CLIENT MEMORANDUM

SEC and FINRA Announce 2017 Examination Priorities

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AUTHORS

James R. Burns | Elizabeth P. Gray | Katherine Doty Hanniford

With a new Administration, changes in Congress and agency oversight committees, and new leadership at the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"), registered entities await potentially significant changes to the regulatory and policy landscape they will face in 2017 and beyond. At the same time, the examination programs at the SEC and FINRA are moving forward with priorities consistent with past practices. Both SEC and FINRA exam priorities reflect a continuity of focus from 2016, although each also includes new and emerging priorities based on recent market and regulatory trends. In addition, the SEC's program reflects a more pronounced use of data analytics tools in connection with examinations to identify registrants and practices with elevated risk profiles.

Below is a summary of highlights from the 2017 examination priorities lists published by the SEC and FINRA, with particular attention to issues of significance for our clients.[1]

[1] *See FINRA 2017 Annual Regulatory and Examination Priorities Letter* (Jan. 4, 2017), available here; *OCIE National Exam Program Examination Priorities for 2017* (Jan. 12, 2017), available here.

I. OCIE Examination Priorities

On January 12, 2017, the SEC's Office of Compliance Inspections and Examinations ("OCIE") released its 2017 examination priorities in connection with its National Exam Program. OCIE has enumerated three thematic priorities for 2017: (i) examining matters of importance to retail investors; (ii) focusing on risks specific to elderly and retiring investors; and (iii) assessing market-wide risks. The list of priorities is not exhaustive, and OCIE also intends to conduct examinations on matters that arise from market developments or new information derived from the SEC's Tips, Complaints, and Referrals portal, in addition to risk-based examinations. Many of OCIE's examination priorities, such as the assessment of conflicts of interest at private fund advisers, reflect a continued focus on previous years' initiatives.

a. Retail Investors

OCIE has identified multiple initiatives designed to assess risk in the context of retail investor activities. A number of these initiatives are continuations or expansions of previous years' priorities, including never-examined investment advisers; exchange-traded funds ("ETFs"); recidivist individuals and the investment advisers that employ them; wrap fee programs; multi-branch advisers; and mutual fund share class selection.

However, among the more notable new additions to OCIE's risk-based and data-driven approach to examinations is the inclusion of "robo-advisers" as an examination priority. "Robo-advisers," or automated, electronic investment advice platforms, and the investment advisers and broker-dealers that offer them, will be examined in order to assess their compliance programs, marketing, data protection, conflicts of interest disclosures, and algorithmic portfolio methodologies.

b. Elderly and Retiring Investors

OCIE will continue its ReTIRE initiative, which focuses on services provided to retirement accounts. Variable insurance products and fixed income cross-transactions will be a key focus of this effort. OCIE also plans to devote resources to examinations of investment advisers to pension plans and other large holders of U.S. investor retirement assets.

c. Market-Wide Risks

OCIE intends to examine money market funds for compliance with a series of amendments that became effective in October 2016, including the degree of board oversight of fund compliance and a more targeted review of compliance policies and procedures with respect to stress testing and periodic reporting. OCIE also intends to assess a subset of broker-dealers, market makers in particular, for best execution compliance.

OCIE will continue to assess registrants' compliance with Reg SCI, and their enterprise risk management capabilities, as well as cybersecurity compliance.[2] OCIE expects to focus on operational resiliency as well as on testing the implementation of cybersecurity-related procedures and controls.

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[2] *See SEC Adopts Regulation Systems Compliance and Integrity*, WFG Client Memorandum (Dec. 2, 2014), available here.

II. FINRA Examination Priorities

FINRA will prioritize efforts in five regulatory areas as part of its mission to support investor protection and promote market integrity. As with OCIE's stated priorities, FINRA's Regulatory and Examination Priorities Letter ("Priorities Letter") is noteworthy for its emphasis on a mix of continuing initiatives and new endeavors aimed at ensuring a high standard of ethical conduct among regulated broker-dealers.

a. High-Risk and Recidivist Brokers

FINRA intends to strengthen its review of firms' supervisory policies and compliance controls for high-risk and recidivist brokers in three respects. First, FINRA recently established an examination unit dedicated to high-risk broker exams. Second, FINRA will review firms' supervisory procedures for hiring or retaining statutorily disqualified and recidivist brokers, and it will inquire as to whether firms have relied on a third-party service provider for verification of background checks and public records searches. As part of the effort to enhance its scrutiny of such supervisory procedures, FINRA will assess whether firms' policies are tailored to identify brokers with past disciplinary records. Third, FINRA will continue to evaluate firms' branch office inspection programs and supervisory systems.

