

SEC STAFF ANNOUNCES PRIORITIES FOR EXAMINING INVESTMENT ADVISERS AND BROKER-DEALERS

The Securities and Exchange Commission (“SEC”) Office of Compliance Inspections and Examinations (“OCIE”) conducts routine and special examinations of registered Investment Advisers (“IAs”) and registered broker-dealers (“B-Ds”) to foster compliance with securities laws, detect violations, identify risks, and inform policy. On February 21, 2013, the OCIE announced its 2013 priorities for the examinations it conducts. Many of the topics are continuing concerns that have been included in examinations for years, but some topics are new. This *Client Alert* highlights a few of the “new and emerging issues” identified by the OCIE for its examinations of IAs and B-Ds for 2013, but IAs and B-Ds can review the entire document here: www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf.

INVESTMENT ADVISERS

New Registrants. Of the 2,000 new IA registrants since the 2012 effective date of the Dodd-Frank Act, the vast majority are advisers to hedge funds and private equity funds that have never been registered, regulated, or examined by the SEC. The OCIE intends to launch a coordinated national examination initiative designed to establish a meaningful presence with newly registered advisers. The initiative is expected to run for approximately two years and consists of four phases: (i) engage with the new registrants; (ii) examine a substantial percentage of the new registrants;

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(iii) analyze the examination findings; and (iv) report to the industry on the Staff’s observations. The OCIE will also prioritize examinations of private fund advisers where the Staff’s analytics indicate higher risks to investors relative to the rest of the registrant population or where there are indicia of fraud or other serious wrongdoing.

Dually Registered IAs and B-Ds. Due to the continued convergence in the IA and B-D industry, the OCIE will continue to expand examinations of dually registered firms and distinct B-D and IA businesses that share common financial professionals. For example, it is not uncommon for a financial professional to conduct brokerage business through a B-D that the individual does not own or control and to conduct investment advisory business through an IA that the individual does own and control but that is not overseen by the B-D. This business model presents multiple conflicts. Among other things, the Staff will review how financial professionals and firms satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations, and whether all conflicts of interest are fully and accurately disclosed. In addition, the Staff will review dually registered firms’ policies and procedures to understand if such policies and procedures provide guidelines to follow when a financial professional makes a securities recommendation to a customer with a B-D account versus an IA account.

“Alternative” Investment Companies. The Staff is focusing on the growing use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds (“ETFs”), and variable

annuity structures. More specifically, the Staff will assess whether: (i) leverage, liquidity, and valuation policies and practices comply with regulations; (ii) boards, compliance personnel, and back-offices are staffed, funded, and empowered to handle the new strategies; and (iii) the funds are being marketed to investors in compliance with regulations.

Payments for Distribution in Guise. The Staff is focusing on the wide variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments, and boards' oversight of the same. These payments go by many names and are purportedly made for a variety of services, most commonly revenue sharing, sub-transfer agent, shareholder servicing, and conference support. The Staff will assess whether such payments are made in compliance with regulations, including Investment Company Act Rule 12b-1, or whether they are instead payments for distribution and preferential treatment.

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BROKER-DEALERS

In addition to the joint examinations of dually registered IAs and B-Ds described above, the Staff anticipates that new and emerging issues for the B-D program for 2013 will include:

Exchange Act Rule 15c3-5, (the Market Access Rule). The Staff will focus on firms' compliance with this rule, paying particular attention to master/sub-accounts relations and proper controls relating to proprietary trading. Some areas of particular focus:

- **Master / Sub-Accounts:** The structure of this model lends itself to potential issues related to money laundering activity, market manipulation, unregistered broker-dealers, excessive margin, and inadequate minimum equity for pattern day traders. Staff will also

look at the adequacy of books and records maintained by broker-dealers that provide market access.

- **Proprietary Trading:** Some firms are unaware that the rule applies to and requires capital thresholds on proprietary trading, including error accounts. These thresholds must also encompass a methodology for accounting for open quotes, taking into account quotes associated with market making activities.

- **Supervision of Registrants' Technology System Controls and Governance:** The Staff has observed a series of technology system problems that have caused firms significant losses and eroded customer confidence in the markets. These technology system errors have occurred at both the exchange level as well as at multiple B-Ds. These events have raised questions as to the effectiveness of B-Ds' controls and oversight over technology systems and supervision of personnel, as well as the adequacy of firms' protocols to address systems that are acting counter to expectations, and the robustness of firms' risk management procedures.

- **Dual Registrants/ Regulatory Coordination:** In the aftermath of notable problems encountered in the past year by certain B-Ds dually registered as futures commission merchants, the examination program will maintain its focus in this area in coordination with the Commodity Futures Trading Commission ("CFTC"). More broadly, the B-D Program is emphasizing stronger coordination among Designated Examination Authorities.

Exchange-Traded Funds. Recent examinations have highlighted certain issues and risks relating to ETFs, such as failures to deliver and compliance with Regulation SHO. In addition, the B-D Program will continue to review the suitability of recommendations of leveraged or inverse ETFs to retail investors.

JOBS Act. Upon approval of a final rule relating to the JOBS Act, which creates a new exemption from registration under the Securities Act for qualified “crowd funding” transactions, the Staff intends to conduct reviews of entities participating in the crowd funding business, as appropriate.

Other Regulatory Requirements. The Staff intends to assess compliance with the new registration and related rules applicable to municipal advisors as well as incentive compensation, pending adoption of final rules.

ADDITIONAL INFORMATION

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