as a third party to other, often small advisers, through sub-advisory or wrap fee programs.

In 2017, OCIE plans to focus on the digital advice firm's compliance program, marketing, formulation of investment recommendations, data protection, disclosures related to conflicts of interest, and the

[1] Presentation by Stephanie Avakian, Deputy Director, Division of Enforcement, at the SIFMA C&L New York Regional Seminar, Nov. 2, 2016.

compliance program's oversight of algorithms that generate recommendations. This focus area may involve broker-dealers as well as investment advisers, as some robo-advisers have affiliated broker-dealers that provide key services to the advisers and their clients. In the past, an exam team would focus primarily on the advisory business; this may not be the case in the future.

Firms should carefully consider:

- Review/approval of website and social media, especially blogs, white papers and the more innovative marketing materials.
- Review requirements for mutual funds if they are part of the make-up of portfolio(s) or part of 529 Plan offerings.
- Consider how the digital tool review the customer information and investment objectives to arrive at the investment portfolio and the strategy recommended and implemented. Is there an exception report process to weed out inconsistent or deliberately wrong answers?
- Evaluate all potential conflicts of interest. *This cannot be stressed enough.* Consider the use of affiliated investment products, all vendors, the activities of boards of directors and advisory boards; and
- Supervise the digital investment tool or algorithm. While it is always difficult to supervise any algorithm, doing so as a third-party adviser is even more challenging. It is necessary to document testing of the investment advice decisions and the order entry/execution process, and to verify allocations.
- Ensure there is adequate data protection, which is cybersecurity, added onto internal controls, is the bedrock of a FinTech business.

As smaller advisers establish relationships with robo-advisers, the compliance officer(s) of those firms will need to take up the same issues as the teams in the larger firms.

If a firm is considering creating or using a digital advice model, remember that the financial planning modules firms started to use years ago are not at all the same thing. Consult with someone who has already thought through some of the issues. As the popularity of using robo-advisers increases, firms should make sure this technology is channeled into a direction that works for the business and helps avoid client-facing issues and regulatory problems.

Wrap Fee Programs. The Letter also indicates the areas of focus may include wrap account suitability, effectiveness of disclosures, conflicts of interest and brokerage practices. OCIE will likely review whether investment advisers are acting in a manner consistent with their fiduciary duty, and whether they are meeting contractual obligations to clients.

OCIE has previously indicated that its staff would evaluate:

1. how financial professionals and firms satisfy their suitability requirements when determining whether to recommend brokerage or advisory accounts;
2. the financial incentives for making such recommendations; and
3. whether all conflicts of interest are fully and accurately disclosed.

OCIE also indicated that, when different fee arrangements are offered for advisory accounts, the staff would assess whether the recommendation of an advisory account is in the best interest of the client at the inception of the arrangement and afterward, including the fees charged, services provided and disclosures made about such relationships.

Fee-based advisory accounts are often structured as wrap-fee programs ("wrap accounts"), whereby a bundled fee is charged that covers all services and charges, including ticket charges. Wrap accounts are utilized by investors who intend to actively trade positions within their accounts. An alternative to wrap accounts is a fee-based advisory account with a lower ongoing fee that does not cover ticket charges.

In a 2003 Notice to Members[2], FINRA's predecessor, the NASD, noted that before opening a fee-based account for a customer, members must have reasonable grounds to believe the account is appropriate for that customer.

Firms should identify and address the following:

- Whether a wrap account is in the best interests of a client at the inception of the arrangement and thereafter.
- Wrap accounts should be monitored and reviewed on a regular basis to determine whether they continue to be suitable for clients. This should include a review for inactivity (also known as "reverse churning"). Inactivity reports should be produced and shared with supervisory and compliance personnel.
- Financial professionals should maintain records that show evidence of suitability for wrap accounts. Evidence may include documented client meetings and documented account reviews, including portfolio monitoring and asset allocation reviews.
- Firm disclosure to clients of all material components of a wrap account, including the fee schedule, services provided, and the fact that the wrap fee program may cost more than paying for the services separately.

[2] http://www.finra.org/sites/default/files/NoticeDocument/p003079.pdf

Exchange-Traded Funds ("ETFs"). The SEC will continue to examine ETFs, including the review of ETFs' unit creation and redemption processes. The Commission's focus will also be on sales practices and disclosures involving ETFs and the suitability of broker-dealers' recommendations to purchase ETFs with niche strategies (those that track a basket of stocks aimed at a single industry or theme).

The growth, diversification and complexity of ETFs continues as ETFs are one of the most successful product developments in the securities industry in recent years. Since their launch 22 years ago, almost 2,000 ETFs have been introduced in the US, and they hold more than $2.6 trillion in assets[3].

ETFs have become one of the most actively traded classes of securities in the US. Current average daily trading volume for all ETFs is over $70 billion.

As exchange-listed products, all ETFs must be registered with the SEC under the Securities Act of 1933. They are also subject to ongoing reporting and trading requirements under the Securities Exchange Act of 1934. The funds and their issuers are also subject to regulation under the Investment Company Act of 1940.

The focus of the SEC's registration process has been primarily to assure there is adequate disclosure of the nature of the ETF, its composition, its relation to the underlying index, basket or other investment target, and the risks of investment in the ETF. As the number and kinds of ETFs have proliferated, the investor protection issues associated with them have also increased.

The first ETFs, based on the most widely followed broad-based indices, were viewed as relatively conservative equity investments suitable for most investors. Even then, it was recognized that the ability to trade in and out of them at any time of the trading day raised potential investor protection issues not posed by mutual funds based on the same indices. The development of funds targeted toward increasingly narrow market segments, the introduction of competing funds by multiple issuers with vastly varying numbers of investors, as well as assets and liquidity, posed additional concerns.

ETFs have become increasingly complex; leveraged and inverse ETFs, while appearing simple in concept, have proven difficult to construct. While they reasonably track the underlying index or securities basket over short periods of time, their performance can deviate substantially over longer periods of time, making them questionable "buy and hold" investments.

