

U.S. SECURITIES AND EXCHANGE COMMISSION

# 2018 NATIONAL EXAM PROGRAM EXAMINATION PRIORITIES

Office of Compliance  
Inspections and Examinations

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## MESSAGE FROM OCIE'S LEADERSHIP TEAM

It is our privilege to share with you the 2018 examination priorities of the Office of Compliance Inspections and Examinations (OCIE) of the U.S. Securities and Exchange Commission (SEC or Commission).

This year we will continue to prioritize our commitment to protect retail investors, including seniors and those saving for retirement. We will especially be looking closely at products and services offered to retail investors, as well as the disclosures they receive about those investments. We intend to do this by conducting examinations targeting circumstances in which retail investors may have been harmed and reviewing whether financial service professionals have met their legal obligations.

Compliance with the securities laws overseen by the SEC has helped make our markets the safest and most vibrant in the world. Our National Exam Program (NEP) fosters compliance and helps fulfill the SEC's mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation. We do this through a variety of risk-focused strategies, including conducting compliance examinations of entities regulated by the SEC, publishing Risk Alerts, holding outreach events, and speaking to investors and market participants.

Our work stands on four "pillars": promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy. This is the sixth year we have published our examination priorities. It is our hope that this publication provides transparency into our thinking on issues and areas that we believe constitute an appropriate focus for us in the upcoming year and which entail the most effective use of examination resources in fulfilling our mission.

### DID YOU KNOW?

Our work stands on four "pillars": promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy.

Determining our priorities is a collaborative effort. We consult with our examination staff, as well as key constituencies outside the program. OCIE examiners are in discussions daily with financial professionals, market participants, compliance professionals, accountants, and attorneys regarding new products, recent trends, compliance challenges, and high risk areas. In addition, examiners see firsthand how firms are, or are not, complying with the federal securities laws. As a result, examiners are uniquely positioned to identify the practices, products, and services that may pose significant risk to investors or the financial markets.

In formulating priorities, we also seek the advice of the Chairman and Commissioners, staff from other SEC Divisions and Offices, the SEC's Investor Advocate, and our fellow regulators. Throughout the year we will add priorities—beyond those published here—as we identify emerging risks and trends and respond to tips, complaints, and referrals. Our regional offices also initiate exams based on their local assessment of risk and knowledge of their registrant population.

In executing on these priorities, we abide by the following principles:

**Principle 1: We are risk-based.**

The sheer size and continued growth of the securities industry prevents us from conducting regular comprehensive examinations of each registered firm. In order to effectively oversee all of the varying market participants within our jurisdiction, and given our limited resources, we utilize a risk-based strategy. A central part of this effort is ongoing analysis of root causes of harm to investors and markets and the identification of the greatest risks. The analysis flows into a number of aspects of our program, including our process for setting priorities, the criteria we use to select potential examination candidates, and determining the appropriate scope of our exams, as well as resource allocation more generally. We recognize that the choices we make in this regard imply foregone attention on other areas and firms, but such hard decisions are necessary in order to maximize our impact.

**Principle 2: We are data-driven.**

Our use of data is integral to the program and complements our risk-based exam approach and utilization of technology. We use data in areas such as risk assessment and exam scoping, planning, and execution. For example, we are rapidly advancing in our capacity to use data to analyze regulatory filings and trading activity. Among other things, this has included development by our Quantitative Analytics Unit (QAU) of the National Exam Analytics Tool (NEAT) to facilitate the analysis of trading blotters. The QAU is comprised of financial engineers who, in addition to developing tools, directly assist exam teams with quantitative analysis. Our sophistication in using data analytics to identify potential non-compliance with the securities laws, including possible fraudulent behavior, is ever growing. We also use data to better identify high-risk exam candidates and to more efficiently analyze information during examinations. We continuously look for ways to employ technology and data analytics to enhance our effectiveness in every aspect of the examination program.

**Principle 3: We are transparent.**

Transparency is an important tool for us. We believe that publicly sharing certain information about our examination program—particularly our priorities, common findings, and what we believe to be the highest risk areas—will ultimately benefit investors by assisting the work of legal, compliance, and risk staff at registered entities as they work within their organizations to achieve compliance with the securities laws. To this end, we have been publishing more information about what we are doing, why we are doing it, and what we have found and learned in the process.

**DID YOU KNOW?**

The NEP published six Risk Alerts to the industry in FY 2017.

