

January 2019 —Legislative Intelligence Update | Oldies but Goodies: SEC Exam Priorities for RIAs Continue Focus on AML, Cybersecurity, Seniors, and Fee Disclosures

Welcome to this edition of the Investments & Wealth Institute *Legislative Intelligence*. This month's update reviews the December 2018 announcement of the Securities and Exchange Commission's (SEC) examination priorities for 2019, with a focus on compliance practices of SEC-registered investment advisers (RIAs) and related priorities of the Financial Industry Regulatory Authority (FINRA) to enhance investor protection for retail clients.

SEC, FINRA Announce Exam Priorities; In a Slight Twist, 'Not Recently-Examined' RIAs Added to 'Never-Befores' on OCIE's 2019 Check List

The Office of Compliance Inspections and Examinations (OCIE), the SEC's examination arm for investment advisers and other market participants, has [released its priority list](#) of what will be top of mind for its examiners in 2019.

The annual priority list, usually released early in January or February, came out on December 20, 2018. In hindsight, the early release was timely because the partial government shutdown of 35 days would have delayed it. While the priority list usually red flags problem areas that surfaced in previous years, compliance professionals eagerly await the list to see what is top of mind for the regulators. After an exam, the vast majority of advisory firms are usually cited for weaknesses in compliance procedures, in ADV filings, or for inaccurate disclosures. Only a small percentage is referred each year to the SEC's enforcement division for further investigation.

As it was, the government shutdown temporarily halted the OCIE examination program at the SEC. While the agency has reopened its doors for business, a lack of progress by congressional negotiators and the White House over fiscal appropriations for border security by a February 15, 2019, deadline could return OCIE's to-do list to a wish list once more.

OCIE's December 20, 2018, release says its priorities have changed "as new risks have emerged, and existing risks have been heightened or mitigated." However, as compliance blogs have noted, the standard fare of tagging common compliance issues remains firmly in place. For example, review of broker-dealers' **anti-money laundering programs (AML)** and **cybersecurity issues** for both brokerage and advisory firms has been on OCIE's priority list since 2013.

What is probably welcomed more by compliance officers are the specific products and firm conflicts of interest that are flagged as problem areas by OCIE. For example, in the past two years transactions involving digital assets such as bitcoin and tokens are top of mind, as well as disclosure of specific compensation arrangements including the use of services or products provided by affiliates of the firm, and securities-backed non-purpose loans and lines of credit in which securities in the brokerage or advisory accounts are used as collateral.

OCIE Priorities* 2015-2019

Year	AML	Cyber-Security	Digital Assets	Fee Disclosures	Retirement Accounts	Seniors	Share-class Selection
2019	Yes	Yes	Yes	Yes	Yes	Yes	Yes
2018	Yes	Yes	Yes	Yes	Yes	Yes	Yes
2017	Yes	Yes			Yes	Yes	Yes
2016	Yes	Yes			Yes		
2015	Yes	Yes					

* Compliance issues related to retail investment advice.

Fig. 1

And while the term “priorities” is a much-abused term because OCIE lists about a dozen annually, the year-to-year list also shows trends in what examiners are reviewing. For example, in reviewing Fig. 1, we can see that **retirement accounts** have been on the priority list for the past four years, and **seniors** for the past three years. Specifically, under these broad topics OCIE is looking at firms’ ability to identify financial exploitation of seniors and how services and products impact their retirement savings goals. Prior to that, and probably in reaction to a 2013 General Accountability Office report on unsuitable rollover recommendations (along with the ill-fated fiduciary rule adopted by the Department of Labor) **rollover advice** also became a priority for both the SEC and the Financial Industry Regulatory Authority (FINRA). RIAs that ignore rollover advice in 2019 do so at their own peril, still is, although it has been subsumed under the broader category of retirement accounts/savings. **Share-class selection** in mutual funds – in which OCIE examiners review whether client portfolios contain lower-cost institutional shares (if available) instead of more expensive retail shares -- is also a perennial target. Whether the SEC is reacting to excessive fee class-action litigation alleging violations of the Employee Retirement Income Security Act (ERISA) or is merely a coincidence, in the last three years share-class selection has been another OCIE examination priority.

