



Insights: Alerts

SEC Division of Examinations Releases 2021 Examination Priorities

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Each year, the SEC's Division of Examinations (f.k.a. OCIE) (the "**Division**") releases its priorities for the upcoming year, providing SEC registrants with a helpful tool to assist in managing, reviewing, and updating their compliance programs. The [2021 Examination Priorities](#) (the "**2021 Priorities**"), which were released last month, indicate a greater focus on conflicts of interest for broker-dealers ("**BDs**") and registered investment advisers ("**RIAs**"); a special emphasis on disclosure of climate and environmental, social, and governance ("**ESG**")-related risks; and concern about risks related to financial technology ("**FinTech**") investments, including digital assets.¹

The 2021 Priorities offer another indication of the Division's sharpening focus on the investment management industry. Despite the significant increase in the number of RIAs and disruptions due to the pandemic, the 2021 Priorities report that the Division still managed to examine 15% of RIAs in FY 2020.² Notably, the Division has already referred more than 130 FY 2020 examinees to the SEC's Division of Enforcement (the "**Enforcement Division**") and has stated that it expects to continue to make referrals from last year's exams.³ In addition, as a 42-page March release, the 2021 Examination Priorities are notably longer than prior years' reports, as the Division continues to add new areas of emphasis for its examination and enforcement programs.

The 2021 Priorities also shed light on shifting priorities in light of the transition from the Trump administration to the Biden administration. Already, we have observed a notable increase in Division hiring under the new administration in DC and several SEC regional offices. While the cynic might argue that these new hires, the longer list of priorities, and the expectation of more enforcement cases represent a natural evolution of government bureaucracy that only grows bigger, we believe that these changes are more appropriately viewed as responses to the dramatic increase in the number of RIAs and total assets under management ("**AUM**") (e.g., from 12,000 to 13,900 RIAs and \$67 million to \$97 million in AUM in the last 5 years alone).⁴ These increases are positive for the industry, but firms should recognize that the importance (and risks) of wealth management to the financial health and well-being of the nation increases commensurate with increases in AUM. As a result, the Division, as the sole regulatory examination program for federally registered RIAs,⁵ has an incentive and responsibility to enhance and expand its oversight and examination capabilities, and to show results through its enforcement program. This makes reviewing and reflecting on the 2021 Priorities in light of your firm's business more important than ever to ensure that policies, procedures, and practices at your firm reflect regulatory expectations and avoid pitfalls and issues called out in the report.

Our summary of key focus points from the 2021 Priorities is below, beginning with a Table of Contents so that you can more easily reference topics of importance to you and your firm.

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Protecting Retail Senior and Retirement Investors through Reg BI and Fiduciary Duties

Examinations in 2021 will emphasize the protection of retail investors, with a particular focus on seniors and individuals saving for retirement. The Division will prioritize examinations of RIAs, BDs, and dually-registered or affiliated firms, focusing on whether registrants are fulfilling their duties of care under their respective standards of conduct and which investments and services are being marketed to retail investors.

Standards of Conduct

- **Regulation Best Interest.** BD exams will continue to assess compliance with Regulation Best Interest (“Reg BI”),⁶ moving beyond the review of implementation and processes that has been the Division's emphasis to date. In 2021 and going forward, the 2021 Priorities indicate the Division will not only review implementation and processes, but will also scrutinize:
 - Whether registered representatives (“RRs”) had a reasonable basis to believe the recommendations made were in the customers' best interests;
 - Alterations made to firms' product offerings in order to bring a firms product suite into compliance with Reg BI; and

- Firms' policies and procedures for addressing the additional elements of Reg BI, such as:
 - recommendations of rollovers,
 - complex product recommendations,
 - assessment of costs and reasonably available product alternatives,
 - how sales-based fees impact recommendations, and
 - how firms identify and address conflicts of interest.⁷

The Division reiterated its concern that too often procedures simply state the legal standard without providing any meaningful guidance as to how standards should be implemented,⁸ and the Division plans to use enhanced transaction testing to examine whether BDs have effectively implemented their written policies and procedures.⁹

- **RIA Fiduciary Duty.** The Division will continue to examine whether RIAs are fulfilling their duties of care and loyalty to clients in accordance with the SEC's [Interpretation Regarding Standard of Conduct for RIAs](#).¹⁰ In particular, examiners will scrutinize:
 - Whether RIAs provide advice, and whether RIAs' account or program types continue to be, in their clients' best interests, based on their clients' objectives; and
 - Whether RIAs have eliminated or made full and fair disclosure of all conflicts of interests that could incentivize RIAs to render advice that is not disinterested in such a manner so that clients can provide informed consent to the conflicts before accepting the RIA's advice.