Risk Alerts, in particular, have become a valuable tool, and we have made a concerted effort to publish them more frequently. The ultimate goal of these Risk Alerts is to promote compliance. Recent topics in our Risk Alerts include the most frequently-cited deficiencies from various examination initiatives, as well as observations

of industry practices and compliance issues from cybersecurity examinations. We believe sharing this information helps registered firms—particularly those that have not been examined recently—sharpen their identification and correction of deficient practices, maximizing the impact of the examination program and resulting in better protection for investors.

**Principle 4: We strive to put our resources to their highest and best use.**

We rely heavily on our talented and experienced staff, many of whom are subject matter experts in key risk areas. We also increasingly leverage technology and data in our risk assessment and examination processes. Resources, however, are limited. We continually assess our resource deployment and ask: Are we using our resources in way that maximizes the benefit to investors? The decisions we make come with tradeoffs, but top of mind is always effectively advancing investor protection and fulfilling the SEC's mission.

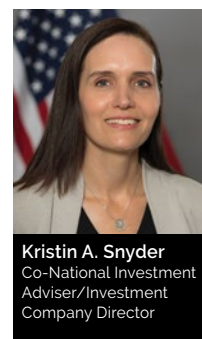
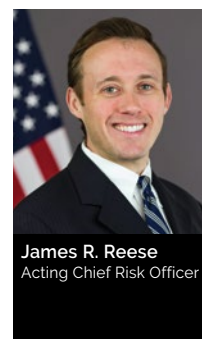
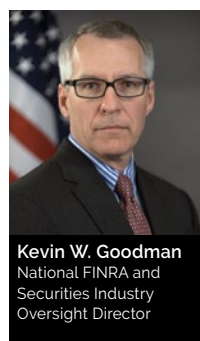
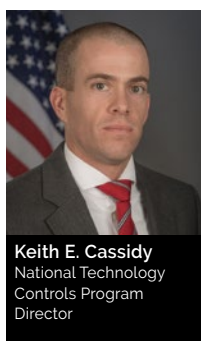
**DID YOU KNOW?**

In Fiscal Year 2017, the National Exam Program completed over 2,870 examinations—representing an 18 percent increase over FY 2016.

**Principle 5: We embrace innovation and new technology, both as a means to do more with less and as a necessary focal point of our analytic efforts.**

We recognize that technology in the financial markets often spurs innovation in ways that are beneficial to investors. It has the potential, for example, to help drive down costs to investors and provide new ways for people to access our financial markets, investment information, and financial advice. Where technological advances lead to new business models, we seek to assess their potential impact on the financial markets, identify ways investors may be harmed, if any, and work with our colleagues to share critical observations that may assist the Commission in adapting to emerging risks and concerns. We also seek to keep pace with advancing technology, to monitor for cybersecurity risks, to engage with industry in efforts to help combat cybersecurity attacks, and to prevent investor harm.

We hope you find publication of our examination priorities valuable in your efforts to promote compliance and protect investors. Please know also that we are always interested in hearing more about new and emerging risk areas and products as well as how OCIE can be more effective in its mission. Our contact information can be found at: <https://www.sec.gov/contact-information/sec-directory>.



## INTRODUCTION

This document presents OCIE’s 2018 examination priorities.<sup>1</sup> In general, the priorities reflect certain practices, products, and services that OCIE believes may present potentially heightened risk to investors and/or the integrity of the U.S. capital markets. Our 2018 priorities are organized around five themes:

1. Matters of importance to retail investors, including seniors and those saving for retirement;
2. Compliance and risks in critical market infrastructure;
3. Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB);
4. Cybersecurity; and
5. Anti-Money laundering programs.

### DID YOU KNOW?

In FY 2017, the NEP held four regional investment adviser/investment company compliance outreach programs, a national broker-dealer compliance outreach program and participated in hundreds of other outreach events in order to promote and improve industry compliance.

While we believe these areas are critical, this list is not comprehensive; OCIE remains flexible in order to cover emerging and exigent risks to investors and the marketplace as they arise. Rapid institutional and technological change in the market landscape demands a responsive approach. While the change is fast and perhaps accelerating, we keep both our analytic efforts and our examinations firmly grounded in our four pillars: promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy.

