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# The SEC'S 2017 Priorities: What They Are and What Compliance Professionals Need to Know

As we all have anticipated, the SEC 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 also states that the SEC staff has incorporated data analytics into its examination initiatives, using data analytics to identify high risk profiles and to analyze complex products.[1]

## 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 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 processes.

As it relates to third party "robo", or digital adviser activities, OCIE plans to focus on the firm's compliance program, marketing, formulation of investment recommendations, data protection, disclosures related to conflicts of interest, and the compliance program's oversight of algorithms that generate recommendations.

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

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Firms should carefully:

- Review/approval of website and social media;
- 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 reviews the customer information and investment objectives to arrive at the investment portfolio and the strategy recommended and implemented;
- Evaluate all potential conflicts of interest, including the use of such things as affiliated investment products, all vendors, the activities of boards of directors and advisory boards; and
- Supervise the digital investment tool or algorithm.

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, consult with someone who has already thought through some of the issues.

Wrap Fee Programs. The Letter also indicated that areas of focus may include wrap account suitability, effectiveness of disclosures, conflicts of interest and brokerage practices.

OCIE has previously indicated it would evaluate:

- how financial professionals and firms satisfy their suitability requirements when determining whether to recommend brokerage or advisory accounts;
- the financial incentives for making such recommendations; and
- 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.

In a 2003 FINRA Notice to Members[2], it was 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.

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

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 if they continue to be suitable for clients. This should include a review for inactivity ("reverse churning").
- The firm's 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.

**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 that are aimed at a single industry or theme).

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.

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.

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.

**Never-Before Examined Investment Advisers.** In 2014, the SEC launched its "Never-Before Examined Initiative", focusing on firms that have been registered three years or more[3]. In this year's Letter, the SEC notes it is expanding the "Never-Before Examined Adviser initiative"[3] to include focused, risk-based examinations of newly-registered advisers[4], 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 will take a two-pronged approach in conducting its reviews: the risk assessment approach and the focused review approach.

3. 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.

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

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, the SEC shifted its broker-dealer staff over to investment adviser examinations[5]. The SEC has also indicated it was exploring allowing third-party examiners to conduct reviews[6].

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 engaging Compliance or outside consultants to conduct a mock-SEC examination.

**Recidivist Representatives and their Employers.** Both the SEC[7] and FINRA[8] 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.

Further, the SEC will be looking at firms' marketing pieces to identify any conflicts of interests or risks associated with supervised persons with a history of disciplinary events, to determine whether the conflicts or risks are clearly disclosed, and to determine if 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[9].

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

5. http://www.reuters.com/article/us-sec-brokers-idUSKCN0VT0SQ
6. Speech by SEC Chair Mary Jo White. https://www.sec.gov/news/speech/white-speech-beyond-disclosure-at-the-sec-in-2016-021916.html
7. 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.
8. See, FINRA 2017 Priorities Letter. http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf
9. https://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf

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; and
    - accuracy of information contained in the firm's filings regarding branch offices, 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 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.

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 regarding trade allocation;
    - the experience level and level of autonomy of branch office personnel operating as advisers;
    - portfolio management practices, including consistency of portfolios with clients' objectives; and
    - safeguards for the privacy and protection of client records.

**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[10]. OCIE indicated this type of conflict may influence recommendations in favor of share classes that have higher loads or distribution fees.

10 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.

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.

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

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 2A brochure if the firm or its supervised persons receive compensation for the sale of securities or other investment products. 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 they are adequately addressed in the firm's policies and procedures.
- Ensure such conflicts are 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

**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[11]. 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.

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

1. Suitability
2. Supervision and Compliance Controls
3. Conflicts of Interest
4. Marketing and Disclosure

11. 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.

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.

Ongoing firm training on pay-to-play, receipt of gifts and entertainment expenses is a vital component to educating individuals on these issues.

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 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.

Procedures should 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, firms 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 onset of cognitive decline as an investor ages. Firms should adopt procedures to escalate any such 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. Firms should follow the progress of this proposal. In addition, as of January 1, 2017, seven states[12] have regulations in place to address disbursement holds by firms on accounts where financial exploitation is suspected.

### 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 ("MMFs") to make structural and operational reforms to address redemption risks in MMFs[13], while preserving the benefits of the funds for remaining investors. The SEC will examine these funds 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 a review of compliance policies and procedures relating to stress testing and funds' periodic reporting of information to the Commission.

**Overview of the 2014 Money Market Mutual Fund Rule Changes[14]**

| 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 |

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

A report to a Board must include:

- A summary of significant assumptions
- Information to allow the board to evaluate results[15]

As this is the first round of examinations under revised SEC Rule 2a-7, this should be a learning curve for both registrants and

12. Alabama, Delaware, Indiana (for BDs only), Louisiana, Missouri, Vermont, State of Washington
13. https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679
14. 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/
15. See, Joan Ohlbaum Swirsky, Esq. Stradley Ronon Stevens & Young, Money Market Fund Reform (Exactly) One Year Later, slide presentation. http://mfdf.org/images/ArchiveMaterial/MMFReformUpdate.pdf

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.

