

# PUBLICATION

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## SEC Issues Guidance on its 2014 Examination Priorities

**Authors: Matthew George White**

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Each year, the SEC Office of Compliance Inspections and Examination's National Exam Program (NEP) issues a letter communicating to investors and registrants the areas that the staff perceives to present heightened risks. This year, the NEP published its [Examination Priorities for 2014](#) on January 9, 2014. <sup>1</sup>

The NEP's examination priorities address issues that span the entire market, as well as issues that relate specifically to particular business models and organizations. This Alert will address examination priorities identified by the NEP in the following areas:

1. Market-wide;
2. Investment Advisors and Investment Companies;
3. Broker-Dealers;
4. Exchanges and Self-Regulatory Organizations; and
5. Clearing and Transfer Agents.

The NEP's Examination Priorities Letter reminds investors and registrants that while it intends to allocate significant resources in 2014 to these areas, the NEP will conduct additional examinations focused on risks, issues and policy matters that are not discussed in its guidance.

### **Market-Wide Examination Priorities**

The NEP identified the following, among others, as its most significant initiatives for 2014.

- **Fraud Detection and Prevention** – Because scams, theft, unfair advantage and other fraudulent activities erode the trust in the nation's capital markets and adversely affect investors and the efficient functioning of the markets, the NEP indicated it will continue to use a risk-based approach to targeting registrants and business practices. As part of this effort, the NEP advised that it will continue to utilize and enhance its quantitative and qualitative tools and techniques to seek to identify market participants engaged in fraudulent or unethical behavior. The NEP reminded registrants that it has rolled out both a Quantitative Analytics Unit and a Risk Analyses Examination Initiative to assist in these efforts.
- **Technology** – Given the increasing complexity, interconnectedness and speed fostered by technology utilized in the capital markets, the NEP intends to continue focusing on examining the governance and supervision of information technology systems, operational capability, market access, information security and preparedness to respond to sudden malfunctions and system outages.
- **Dual Registrants** – The NEP considers the convergence among broker-dealers and investment advisory representatives to be a significant risk. Therefore, the NEP will continue to examine the risks inherent in this business model. Moreover, the NEP will continue to assess the impact to investors of the different supervisory structures and legal standards of conduct that govern the provision of brokerage and investment advisory services.
- **New Laws and Regulation** – The NEP provided that it will review general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c) of the Securities Act of

1933. Moreover, the NEP intends to review, monitor and analyze the use of Rule 506(c) generally, as well as evaluating the due diligence conducted by broker-dealers and investment advisors for such offerings. The NEP also intends to examine industry developments and compliance with crowdfunding offerings and the recently-adopted rules governing municipal advisors.

### **Investment Advisor and Investment Company Priorities**

The NEP identified as "core risks" in this area the safety of assets and custody, conflicts of interest inherent in certain investment advisor business models, and marketing/performance. Specifically, in these areas, the NEP indicate that it would continue to test compliance with Rule 206(4)-2 under the Advisors Act (the "Custody Rule"), as examiners have continued to find that registrants have been out of compliance with its requirements. Additionally, the NEP has observed that non-compliance with the federal securities laws is frequently the result of unaddressed conflicts of interest. The staff noted that conflicts of interest are often found in compensation arrangements, the allocation of investment opportunities, controls and disclosures related to the side-by-side management of performance-based and asset-based fee accounts, disclosures related to illiquid or leveraged investments, and higher-risk products or strategies targeted to retail (particular retired or elderly) investors. Finally, the NEP provided that it will review the accuracy and completeness of advisers' claims about their investment objectives and performance.

The NEP also explained that its 2014 examinations will focus on the following "New and Emerging Issues and Initiatives":

- Never-Before Examined Advisors;
- Wrap Fee Programs;
- Quantitative Portfolio Management and Trading Strategies;
- Presence Exams (focusing on marketing, portfolio management, conflicts of interest, safety of client assets and valuation);
- Payments Made by Advisors and Funds to Distributors and Intermediaries (payments "in guise"); and
- Fixed Income Investment Companies.

Finally, the NEP indicated that in 2014 it will continue to target "policy topics" including money market funds, "alternative" investment companies and securities lending arrangements.