## RETAIL INVESTORS, INCLUDING SENIORS AND THOSE SAVING FOR RETIREMENT

The protection of retail investors is embedded in the SEC’s mission and likewise in OCIE’s organizational culture. This year, we will continue to prioritize protecting retail investors, particularly seniors and those saving for retirement, and pursue examinations of firms that provide products and services directly to them. We will also focus on higher risk products as well as recent technological changes in how investment advice is delivered. We will particularly focus on the following areas:

### Disclosure of the Costs of Investing

When a retail investor hires a financial professional, some of the most important information they receive relates to the fees charged and other compensation the financial professional may receive, such as compensation from transactions involving affiliates of the financial professional. Every dollar an investor pays in fees and expenses is a dollar not invested for his or her benefit. Therefore, the proper disclosure and calculation of fees, expenses, and other charges investors pay is critically important. It is also important for financial professionals to inform investors of any

<sup>1</sup> This document was prepared by SEC staff, and the views expressed herein are those of OCIE. The Commission has expressed no view on this document’s contents. It is not legal advice; it is not intended to, and does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.



conflicts of interest that might provide incentives for the financial professionals to recommend certain types of products or services to investors, including any higher cost or riskier products. Examiners will review, among other things, whether fees and expenses are calculated and charged in accordance with the disclosures provided to investors. Examiners will also review fees charged to advisory accounts, particularly where the fee is dependent on the value of the account, to assess whether assets are valued in accordance with investor agreements, disclosures, and the firm's policies and procedures.

We will also focus on firms that have practices or business models that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges. These practices or business models include:

- certain advisory personnel that may receive financial incentives to recommend that investors invest, or remain invested, in particular share classes of mutual funds where the investors may pay higher sales loads or distribution fees and the conflict of interest may not be disclosed to investors;
- accounts where investment advisory representatives have departed from the firms, and the accounts have not been assigned a new representative to properly oversee them;
- advisers that changed the manner in which fees are charged from a commission on executed trades to a percentage of client assets under management; and
- private fund advisers that manage funds with a high concentration of investors investing for the benefit of retail clients, including non-profit organizations and pension plans.

### **Electronic Investment Advice**

We will continue to examine investment advisers and broker-dealers that offer investment advice through automated or digital platforms. This includes “robo-advisers” and other firms that interact primarily with clients online. Examinations will focus on registrants' compliance programs, including the oversight of computer program algorithms that generate recommendations, marketing materials, investor data protection, and disclosure of conflicts of interest.

### **Wrap Fee Programs**

We will continue to examine registered investment advisers and broker-dealers associated with wrap fee programs, which charge investors a single bundled (wrapped) fee based on a percentage of assets for investment advisory and brokerage services. We will review whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients. Areas of interest will include whether (i) the recommendations to invest in a wrap fee program and to continue in the program are reasonable, (ii) conflicts of interests are disclosed in compliance with applicable regulatory requirements, and (iii) investment advisers are obtaining best execution and disclosing costs associated with executing trades through another broker-dealer.

### **Never-Before-Examined Investment Advisers**

Given the percentage of investment advisers that are either newly registered or that have not been examined in some time, we will continue to make risk-based assessments and select those investment advisers for examination that have elevated risk profiles.

#### **DID YOU KNOW?**

In FY 2017, the SEC achieved examination coverage of approximately 15 percent of all investment advisers, up from 8 percent just five years ago.

## Senior Investors and Retirement Accounts and Products

Seniors and those saving for retirement are increasingly reliant on returns from their investments. We will review how broker-dealers oversee their interactions with senior investors, including the ability of firms to identify financial exploitation of seniors. We will also focus on internal controls at firms designed to supervise their representatives, particularly relating to sales of products and services directed at senior investors.

### DID YOU KNOW?

The NEP completed more than 2,100 exams of investment advisers in FY 2017, which is an increase of approximately 46 percent over FY 2016.

We will continue to conduct examinations of investment advisers and broker-dealers that offer services and products to investors with retirement accounts. These examinations will focus on, among other things, investment recommendations, sales of variable insurance products, and sales and management of target date funds. In addition, we will examine investment adviser and broker-dealer facilitation and involvement in retirement vehicles that primarily serve state and local government employees and non-profit employees, including 403(b) and 457 plans.

## Mutual Funds and Exchange Traded Funds (ETFs)

Mutual funds and ETFs are the primary investment vehicles for many retail investors. We will focus on mutual funds (i) that have experienced poor performance or liquidity in terms of their subscriptions and redemptions relative to their peer groups, (ii) that are managed by advisers with little experience managing registered investment companies, or (iii) that hold securities which are potentially difficult to value during times of market stress, including securitized auto, student, or consumer loans, or collateralized mortgage-backed securities. We will also focus on ETFs and mutual funds that seek to track custom-built indexes to review for any conflicts the adviser may have with the index provider and the adviser's role with respect to the selection and weighting of index components.