Some OCIE exam priorities that have fallen off the priority list in the past couple of years include **robo-advisors**, **branch offices**, and **recidivist brokers**, but that doesn’t mean they’re not on their radar. For example, in December [the SEC cited two robo-advisors](#), Wealthfront Advisers and Hedgeable Inc., for making misleading claims, respectively, about tax-harvesting strategies and investment performance. Interestingly, FINRA this year picked up where the SEC

left off, highlighting its own concerns with recidivist broker activity, describing the issue in its 2019 letter as “risks related to associated persons with a problematic regulatory history.”

In addition, OCIE’s emphasis on visiting the offices of **never-examined RIAs** has been a priority since 2013, although the list of ‘never ever’ may be an endangered species. This year it added “not recently-examined” advisory firms to that category, especially those firms that “may have substantially grown or changed business models,” according to the OCIE release. Under heat from Congress to ramp up its exam cycle for RIAs several years ago, OCIE hasn’t forgotten. The 2019 release noted that in fiscal year 2018 the exam rate had increased to 17 percent, up from 9 percent in the past five years. This compares unfavorably to FINRA’s exam rate for brokerage firms of around 40 percent, a statistic that was cited frequently several years ago by critics who wanted FINRA to take over as a self-regulatory organization for investment advisers.

A little more on the ‘never ever’ topic. While Congress has appropriated funding for some new hires in recent years, OCIE has not provided any details on whether the scope of the exams has been narrowed, thereby reducing the amount of time spent on each review. In 2015 the former director of the SEC’s Division of Investment Management, Norm Champ, wrote an op-ed piece in *The Wall Street Journal* stating that the agency’s 450 examiners each averaged only two exams a year, and suggesting there was a productivity problem in the department. While the SEC took him up on a suggestion to transfer some of its examiners from the brokerage side to beef up RIA exams, OCIE has not publicly ever addressed the productivity charge, and whether the scope of exams, or the time spent on each RIA review, remains unchanged.

The other priorities cited by OCIE related to retail advice were disclosures of investment expenses for wrap-fee programs, portfolio management activities including, among other things best execution, trade allocation, consistency between clients’ investment objectives and portfolio allocations, and clients’ risk tolerance.

Finally, microcap fraud emerged again, as it did in 2014 and 2016, on OCIE’s target list. More specifically, OCIE said it would look at broker–dealers selling stocks with a market cap of less than \$250 million, including pump-and-dump schemes¹.

[FINRA’s annual priorities letter](#) does not overlap much with OCIE’s list, because the former does the bulk of the broker-dealer exams, although in the past there has been some duplication. The only overlap this year mentioned by both as priorities are AML, digital assets, share-class selection, cybersecurity, and senior exploitation. Other issues of interest to FINRA examiners that dually registered broker/advisors should be aware of are fixed-income mark ups and suitable product transactions. Regarding the latter, FINRA will focus this year on what it describes as “deficient quantitative suitability determinations,” overconcentration of illiquid securities in portfolios such as variable annuities, non-traded alternative investments, and private placements. FINRA also added leveraged loans and mutual funds that invest in loans extended to highly indebted companies of lower credit quality to the mix.

As in recent years, FINRA will continue to look at outside business activities and private securities transactions of registered reps, commonly known as “selling away,” which refers at least in part to transactions of brokers with their own independent RIAs.

Given the SEC’s recent adoption of [a rule requiring greater disclosure of order handling information](#), which goes into effect in spring 2019, it is not surprising that FINRA also will be examining customer order flow to assure it is “directed to the best market given the size and types of transactions.”

All in all, compliance-abiding advisors have no reason to make big changes to their compliance procedures in 2019, but some tweaks may be in order. It’s always helpful to know what the regulators are thinking about in case they do make a surprise visit to your office.

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i Pump and dump is a scheme that attempts to boost the price of a stock through recommendations based on false, misleading or greatly exaggerated statements. The perpetrators of this scheme already have an established position in the company's stock and sell their positions after the hype has led to a higher share price. This practice is illegal based on securities law and can lead to heavy fines.