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## INVESTMENT ADVISER NEWS UPDATES

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### 2016 SEC Exam Priorities

On January 11, 2016 the United States Securities & Exchange Commission (“SEC”) Office of Compliance Inspections and Examinations (“OCIE”) released their Examination Priorities for 2016.<sup>[1]</sup> The Investor Bulletin highlights the SEC’s focus on practices and products presenting a “heightened risk to investors and or the integrity of US capital markets.”<sup>[2]</sup> The OCIE will examine matters pertaining to retail investors, market-wide risks, and identification of registrants engaged in potentially illegal activity.<sup>[3]</sup>

The following represents the SEC’s non-exhaustive list exam priorities for the upcoming year:<sup>[4]</sup>

- **Exchange-Traded Fund (“ETFs”):** With the increased popularity of ETF trading, the SEC will pay careful attention to ETF exemptive relief granted under the Securities Exchange Act of 1934 and the Investment Company act of 1940. The SEC will focus on ETF unit creation, redemption processes, sales strategies, disclosures, excessive portfolio concentration, suitability, and trading practices surrounding ETFs.<sup>[5]</sup>
- **Fee Selection & Reverse Churning:** The SEC will review the fee arrangements (e.g. asset-based fees, hourly fees, wrap fees, commissions) of advisers and dually registered broker-dealers. The Commission will assess whether account “recommendations are in the best interest of the retail investor at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such arrangements.”<sup>[6]</sup>
- **Cybersecurity:** The SEC will continue its efforts to assess the cybersecurity programs of advisers and broker-dealers. Examination will center on the procedures, processes, and safeguards surrounding the protection of personal data from unauthorized access and dissemination.
- **Liquidity Controls:** The SEC will evaluate advisers and broker dealers in the mutual fund, ETF, and private fund space, with specific emphasis on illiquid fixed income securities. “These examinations will include a review of various controls in these firms’ expanded business areas, such as controls over

market risk management, valuation, liquidity management, trading activity, and regulatory capital.”<sup>[7]</sup>

- **Misconduct and Bad Actors:** As part of the SEC’s ongoing effort to curb investment-related fraud, the Commission will continue to take interest in officers or access persons that have a history of misconduct. The SEC will closely examine firms that employ so-called “bad actors” in compliance and oversight roles.
- **Anti-Money Laundering (“AML”):** Broker-dealer procedures surrounding AML compliance will be subject to heightened scrutiny by the SEC. Attention will focus on comparing the consistency of suspicious activity reports (“SARS”) with a firm’s business operations. The SEC will look to emphasize this exam area for broker-dealers in particular, rather than investment advisers.
- **Microcap Fraud:** Another broker-dealer specific item—the SEC will continue to evaluate the “operations of broker-dealers and transfer agents for activities that indicate they may be engaged in, or aiding and abetting, pump-and-dump schemes or market manipulation.”<sup>[8]</sup>
- **Private Placements/Private Fund Advisers:** Additional SEC resources will be shifted to examine registrants that participate in Regulation D offerings, as well as those who manage private funds.<sup>[9]</sup> Focus will center on disclosure, determination of investor suitability, and controls for accounts that charge both management and performance fees.
- **Never Before Examined Managers:** The SEC will continue to focus on registrants that have never been examined.

While this list is not exhaustive, it provides valuable insight into the SEC’s resource allocation and areas of emphasis for the upcoming year. Please contact your Gordian consultant to understand how these areas of focus may affect your firm.

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[1] *Examination Priorities for 2016*, United States Securities & Exchange Commission (January 11, 2016)

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Examination Priorities for 2016*, United States Securities & Exchange Commission (January 11, 2016); see also *SEC adds ETFs, Variable Annuities to Exam Priorities*, InvestmentNews.com (January 11, 2016)

[6] *Examination Priorities for 2016*, United States Securities & Exchange Commission (January 11, 2016)

[7] *Id.*

[8] *Id.*

[9] *Examination Priorities for 2016*, United States Securities & Exchange Commission (January 11, 2016); see also *SEC’s Risk Chief to Target Hedge Funds With Exams*, ThinkAdvisor.com (March 11, 2016) “[F]ocus on hedge funds will zero in on such areas as portfolio management trading and back-office operations.”

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## Amendment to Gramm–Leach–Bliley Act Alters Privacy Policy Delivery

On December 4, 2015, President Obama signed several changes into law affecting Title V of the Gramm–Leach–Bliley Act.<sup>[1]</sup> The new changes alter the delivery practices of the annual privacy policy delivery for financial institutions. Going forward, distribution and delivery of an institution’s privacy notice will be required where a firm:

1. Changes its privacy policies since the last privacy notice provided to consumers, OR
2. Discloses nonpublic personal information to nonaffiliated third parties in a manner that triggers an opt-out right.[2]

For private fund managers, and other investment advisers, these new changes **do not alter** requirement to furnish the privacy notice upon inception of the investor/client relationship.