Examinations will continue to consider risks associated with RIAs' fees and expenses (including whether fees assessed align with fees described in client agreements), recommendations of complex products, best execution, and disclosures of compensation arrangements that could result in a conflict of interest.¹¹

- **Form CRS.** The Division will prioritize Form CRS compliance.¹² In particular, registrants should focus on:
 - improving the readability of their Form CRS,
 - ensuring the Form CRS is timely filed, and
 - ensuring that full and adequate responses are provided to the disciplinary disclosure requirements.¹³

****KTS Practice Tip:** The SEC provided helpful input on issues regarding compliance with both Reg BI and Form CRS at a roundtable last November. For a summary of key points from the roundtable, please see our blog post, [Key Take-Aways from SEC Roundtable on Regulation Best Interest and Form CRS](#).

Fraud, Sales Practices, and Conflicts

Against the backdrop of the relevant standards of conduct, 2021 examinations will also focus on the appropriateness of recommendations for retail customers, with a particular emphasis on: (1) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; (2) teachers; (3) military personnel; and (4) individuals saving for retirement. In addition, examinations are expected to concentrate on:

- Recommendations regarding account type, conversions, and rollovers, and sales practices used by firms for various product types;

****KTS Practice Tips:**

- Large firms, or firms with a geographically diverse client base, may consider using census data to target surveillance programs aimed at supervising advice provided to seniors or military personnel. (FINRA staff has previously described this as a basis for targeting their programs.)
- It is important to ensure that supervision of accounts is not limited to systems that reference the account owner's date of birth, because many individuals maintain a substantial portion of their investment assets in trusts, which do not have a date of birth.
- While not stated in the 2021 Priorities, the Division could refer its findings to the Department of Labor ("DOL") (the two agencies worked closely on the DOL's most recent iteration of its fiduciary rule). It is important that registrants are aware of, and complying with, IRS and DOL rules governing services provided to 401K plans and individual retirement accounts.
- Whether BDs meet legal and compliance obligations when providing retail customers access to complex products and strategies (e.g., options trading, unlisted REITs and BDCs, 1031 Exchanges);
- How firms are complying with recent changes to the accredited investor definition when recommending and selling certain private placement offerings; and

****KTS Practice Tip:** The accredited investor definition has been expanded to cover additional categories of investors that do not turn on investor wealth. For more information regarding these new categories, please see our blog post, [SEC Adopts Amendments to Accredited Investor Definition](#).

- Firms' disclosures regarding conflicts of interest, including those related to fees and expenses (e.g., revenue sharing arrangements with issuers, service providers, and others, and direct or indirect compensation to personnel for executing client transactions). In addition, the Division will prioritize

examinations of RIAs operating and utilizing turnkey asset management platforms, with a focus on assessing whether such firms are adequately disclosing fee and revenue sharing arrangements.¹⁴

****KTS Practice Tip:** The SEC's focus on issues related to fees and conflicts disclosures is not new. The Enforcement Division has shown a particular focus on fee and conflicts-related issues, doling out hefty fines to registrants who inaccurately calculate fees and/or inadequately disclose fee-related and other conflicts. For examples of enforcement actions involving fees and conflicts disclosures, please see our blog post, [PE Fund Adviser Sanctioned by SEC for Fee Calculation Errors – Ordered to Disgorge Fees and Pay Fine, Totaling Nearly \\$1.2 Million](#), and legal alert, [Recent Enforcement Action Provides Helpful Guidance in Several Areas for Advisers to Private Funds](#).

Retail-Targeted Investments

Examinations will scrutinize products that may pose elevated risks when marketed or sold to retail investors, including mutual funds and exchange-traded funds (“**ETFs**”) (including with respect to leveraged/inverse ETFs), municipal securities and other fixed income securities, and microcap securities (*i.e.*, securities of companies with a market capitalization under \$250 million).

