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SEC Examination Priorities for 2020 Include Both Emerging and Existing Concerns for Registered Investment Advisers and Broker-Dealers

On January 7, 2020, the Securities and Exchange Commission (“SEC”) issued its 2020 Examination Priorities, a yearly publication highlighting new and existing areas of focus for the Office of Compliance Inspections and Examinations (“OCIE”) Staff.¹ This Client Alert discusses our key takeaways describing OCIE’s newly stated priorities and continued concerns about which registered investment advisers (“RIAs”) and broker-dealers (“BDs”) should remain aware.²

KEY TAKEAWAYS

In its 2020 Examination Priorities, the SEC emphasized the additional resources necessary to supervise an increasing number of RIAs and BDs. The SEC is the primary regulatory body supervising RIAs—a group that has risen from 11,500 to 13,475 in the last five years, with assets under management rising from approximately \$62 trillion to \$84 trillion over that same time. With additional resources dedicated to supervising RIAs, the SEC continues to collaborate with and rely upon the Financial Industry Regulatory Authority (FINRA) to perform many of the examination, enforcement, and surveillance functions related to BDs.

Key takeaways impacting both RIAs and BDs include:

- **Risk-Based Examination Approach** — For both RIAs and BDs, OCIE considers “dozens” of potential risk factors as criteria for determining how and what to scrutinize in order to focus on “key aspects” of oversight, including the “adequacy of disclosures concerning services, fees and expenses; firms’ management and handling of conflicts of interest for RIAs; and sales practice, trading and execution quality issues for [BDs].”



- **Focus on Retail Investors; Standards of Care** — As in years past, the 2020 Examination Priorities prioritize the protection of retail investors, particularly seniors and those saving for retirement. A new and specific concern is the implementation of Regulation Best Interest (“Reg BI”) and Form CRS, which, in addition to its significant impact on BDs (discussed in further detail in the BD section below), have a direct impact on the retail investor experience with RIAs.
- **Information Security and Cyber Security** — Cyber-attacks and other information security threats to firms remain a priority for the SEC, which will “work[] with firms to identify and address information security risks.” In addition to assessing protection of client information, the SEC noted that it expects to continue to examine for compliance with Regulations S-P and S-ID.
- **FinTech and Digital Assets** — OCIE noted that it intends to continue to monitor FinTech developments and the use of “alternative data” by registered firms. Pointing to its rapid growth and potential risks, the SEC detailed how its examinations will focus on digital assets and protecting retail investors by assessing “(1) investment suitability, (2) portfolio management and trading practices, (3) safety of client funds and assets, (4) pricing and valuation, (5) effectiveness of compliance programs and controls, and (6) supervision of employee outside business activities.”

REGISTERED INVESTMENT ADVISERS

With the growth and increased complexity of the RIA segment and in connection with the general focuses discussed above, the SEC identified other priorities including:

- **Compliance Program Quality and Implementation** — OCIE will continue to conduct its review of the compliance programs of RIAs, including assessing the effectiveness and successful implementation of policies and procedures within those programs. In particular, OCIE will focus on reviewing the accuracy and adequacy of disclosures provided by RIAs that are offering their clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing which incorporate environmental, social and governance (“ESG”) criteria. For any RIA that is dually registered as a BD, its compliance program should also ensure its compliance with both fiduciary duty/standard of care under the RIA context and Reg BI under the BD context (as further described below).
- **New and Not Recently Examined RIAs** — Similar to past years, OCIE will continue to conduct risk-based examinations of RIAs, including new and existing RIAs that have yet to be examined. OCIE will also prioritize the examination of RIAs that previously were examined by OCIE but have not been subject to examination in recent years, with a focus on reviewing the evolution of RIA compliance programs to sufficiently account for any material growth, development, or change in its business model.
- **Private Funds with a Focus on Retail Investors** — In 2019, new rules and interpretations were finalized to enhance the quality and transparency of the RIA relationship with retail investors. In light of those developments, OCIE will focus on RIAs to private funds that have a greater impact on retail investors, such as firms that provide management to separately managed accounts side-by-side with private funds. Those RIAs should make sure that they make adequate disclosures on an ongoing basis and that they are making investment decisions in a manner consistent with the applicable standard of care.

BROKER-DEALERS

For BDs, the 2020 Examination Priorities state that the SEC will evaluate the implementation of Reg BI and Form CRS, arguably the “most significant” rulemaking to take effect this year. In addition, the SEC identified several other priorities concerning risk management, best execution, and anti-money laundering (“AML”) programs.



- **Reg BI and Form CRS: June 30, 2020 Compliance Date Remains in Effect** — As discussed in prior Client Alerts,³ Reg BI requires broker-dealers and their associated persons to “act in the best interest” of retail customers when recommending securities transactions or strategies to retail customers. This year the SEC will focus on assisting BDs with implementation of the new rules prior to the June 30, 2020 compliance date, including encouraging firms to “actively engage” and pose questions to the SEC-created inter-Divisional Standards of Conduct Implementation Committee. Following the June 30 compliance date, OCIE indicated it would begin to “assess implementation of [Reg BI] requirements” as well as the “content and delivery of Form CRS.”
- **Trading and Risk Management: Automated Trading Algorithm Controls and Best Execution** — The SEC affirmed its continuing interest in firms’ use of algorithmic trading, which will include further scrutiny of “how broker-dealers supervise algorithmic trading activities.” In addition, the SEC remains focused on best execution practices, including the examination of trading or other activities in “odd lots” (orders under 100 shares) due to the likelihood of retail investor involvement.
- **Continued focus on the Net Capital Rule and the Customer Protection Rule** — Consistent with the overall emphasis on the protection of retail investors, OCIE will continue its efforts to scrutinize whether BDs are properly safeguarding customer assets by examining for compliance with two key rules: the Net Capital Rule and Customer Protection Rule, both meant to ensure the safety and soundness of firms, and customer assets and information.
- **AML Program Compliance** — The 2020 Examination Priorities highlighted ongoing efforts regarding compliance with AML programs under the Bank Secrecy Act, in order to ensure that BDs remain able to identify, investigate, and report suspicious activity and illegal money-laundering activities, as well as OCIE’s continuing effort to collaborate with and rely upon their regulatory partners at FINRA to further scrutinize BD AML compliance.

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¹ 2020 Examination Priorities, SEC Office of Compliance Inspections and Examinations, available at <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf>.

² OCIE completed 3,089 examinations in Fiscal Year 2019, including 2,180 RIA and 350 BD examinations. OCIE also issued over 2,000 deficiency letters in FY 2019, with more than 150 enforcement referrals from FY 2019 examinations made to date.



³ King & Spalding Client Alert, *The SEC Approves Regulation Best Interest: The Broker-Dealer Standard of Conduct*, (June 27, 2019), <https://www.kslaw.com/news-and-insights/the-sec-approves-regulation-best-interest-the-broker-dealer-standard-of-conduct>; King & Spalding Client Alert, *Regulation BI: Updates and Developments*, (Oct. 31, 2019), <https://www.kslaw.com/news-and-insights/regulation-best-interest-updates-and-developments>.