Firms should consider having training programs for their sales personnel and investor education programs for their customers if their marketing efforts venture beyond the more broad-based and established ETFs.

[3] LSEG Information Services, as of January 18, 2017. http://xtf.com/

Firms should also have programs to assess the risk levels associated with certain kinds of ETFs, such as actively traded, niche, leveraged and inverse funds, and their suitability for certain kinds of investors. Some firms have adopted policies imposing special approval requirements, or even outright restrictions, on some ETFs for certain classes of investors. Enforcement actions have been brought against broker-dealers by the SEC, state regulators and FINRA related to unsuitable recommendations and inadequate monitoring of customer accounts related to ETFs, and private lawsuits continue to grow. With the continued development and issuance of new ETFs, and growing investor interest in these products, we can expect increased scrutiny by the SEC and other regulators in 2017 and beyond.

Never-Before Examined Investment Advisers. In 2014, the SEC launched its "Never-Before Examined Initiative", focusing on those that have been registered three years or more[4]. In this year's Letter, the SEC notes that it is expanding the Never-Before Examined Adviser initiative[3] to include focused, risk-based examinations of newly-registered advisers[5], and of selected advisers that have been registered for a longer period but have never been examined by OCIE.

The Never-Before Examined Initiative noted the staff would take a two-pronged approach in conducting its reviews: the risk assessment approach and the focused review approach.

The risk-assessment approach is a review of an adviser's overall business activities, focusing on the compliance program and documents needed to assess the representations made on disclosure documents.

The focused review approach includes conducting comprehensive, risk-based examinations of one or more of the following:

- Compliance Program
- Filings/Disclosures
- Marketing
- Portfolio Management
- Safety of Client Assets

Just how is the SEC staff going to accomplish these additional reviews? The Commission traditionally has reviewed only 10% of advisers annually. In 2016, SEC shifted its broker-dealer staff to investment adviser examinations[6]. The SEC has also indicated it was exploring allowing third-party examiners to

[4] *See* OCIE's Letter to Never-Before Examined Investment Advisers, February 20, 2014, http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf.

[5] The SEC has provided guidance to Newly-Registered Advisers. https://www.sec.gov/divisions/investment/advoverview.htm

[6] http://www.reuters.com/article/us-sec-brokers-idUSKCN0VT0SQ

conduct reviews[7].

The takeaway here is that those advisers that have not been examined in years, and newly-registered advisers, should be ready for an SEC exam. These firms should consider allowing Compliance or outside consultants to be used to conduct a mock-SEC examination.

Recidivist Representatives and their Employers. Both the SEC[8] and FINRA[9] have expressed concerns about individuals with multiple disclosures, and how firms supervise them. The Letter notes that the SEC will continue to use its analytic capabilities to identify individuals with a track record of misconduct and examine the firms that employ them, focusing on the firms' compliance oversight and controls.

These exams will focus on the firm's compliance program to ensure it has processes to assess incoming advisers and to properly supervise those with disclosure histories.

Clear and comprehensive disclosures will also be looked at, particularly in the ADV Part 1 and ADV Parts 2A and 2B. In the ADV 2A brochure, firms need to be clear about conflicts of interest disclosures, as well as fee charges and other costs.

Further, the SEC will be looking at firms' marketing pieces, such as pitch-books, website postings, and public statements, to identify any conflicts of interests or risks associated with supervised persons with a history of disciplinary events, and to determine whether the conflicts or risks are clearly disclosed, and whether the firm has procedures in place to address the conflicts and mitigate the risks.

Multi-Branch Advisers. OCIE will continue to focus on registered investment advisers that provide advisory services from multiple locations. The Letter referenced a December 2016 Risk Alert that addresses OCIE's Multi-Branch Adviser Initiative[10].

In its Risk Alert, OCIE noted that the use of a branch model (i.e., the use of multiple office locations in addition to the firm's principal office) can pose unique risks and challenges, particularly in the design and implementation of a compliance program and the supervision of people and processes in branch offices.

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[7] Speech by SEC Chair Mary Jo White. https://www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html

[8] *See* OCIE Risk Alert, "Examinations of Supervision Practices at Registered Investment Advisers," Sept. 12, 2016, https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf.

[9] *See,* FINRA 2017 Priorities Letter. http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf

[10] https://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf

With that in mind, the Risk Alert highlighted the following areas regarding multi-branch advisers:

1. Compliance Programs. The OCIE staff will assess, among other things, the:

   - implementation of policies and procedures in the main and branch offices;
   - firm's assessment of how such supervision is tailored to the unique risks around branches;
   - role and empowerment of compliance personnel charged with overseeing branch offices, including their level of access to documents and relevant information; and
   - accuracy of information contained in the firm's filings regarding branch offices, including Form ADV, as compared to actual practices.

2. Fees and Expenses, Advertising and Code of Ethics. The SEC staff may focus attention on assessing compliance and testing controls in one or more of these areas, including:

   - the calculation of fees and expenses, including the effectiveness of controls over the billing and invoicing processes and communications with clients;
   - controls over advertisements, including the process for reviewing and approving them;
   - the implementation of the firm's Code of Ethics, including oversight and monitoring of personal securities transactions and whether advisers have properly identified access persons at branch offices; and
   - compliance with the Custody Rule.

3. Investment Recommendations. The SEC staff will review the process by which investment advice, including the formulation of investment recommendations and the management of client portfolios, is provided to advisory clients from supervised persons located in branch offices. The staff will focus on policies and procedures and supervisory controls designed to address specific risks presented in a branch office model regarding the provision of advisory services to clients, such as the identification of potential conflicts of interest and the level of autonomy supervised persons have in providing advice.