Information Security and Operational Resiliency

As remote operations have increased in response to the COVID-19 pandemic, so too has the Division's focus on registrants' information security. The Division is “acutely focused” on firms' ability to identify and address information security risks, especially in the remote work environment. 2021 examinations will focus on whether firms have appropriate measures in place to safeguard customer accounts, oversee vendors and service providers, address malicious email activities, respond to incidents, and manage operational risk as a result of a work-from-home environment (*e.g.*, risks surrounding mobile access to investor account information).¹⁵

Additionally, in light of substantial disruptions to normal business operations in the past year, the Division will review registrants' business continuity and disaster recovery plans, with an enhanced focus on whether such plans account for risks associated with climate change.¹⁶

****KTS Practice Tip:** The Division is well aware of cyber-crime and the potential problems that a successful cyber-penetration of a money management firm could create. These risks are particularly acute when a firm has custody over client assets. We recommend that firms employ capable IT professionals and/or engage appropriate third party firms to ensure their electronic systems maintain the latest protections from malware attacks. In addition, we recommend that firms provide regular employee training on cyberattack risks and prevention.

FinTech and Innovation, Including Digital Assets

In the 2021 Priorities, the Division recognized that innovations in FinTech, capital formation, and the digital asset market are quickly advancing and evolving, and that these advancements have dramatically changed the way firms interact with their customers and clients (*e.g.*, the growth of robo-advisors (*i.e.*, automated investment tools and platforms)).¹⁷ In response to these advancements, examinations will focus on:

- Whether firms are operating consistently with their representations and are handling customer orders in accordance with customer instructions;
- Compliance around recommendations made in mobile applications;
- Whether firms are implementing appropriate controls and compliance surrounding data collected from alternative data (*i.e.*, non-traditional sources);
- To the extent that firms rely on technology to facilitate compliance with regulatory requirements (“**RegTech**”), whether such RegTech is properly configured, implemented, and integrated in firms' compliance programs; and
- To the extent market participants are engaged with digital assets:
 - Whether investments in such digital assets are in the best interests of investors;
 - Firms' portfolio management and trading practices with respect to digital assets;
 - Safety of client funds and assets;
 - Pricing and valuation of digital assets;
 - Effectiveness of compliance programs and controls related to digital assets; and
 - Supervision of outside business activities.¹⁸

****KTS Practice Tip:** The Division recently released a risk alert that summarized common deficiencies and best practices related to RIAs, BDs, and transfer agents engaged in activities related to digital assets. For a summary of this risk alert, please be on the lookout our upcoming blog post, *SEC Increases Scrutiny of Digital Assets*.

Anti-Money Laundering Programs

The Division will continue to examine BDs' and registered investment companies' compliance with anti-money laundering (“AML”) obligations, with a goal of evaluating whether policies and procedures are reasonably designed to identify suspicious activity and illegal money-laundering activities.¹⁹

****KTS Practice Tip:** We recommend that RIAs monitor developments related to AML regulations, as some in the industry anticipate that FinCEN will revive a proposed AML rule for RIAs that, though proposed shortly before President Obama left office, was never finalized under the Trump administration.²⁰ The Division is already focused on AML compliance with respect to BDs and mutual funds, as indicated by the Division's recent [risk alert](#), released on March 29, 2021, which shared AML-related observations from examinations of BDs and

mutual funds and reminded firms to review and enhance their AML programs, particularly with respect to monitoring and reporting suspicious activity to law enforcement and financial regulators.²¹

The London Inter-Bank Offered Rate (“LIBOR”) Transition

Examinations will assess firms' understanding of any exposure to LIBOR and preparations for the discontinuation of LIBOR and transition to an alternative reference rate.

Additional Focus Areas Relating to RIAs and Investment Companies

RIA Compliance Programs

Examinations will focus on whether RIA compliance programs, policies, and procedures are reasonably designed, implemented, tested and continuously enhanced. Specifically, the Division will prioritize examinations of:

- RIAs that have never been examined (including both new RIAs and RIAs that have been registered for several years);
- RIAs that have not been examined for several years, with a particular focus on whether such RIAs' compliance programs have been appropriately adapted in light of any substantial growth or change in business models (e.g., an RIA that previously advised only separately managed accounts beginning to also advise private funds);

****KTS PracticeTip:** As noted above, despite the pandemic and increase in RIAs, the Division examined 15% of RIAs in 2020. In light of this increased Division scrutiny, we caution RIAs against assuming that they will be able to go an extended amount of time without being subject to a Division exam, especially given the Division's stated priority of examining RIAs who have never experienced, or have not recently experienced, an exam.