With respect to ETFs, our focus will be on funds that have little secondary market trading volume and that face the risk of being delisted from an exchange and having to liquidate assets. When this happens, the value of the ETF has the potential to rapidly decline and investors may pay the cost to liquidate the funds' assets. The focus of these examinations will include analyzing whether investment risks are adequately disclosed to investors.

## Municipal Advisors and Underwriters

Municipal advisors provide advice to, or on behalf of, a municipal entity or obligated person about the issuance of bonds and other financial products. We will continue to examine municipal advisors to evaluate their compliance with registration, recordkeeping, and supervision requirements, particularly those municipal advisors that are not registered as broker-dealers. Examinations will also review for compliance with MSRB rules regarding professional qualification requirements, continuing education requirements, and core standards of conduct and duties of municipal advisors when engaging in municipal advisory activities.

State and local governments and other municipal entities often rely on broker-dealer and municipal advisors, among other financial professionals, to raise money for essential infrastructure such as hospitals, schools, and utilities through the issuance of fixed income securities. We will continue to examine municipal underwriters for their compliance with MSRB and SEC rules.

### **Fixed Income Order Execution**

One of the key investor protection requirements in the fixed income secondary market is the best execution of customer orders. We will conduct examinations to assess whether broker-dealers have implemented best execution policies and procedures, consistent with regulatory requirements, for both municipal bond and corporate bond transactions.

### **Cryptocurrency, Initial Coin Offerings (ICOs), Secondary Market Trading, and Blockchain**

The cryptocurrency and ICO markets have grown rapidly and present a number of risks for retail investors. Along with the growth of these products and markets, the number of broker-dealers and investment advisers engaged in this space continues to grow as well. We will continue to monitor the sale of these products, and where the products are securities, examine for regulatory compliance. Areas of focus will include, among other things, whether financial professionals maintain adequate controls and safeguards to protect these assets from theft or misappropriation, and whether financial professionals are providing investors with disclosure about the risks associated with these investments, including the risk of investment losses, liquidity risks, price volatility, and potential fraud.

## **COMPLIANCE AND RISKS IN CRITICAL MARKET INFRASTRUCTURE**

### **Clearing Agencies**

Clearing agencies perform a variety of services that help ensure that trades settle on time and at the agreed upon terms. For example, clearing agencies compare transaction information, calculate settlement obligations, collect margin, and may serve as a depository to hold securities as certificates or in electronic form to facilitate automated settlement. We will continue to conduct annual examinations of clearing agencies that the Financial Stability Oversight Council has designated as systemically important and for which the Commission is the supervisory agency. Examinations will focus on compliance with the Commission's Standards for Covered Clearing Agencies,<sup>2</sup> whether clearing agencies have taken timely corrective action in response to prior examinations, and other areas identified in collaboration with our colleagues in the Division of Trading and Markets and with other regulators, as applicable.

#### **DID YOU KNOW?**

Clearing agencies perform a variety of services that help ensure that trades settle on time and at the agreed upon terms.

<sup>2</sup> See Standards for Covered Clearing Agencies, Release No. 34-78961 (adopted Sept. 28, 2016), <https://www.sec.gov/rules/final/2016/34-78961.pdf> (compliance date April 11, 2017).

## National Securities Exchanges

With over 20 national securities exchanges facilitating transactions in the marketplace, OCIE will focus on, among other things, the internal audits conducted by the exchanges, the fees paid under Exchange Act Section 31, and the governance and operation of certain National Market System (NMS) plans. Specific to NMS plans, OCIE, in coordination with our colleagues in the Division of Trading and Markets, will conduct examinations of the equities and options consolidated market data plans, with a focus on governance, revenue and expense generation, and revenue and expense allocation procedures.

## Transfer Agents

Transfer agents stand between the companies that issue securities and the individuals and entities that own those securities and perform four main functions: (i) track, record, and maintain an issuer's security holder records, (ii) cancel and issue certificates, (iii) facilitate communications between issuers and security holders, and (iv) make distributions to security holders. Efficient transfer agent operations are critical to secondary securities markets. Our examinations will focus on transfers, recordkeeping, and the safeguarding of funds and securities. Examination candidates will include transfer agents that serve as paying agents or that service microcap or crowdfunding issuers.