4. Oversight, Conflicts of Interest and Allocation of Investment Opportunities. The staff may focus attention on assessing compliance and testing controls in the following risk areas:

   - supervision and review of investment recommendations made to clients within branch offices;
   - identification, management and disclosure of conflicts of interest arising through branch office activities, including conflicts from compensation arrangements and advisers' outside business activities;
   - allocation of investment opportunities among client accounts, including how branch office trading activity is monitored and disclosures are made regarding trade allocation

Compliance programs should be reviewed to ensure the risks associated with the maintenance of branch office locations are adequately addressed. Included among the risks that may be relevant are:

- the experience level of branch office personnel operating as advisers;
- the level of autonomy such persons have in providing advice; and

- the conflicts of interest noted above.

Under the Advisers Act, the SEC can sanction a registered investment adviser that has failed to reasonably supervise its advisers when violations of laws, rules or regulations have occurred. Firms should establish policies and procedures and a supervisory system that can reasonably be expected to detect and prevent such violations within branch office locations. Among other things, such policies and procedures should cover:

- portfolio management practices, including consistency of portfolios with clients' objectives;
- personal trading activities of advisers;
- the accuracy of disclosures made to investors, including account statements and advertisements;
- the review and approval of proposed outside business activities; and
- safeguards for the privacy protection of client records and information.

Share Class Selection. OCIE will continue reviewing factors that may affect recommendations relating to mutual fund share classes. As an example, OCIE noted that examiners will identify and assess conflicts that advisers may have, such as those situations in which investment adviser representatives are also registered representatives of a broker-dealer[11]. OCIE indicated this type of conflict may influence recommendations in favor of share classes that have higher loads or distribution fees.

In a July 2016 Risk Alert detailing its Share Class Initiative, OCIE stated it will seek to identify conflicts of interest tied to advisers' compensation or financial incentives for recommending mutual fund and 529 Plan share classes that have substantial loads or distribution fees.

The following examples of conflicts of interest related to share class recommendations were provided:

- situations where the adviser is affiliated with a broker-dealer that receives fees from sales of certain share classes; and
- situations where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives more fees.

In the background section of the Risk Alert, OCIE cited cases in which the SEC has stated that an investment adviser has failed to uphold its fiduciary duty when it causes a client to purchase a more expensive share class of a fund when a less expensive class of that fund is available. OCIE also indicated the SEC has highlighted the need for advisers making share class selections to adopt and implement written policies and procedures that are reasonably designed to prevent Advisers Act violations, including those that govern the share class selection process.

[11] *See* OCIE Risk Alert, "OCIE's 2016 Share Class Initiative," July 13, 2016, https://www.sec.gov/ocie/announcement/ocie-risk- alert-2016-share-class-initiative.pdf.

With the foregoing in mind, the Risk Alert highlighted the following topics the OCIE staff will focus on:

1. Fiduciary Duty. Whether advisers are acting in clients' best interests when recommending mutual fund investments.

2. Disclosures. Whether Advisers provide narrative disclosure in the ADV Part 2 brochure if the firm or its supervised persons receive compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from mutual fund sales. Firms must also explain the conflict of interest that such compensation creates and how the conflict is addressed.

3. Compliance Program. Firm practices surrounding the selection of mutual fund share classes and assess the adequacy and effectiveness of the firm's policies and procedures.

Compliance officers should work with firm personnel to:

- Identify all relevant conflicts of interest related to mutual fund share class recommendations and take steps to ensure that they are adequately addressed in the firm's policies and procedures.
- Ensure that such conflicts are also adequately disclosed in the ADV Part 2A.
- Periodically review client accounts to ensure that mutual fund share classes held in those accounts are appropriate.

B. SENIOR INVESTORS AND RETIREMENT INVESTMENTS

As the U.S. population ages and investors become more dependent than ever on their own investments for retirement income, the SEC is devoting increased attention to issues affecting senior investors and those investing for retirement.

ReTIRE. In June 2015, the SEC issued a National Examination Program Risk Alert announcing the Retirement-Targeted Industry Reviews and Examination ("ReTIRE.") initiative. OCIE will continue its multi-year ReTIRE initiative, focusing on investment advisers and broker-dealers, along with the services they offer to investors with retirement accounts[12]. This year, these examinations will likely focus on, among other things, registrants' recommendations and sales of variable insurance products as well as the sales and management of target date funds. The areas of examination focus relate to products and services being provided to seniors which are suitable, for a person nearing or in their retirement years, and that adequate disclosure is made for marketing and advertisements targeting products for senior clients. OCIE will also assess controls surrounding cross-transactions, particularly with respect to fixed income securities.

[12] *See* OCIE Risk Alert, "Retirement-Targeted Industry Reviews and Examinations Initiative," June 22, 2015, http://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

These reviews focus on issues relating to senior investors, who are dependent on retirement funds, in the following areas:

1. Suitability. As a client moves closer to and into their retirement years, the investment objectives, risk tolerance, and time horizon must be aligned to the products present in the account.

2. Supervision and Compliance Controls.

   - FINRA Members must have compliance controls in place to establish, maintain, review, test, and modify policies and procedures reasonably designed to achieve compliance with applicable rules.
   - SEC-registered investment advisers must establish a compliance program that addresses the firm's performance of its fiduciary and other obligations under the Advisers Act of 1940.

3. Conflicts of Interest. SEC rules require that both broker-dealer and investment advisers identify and disclose conflicts of interest and, to the extent possible, mitigate those conflicts. The conflicts and mitigation review must be an ongoing process; firms must also provide ongoing training to staff to identify and manage these conflicts in a meaningful manner.

4. Marketing and Disclosure. Disclosure of information in both marketing and advertisements will be closely scrutinized. The SEC will concentrate on whether the content of the materials is accurate and does not omit material information, and that fee disclosures are accurate and so-called professional designations and/or certifications utilized by individuals meet applicable standards. FINRA's rules focus on the communications being "fair and balanced" and that a broker-dealer does not omit material information that would cause the communication to be misleading.

Public Pension Advisers. Pension plans of government entities hold a large amount of U.S. investors' retirement assets. The Commission will examine investment advisers to these entities to assess how they are managing conflicts of interest and fulfilling their fiduciary duty. The Commission will also review other risks specific to these advisers, including pay-to-play and undisclosed gifts and entertainment practices.