- Recommendations, disclosures, advertisements, and supervision of investment products and strategies labeled as “sustainable,” “socially responsible,” “impact,” or “ESG conscious,” including both products that are widely available to investors (e.g., open-end funds and ETFs) and those that are limited to accredited investors (e.g., qualified opportunity funds);²²

****KTS Practice Tip:** The SEC has established a number of resources for firms and investors regarding ESG-related products, including a dedicated [webpage](#). For a summary of these resources, please be on the lookout for our upcoming blog post, *SEC Expands Focus on ESG-Related Products*.

- RIAs that are dually registered as, or are affiliated with, BDs, or have supervised persons who are RRs of unaffiliated broker-dealers (i.e., “independent BDs”), with a focus on compliance programs addressing the risks associated with these business models (e.g., conflicts of interest related to compensation arrangements and outside business activities, best execution, and prohibited transactions).

****KTS Practice Tip:** As we discussed in a recent legal alert, [SEC Sharpens Focus on RIA Compliance Programs, Part 2](#), the ability to evidence a well-designed, fully implemented, and tested compliance program is the best defense to an inquiry from the Enforcement Division. RIAs should ensure that their compliance programs are tailored to the specific needs of their business (e.g., avoid using “off-the-shelf” policies and procedures); that compliance personnel have the resources needed to properly implement, test, and adapt compliance programs; and that chief compliance officers are knowledgeable, empowered, and not subject to frequent turnover).

Registered Funds, Including Mutual Funds and ETFs

The Division will continue to examine registered funds' compliance programs and governance practices, focusing on:

- Mutual fund filings and reports to funds' boards, with a particular focus on:
 - Compliance with regulatory requirements; and
 - Valuation issues and the resulting impact on fund performance, liquidity, and risk-related disclosures, especially regarding investments in market sectors that experienced, or are currently experiencing, stress due to the pandemic (e.g., energy, real estate, or products such as bank loans and high yield corporate and municipal bonds);
- Registered funds' (and their advisers') disclosures and practices related to securities lending;
- Mutual funds and ETFs that have not been previously examined or have not been examined in a number of years, with a focus on funds' compliance programs, financial conditions (especially where such funds have implemented advisory fee waivers), and compliance with exemptive relief;
- Liquidity risk management programs (“LRMPs”), with a focus on: (1) whether the LRMPs are reasonably designed to assess and manage the funds' liquidity risk, and (2) registered funds' implementation of required liquidity classifications; and
- Money market funds' compliance with stress-testing requirements, website disclosures, and board oversight.²³

RIAs to Private Funds

The Division will continue to focus on advisers to private funds, assessing compliance risks with a focus on liquidity, disclosures of investment risks, and conflicts of interest.²⁴ Specifically, the Division will review for:

- Preferential treatment of certain investors in private funds that have experienced liquidity issues, such as imposing gates or suspensions on withdrawals;

- Portfolio valuations and the resulting impact on management fees;
- Adequacy of disclosures and compliance with regulatory requirements of cross trades, principal investments, or distressed sales;
- Conflicts regarding liquidity, such as adviser-led restructurings (e.g., stapled secondary transactions where new investors purchase interests of existing investors while agreeing to invest in one of the adviser's new funds);
- With respect to advisers of private funds with a higher concentration of structured products (e.g., collateralized loan obligations and mortgage backed securities), whether such private funds have a higher risk of holding non-performing loans and having loans with a higher default risk than that disclosed to investors; and
- Issues related to advisers of private funds whose portfolio companies were materially impacted by recent economic conditions (e.g., real estate-related investments).²⁵

*****KTS Practice Tip:*** As noted in our legal alert, [OCIE's Focus on Private Fund Advisers Continues in Recent Risk Alert](#), the Division has been especially concerned regarding fee-related issues and conflicts disclosures of private fund advisers in the last year.