### **Broker-Dealer Priorities**

The NEP identified the following "core risks" in this area.

- Sales Practices/Fraud – The NEP highlighted its broker-dealer program's efforts to conduct examinations focused on detecting and preventing fraud and other sales practice violations to retail investors with respect to affinity fraud targeting seniors and other groups; micro-cap fraud; "pump and dump" schemes; unsuitable recommendations of higher yield and/or complex products; the adequacy of due diligence efforts; and unregistered entities engaged in the sale or promotion of unregistered offerings or other unusual capital raising activities.
- Supervision – The NEP indicated its efforts to prevent securities laws violations will focus on broker-dealer's supervision of: independent contractors and financial advisors in "remote" locations and large branch offices; registered representatives with significant disciplinary histories; and private securities transactions.

In addition, the NEP indicated it would focus on examining market access controls related to, among other things, erroneous orders; the use of technology with a focus on algorithmic trading and high frequency trading;

information leakage and cyber security; and market manipulation practices involving practices such as marketing the close, parking, fraudulent stimulation of demand (spoofing), and excessive markups and markdowns. The NEP also provided that it would continue its efforts to focus on examining internal controls, compliance with customer protection and net capital rules, and the adequacy of anti-money laundering (AML) programs.

The NEP noted that it would also focus its 2014 examinations on the following "new and emerging issues and initiatives":

- Exchange Act Rule 15c3-5 (the "Market Access Rule");
- Suitability of Variable Annuity Buybacks; and
- the Fixed Income Market.

### **Exchanges and Self-Regulatory Organization Priorities**

The OCIE's Office of Market Oversight, and its Market Oversight Program, are responsible for examining certain SROs and exchanges to evaluate their compliance with applicable securities laws and rules, as well as the SROs' own rules. In this area, the NEP identified the following 2014 priorities:

- Oversight of FINRA;
- Exchange examinations, including risk targeted exams focused on areas of perceived control weaknesses at the exchanges;
- Pre-launch reviews of new exchange applicants to determine whether each applicant is organized and has the capacity to carry out its responsibilities as an SRO by enforcing its members' compliance with the federal securities laws; and
- Section 31 fee examinations.

### **Clearing and Transfer Agent Priorities**

The Clearance and Settlement Program identified the following areas as priorities in 2014:

- Annual Exams Mandated by the Dodd-Frank Act, including risk-based exams of the Depository Trust Company (DTC), the National Securities Clearing Corporation (NSCC), the Fixed Income Clearing Corporation (FICC) and the Options Clearing Corporation (OCC);
- Other Examinations, including utilizing a risk-based approach to examine clearing agencies; and
- Pre-launch review of new clearing firm applicants.

Additionally, in 2014, the Transfer Agent Program intends to focus on examining the following areas:

- Compliance and controls with respect to the "core activities" of transfer agents: the timely turnaround of items and transfers; accurate recordkeeping and associated retention; and safeguarding funds and securities;
- Transfer agents that service microcap securities and private offerings;
- Policies and procedures adopted by transfer agents;
- Transfer agents that provide "third-party" administration;
- Policies and procedures related to order taking, recordkeeping and clearing relationships, particularly with respect to the Direct Registration System; and
- Business continuity and disaster recovery plans.

### **Conclusion**

The NEP's 2014 Examination Priorities Letter provides a blueprint of areas the SEC deems to be "high risk" going into 2014. In light of this guidance, firms should assess their compliance and supervisory programs in the context of these key risk areas. Firms must also evaluate their sales practices, as well as their policies and procedures with respect to these areas, in order to ensure they are in compliance with all applicable rules and securities laws.

If you have any questions regarding these issues or any other securities-related issues, or need assistance in evaluating your company's policies and procedures, please contact any of the attorneys in Baker Donelson's Broker-Dealer/Registered Investment Adviser group.

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<sup>1</sup> On January 2, 2014, the Financial Industry Regulatory Authority (FINRA) issued its 2014 Regulatory and Examination Priorities Letter, which identifies several areas that overlap the SEC's concerns. See Baker Donelson's alert on this topic [here](#).