The pay-to play rule prohibits advisers, or any covered associate of the adviser, from providing compensatory advisory services either directly to a government client or through a pooled investment vehicle for a two-year period from the date of the payment, after political contributions were made to a candidate who could influence the investment adviser selection process for a public pension fund or who could appoint someone with such influence.

Most issues relating to the pay-to-play issue involve the failure of the adviser, or covered associate, to disclose the political contribution, fail to suspend the advisory activity or wait until the two-year period expires, before resuming the advisory activity with the public entity.

Procedures should include activities requiring pre-approval, and logs for political contributions and entertainment expenses. Firms also may wish to require affirmations, to be completed at various intervals during the year, requiring disclosures on gifts, as well as political contributions and entertainment expenses.

Senior Investors. OCIE noted it will evaluate how firms manage their interactions with senior investors, including their ability to identify financial exploitation of seniors. Examinations will likely focus on registrants' supervisory programs and controls relating to products and services directed at senior investors.

Every day in the United States 10,000 people turn age 65, and people are living longer and leading more active lives. Investors should begin saving for retirement sooner, and broker-dealers and investment advisory firms should ensure that individuals servicing these accounts have the proper tools and training to meet this need.

Regulators require that adequate written policies and procedures, including best practices, be adopted and implemented to govern the activity of firms and their registered representatives ("RRs") and investment adviser representatives ("IARs"). These procedures must include requirements pertaining to the discussion of the investment objectives, risk tolerance and time horizon, not only in the early stages of the account, but also to conduct enhanced and more active account reviews as the account holder(s) begin to approach, and during, their retirement years.

In addition, the RRs and IARs should address other items with clients such as whether the client has a Power of Attorney, long-term care insurance and a current will.

Another area of concern involves the inevitable onset of cognitive decline as an investor ages. Firms should adopt procedures to document activities that could be indicative of this decline and have a process to escalate a RR's or IAR's concerns to a supervisor, Legal or Compliance.

In October 2016, proposed FINRA Rule 2165 was filed with the SEC, which addresses disbursement holds on client accounts where suspected financial exploitation may be present. As of January 1, 2017, seven states[13], have regulations in place to address disbursement holds by firms on accounts where financial exploitation is suspected. In these instances, depending upon the state, reports may need to be made to state agencies

[13] Alabama, Delaware, Indiana (for BDs only), Louisiana, Missouri, Vermont, State of Washington

C. ASSESSING MARKET-WIDE RISKS

The SEC has indicated it will examine for structural risks and trends that may involve multiple firms or entire industries. In 2017, the focus will be on the following initiatives:

Money Market Funds. In 2014, the SEC adopted amendments to rules governing money market funds to make structural and operational reforms to address redemption risks in money market funds ("MMFs"), while preserving the benefits of the funds for remaining investors. The SEC will examine MMFs for compliance with these rule amendments, which became effective in October 2016. Examinations will likely include assessments of the boards' oversight of the funds' compliance with these new amendments as well as review of compliance policies and procedures relating to stress testing and funds' periodic reporting of information to the Commission.

2017 will be the first opportunity for the Commission to examine registrants with respect to the massive changes to the money market funds rules. The most significant of the amendments is to Rule 2a-7 under the Investment company Act of 1940.

The amended Rule 2a-7 imposed new or expanded duties for MMF boards of directors. The amended Rule creates two classes of MMFs: Government MMFs and Retail MMFs, which can continue to seek to maintain a stable dollar price per share as under the current Rule. All other MMFs (referred to generally as institutional or prime MMFs) are not qualified to seek to maintain a stable dollar price per share and must price their assets daily, like other types of mutual funds, so that the net asset value (NAV) will reflect daily pricing changes (commonly known as a floating NAV).

The determination of whether a fund qualifies as a Government MMF or a Retail MMF is based on considerations subject to the judgment of MMF boards. The amended Rule provides MMF boards the discretion to impose temporary liquidity fees or to restrict redemptions in times of financial stress. In the Adopting Release, the SEC provides expanded guidance to boards on the use of amortized cost valuation by all funds as well as other related valuation issues. Boards should also be aware that all MMFs will be subject to new disclosure requirements and revised requirements related to diversification and stress testing. [14]

[14] See, K&L Gates, Legal Insights, *Board Responsibilities Under SEC's Money Market Fund Reforms* by Diane E. Ambler, Craig A. Ruckman, August 2014. http://www.klgates.com/board-responsibilities-under-secs-money-market-fund-reform-08-15-2014/

Overview of the 2014 Money Market Mutual Fund Rule Changes[15]

Money Market Fund Reform	Final Rule	Implementation Date
Stress Testing	Funds must test their ability to maintain weekly liquid assets of at least 10% in response to several SEC defined stress scenarios. Results must be presented to the fund's board at regular intervals.	14 April, 2016
Disclosure	Daily and weekly liquid assets as a percentage of total fund assets must be displayed on a website daily. Prior day net shareholder flows must also be displayed.	14 April 2016
Floating NAV	Nonexempt funds price and transact at a net asset value per share that "floats" based on the underlying fund holdings calculated to four decimal points.	14 October 2016
Liquidity Fee	If weekly liquid assets fall below 30%, the fund may impose a 2% redemption fee. If weekly liquid assets fall below 10%, redemptions are subject to a fee up to 2% unless the fund's board votes otherwise. Need approval of majority of disinterested as well. Fee/gate decisions are non-delegable Board decisions.	14 October 2016
Redemption Gate	If weekly liquid assets fall below 30%, a fund's board may suspend redemptions for up to 10 days.	14 October 2016

[15] See Money Market Mutual Funds: Stress Testing & New Regulatory Requirements, *Posted by Dr. Jeremy Berkowitz, NERA, on Tuesday, July 14, 2015*
https://corpgov.law.harvard.edu/2015/07/14/money-market-mutual-funds-stress-testing-new-regulatory-requirements/

Consistent with these amendments, OCIE will be looking at the activities of MMF boards in adopting these changes and other such issues.

