



Investment Management Update

March 2021

SEC Announces 2021 Exam Priorities

The Securities and Exchange Commission's (SEC) Division of Examinations (Division) recently announced its 2021 examination priorities, which will continue to prioritize the examination of certain practices, products, and services that the SEC believes present heightened risks to investors or the integrity of the U.S. capital markets. Although the Division's examination schedule remains flexible to address any emerging or imminent risks to investors, its priorities center around:

- Retail investors, including seniors and those saving for retirement, through Regulation Best Interest (Reg. BI) and fiduciary duty compliance
- Information security and operational resiliency
- Financial technology (fintech) and innovation, including digital assets
- Anti-money laundering (AML) programs
- London Inter-Bank Offered Rate (LIBOR) transition, and
- Other focus areas relating to investment advisers and investment companies.

Retail Investors, Including Seniors and Those Saving for Retirement, Through Reg. BI and Fiduciary Duty Compliance

The Division will maintain its focus on protecting retail investors by expanding the scope of examinations to focus on assessing whether broker-dealers are making recommendations that they have a reasonable basis to believe are in customers' best interests and evaluating broker-dealer processes for compliance and alterations made to product offerings.

The SEC will also conduct enhanced transaction testing as part of these examinations, and will evaluate whether a firm's policies and procedures are designed to address:

- Additional elements of Reg. BI
- Recommendations of rollovers and alternatives considered, complex product recommendations, assessment of costs and reasonably available alternatives.
- How sales-based fees paid to broker-dealers and representatives impact recommendations, and policies and procedures regarding how broker-dealers identify and address conflicts of interest.

The Division will continue to incorporate Reg. BI into its examination program for Registered Investment Advisers (RIAs) by examining RIAs to assess whether, as fiduciaries, they have fulfilled their duty of care and duty of loyalty. This will include assessing, among other things, whether RIAs provide advice, including whether account or program types continue to be, in the best interests of their clients, based on their clients' objectives, and eliminate or make full and fair disclosure of all conflicts of interest which might incline RIAs—consciously or unconsciously—to render advice which is not disinterested such that their clients can provide informed consent to the conflict. The Division will focus on risks associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed, compensation arrangements. Finally, the Division will prioritize examinations of broker-dealers and RIAs to assess compliance with Form CRS.

Fraud, Sales Practices, and Conflicts

The Division noted the importance of the role broker-dealers, investment companies, and RIAs with respect to disclosures to investors required by federal securities laws, including those relating to fees and expenses and conflicts of interest. Based on the importance of these disclosures, the Division's examinations will focus on the appropriateness of recommendations and advice provided to retail investors, 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. Specifically, the Division will:

- concentrate on recommendations regarding account type, conversions, and rollovers, as well as the sales practices used by firms for various product types, such as structured products, exchange-traded products, real estate investment trusts, private placements, annuities, digital assets, municipal and other fixed income securities, and microcap securities.
- examine broker-dealers to assess whether they are meeting their legal and compliance obligations when providing retail customers access to complex strategies, such as options trading and complex products.
- focus on how firms are complying with the recent changes to the definition of "accredited investor" when recommending and selling certain private offerings.
- review firms' disclosures regarding their conflicts of interest, including those related to fees and expenses.

Retail Targeted Investments

The Division also recognizes that certain products pose elevated risks when marketed or sold to retail investors. The Division will prioritize examinations of issues regarding these products given their importance to retail investors. Specifically, the Division will focus on:

- **Mutual Funds and Exchange Traded Funds:** The Division will focus on financial intermediaries' recommendations and disclosures involving ETFs, including adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs. The Division will prioritize the examination of incentives provided to financial services firms and professionals that may influence the selection of higher cost mutual

fund share classes when lower cost classes are available.

- **Municipal Securities and Other Fixed Income Securities:** The Division will examine the activities of broker-dealers, underwriters, and municipal advisors to assess whether these firms are meeting their respective obligations, and to the extent applicable, in relation to municipal issuer disclosure. In addition, the Division will examine broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements, including disclosures relating to mark-ups and mark-downs.
- **Microcap Securities:** The Division will continue to prioritize examinations of broker-dealers and transfer agents for compliance with their obligations in the offer, sale, and distribution of microcap securities.

Focus areas for examinations will include:

- transfer agent handling of microcap distributions and share transfers;
- broker-dealer sales practices and their consistency with Reg. BI;
- broker-dealer compliance with certain regulatory requirements, including the locate requirement of Regulation SHO, penny stock disclosures under Rules 15g-2 through 15g-6 of the Securities Exchange Act of 1934, and the obligation to monitor for and report suspicious activity and other anti-money laundering (AML) obligations.

Information Security and Operational Resiliency

With increased remote operations in response to the pandemic, the Division will review whether firms have taken appropriate measures to:

- safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access;
- oversee vendors and service providers;
- address malicious email activities, such as phishing or account intrusions; respond to incidents, including those related to ransomware attacks; and
- manage operational risk as a result of dispersed employees in a work-from-home environment.

Fintech and Innovation

Recognizing the rapid growth of and related risks presented by the digital asset market, including cryptocurrency, the Division is steady in its efforts to examine SEC-registered market participants engaged in such market. The Division's examinations will assess:

- investment suitability;
- portfolio management and trading practices;
- safety of client funds and assets;
- pricing and valuation;
- effectiveness of compliance programs and controls; and
- supervision of employee's outside business activities.

Additionally, examinations will focus on evaluating whether registrants are operating consistently with their representations, whether firms are handling customer orders in accordance with their instructions, and review compliance around trade recommendations made in mobile applications.

AML Programs

The Division will continue to prioritize examinations of broker-dealers and registered investment companies for compliance with their AML obligations in order to assess, among other things, whether firms have established appropriate customer identification programs and whether they are satisfying their SAR filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs.

London Inter-Bank Offered Rate (LIBOR) Transition

The Division intends to engage with registrants through examinations to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate, in connection with registrants' own financial matters and those of their clients and customers.

Other Focus Areas

RIA Compliance Programs

The Division will continue to prioritize its examination of RIA compliance programs. The Division will conduct risk-based examinations of RIAs that have never been examined, including new RIAs and RIAs registered for several years. For RIAs that have not been examined for several years, the focus will be to evaluate whether their compliance programs have been updated in the event of substantial changes in the business model. Additionally, the Division will particularly focus on products and services marketed as sustainable, socially responsible, impact and ESG conscious, as a result of increased investor demand for such products.

Operational Resiliency

As climate-related events become more frequent and more intense, the Division intends to review and assess whether firms are considering effective practices to help improve market response to large-scale events. The scope of these examinations will include a review of business continuity and disaster recovery plans similar to the work performed post-Hurricane Sandy, with a heightened focus on the improvements to these plans over the intervening years.

Outlook

The 2021 examination priorities reflect the Division's assessment of issues, risks and policy matters stemming from developments in the markets and regulation of those markets. While the 2021 priorities will steer the Division's examination, the list is not exhaustive. The Division can and will look at other areas as well.

If you have any questions regarding the 2021 exam priorities, need assistance in preparing for a regulatory exam, or would like to discuss your firm's compliance and supervisory policies and procedures, please contact one of the authors.

FOR MORE INFORMATION

For more information, please contact:

Andrew J. Davalla

614.469.3353

Andrew.Davalla@ThompsonHine.com

Brian Doyle-Wenger

614.469.3294

Brian.Doyle-Wenger@ThompsonHine.com

Tashia Love

614.469.3284

Latashia.Love@ThompsonHine.com

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