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 their receipt of payment for order flow and the impact of such practices on execution quality.

The following approach should be kept in mind by broker-dealers in relation to their Best Execution 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 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 Execution, 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, 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, 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 to the public.

**FINRA.** In the past, the SEC conducted periodic reviews of FINRA operations and programs through OCIE. These exams typically focused on targeted areas (e.g., FINRA's arbitration or Enforcement programs). In addition, OCIE conducted oversight of several of FINRA examinations of specific 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. 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 ("Reg SCI")[21].** The SEC will continue to examine Reg 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

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

entities' enterprise risk management, including whether these programs cover appropriate business units, subsidiaries, and related interconnected infrastructure.

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

- Firms should review their policies and procedures (including their software development life cycles) to ensure that 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 also 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.

**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. The National Exam Program Risk Alert, 2015 Cybersecurity Examination Initiative, Vol. IV, Issue 8 (September 15, 2015)[24] is a good reference to guide firms.

The NIST – Framework for Improving Critical Infrastructure Cybersecurity (vers. 1.0, 201425) is another great reference to help firms understand how to build a robust cybersecurity program. Firms should take steps to make sure they have:

- a cybersecurity risk assessment 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[26] in place;
- systems that are consistently patched and continuously monitored;
- vendors that are reviewed and assessed;
- properly trained employees; and
- a well-designed incident response plan.

As a note of emphasis, New York is raising the bar for cybersecurity compliance[27]. Firms should pay close attention to New York as it may become the new standard for cybersecurity in other states.

**National Securities Exchanges.** The SEC will continue to conduct risk-based inspections of the national securities exchanges.

OCIE did not issue a separate priorities letter to exchanges in 2017, as it had done in 2015[28] and 2016.[29] 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)
- Reg SCI compliance (in coordination with OCIE's Technology Controls Program)
- Section 31 compliance[30]
- Compliance with undertakings imposed by SEC orders

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.

**Anti-Money Laundering ("AML").** OCIE will continue to assess whether AML programs of broker-dealers are adapted to meet and detect the specific risks that the individual firm may encounter. OCIE will also be reviewing broker-dealers' procedures for monitoring of suspicious activity. OCIE has indicated it will be looking 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 caused by data integrity problems, poorly set parameters or surveillance patterns that

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" (November 19, 2014) https://www.sec.gov/rules/final/2014/staff-guidance-current-sci-industry-standards.pdf
24. https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf
25. https://www.nist.gov/sites/default/files/documents/cyberframework/cybersecurity-framework-021214.pdf
26. Every program and every user of the system should operate using the least set of privileges necessary to complete the job. Primarily, this 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
27. http://www.natlawreview.com/article/new-york-revamps-proposed-cybersecurity-regulation-financial-services-and-insurance
28. https://www.sec.gov/about/offices/ocie/omo-letter-to-exchanges-011315.pdf
29. https://www.sec.gov/about/offices/ocie/omo-letter-to-exchanges-011116.pdf
30. https://www.sec.gov/divisions/marketreg/sec31feesbasicinfo.htm

do not specifically capture problematic behavior.

OCIE released on January 11, 2017 the Anti-Money Laundering (AML) Source Tool for Broker-Dealers[31]. This "source tool" is a compilation of key AML laws, rules, orders and guidance specifically applicable to broker-dealers.

Investment advisers must watch the progress of the proposed FinCEN rule that would impose AML program responsibilities on them[32].

**D. OTHER INITIATIVES**

Municipal Advisors. The SEC intends to continue its focus on municipal advisers. Although the Letter provided 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 in Rule G-17; and, more specifically, in MSRB rules involving political contributions and suitability (Rules G-19, G-37 and G-38).

Compliance personnel are encouraged to conduct regular reviews of certain targeted areas of regulatory concern, such as gifts and gratuities, political contributions, and registration requirements.

Transfer Agents. 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.

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, including guidance regarding a firm's policies and procedures.

The Regulatory Notice underscores that both the SEC and FINRA have repeatedly warned broker-dealers that they are obligated to conduct their own review. A broker-dealer cannot 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.

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. Among other practices, the SEC has brought actions involving the following[33]:

- 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.

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.

**E. SUMMARY**

All firms are well-advised to assess the topics addressed by the SEC's 2017 Examination Priorities Letter. The timing of the letter comes right as a new administration is coming into office and it remains to be seen if these priorities will shift with the new Republican SEC Chairperson. Stay aware of further developments. ★

31. https://www.sec.gov/about/offices/ocie/amlsourcetool.htm
32. 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.
33. 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.