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[1] *Changes to Annual Privacy Notice Requirements*, Debevoise & Plimpton LLP (January 6, 2016); see also *Gramm-Leach-Bliley Act Amendment Eliminates Annual Privacy Notice Requirement for Many Advisers and Funds*, Ropes & Gray LLP (December 14, 2015)

[2] *Id.*

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## SEC to Shift Examiners from BDs to IAs in 2016

On February 19, 2016 the United States Securities & Exchange Commission (“SEC”) Chief Mary Jo White announced her plan to move 100 broker-dealer examiners to adviser exams during the year, in addition to 102 new investment adviser and investment company (IA/IC) examiners.[1]

Resources for the additional 102 examiners are accounted for in President Obama’s proposed 2017 budget.[2] The goal of these shifts is to “increase [the SEC’s] advisory exam rate – currently at 10% of advisors per year – to 12%” which is still significantly lower than the “50% per year [rate] for broker-dealers.”[3]

White mentioned enforcement would on areas such as “financial reporting; market structure; and the structuring, disclosing and sales of complex financial instruments.”[4]

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[1] *SEC to Move Examiners from BDs to RIAs in 2016: Chief White*, ThinkAdvisor.com (February 19, 2016)

[2] *Id.*

[3] *Id.*

[4] *Id.*

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## SEC Issues New Guidance on Crowdfunding for Investors

On February 16, 2016, the United States Securities & Exchange Commission’s (“SEC”) Office of Investor Education and Advocacy released an Investor Bulletin providing new guidance to the rules regarding crowdfunding investments.[1] “Crowdfunding generally refers to a financing method in which money is raised through soliciting relatively small individual investments or contributions from a large number of people.”[2] Starting on May 16, 2016, companies can begin using crowdfunding methods to offer or sell securities to the general public.

Due to the risks involved with crowdfunded investments, the SEC has placed specific contribution limits on these transactions relating to annual income and investor net worth:[3]

- “If *either* your annual income *or* your net worth is less than \$100,000, then during any 12-month period, you can invest up to the greater of either \$2,000 or 5% of the lesser of your annual income or net worth.”[4]
- “If *both* your annual income *and* your net worth are equal to or more than \$100,000, then during any 12-month period, you can invest up to 10% of annual income or net worth, whichever is lesser, but not to exceed \$100,000.”[5]

Net worth calculations are determined by adding up an individual’s assets and subtracting their liabilities. It is important to note “[f]or the purposes of crowdfunding, the value of your primary residence is not included in your net worth calculation.”[6] Moreover, any mortgage or other loan on your home is not counted as a liability unless it exceeds the fair market value of your home—then the difference is counted as a liability.[7]

The SEC also highlights that early-stage investments may involve a high degree of risk,[8] including but not limited to:

- Speculative Strategies
- Illiquidity
- Cancellation Restrictions
- Complications with respect to Valuation and Capitalization
- Limited Disclosure
- Investment in Personnel
- Possibility of Fraud
- Lack of Professional Guidance

While the Investor Bulletin provides a high level look at the new crowdfunding rules, the SEC cautions investors to conduct extensive diligence in deciding whether these crowdfunded opportunities align with their overall investment goals.

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[1] *Investor Bulletin: Crowdfunding for Investors*, United States Securities & Exchange Commission (February 16, 2016)

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Investor Bulletin: Crowdfunding for Investors*, United States Securities & Exchange Commission (February 16, 2016)

[6] *Id.*

[7] *Id.*

[8] *Id.*

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## BROKER DEALER UPDATES

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## 2016 FINRA Exam Priorities

On January 5, 2016 the Financial Industry Regulatory Authority (“FINRA”) released its 2016 Exam Priorities Letter, detailing exam areas of focus for the coming year.

The non-exhaustive list below highlights specific areas of interest for FINRA as they look towards the year ahead:[1]

### 1. Culture, Conflicts of Interest and Ethics

Culture plays an important role in “identifying and managing conflicts of interest and ensuring ethical treatment of customers” while closely affecting firm supervision.[2] FINRA plans to assess “firm culture” by evaluating:

- If control functions are seen as values within the organization;
- Adequacy of policy and control breach response;
- Proactive identification of risk and compliance events;
- If supervisors act as role models of firm culture;
- Departmental Sub-cultures (e.g. trading departments, branch office, etc.) and how they conform to the overall corporate culture;

### 2. Supervision, Risk Management and Controls

FINRA requires a “system to supervise the activities of associated persons to achieve compliance with securities laws and regulations, and with FINRA rules.”[3]

Evaluation of these systems will include the following assessments:

#### a. Management of Conflicts of Interest.

- *Incentive Structures*

FINRA will continue to examine incentive structures and conflicts of interest in connection with firm’s retail brokerage business. FINRA’s focus comes on the heels of Rule 2273, recently proposed to SEC, which would require firms to “deliver educational communications in connection with firm recruitment practices”. [4]

