

## SEC Announces 2013 Examination Priorities for the Investment Management Industry

The SEC's Office of Compliance Inspections and Examinations ("OCIE") has published its [list and discussion of examination priorities](#) for the investment management industry in 2013, which includes both market-wide initiatives and those relevant to specific industry areas. This Alert focuses on elements of the announcement that are of particular relevance to investment managers, where themes of conflicts of interest, risk management, and disclosure appear to take center stage.

### Market-Wide Initiatives

OCIE, through its National Examination Program (the "NEP"), has identified four market-wide examination priorities. These initiatives include (i) enhanced use of quantitative and qualitative tools, tips, and investor complaints to identify fraudulent or unethical behavior; (ii) continued engagement with the senior management and boards of registered entities to assess a firm's "tone from the top" regarding regulatory compliance and risk management; (iii) conflicts of interest, with a focus on a firm's overall conflict mitigation framework and the adequacy of its related disclosures; and (iv) a new focus on information technology controls, particularly operational capability, market access, information security, outage risks, and compromises to data integrity. These four general initiatives are expected to guide the NEP's sector-specific priorities.

### Investment Adviser and Investment Company Priorities

The NEP's Investment Adviser-Investment Company Program (the "IA-IC Program") detailed a number of examination priorities specific to registered investment advisers and registered investment companies. The NEP categorized each priority as an ongoing risk, new and emerging risk or policy topic. "Ongoing risks" have existed for a sustained period and are likely to continue for the foreseeable future. "New and emerging risks" represent issues and business practices that present an increased risk due to changes and developments in the industry. "Policy Topics" are areas in which the NEP has an interest in gaining a better understanding of particular practices or the practical impact of specific rules and guidance. While each examination will be tailored to the issues and practices specific to the registrant, the staff perceives the following as the highest risks to investors and the integrity of the markets.

#### Ongoing Risks

##### Custody of Assets

The IA-IC Program reported that it has identified a high frequency of issues regarding the custody and asset safety requirements of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "[Custody Rule](#)"). The staff expects to pay particular attention to whether advisers (i) recognize when they have custody of assets under the Custody Rule, (ii) are complying with the Custody Rule's "surprise exam" and "qualified custodian" requirements, and (iii) have satisfied the terms of the exception to the independent verification requirements for pooled investment vehicles.

##### Marketing/Performance Advertising and the JOBS Act

The staff expects to focus on aberrational performance and accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology utilized, and related disclosures and compliance with recordkeeping requirements. The staff also intends to review changes in advertising

practices related to the Jumpstart Our Business Startups Act (the “JOBS Act”), which requires modification of the rules restricting general solicitations, although to date no final rules have been adopted by the SEC. More information about the proposed rule changes regarding restrictions on general solicitations and general advertising for privately offered funds is available in Ropes & Gray’s Alert [here](#).

### Conflicts of Interest: Compensation Arrangements and Allocation of Investment Opportunities

Examinations will prioritize two types of conflicts of interest this year. The staff will pay special attention to conflicts arising from undisclosed compensation arrangements, for example, undisclosed fee or solicitation agreements, referral arrangements (particularly with affiliated entities), and receipt of payment for services allegedly provided to third parties, and whether these conflicts of interest are fully and clearly disclosed. The staff also plans to focus on whether advisers have adequate controls in place to monitor conflicts of interest arising from the side-by-side management of performance-based and non-incentive fee-based accounts, particularly where a portfolio manager is responsible for allocating investment opportunities between both types of accounts.

## **New and Emerging Issues**

### Presence Exams for Newly Registered Advisers to Private Funds

OCIE will continue implementing its national “Presence Exam” initiative designed to establish a “meaningful presence” with private fund advisers newly registered as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). More information on the “Presence Exam” initiative is available in Ropes & Gray’s Update [here](#).

### Dually Registered Investment Advisers/Broker-Dealers

OCIE believes that the continued convergence of the investment adviser and broker-dealer industries raises a number of unique conflict of interest concerns. These concerns extend to both dually registered firms and those distinct advisory and brokerage businesses that share common investment professionals. Firms employing these types of business models will be reviewed to determine how they satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives involved in making such recommendations, and whether all conflicts of interest are fully and accurately disclosed to investors.

### “Alternative” Investment Companies

The IA-IC Program will focus on the growing use of alternative and hedge fund strategies in the management of registered open-end funds, exchange traded funds (“ETFs”), and variable annuity structures. The staff will specifically assess whether (i) leverage, liquidity, and valuation policies comply with regulations, (ii) boards, compliance personnel, and back offices have the resources and authority to handle these new strategies, and (iii) the funds are being marketed to investors in compliance with regulations.

