

**MEMO# 27827**

January 10, 2014

# **SEC Publishes the Priorities for its National Examination Program in 2014**

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TO: COMPLIANCE MEMBERS No. 1-14  
OPERATIONS MEMBERS No. 1-14  
BROKER/DEALER ADVISORY COMMITTEE No. 3-14  
TRANSFER AGENT ADVISORY COMMITTEE No. 2-14  
SEC RULES MEMBERS No. 2-14  
INTERNAL AUDIT ADVISORY COMMITTEE No. 1-14  
CHIEF RISK OFFICER COMMITTEE No. 1-14 RE: SEC PUBLISHES THE PRIORITIES FOR ITS NATIONAL EXAMINATION PROGRAM IN 2014

The National Examination Program (“NEP”) within the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) has published its examination priorities for 2014. [\[1\]](#) According to the Priorities, they were selected collaboratively by senior staff from OCIE’s twelve offices as well as by senior representatives of other SEC divisions and offices. In addition to addressing issues that span the entire market, the Priorities discuss the NEP’s focus for the coming year in the following four program areas: investment advisers and investment companies; broker-dealers; exchanges and self-regulatory organizations; and clearing and transfer agents. The Priorities clarify that the issues listed in the document are not exhaustive and are subject to change as events warrant. The portions of the Priorities that may be of interest to the Institute’s members are briefly summarized below. [\[2\]](#)

## **I. Program-Wide Initiatives**

According to the Priorities, “the most significant initiatives” across the entire NEP are fraud detection and prevention; corporate governance, conflicts of interest, and enterprise risk management; [\[3\]](#) technology; [\[4\]](#) registrants dually registered as broker-dealers and investment advisers; [\[5\]](#) and new laws and regulations. [\[6\]](#) In addition, as part of their program-wide initiatives, the staff will be examining the sales practices of investment advisers and broker-dealers relating to retirement vehicles and rollovers.

## **II. Program Specific Initiatives: Investment Advisers and Investment Companies**

The Priorities for investment advisers and investment companies are broken into the

following categories: Core Risks; New and Emerging Issues and Initiatives; and Policy Topics.

## **A. Core Risks**

The Priorities discuss three core risks that will be the focus of the NEP in 2014:

**Safety of Assets and Custody** – The Priorities note that OCIE continues to observe non-compliance with the custody rule under the Investment Advisers Act (Rule 206(4)-2). As such, this area will remain a focus for OCIE during this year.

**Conflicts of Interest Inherent in Certain Investment Adviser Business Models** – The conflicts of interest that will be a focus for OCIE are: compensation arrangements that involve either undisclosed compensation or that impact recommendations made to clients; the allocation of investment opportunities; controls and disclosure relating to side-by-side management of performance-based and asset-based accounts; risk controls and disclosure relating to illiquid investments and leveraged investment products and strategies; and higher risk products or strategies targeted to retail investors, particular those who are retired or elderly.

**Marketing/Performance** – OCIE plans to review the accuracy and completeness of advisers' claims regarding their investment objectives and performance. This will include reviewing and testing hypothetical and back-tested performance.

## **B. New and Emerging Issues and Initiatives**

There are six areas of new and emerging issues and initiatives for 2014:

**Never-Before Examined Advisers** – The staff plans to conduct focused, risk-based examinations of those advisers that are not part of the SEC's "Presence Exam" initiative and that have been registered for at least three-years without having been examined by the staff.

**Wrap Fee Programs** – The staff's focus in this area will be on whether advisers are fulfilling their fiduciary and contractual obligations to clients and reviewing the processes in place to monitor wrap fee program recommendations, conflicts of interest, best execution, trading away from the sponsor, and disclosures.

**Quantitative Trading Models** – The staff plans to review advisers that substantially rely on quantitative portfolio management and trading strategies to assess, among other things, whether firms have adopted and implemented compliance policies and procedures appropriate for their models.

**Presence Exams** – The staff will continue the 2012 initiative to examine "a significant percentage of the advisers registered since the effective date of Section 402 of the Dodd-Frank Act." [These advisers are primarily advisers to hedge funds and private equity funds that were not registered with the SEC prior to the Dodd-Frank Act.] Another priority will be to examine those private fund advisers that, according to the staff's analytics, present higher risks to investors, indicia of fraud, broker-dealer status concerns, or other serious wrong doing.