On the topic of fees/gates, boards should consider:

- Discussing in advance the relevant market and industry factors to imposing a fee or gate;
- Discuss roles of advisers, transfer agents, boards, and communications with intermediaries; and
- Modes to communicate with shareholders – in addition to any required disclosures, boards should also consider telephone scripts, website, social media.

As this is the first round of examinations, under revised rule 2a-7, this should be a learning curve for both registrants and the OCIE. However, there is plenty of guidance, including a slew of releases and information issued by the Commission and others with respect to this rule.[16]

Payment for Order Flow. The SEC states in the Letter it will examine select broker-dealers, especially market makers and those handling retail order flow, to ensure they are attending to their obligation to seek and achieve Best Execution for clients on orders in equities, options, and fixed income products. This continues the focus from the SEC and FINRA on Best Execution and transparency in the markets, all within the frame work of recognizing that payment for order flow happens with both explicit and implicit payment methods.

The SEC describes payment for order flow as a way to attract orders from brokers. Some exchanges or market-makers will pay a broker-dealer for routing orders to them – perhaps a penny or more per share. Payment for order flow is one of the ways broker-dealers can make money from executing trades[17].

Under SEC Rule 607, upon opening a new account and on an annual basis, firms must inform their customers in writing whether they receive payment for order flow and, if they do, a detailed description of the type of payments[18]. Firms must also disclose on trade confirmations whether they receive payment for order flow and that customers can make a written request to find out the source and type of the payment for each transaction.

In the 2015 FINRA release 15-46,[19] FINRA noted that given the potential conflict between the receipt of payment for order flow, which is broadly defined under Rule 10b-10, and the duty of Best Execution, firms should carefully evaluate the receipt of payment for order flow and the impact of such practices on

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[16] *See*, SEC Division of Investment Management *2014 Money Market Fund Reform Frequently Asked Questions* Revised May 23, 2016. https://www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked-questions.shtml
[17] https://www.sec.gov/answers/payordf.htm
[18] https://www.law.cornell.edu/cfr/text/17/242.607
[19] http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf

execution quality.

The following approach should be kept in mind by broker-dealers in relation to their Best Ex obligations:

- Payment for Order Flow is accepted by the SEC and FINRA, but heightens a firm's burden to complete a thorough Best Execution analysis.
- Best Execution analysis should evolve to accommodate a changing marketplace.
- Best Execution Reviews should be regular and rigorous, and, most importantly, documented adequately.
- A healthy and functional Best Execution Committee process is one that uses the monthly committee meetings to review Best Execution analysis and trends, evaluates competing markets and venues, informs constituents internally regarding the ongoing work to attain Best Ex, includes a decision-making process to re-route order flow as needed in response to the date reviewed, and evolves as needed as new evaluation tools and aspects to the markets develop.
- Best Execution analysis and review should be separate from payment for order flow analysis.

Most importantly, remember that whether it is a global firm with multiple distribution channels and divisions, or a small broker-dealer in one location, the firm still carries the burden of seeking Best Execution for clients' orders, for evaluating execution quality on an ongoing basis, and for defining who owns that obligation within the firm.

Clearing Agencies. The SEC will continue to conduct annual examinations of clearing agencies designated systemically important and for which the Commission is the supervisory agency pursuant to the requirements of the Dodd-Frank Act[20]. Areas for review will be determined through a risk-based approach in collaboration with the Division of Trading and Markets and other regulators, as applicable. Once compliance is required, the staff will examine for compliance with the Commission's Standards for Covered Clearing Agencies.

The Dodd-Frank Act called for an enhanced regulatory framework for certain securities clearing agencies that perform a range of services critical to the effective operation of the securities markets, including acting as intermediaries between the parties to a securities transaction, ensuring that funds and securities are correctly transferred between parties and, in some cases, assuming the risks of a party defaulting on a transaction by acting as a central counterparty.

Securities clearing agencies covered by the rules are subject to requirements regarding, among other things, their financial risk management, governance, recovery planning, operations, and disclosures to market participants and the public.

[20] *See* Standards for Covered Clearing Agencies, Release No. 34-78961 (adopted Sept. 28, 2016), https://www.sec.gov/rules/final/2016/34-78961.pdf (compliance date April 11, 2017).

FINRA. In the past, the SEC conducted periodic reviews of FINRA operations and programs through OCIE. These exams typically focused on certain targeted areas (e.g., FINRA's arbitration or Enforcement programs). In addition, OCIE conducted oversight of several of FINRA examinations of specific broker-dealers. On occasion, this would necessitate OCIE performing its own on-site review of these broker-dealers.

Last year, OCIE announced the formation of a new unit named FINRA and Securities Industry Oversight ("FISIO"). This group, comprised of approximately 40 individuals throughout the country, is tasked specifically with overseeing FINRA programs and is aimed at increasing efficiencies in conducting these reviews. This change comes at the same time as OCIE's resources are increasingly being directed to the rapidly rising number of investment advisers in the U.S. The SEC has come under Congressional scrutiny concerning the frequency of its investment adviser exams; subsequently, one of the SEC's other 2017 priorities is the examination of new and otherwise never-examined advisers. The creation of this dedicated FINRA unit will allow OCIE to direct additional resources to its adviser exam program.

One likely result of this enhancement of FINRA oversight will be a reduction in the number of the SEC's own on-site examinations of broker-dealers. As the SEC increasingly relies on FINRA to conduct broker-dealer exams, it will instead focus its efforts on ensuring that FINRA is adequately performing that function.

