

## SEC OUTLINES INVESTMENT MANAGER EXAMINATION PRIORITIES FOR 2020

On January 7, 2020, the Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission (“SEC”) released its 2020 annual examination priorities.<sup>1</sup> Like in prior years, OCIE is prioritizing “perennial risk areas,” including (1) the protection of retail investors, (2) market infrastructure, (3) information security, and (4) anti-money laundering programs, but has also signaled its intention to examine firms in emerging risk areas, such as robo-advice, digital assets, cybersecurity, and new rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) and interpretations on standards of care.

OCIE examined approximately 2,180 SEC registered investment advisers (“RIAs”) in fiscal year 2019 (15% of all RIAs). The 2020 Priorities include several examination areas that are of importance to RIAs. These priorities—coupled with recent enforcement actions—indicate OCIE’s continued focus on issues related to private fund adviser compliance, including insufficient policies and procedures, improper allocation of fees and expenses, and undisclosed conflicts of interest.

### The 2020 Priorities

The areas of the OCIE priorities for this year that are of key importance to private fund managers include:

- New and Emerging Investment Strategies. A new focus this year is on RIAs offering new and emerging investment strategies. Noting that it is important that there are appropriate disclosures to investors about the strategy to ensure that investors can make informed investment decisions, OCIE has announced that it has a “particular interest” in the accuracy and adequacy of disclosures furnished by RIAs that offer clients new types of or emerging investment strategies. According to OCIE, a specific focus will be RIAs that that focus on sustainable and responsible

<sup>1</sup> See U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, 2020 Examination Priorities (Jan. 7, 2020), <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf>.

investing through the incorporation of environmental, social and governance (“ESG”) criteria into the investment strategy.

Regulators in the European Union, the United Kingdom, and other jurisdictions have also demonstrated an interest in this area.<sup>2</sup> Thus, funds operating, or seeking to operate, in this area should consider this increased regulatory attention, particularly as it concerns disclosures to investors.

- RIA compliance programs: OCIE will continue to assess compliance programs of RIAs (for issues such as account selection, portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, and appropriate valuation of client assets).

The 2020 Priorities specifically focus on compliance programs of RIAs that are dually registered as, or affiliated with, broker-dealers (or who have supervised persons who are registered representatives of unaffiliated broker-dealers), including the extent to which a firm’s compliance program addresses risks related to best execution, prohibited transactions, fiduciary advice, or the disclosure of conflicts associated with such arrangements.

Additionally, OCIE will prioritize the examination of RIAs that outsource investment decisions to third-party sub-advisers while largely providing back office services to clients. Such RIAs should review their due diligence practices, policies, and procedures to ensure risks identified by OCIE are properly addressed.

- Fiduciary duties of care and loyalty: OCIE has integrated the SEC’s Interpretation Regarding Standard of Conduct for Investment Advisers, adopted in June 2019, into the Investment Adviser examination program. Accordingly, OCIE will continue to assess whether RIAs are fulfilling their duties of care and loyalty by, at a minimum, providing advice in the best interests of clients, exposing conflicts of interest that may lead to the provision of non-disinterested advice, and reducing and/or eliminating risks associated with fees, expenses, and insufficiently disclosed compensation arrangements.

RIAs should consider practices that OCIE deems to heighten the risk of breaching their fiduciary duties, including: (1) revenue sharing arrangements between a registered firm and issuers, service providers, or others; (2) direct or indirect compensation to advisory personnel for executing client transactions; and (3) failure to aggregate certain accounts for purposes of calculating fee discounts in accordance with the fund disclosure.

- Custody Rule Compliance: OCIE continues to prioritize the examination of RIAs with access to client funds or securities for compliance with the Custody Rule (Rule 206(4)-2 under the Advisers Act).

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<sup>2</sup> For information on ESG-related issues, please see our July 2019 publication, *Growing the Green Economy*, available at <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2019/07/growing-the-green-economy-addressing-the-sustainability-challenges-and-opportunities.pdf>.

- Protection of Client Personal Financial Information: A perennial area of focus for the SEC has been the protection of client personal financial information. As with prior years, OCIE will continue to examine the efforts of firms to identify and mitigate information security risks.

With respect to RIAs, OCIE will assess protection of client personal financial information, with a focus that includes: (1) governance and risk management; (2) access controls; (3) data loss prevention; (4) vendor management; (5) training; and (6) incident response and resiliency.

This examination focus comes on the heels of an April 2019 OCIE Risk Alert, which discussed particular issues that OCIE has identified with the protection of customer personal information.<sup>3</sup> Among the issues that were identified in that alert include: (1) inadequate policies and procedures that do not discuss administrative, technical, and physical safeguards for client personally identifiable information (“PII”); (2) inadequate employee training regarding the firm’s obligations to protect client PII and the firm must enforce its rules regarding client PII; (3) inadequate access restrictions; and (4) failure to inventory PII.

