SEC 2021 Exam Priorities Show Little Change from Prior Years, But Will Focus on Impact of Pandemic on Regulated Entities

The SEC's Office of Compliance Inspections and Examinations (OCIE)—now renamed the Division of Examinations (the "Division" or "Examinations") recently published its annual list of examination priorities for 2021. While the 40-page document purports to address the Division's "priorities," the sweeping, all-encompassing approach does not provide market participants with any clear guidance or true areas of focus. Instead, the "priorities" list includes all of the areas within the Division's broad jurisdiction and covers topics that are typical for each type of registrant. That being said, there are a few insights into the Division's thinking for the year ahead, and helpful reminders of issues that perennially appear on this list.

Important to note is that despite the pandemic, the number of examinations in FY2020 only decreased by just over 4%, and the resulting numbers of deficiency letters and referrals to Enforcement similarly did not materially decrease. The Division completed 2,952 examinations in FY2020 and issued more than 2,000 deficiency letters and made more than 130 Enforcement referrals. The number of referrals is slightly decreased from the prior year (more than 150), but the number still underscores that the SEC has continued its enforcement efforts throughout the pandemic and continues to see a high number of Enforcement referrals from the examinations. We are currently defending a number of Enforcement actions that arose from examinations and continue to reiterate our advice that clients engage assistance *during* the Exam process to try to prevent an Enforcement referral in the first instance.

Below is an overview of some of the more notable areas in the priorities list. A clear theme is that Examinations is thinking critically about how the pandemic has impacted both the operational and investment functions of registered firms and will be scrutinizing how successfully firms executed during this past year and going forward as some changes, such as remote work, become more permanent:

Operational Resiliency

"Operational Resiliency" is a new addition to the focus on Information Security and emphasizes firms' abilities to protect investor information given increasingly-remote business practices. The Division is also increasingly focused on the compliance and operational challenges—particularly with respect to supervision and conflicts of interest—that arise from firm staff working remotely. The Division noted that the pandemic may have put increased pressure on firms and their personnel, which may lead to increased instances of fraudulent conduct, particularly with respect to conflicts of interest.

Fintech

Examinations of market participants engaged with digital assets will continue to assess the following: (1) whether investments are in the best interests of investors, (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 representatives' outside business activities. With respect to point (3), safety of client funds and assets, complicated issues may arise in accordance with the custody rule. The SEC previously issued a statement requesting comment on this topic in December 2020 (December 2020 Press Release), and the Division also recently issued a Risk Alert related to Digital Asset Securities (Risk Alert Digital Assets), specifically noting a focus on the custody rule and employee access to private keys.

LIBOR

As the financial services industry transitions away from the London Inter-Bank Offered Rate (LIBOR), the Division continues to review firms' preparedness and related transition activities. The Division will assess firms' understanding of any exposure to LIBOR and their preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate. The Division will relatedly focus on ensuring that compliance programs and firms' controls environment adapt and provide strong protections even as these and other changes take place.

Registered Investment Advisers

With respect to the pressures private funds may face due to the pandemic, the Division indicated a focus on liquidity and disclosures of conflicts of interest, and specifically noted a focus on examining advisers to private funds where there may have been material impacts on portfolio companies owned by the private fund (*e.g.*, real estate related investments) due to recent economic conditions.

Specifically, the Division highlighted the following areas for review of private funds: (1) preferential treatment of certain investors by advisers to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; (2) portfolio valuations and the resulting impact on management fees; (3) adequacy of disclosure and compliance with any regulatory requirements of cross trades, principal investments, or distressed sales; and (4) conflicts around liquidity, such as adviser-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund.

Given the overall focus on the stressors of the pandemic and resulting pressure on market participants, we expect that the Division will be looking specifically at any decisions made that resulted in improved performance, liquidity, and/or fees and will critically review justifications and exception reports to ensure that adequate support exists.

As always, the Division will be assessing RIA compliance programs in the core areas of (1) the appropriateness of account selection, (2) portfolio management practices, (3) custody and safekeeping of client assets, (4) best execution, (5) fees and expenses, (6) business continuity plans, and (7) valuation of client assets for consistency and appropriateness of methodology.

Regulation Best Interest

Not surprisingly, given the attention to Regulation Best Interest, including two Risk Alerts issued in April 2020 (Risk Alert Regulation Best Interest and Risk Alert Form CRS) the Division has made clear that compliance with the regulation will be a focus. The Division reiterated its concern coming out of the October Roundtable (Best Interest Roundtable) that some firms appear to have updated their written supervisory procedures to simply restate the standards, but not provide any meaningful guidance as to how the standards should be implemented.

ESG

The Division noted that due to investor demand, RIAs are increasingly offering investment strategies that focus on sustainability, including strategies including products and services referred to by a variety of terms, such as sustainable, socially responsible, impact, and ESG conscious. The Division explained that it will review the consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these strategies to determine whether the firms' processes and practices match their disclosures, as well as review fund advertising for false or misleading statements. Of course, this focus is not a surprise given that three weeks ago, the SEC announced the creation of an Enforcement task force designed specifically to develop initiatives to proactively identify ESG-related misconduct. (March 2021 Press Release).

Retail Investors, AML, Broker-Dealers, FINRA

As expected, the Division also included similar guidance as last year with respect to Retail Investors, Anti-Money Laundering, Broker-Dealers, and FINRA, but there is not much to flag with respect to the current guidance, which generally covers the same core areas and issues as it has in the past.

Please contact us should you have additional questions or wish to discuss in more detail.

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If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:

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