### Payments for Distribution “in Guise”

The staff will focus on payments—known under various names, such as revenue sharing, sub-TA, shareholder servicing, or conference support payments—made by advisers and funds to distributors and other intermediaries. The staff intends to appraise the adequacy of disclosures to funds’ boards of directors

and the adequacy of how boards oversee these payments. In particular, the staff plans to focus on whether such payments comply with various regulations, including Rule 12b-1 under the Investment Company Act of 1940, or whether such payments are impermissible payments for distribution or preferential treatment.

## Policy Topics

### Money Market Fund Stress Testing

The staff plans to review whether money market funds are complying with recent amendments to Rule 2a-7 under the Investment Company Act. Rule 2a-7 requires money market funds to periodically stress test their ability to maintain stable share prices. These examinations will focus on whether stress tests were conducted, what factors these tests considered, and their results.

### Compliance with Exemptive Orders

The IA-IC Program will evaluate compliance with previously granted exemptive orders, with a specific focus on exemptive orders related to closed-end funds and managed distribution plans, employee securities companies, ETFs and the use of custom baskets, and orders granted to fund advisers and their affiliates permitting them to engage in co-investment opportunities with funds they sponsor.

### Pay to Play Rule

The staff will review compliance with, and the practical impact of, the recently adopted and amended “Pay to Play Rule,” which was designed to prevent advisers from gaining government business in exchange for political contributions.

## Other Examination Priorities Relevant to the Investment Management Industry

A number of additional examination initiatives affecting broker-dealers, transfer agents, and clearance agencies were also announced. The following may be of particular interest to the investment management industry:

- Sales Practices and Fraud. Broker-dealer sales practices and fraud continue to be top concerns, particularly those practices affecting retail investors. The staff emphasized unsuitable recommendations of high yield products and activities and products on the periphery of registered entities (such as outside business activities or affiliated entities that a registrant claims are beyond SEC jurisdiction) as other potentially problematic practices.
- Anti-Money Laundering (“AML”). Broker-dealer examinations will focus on firms that appear to have weak AML programs, especially customer identification programs, suspicious activity identification and reporting deficiencies, and weak due diligence procedures.
- Market Access Rule. The staff will emphasize broker-dealer compliance with the new “market access rule” (Rule 15c3-5 under the Securities Exchange Act of 1934), specifically the provisions relating to master/sub-accounts relations and proprietary trading.
- ETFs. The staff is also beginning to focus on recent issues regarding the relationship between broker-dealers and ETFs. Special attention will be paid to delivery failures, compliance with Regulation SHO, and the suitability of recommendations of leveraged or inverse ETFs to retail investors.

- Dual Registrants/Regulatory Coordination. In light of problems experienced during the past year by broker-dealers dually registered as futures commission merchants, the staff plans to maintain its emphasis on stronger regulatory coordination with the Commodities Futures Trading Commission (“CFTC”).
- Transfer Agent Safeguarding. The staff will examine whether transfer agents offering purchase and sale services are providing the appropriate customer service without offering investment advice that would require registration as a broker-dealer or investment adviser.
- Third Party Administration Services. The staff will examine whether transfer agents providing third party administration services involving accepting and routing plan-member orders are appropriately registered or exempt from registration as broker-dealers or investment advisers.
- Risk Assessments of Self-Regulatory Organizations (“SROs”). OCIE’s Office of Market Oversight plans to prioritize risk assessments of SROs, including the enhanced oversight of FINRA required under the Dodd-Frank Act.
- Risk Assessments of National Clearance Agencies. OCIE also plans to begin the newly required annual risk assessments of national clearing agencies designated as systemically important under the Dodd-Frank Act.<sup>1</sup>

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<sup>1</sup> In July 2012, the Financial Stability Oversight Council designated Depository Trust Company (“DTC”), National Securities Clearing Corporation (“NSCC”), Fixed Income Clearing Corporation (“FICC”), and Options Clearing Corporation (“OCC”) as systemically important under the Dodd-Frank Act with the SEC as the primary supervisory agency. CME Group (“CME”) and ICE Clear Credit were designated as systemically important with the CFTC as the primary supervisory agency. OCIE plans to conduct risk assessments of each of these organizations (in the case of CME and ICE Clear Credit, in conjunction with the CFTC).

If you would like to learn more about the developments discussed in this Alert, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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