Regulation Systems Compliance and Integrity ("SCI")[21]. The SEC will continue to examine SCI entities to evaluate whether they have established, maintained, and enforced written policies and procedures reasonably designed to ensure their systems have levels of capacity, integrity, resiliency, availability, and security adequate to maintain operational capacity and promote maintenance of fair and orderly markets, and that they operate in a manner compliant with the Securities Exchange Act of 1934. OCIE will also review, among other things, controls relating to (i) how systems record the time of transactions or events, (ii) how they synchronize with other systems, as well as (iii) collection, analysis, and dissemination of market data. Examinations will also assess entities' enterprise risk management, including whether these programs cover appropriate business units, subsidiaries, and related interconnected infrastructure.

The updated its FAQs on Reg SCI in early December 2016, including a new FAQ on disseminating information when there is a Reg SCI event.[22] The SEC did not directly prescribe specific technical standards for resiliency, system integrity or operational capacity; instead it provided guidance to firms on those areas,[23] and required firms to adopt policies and procedures addressing those issues, to ensure that firms

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[21] *See* Regulation Systems Compliance and Integrity, Release No. 34-37639, (November 19, 2014), http://www.sec.gov/rules/final/2014/34-73639.pdf.

[22] FAQs question 3.08

[23] See, e.g., "Responses to Frequently Asked Questions Concerning Regulation SCI" (last modified December 8, 2016) ("FAQs") https://www.sec.gov/divisions/marketreg/regulation-sci-faq.shtml; see also "Staff Guidance on Current SCI Industry Standards"

think through, and are prepared for, technology and controls issues that could affect their systems and market integrity.

The SEC has made it clear in recent enforcement actions that it has adopted a "strict liability" approach in enforcing rules relating to systems performance. We expect a similar approach with respect to Reg SCI, particularly in the wake of data breaches and cybersecurity problems at places like Yahoo (500 million accounts potentially compromised), Oracle Micros ("hundreds of systems" compromised at the largest maker of retail point-of-sale terminals), the IRS (personal data in 700,000 taxpayer accounts potentially stolen) and SWIFT (fraudulent transfers from the New York Federal Reserve Bank resulting in an $81 million loss).

While the SEC's guidance is not binding on firms, it is reasonable to expect the staff would reference those materials in assessing the reasonableness of the policies, procedures and practices that exchanges and ATSs have developed, or will be expected to develop.

Firms should review their policies and procedures (including their software development life cycles) to ensure they:

- adequately document and respond to technology issues, including automatically switching over to an established back-up system or manual process;
- are reasonably designed to ensure that the firm meets its ongoing compliance obligations; and,
- provide for timely and appropriate communications to customers, counterparties and regulators regarding technology issues, outages and remedial measures.

Firms should undertake to update existing technology control assessments by "objective personnel" (e.g., internal audit or an outside consultant) to:

- comprehensively identify where improvements may be needed, especially surrounding systems disruptions, intrusions and compliance issues;
- ensure the firm has defined appropriate command-and-control hierarchies and escalation paths in the event of disruptions or intrusions; and
- review how information regarding disruptions, intrusions and compliance should be communicated within the appropriate business units or subsidiaries and between the firm and regulators. The SEC's updated FAQs include a modification to its previous guidance on when an "indirect SCI system" is "reasonably likely to pose a security threat to SCI systems."[24]

Firms should also establish or update their technology controls roadmap to continue driving toward "best in class" application controls management.

(November 19, 2014) https://www.sec.gov/rules/final/2014/staff-guidance-current-sci-industry-standards.pdf

[24] FAQs, question 2.01

Finally, firms should specifically review how their systems are recording transaction information including, but not limited to, the time of transactions and events; how their systems synchronize with other systems, and how they collect, analyze and disseminate market data. Firms should particularly note that the SEC's updated FAQs contain a new FAQ indicating that systems providing historical market data may be included in the definition of "SCI systems."[25]

Cybersecurity. In 2017, OCIE will continue its initiative to examine for cybersecurity compliance procedures and controls, including testing the implementation of those procedures and controls. It is not surprising that Cybersecurity continues to be a focus for the SEC, given the volume of attempted and actual breaches and the potential impacts on clients and markets. The National Exam Program Risk Alert, 2015 Cybersecurity Examination Initiative, Vol. IV, Issue 8 (September 15, 2015)[26] is a good reference document to guide you through the expectations of the SEC. You should take note of the specific mention of "testing the implementation" of procedures and controls by OCIE.

The NIST – Framework for Improving Critical Infrastructure Cybersecurity (vers. 1.0, 2014[27]) is another great reference to help you understand how to build a robust cybersecurity program. Firms should take steps to make sure they have:

- a cybersecurity risk assessment that is tailored to the business and has been reviewed within the last twelve months;
- senior management and the board of directors involved in the development and approval of the program;
- robust policies and procedures established to prevent data loss;
- "least privilege" access controls[28] in place;
- systems that are consistently patched and continuously monitored;
- vendors that are reviewed and assessed;
- employees that are properly trained; and
- there is a well-designed incident response plan.

Penetration tests and vulnerability assessments by third parties are quickly becoming an expectation and new regulations by states are raising the bar.

[25] FAQs, question 2.09
[26] https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf
[27] https://www.nist.gov/sites/default/files/documents/cyberframework/cybersecurity-framework-021214.pdf
[28] Every program and every user of the system should operate using the least set of privileges necessary to complete the job. Primarily, this principle limits the damage that can result from an accident or error. It also reduces the number of potential interactions among privileged programs to the minimum for correct operation, so that unintentional, unwanted, or improper uses of privilege are less likely to occur. Thus, if a question arises related to misuse of a privilege, the number of programs that must be audited is minimized. https://www.us-cert.gov/bsi/articles/knowledge/principles/least-privilege

As a note of emphasis, New York is raising the bar for cybersecurity compliance.[29] Firms should pay close attention to New York as it may become the new standard for cybersecurity in all states.

National Securities Exchanges. The SEC will continue to conduct risk-based inspections of the national securities exchanges. These inspections will focus on selected operational and regulatory programs.

OCIE did not issue a separate priorities letter to exchanges in 2017, as it had done in 2015[30] and 2016.[31] We believe that the 2016 priorities will form the basis for this year's exams as well.