Additional Focus Areas Involving Broker-Dealers and Municipal Securities Advisors

Broker Dealers' Financial Responsibility and Trading Practices

With respect to BDs, examinations will focus on, among other things:

- Compliance with the Customer Protection Rule and the Net Capital Rule (including adequacy of internal processes, procedures, and controls, and compliance with requirements for borrowing securities from customers);
- In light of the pandemic, assessments of BD funding and liquidity risk management practices to ensure firms have the liquidity to manage stress events; and
- Compliance with best execution obligations and the recently amended Rule 606 order routing disclosure rules.²⁶

Municipal Advisors

With respect to municipal advisors, the Division will examine, among other things, how municipal advisors adjusted their practices in response to the pandemic, and whether municipal advisors have continued to meet their fiduciary obligations to municipal entity clients (e.g., disclosing and managing conflicts of interest; documenting the scope of client engagements).²⁷

As in prior years, the 2021 Examination Priorities do not contain an exhaustive list of issues the Division will prioritize in routine examinations and guidance in the upcoming year.²⁸ However, we encourage RIAs, broker-dealers, registered investment companies, and other market participants to review the 2021 Examination Priorities and to consider whether their compliance programs adequately address, at a minimum, the issues identified therein.

As evidenced by the 2021 Priorities and other recent Division guidance, the Division is increasing its scrutiny of registrants in the investment management industry. Given this increased scrutiny and the Division's discretionary authority to refer examinees to the Enforcement Division, we encourage registrants to engage regulatory counsel to prepare for examinations and respond to any follow-on requests. Further, we encourage registrants to consider assessing their current readiness for an examination by engaging counsel to conduct a mock exam of the registrant's compliance program.

If you have any questions about the 2021 Examination Priorities, or about the regulation of RIAs, broker-dealers, and registered investment companies generally, please feel free to contact us.

By the **Investment Management and Broker-Dealer Team** at ***Kilpatrick Townsend & Stockton***

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Footnotes

¹ Press Release, SEC, SEC Division of Examinations Announces 2021 Examination Priorities (Mar. 3, 2021), <https://www.sec.gov/news/press-release/2021-39> (hereinafter, "Press Release").

² SEC, Division of Examinations, 2021 Examinations Priorities, at page 7 (Mar. 3, 2021), <https://www.sec.gov/files/2021-exam-priorities.pdf> (hereinafter, "2021 Priorities").

³ *Id.* at 9. The Division stated that these enforcement matters resulted from mutual fund share class selection, failing to disclose conflicts of interest, fraudulently inflating net asset values and performance results of managed funds, and violating the Custody Rule; and BDs for net capital deficiencies, violating Regulation SHO, failing to report suspicious activity reports, and failing to supervise registered representatives who made

unsuitable recommendations to retail customers. *Id.*

⁴ *Id.* at 6.

⁵ FINRA and state securities administrators do not have examination authority over federally-registered RIAs.

⁶ 2021 Priorities, *supra* note 2, at 19.

⁷ *Id.* at 20. The Division also pointed registrants to the Division's [Statement on Recent and Upcoming Regulation Best Interest Examinations](#), released in December 2020, which identified aspects of Regulation Best Interest on which the Division might focus in upcoming examinations. *Id.* at 5.

⁸ *Id.* at 24.

⁹ *Id.* at 20.

¹⁰ *Id.* at 20.

¹¹ *Id.* at 20.

¹² *Id.* at 21.

¹³ *Id.* at 4.

¹⁴ *Id.* at 22.

¹⁵ *Id.* at 24.

¹⁶ *Id.* at 25.

¹⁷ *Id.*

¹⁸ *Id.* at 26.

¹⁹ *Id.* at 27.

²⁰ See Neil Weinberg, Hedge Funds Risk Biden-Era End to Money-Laundering Loophole, Bloomberg (Feb. 5, 2021), <https://www.bloomberg.com/news/articles/2021-02-05/hedge-funds-risk-biden-era-closing-of-money-laundering-loophole?sf242843169=1>.

²¹ SEC, Division of Examinations, Compliance Issues Related to Suspicious Activity Monitoring and Reporting at Broker-Dealers (Mar. 29, 2021), <https://www.sec.gov/files/aml-risk-alert.pdf>.

²² 2021 Priorities, *supra* note 2, at 28.

²³ *Id.* at 29-30.

²⁴ *Id.* at 30.

²⁵ *Id.*

²⁶ *Id.* at 31.

²⁷ *Id.* at 33.

²⁸ Press Release, *supra* note 1.

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