## Regulation Systems Compliance and Integrity (SCI) Entities

Regulation SCI was adopted by the Commission to strengthen the technology infrastructure of the U.S. securities markets.<sup>3</sup> Among other things, it requires SCI entities, which include, national securities exchanges, clearing agencies, and certain alternative trading systems, to establish, maintain, and enforce policies and procedures for their systems' capacity, integrity, resiliency, availability, and security. If certain SCI events occur, these entities are required to take corrective action as soon as reasonably practical and immediately notify the SEC of the occurrence. We will continue to examine SCI entities to evaluate whether they have effectively implemented such written policies and procedures. OCIE will also review, among other things, controls relating to how systems record the time of transactions or events and how they synchronize with other systems. Examinations will also assess entities' readiness and business continuity plan effectiveness, vendor risk management, particularly in cloud environments, and enterprise risk management, including whether these programs cover appropriate business units, subsidiaries, and related interconnected infrastructure.

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<sup>3</sup> See Regulation Systems Compliance and Integrity, Release No. 34-37639, (November 19, 2014), <http://www.sec.gov/rules/final/2014/34-73639.pdf>.

## FOCUS ON FINRA AND MSRB

### FINRA

FINRA is a registered national securities association and a primary regulator of the vast majority of SEC-registered broker-dealers. As an SRO, FINRA adopts and enforces rules governing the conduct of its members. FINRA oversees approximately 3,700 brokerage firms, 156,000 branch offices, and 630,000 registered representatives through examinations, enforcement, and surveillance. In addition, FINRA, among other things, provides a forum for securities arbitration and mediation, conducts market regulation by contract for numerous exchanges, reviews broker-dealer advertisements, administers the testing and licensing of registered persons, and operates industry utilities such as Trade Reporting Facilities. Our examinations of FINRA will focus on FINRA's operations and regulatory programs and the quality of FINRA's examinations of broker-dealers and municipal advisors that are also registered as broker-dealers.

### MSRB

MSRB regulates the activities of broker-dealers that buy, sell, and underwrite municipal securities. MSRB also regulates municipal advisors. MSRB establishes rules for municipal securities dealers and municipal advisors, supports market transparency by making municipal securities trade data and disclosure documents available, and conducts education and outreach regarding the municipal securities market. Given the responsibility of the MSRB to regulate municipal securities firms, examination staff will examine the MSRB to evaluate the effectiveness of select operational and internal policies, procedures, and controls.

#### DID YOU KNOW?

FINRA oversees approximately 3,700 brokerage firms, 156,000 branch offices, and 630,000 registered representatives through examinations, enforcement, and surveillance.

## CYBERSECURITY

Cybersecurity protection is critical to the operation of our markets. The scope and severity of risks that cyber threats present have increased dramatically. The impact of a successful cyber attack may have consequences that extend beyond the firm compromised to other market participants and retail investors, who may not be well informed of these risks and consequences. We are focused on working with firms to identify and manage cybersecurity risks and to encourage market participants to actively and effectively engage in this effort.

We will continue to prioritize cybersecurity in each of our examination programs. Our examinations have and will continue to focus on, among other things, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

## ANTI-MONEY LAUNDERING PROGRAMS

Certain financial institutions are required by regulations adopted under the Bank Secrecy Act to establish anti-money laundering programs. These “AML program” rules require institutions (including the securities firms we regulate such as broker-dealers and investment companies) to, among other things, establish written programs to identify their customers, perform customer due diligence, and monitor accounts for suspicious activity. Where suspicious activity is noted, institutions have an obligation to file Suspicious Activity Reports (SARs) with the Financial Crimes Enforcement Network. These SARs have been used by the SEC and various law enforcement agencies to detect and combat terrorist financing, organized crime, public corruption, and a variety of other fraudulent behavior. As a result, ensuring financial institutions meet their AML program obligations is an important and critical task for financial regulators.

### DID YOU KNOW?

Certain financial institutions are required by regulations adopted under the Bank Secrecy Act to establish anti-money laundering programs.

In 2018, we will continue to focus a portion of our resources on examining whether the entities we regulate are appropriately adapting their AML programs to address their obligations. Our reviews will cover, for example, the customer due diligence requirement and will look to determine whether these entities are taking reasonable steps to understand the nature and purpose of customer relationships and to properly address risks. We will also assess whether these entities are

filing timely, complete, and accurate SARs. Last, we will take steps to evaluate whether these entities are conducting robust and timely independent tests of their AML programs.

## CONCLUSION

This description of OCIE priorities is not exhaustive. While we expect to allocate significant resources throughout 2018 to the examination issues described herein, our staff will also conduct examinations focused on risks, issues, and policy matters that arise from market and regulatory developments, new information learned from examinations, or other sources, including tips, complaints, and referrals, and coordination with other regulators. OCIE welcomes comments and suggestions regarding how we can better fulfill our mission to promote compliance, prevent fraud, identify and monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify SEC Staff at <https://www.sec.gov/tcr>.





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