Last year's priorities included a focus on:

- Exchanges' regulatory programs (performance by the exchange, outsourcing of regulatory functions, internal controls over regulatory programs, funding, and governance and oversight)
- Listing programs (evaluating listing and delisting criteria for both equities and options)
- Regulation SCI compliance (in coordination with OCIE's Technology Controls Program)
- Section 31 compliance[32]
- Compliance with undertakings imposed by SEC orders

Since OCIE seems to be continuing its program from 2016, national securities exchanges are encouraged to review, or update their reviews, regarding the areas outlined above, including their adherence to undertakings and commitments from previous exams. Exchanges should also pay careful attention to OCIE's focus on Reg SCI in the 2017 Letter, as those will likely be areas of focus for exchanges as well as non-exchange SCI entities.

As a general point of reference, firms should be mindful of what OCIE deems to be a "successful" exam. In a speech at the NSCP National Conference in October 2016, OCIE Director Mark Wyatt described the four pillars of a successful exam as: (1) Improve Compliance, (2) Prevent Fraud, (3) Monitor Risk, and (4) Inform Policy[33]. Of these, he stressed that improving compliance is first among equals. He noted that OCIE's primary goal in its exams is to provide firms/exchanges (and their compliance officers) with information so they can assess their own compliance programs based on their unique business model and undertake steps to develop solutions which address any potential gaps.

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[29] http://www.natlawreview.com/article/new-york-revamps-proposed-cybersecurity-regulation-finnacial-services-and-insurance
[30] https://www.sec.gov/about/offices/ocie/omo-letter-to-exchanges-011315.pdf
[31] https://www.sec.gov/about/offices/ocie/omo-letter-to-exchanges-011116.pdf
[32] https://www.sec.gov/divisions/marketreg/sec31feesbasicinfo.htm
[33] https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html

Exchanges (and all firms) should develop and fine-tune their enterprise risk management infrastructures, including reviewing existing businesses for new or amplified risks to business lines; reviewing the enterprise as a whole and the integrity of the market; and, developing policies and procedures to address any identified shortcomings. In addition, exchanges should engage in meaningful self-analysis when they uncover gaps or issues with their compliance, and to timely self-report issues that they uncover.

Anti-Money Laundering ("AML"). OCIE will continue to assess whether the AML programs of broker-dealers are adapted to meet and detect the specific risks that the individual firm may encounter. Those risks are continuously changing and firms need to be adapting their AML programs to identify those new risks to the firm. OCIE will also be reviewing broker-dealers' procedures for monitoring of suspicious activity. OCIE has indicated it will be taking a hard look at the effectiveness of the independent testing conducted for the firm and how the firm has complied with the reporting requirements of suspicious activity reports ("SARs").

FINRA stated in its 2017 Annual Regulatory and Examination Priorities Letter that it, too, will continue to focus on the AML programs of broker-dealers, especially those areas where FINRA has observed shortcomings by firms in the past, such as gaps in a broker-dealer's automated trading and money movement surveillance systems which appeared to have been caused by either data integrity problems, poorly set parameters or surveillance patterns that do not specifically capture problematic behavior. FINRA stated that firms can use their trading surveillance systems for AML suspicious activity monitoring; however, those systems must be tailored to the firm's specific AML red flags.

Members of OCIE staff have said on numerous occasions that AML monitoring is the "cornerstone of effective compliance.[34] To assist broker-dealers in building an effective and compliant AML program, OCIE released on January 11th, 2017 the Anti-Money Laundering (AML) Source Tool for Broker-Dealers[35]. This "source tool" is a compilation of key AML laws, rules, orders and guidance specifically applicable to broker-dealers.

AML compliance professionals need to be monitoring their individual AML programs and building programs with oversight controls that specifically address AML risks and red flags the firm may encounter based on the firm's business model and clients. OCIE will be expecting firms to have developed an AML compliance program customized to their specific business model and clients, while also conforming to the AML laws, rules and orders specifically applicable to broker-dealers.

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[34] Kevin Goodman - OCIE National Associate Director of Broker-Dealer Exam Program June 18th, 2015. http://sddco.com/updates/ocie-will-evaluate-broker-dealer-aml-compliance/

[35] https://www.sec.gov/about/offices/ocie/amlsourcetool.htm

Investment advisers must watch the progress of the proposed FinCEN rule that would impose AML program responsibilities on them.[36]

D. OTHER INITIATIVES

In addition to examinations related to the themes described above, the SEC expects to allocate examination resources to other priorities, including:

<u>Municipal Advisors</u>.
The SEC intends to continue its focus on municipal advisers, a priority since its issuance of a 2014 letter outlining the formation of a National Exam Program administered by OCIE and providing for focused, risk-based exams of municipal advisers. Although the 2017 Letter provides little guidance concerning this area, the SEC is expected to continue its review of its own, and the MSRB's, registration requirements for municipal advisers.

The SEC will continue to focus on advisers':

- compliance with MSRB rules involving gifts and gratuities (Rule G-20);
- registration and continuing education requirements (Rule G-3); and
- the use of ownership information obtained in a fiduciary or agency capacity (Rule G-23).

The SEC has also stated its focus on municipal adviser disclosure obligations to their municipal clients, specifically as outlined in MSRB Rules G-32 and G-42; and on advisers' fair dealing obligations as outlined generally in Rule G-17, and more specifically in MSRB rules involving political contributions and suitability (Rules G-19, G-37 and G-38).

The SEC is also likely to focus on municipal advisers' supervisory procedures, maintenance of books and records, and staff training and qualifications. Compliance personnel are encouraged to review their firms' procedures to ensure they address each of these issues. They are also encouraged to conduct regular reviews of certain targeted areas of regulatory concern, such as gifts and gratuities, political contributions, and registration requirements.

<u>Transfer Agents.</u> In addition to examining transfer agents' timely turnaround of items and transfers, recordkeeping and record retention, and safeguarding of funds and securities, the SEC indicated it will examine transfer agents that service microcap issuers, focusing on detecting issuers that may be engaging in unregistered, non-exempt offerings of securities.