- *Investment Banking and Research Business Lines*

The use of research analysts and the promise of offering favorable research to win investment business is prohibited. FINRA will evaluate whether firms’ research analysts are inappropriately involved in investment banking activity. [5]

- *Information Leakage*

FINRA will evaluate a “firm’s controls to identify, minimize and mitigate information leakage within or outside the firm.”[6]

- *Position Valuation*

Focus will be on assessment of firm’s supervision, control, and validation of traders’ pricing of illiquid assets to ensure fair valuation.[7]

#### b. Technology

- *Cybersecurity*

FINRA will conduct a thorough review of cybersecurity risk management, governance, risk assessment, technical controls, incident response, vendor management, data loss prevention and staff training.[8]

- ***Technology Management***

In examining a firm's technology governance, FINRA will expand their assessment of management practices to include things like life cycle development and algorithm testing.[9]

- ***Data Quality and Governance***

FINRA will focus on the quality of data governance for accuracy, completeness, consistency and timeliness of data delivered to management and supervisory systems.

**c. Outsourcing**

- FINRA recognizes the value of outsourcing business functions to outside third-parties. However, it is still a member firm's responsibility to ensure adequate supervision is granted to covered activities for compliance with federal securities regulations and SRO rules. FINRA reminds firms to avoid outsourcing functions which require qualified registered persons.

**d. Anti-Money Laundering (AML)**

- ***Suspicious Activity Monitoring***

Firms should routinely verify the accuracy of data sources to ensure that all types of accounts are reviewed and any suspicious activity is promptly identified.

- ***Microcap Services***

Microcap securities are defined as a "low-priced stocks issued by the smallest of the companies." [10] FINRA's interest in microcap investing stems from the high-risk nature of these instruments. "Firms should assess whether their process for conducting due diligence on deposits of large blocks of microcap securities is appropriate to ensure compliance with the registration provisions of the Securities Act of 1933." [11]

**3. Suitability and Concentration**

"Effectively discharging suitability obligations is a fundamental obligation and one that can become more challenging in the context of recommendations regarding complex, speculative or longer-duration interest-rate sensitive and alternative products. By their nature, the essential characteristics of these products and their heightened risks may make them more difficult for retail investors to understand and often require additional scrutiny to arrive at a suitable recommendation." [12]

While many companies have established robust systems to support such recommendations, other firms have yet to tailor their systems to the specifics of their product offerings. The largest shortcoming observed thus far centers on firms' failure to adequately monitor for excess concentration. FINRA notes that systems used in monitoring concentration should be dynamic, taking into account the changing market, issuer financial condition and any other factors that may increase concern about concentration in a certain product.

**4. 529 College Saving Plans**

529 plans typically have more than three different share classes - each of which has a different fee and expense structure. FINRA will assess whether firms are performing adequate analysis on fee structures and investor suitability, while considering their investment time horizons and liquidity needs.

## 5. Outside Business Activity (OBA)

FINRA will evaluate procedures relating to OBAs as required by FINRA Rule 3270. One of FINRA's most common examination findings is the absence of, or inadequately assessed, registered representatives' written notification of proposed OBAs.

## 6. Sales Charge Discounts and Waivers

Volume discounts (aka breakpoints) or sales charge waivers will continue to be an area of focus for products such as mutual funds, unit investment trusts (UIT), non-traded Real Estate Investment Trusts (REITs), and Business Development Companies (BDCs).

## 7. Client Onboarding

"FINRA will assess firms' policies and controls related to onboarding clients and correspondents. FINRA has observed that firms encountering capital and liquidity problems or shortfalls generally have not employed good practices to onboard professional clients, *e.g.*, institutional, trading, hedge fund and broker-dealer clients."<sup>[13]</sup>

Please contact your Gordian consultant with any questions surrounding FINRA's 2016 exam priorities.

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[1] *2016 Regulatory and Examination Priorities Letter*, Financial Industry Regulatory Authority (January 5, 2016)

[2] *2016 Regulatory and Examination Priorities Letter*, Financial Industry Regulatory Authority (January 5, 2016); *see also FINRA Plans to Scrutinize Brokerages' Compliance Culture*, InvestmentNews.com (January 5, 2016)

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *2016 Regulatory and Examination Priorities Letter*, Financial Industry Regulatory Authority (January 5, 2016); *see also FINRA Plans to Scrutinize Brokerages' Compliance Culture*, InvestmentNews.com (January 5, 2016)

[7] *2016 Regulatory and Examination Priorities Letter*, Financial Industry Regulatory Authority (January 5, 2016)

[8] *Id.*

[9] *Id.*

[10] *Microcap Stock: A Guide for Investors*, United States Securities & Exchange Commission (September 18, 2013)

[11] *2016 Regulatory and Examination Priorities Letter*, Financial Industry Regulatory Authority (January 5, 2016)

[12] *Id.*

[13] *Id.*



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