**Payments for Distribution in Guise [\[7\]](#)** – Like the Presence Exams, this area of focus, which involves a review of the variety of payments made by advisers and funds to distributors

and intermediaries, the adequacy of disclosure made to fund boards about these payments, and board oversight of them, will be a continuation from the NEP's 2013 Priorities. The staff's focus will be on "whether such payments are, in fact, payments for distribution and preferential treatment."

Fixed Income Investment Companies – The staff will monitor the risks associated with a changing interest rate environment and the impact this may have on bond funds and their related risk disclosure.

### **C. Policy Topics**

The three policy topics for 2014 involve the continuation of reviews started by OCIE in 2013:

Money Market Funds – The staff will continue to target some exams at money market funds with a focus on how they manage stress events. They will also work with the Division of Investment Management "to examine particular money market funds that exhibit outlier behavior in some respect."

Alternative Investment Companies – OCIE plans to review funds offering alternative investment strategies with a particular focus on leverage, liquidity, valuation, board oversight, compliance personnel, back office support, and the manner in which such funds are marketed to investors, which will include looking at suitability issues.

Securities Lending Arrangements – The focus of these continuing reviews will be on whether the firms are complying with exemptive orders and conducting their securities lending activity in a way that is consistent with relevant no-action letters.

### **III. Program Specific Initiatives: Transfer Agents [8]**

With respect to the approximately 450 transfer agents subject to the SEC's inspection authority (which includes SEC-registered transfer agents and bank-registered transfer agents), the SEC plans to focus its inspections on:

Core Activities – OCIE plans to review transfer agents' compliance and controls relating to their three core activities – i.e., the timely turnaround of items and transfers; accurate recordkeeping and record retention; and safeguarding funds and securities.

Direct Registration System – The staff plans to review the policies and procedures around order taking, recordkeeping, and clearing relationships for those transfer agents that are registered Fast Automated Transfer Program agents with DTC who may offer security holders an option to maintain their ownership on the books of the issuer.

Business Continuity and Disaster Recovery Plans – The staff will review whether transfer agents' business continuity and disaster recovery plans are adequate based on the size and scope of their business.

Additional Areas of Focus – Additional areas of focus in this program-specific area will be: (1) transfer agents that service microcap securities and private offerings; (2) the policies and procedures adopted by transfer agents for handling and transferring certificates damaged by Hurricane Sandy and for Letters of Indemnity received from the DTC; and (3) transfer agents "that provide 'third party' administration (services similar to transfer agent recordkeeping functions but performed for parties other than the issuer of a Section 12 security, such as retirement plans.)" With respect to (3), among other things, the staff

plans to evaluate whether entities providing such administration “are appropriately registered or exempt from broker-dealer registration.”

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#### **endnotes**

[1] See Examination Priorities for 2014, OCIE (Jan. 9, 2014), which is available at: <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf> (the “Priorities”). The Priorities are expected to be discussed at the SEC’s Compliance Outreach Program on January 30th. The Compliance Outreach Program is sponsored by OCIE and will be broadcast live via a webcast from the SEC’s website from 8:30 a.m. to 5:30 p.m. [Eastern]. The agenda for the program is available at: <https://www.sec.gov/info/cco/ccons2014agenda.pdf>.

[2] This memo omits the areas of focus for broker-dealers and market oversight because the issues listed in those sections do not appear to impact our mutual fund and investment adviser members.

[3] In particular, the NEP plans to continue to meet with senior managers and boards of registrants to discuss how they identify and mitigate conflicts of interest and risks. This will also include assessing the “tone at the top” of registrants and initiating a dialogue with industry on key risks and regulatory requirements.

[4] The NEP’s review of technology will include a review of the governance and supervision of systems, operational capability, market access, information security, and preparedness to respond to sudden malfunctions and system outages such as those that occurred after Hurricane Sandy in 2012.

[5] A focus of these reviews will be whether customers of a dual registrant are placed in accounts that increase revenues to the firm without providing a corresponding benefit to the customer.

[6] The new provisions discussed in this section are Rule 506(c) relating to accredited investors, the SEC’s new municipal advisor rule, and, in the event rules are adopted relating to security-based swaps dealers, those rules as well.

[7] Interestingly, there is not a corresponding target area of distribution in guise in the Priorities for broker-dealers.

[8] Unlike other program-specific areas listed in the Priorities, the priorities for transfer agents are not discussed under the sub-categories of core risks, new and emerging issues and initiatives, and policy topics.