- Use of alternative data: OCIE has stated that as registered firms use new data sources, “alternative data,” that may influence investment decision-making, examinations will look at the use of these data sets and technologies. Regulators in the United Kingdom have also highlighted the risks presented by the use of such data and technologies.<sup>4</sup> Firms employing alternative data as part of their investment strategy should ensure the sufficiency of related compliance and control functions.
- Robo-Advisers: OCIE will also focus on RIAs that provide services to clients through automated investment tools and platforms, so-called “robo-advisers.” In this area, OCIE will concentrate on issues such as SEC registration eligibility, cybersecurity policies and procedures, marketing practices, adherence to fiduciary duties, and compliance program effectiveness. OCIE notes that prior examinations have resulted in actions brought against providers of electronic investment advice. Thus, RIAs should be aware of the enforcement risk presented by the use of such tools and platforms.
- RIAs to Mutual Funds and ETFs: As part of prioritizing the examination of mutual funds and ETFs, OCIE will focus on the activities of their RIAs. In particular, RIAs that use third-party administrators to sponsor advisee or affiliated mutual funds and private fund RIAs that also manage one or more registered investment companies with similar investment strategies.
- Private Fund Advisers. The 2020 Priorities note that one of the areas of focus will be on RIAs to private funds that have an impact on retail

<sup>3</sup> See SEC Risk Alert, “Investment Adviser and Broker Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies,” (April 16, 2019).

<sup>4</sup> See Clifford Chance LLP, “Big Data and Artificial Intelligence – Evolving Market Misconduct Risks,” (March 2019), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2019/03/big-data-and-artificial-intelligence-evolving-market-misconduct-risks.pdf>.

investors, such as those that manage separately managed accounts alongside private funds.

OCIE will assess compliance risks of such RIAs in several areas, including (1) the adequacy of controls to prevent the misuse of material, non-public information, (2) conflicts of interest (for example, undisclosed or insufficiently disclosed fees and expenses), and (3) the use of RIA affiliates to provide client services.

- Never Examined RIAs: OCIE will continue to conduct risk-based examinations of RIAs that have never been examined (including both newly registered RIAs and those that have been registered for several years). Additionally, OCIE will prioritize RIAs that while previously examined have not been so examined for “a number of years” to determine whether such RIAs’ compliance programs have been appropriately updated and modified since the prior examination.

## **Continued Importance of Effective Compliance Program**

OCIE also remains focused on the effectiveness of an RIA’s compliance program. Both the 2020 Priorities and recent enforcement trends continue to highlight the vital importance of developing, maintaining, and following an effective compliance program reasonably designed to fit your firm’s needs. The 2020 Priorities identify what OCIE believes to be the “hallmarks” of such a program:

- The active engagement of compliance personnel across firm operations and in the early stages of significant business developments.
- A “knowledgeable and empowered” chief compliance officer with the full responsibility, authority, and resources necessary to develop and enforce the firm’s policies and procedures.
- A commitment to compliance from senior management, including setting a tone throughout the organization that stresses the importance of compliance.

## **Other Examination Priorities**

OCIE will continue to prioritize those risk areas that it has routinely covered. Among these continuing priorities are the market infrastructure, information security, focus areas relating to broker-dealers and municipal advisors, anti-money laundering controls, oversight of FINRA and MSRB, and fintech and innovation.

OCIE’s continued prioritization of fintech and innovation, including digital assets and electronic investment advice merits a brief comment:

- OCIE will focus on the use by firms of “alternative data,” which may drive investment decision-making. Specifically, OCIE will assess the efficacy of compliance and controls in place related to the use of such data and similar technologies that interact with and provide services to investors, firms, and other service providers.
- Specific to firms engaged in the digital assets market, OCIE will continue to focus examinations on portfolio management, trading practices, safety

of client funds and assets, pricing and valuation, and compliance and controls. And in 2020, OCIE will also consider investment suitability and the supervision of employee outside business activities.

These new, stated examination priorities indicate OCIE's evolving understanding of this sector.

## **Conclusion**

As stated in the 2020 Priorities, OCIE understands its role as "the primary, and often only, regulator responsible for supervising this segment of financial firms." Like in prior years, we can expect OCIE to adhere to these priorities and to continue to collaborate with the Enforcement Division as it seeks to closely monitor and regulate the activities of RIAs. Firms should therefore comprehensively review their current policies and practices to ensure the principles and priorities articulated by OCIE in the 2020 Priorities are properly accounted for and addressed as appropriate.

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