b. Sales Practices

As with OCIE, FINRA likewise lists protection of senior investors as a top priority for 2017, with plans to assess firms' controls to protect seniors from fraudulent or risky products and advice poorly suited to the needs of a senior investor. FINRA specifically singles out microcap fraud as a target of its initiative. Oversight of product suitability will also extend to sales directed at non-senior customers, based on several instances in the past year where FINRA found that registered representatives provided advice that resulted in excessive portfolio concentration for a customer. FINRA has also made a priority of increasing its monitoring of excessive and short-term trading of long-term products, firms' policies with regard to outside business practices and private securities transactions, and firms' social media communications.

c. Financial Risks

After 2016 assessments indicated the insufficiency of liquidity management practices among many firms, FINRA has prioritized evaluating firms' policies and practices regarding stress tests, funding contingency plans, and funding sources. FINRA also announced its intent to review firms' implementation of obligations established by FINRA Rule 4210, relating to credit risk policies and risk limit determinations.

d. Operational Risks

Consistent with OCIE's priorities, much of FINRA's attention on operational issues in the coming year will focus on cybersecurity risks, with particular attention on assessing firms' programs to mitigate those risks. Cybersecurity programs need to be tailored to a specific firm's business model, size, and risk profile. Procedures to prevent data loss are of particular concern. Firms should note FINRA's warning that many member firms have demonstrated shortcomings with regard to record retention and branch office data protection.[3] FINRA also made note of its continuing concern with other operational risks, including supervisory control testing, disclosure, and certification pursuant to FINRA Rules 3120 and 3130, client asset segregation, municipal adviser registration, and anti-money laundering controls. Regulation SHO will also feature prominently in FINRA's 2017 priority list, given a trend of recent enforcement actions where firms were found not to have a reasonable basis to believe that securities were available for borrowing prior to accepting a short sale.

e. Market Integrity

FINRA reiterated its commitment to detecting and deterring market manipulation and committed to upgrade several key aspects of its market integrity oversight program. In particular, FINRA plans to enhance its layering pattern surveillance to look for large groups of market participants potentially engaging in manipulation, will include exchange-traded products in the cross-product surveillance patterns to detect layering in underlying equities to influence options prices, and will continue to improve the usefulness of its Cross Market Equity Supervision Report Cards. FINRA also expects to make use of data obtained from the Order Audit Trail System, which requires alternative trading systems to submit a broad array of order book activities to FINRA.

FINRA identified the importance of best execution obligations and indicated this would remain a priority in light of increased automation of the market for equity securities, the prominence of standardized options, and recent advances in trading technology and communications in the fixed income markets. Encouragingly, FINRA plans to allocate its resources by first alerting firms to problems with audit trail reporting and only opening investigations when problems are widespread and long-standing. In addition, FINRA noted its intent to monitor the tick size pilot program and compliance with the market access rule on a continuous basis.

III. Conclusion

As set forth in the OCIE and FINRA examination priorities for 2017, both regulators have signaled a commitment to a robust regulatory and compliance agenda for the coming year. The alignment between the two documents is noteworthy and suggests a shift to an increasing reliance on FINRA for broker-dealer examinations while OCIE focuses its own efforts on investment adviser and SCI-entity examinations. The SEC currently oversees more than 4,000 broker-dealers and 12,000 investment advisers, in addition to 850 fund complexes. Because these priorities may also be supplemented by other areas of focus based on the arrival of new leadership at the SEC and other market developments, registrants and member firms must be watchful for other emerging risks as 2017 unfolds.[4]

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3 *See FINRA Fines Broker-Dealer $650,000 for Cybersecurity Lapses*, WFG Client Memorandum (Nov. 21, 2016), available here.

4 For additional regulatory context related to the presidential transition, please see *The New Administration: Potential Cyber and Privacy Issues*, WFG Client Memorandum (Dec. 21, 2016), available here; *The New Administration: Trade*, WFG Client Memorandum (Dec. 21, 2016), available here.

If you have any questions regarding this memorandum, please contact James R. Burns (202-303-1241, jburns@willkie.com), Elizabeth P. Gray (202-303-1207, egray@willkie.com), Katherine Doty Hanniford (202-303-1157, khanniford@willkie.com) or the Willkie attorney with whom you regularly work.

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