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[36] Financial Crimes Enforcement Network: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, Public Comment, 80 Fed. Reg. 52680, available at https://www.regulations.gov/docketBrowser?rpp=50&so=DESC&sb=postedDate&po=0&dct=PS&D=FINCEN-2014-0003.

Transfer agents are an often overlooked, but critical, segment of the securities industry. Issuers of publicly traded securities enlist the services of a transfer agent to maintain records of their shareholders, to issue and redeem physical security certificates, and to interface with securities depositories, clearing agencies and broker-dealers with respect to transfers of securities positions, whether held electronically or represented by physical certificates. All transfer agents are required to be registered with the SEC, but they are among the most lightly regulated of any class of securities professionals. They have come into increasing focus in recent years for the central role they play in the issuance of microcap stocks.

Using private placements, conversions and exchanges of securities, and the issuance of stock as compensation for legal, sales, consulting or other services, many issues of microcap stocks are not registered with the SEC. In reliance on SEC Rule 144, these microcap stocks can then be sold to the public, making their way without many of the regulatory protections afforded by the normal securities registration process. Transfer agents facilitate the initial issuance, conversion or exchange, de-legending, and other steps in this process of introducing these securities to the public.

Firms that accept deposits by customers of unregistered securities, especially microcap stocks, should have written policies and procedures that provide clear guidance to their registered representatives, operations, supervisory and compliance personnel, on the firm's handling of the deposits and any subsequent liquidations. In 2009, FINRA issued guidance, in Regulatory Notice 09-05, regarding some of the major issues raised by these activities, and matters a firm's policies and procedures.

While firms have historically relied on the opinions and advice of third parties, including the issuer, it's counsel and transfer agents, regarding the appropriateness of sales under Rule 144, the FINRA Notice underscores that both the SEC and FINRA have repeatedly warned that broker-dealers are obligated to conduct their own review. FINRA noted that a broker-dealer cannot merely assume that, because a transfer agent has been willing to remove the restrictive legend from a securities certificate, the securities are in fact unrestricted and can be sold under Rule 144 without being registered. Because of the close relationship between the promoters and issuers of microcap stocks and their transfer agents, regulators expect broker-dealers to exercise caution and to independently verify relevant information related to a sale of such stocks, particularly in transactions that raise red flags.

Private Fund Advisers. OCIE will continue to examine private fund advisers, focusing on conflicts of interest and disclosure of conflicts, as well as actions that appear to benefit the adviser at the expense of investors.

The Letter indicates the SEC's focus has narrowed since last year's letter, which described the conflicts inherent in side-by-side management of performance- and asset-based accounts. The SEC's interest in private funds' management of fees, expenses, and internal conflicts comes as no surprise, given the high-profile enforcement actions against private equity firms in the last two years. Among other practices, the SEC has brought actions involving the following[37]:

- The acceleration of payments of a fund manager's monitoring fees, without disclosure of the manager's ability to do so.
- Payment of legal fees for personal work on behalf of the adviser was less than for fees charged to funds.
- Failure to disclose fees paid to affiliated entities.
- Failure to disclose a loan made to the fund by a general partner, with said loan also for the benefit of the general partner rather than the fund.

What do these disciplinary actions tell the compliance professional? In the press release announcing one of the settlements[38], Andrew J. Ceresney, Director of the SEC Enforcement Division tells us "A common theme in our recent enforcement actions against private equity firms is their failure to properly disclose fees and conflicts of interest to fund investors." He also stated, "Investors … were not adequately informed about accelerated monitoring fees and separately allocated loan interest, and therefore were unable to gauge their impact on their investments." In other words, in at least some cases the SEC has not specifically objected to practices, fees, and conflicts of interest, but rather to the lack of disclosure by the manager. The practical takeaway for a compliance officer is the need to review all disclosure documents carefully and periodically throughout the year to ensure that all conflicts of interest and fees (including payment of interest, acceleration of fees, and fee allocations) are disclosed to fund investors.

Firms and their compliance officers need to review their fee billing practices to ensure that appropriate controls are in place to identify and address potential conflicts of interest and ethical violations. Any practice that may be beyond the norm, such as the need to create a separate legal entity to provide services to insurance funds, should be disclosed and the rationale for these practices should be documented by the fund. In such cases, it is critical that a manager disclose the necessity as well as whether any related fees will be offset or billed. It is much more advisable to disclose any affiliated service providers and the terms of any service fees as clearly and thoroughly as possible.

From a regulatory perspective, it is cleanest if the services fees are netted against management fees, but if any fees are charged above and beyond the nominal management fee, the fund must clearly document the manager's decision to do so, even if the practice has already been well disclosed. This trail should include fair valuations of the services provided, including estimates from outside service providers.

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[37] These include The Blackstone Group, Fenway Partners, Cherokee Investment Partners, JH Partners LLC, Blackstreet Capital Management, WL Ross & Co LLC, Apollo Global Management, First Reserve Management L.P.

[38] https://www.sec.gov/news/pressrelease/2016-165.html

In some of the cases described above, there was an advisory committee to the funds which included some of the larger fund investors. A common thread which runs through these stories is that, under the committee's charter or organizing documents, the fund manager was only permitted to act on behalf of the funds with the consent of the committee, yet the transactions and fees in question went undisclosed. For consent to be valid, it must be an informed consent. While there is no way to know for sure, a contemporaneous memorandum or set of meeting minutes to record the rationale may have helped the fund and the fund manager to defend its actions.

When sitting across the table from a skeptical examiner, it is best to be able to have affirmative defenses such as complete disclosure of all fees and potential and actual conflicts of interest at your disposal.

E. SUMMARY

Firms are well-advised to assess the topics addressed by the SEC's 2017 Examination Priorities Letter. The timing of the letter comes as right as a new administration is coming into office. It remains to be seen if these priorities will change with the new Republican SEC Chairperson.