On March 3, the Division of Examinations (Division) of the Securities and Exchange Commission (SEC) announced its 2021 Examination Priorities. Published annually for the last nine years, the priorities are designed to provide securities industry participants with insight into the Division’s risk-based approach to examinations and the areas it currently believes present potential risks to investors and the US capital markets. The 2021 release highlights nine areas:

- Retail investors, including seniors and retirement savers
- Information security and operational resiliency
- Financial technology and innovation, including digital assets
- Anti-money laundering (AML)
- London Inter-Bank Offered Rate (LIBOR) transition
- Registered investments advisers (RIAs) compliance programs and investment companies
- Broker-dealer financial responsibility and trading practices and municipal advisors
- Market infrastructure (clearing agencies, exchanges, and transfer agents) and
- Regulating the regulators: examinations of the Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB).
The priorities list is prefaced with a message from the Division’s leadership team and an introduction offering further insight to the Division’s work and strategic direction. Set forth below is our summary and key takeaways.

**Leadership message and introduction**

As a preface to the priorities list, the Division included a leadership message and introduction that highlighted several key facts and insights:

- In light of the challenges caused by the COVID-19 pandemic, the Division early on pivoted to focus on the most pressing risks, which included whether registered firms’ business continuity plans were updated, operational, and effective and addressing increased cybersecurity risks facing firms and investors. In the Division’s view, the financial markets’ operations and systems generally continued to work as designed during the pandemic, with exchanges, clearing agencies, RIAs, broker-dealers, and other market participants adapting to significant remote work and continuing to operate largely without incident. Cybersecurity risks – in particular an increased use of ransomware and credential stuffing – remain a concern, and the Division reminded market participants of its recent risk alerts and report on these topics.
- Regulation BI and Form CRS are an important focus of the Division. The Division reminded market participants of its 2020 risk alerts and its December 2020 Statement on Recent and Upcoming Regulation BI Examinations (discussed below.) The Division also highlighted its Broker-Dealer and Exchange (BDX) program, through which the Division coordinates with other SEC Divisions and FINRA to develop examination materials. BDX is also working on examination materials for security-based swaps.
- Culture and tone at the top remain a key focus of the Division. It identifies hallmarks of an effective compliance program as active engagement in most firm operations, early involvement in important business developments, and knowledgeable and empowered Chief Compliance Officers with the authority and resources to develop and enforce policies and procedures.
- Despite the pandemic, the Division completed 2,952 examinations, about a 4 percent decrease from the prior fiscal year. This included examining 15 percent of 13,900 RIAs. The examination program covered 100 fund complexes, 330 broker-dealers, over 110 exchanges, and 90 municipal advisors and transfer agents. The Division issued more than 2,000 deficiency letters and made more than 130 referrals to the Division of Enforcement thus far.
- The Division is adjusting course in FY 2021 to respond to market events, for example risks regarding the widespread compromise of commonly used network management software and “meme” stock activity. To respond to new and emerging risk areas more effectively, the Division has created the Event and Emerging Risks Examination Team (EERT). The Division will leverage the EERT “to proactively engage with registered firms and other market participants about emerging threats and current market events and quickly mobilize to provide expertise and resources to the SEC’s regional offices when critical matters arise.”
- The examination program remains grounded in the Division’s four pillars: promoting compliance, preventing fraud, identifying and monitoring risks, and informing policy.

**2021 priorities**

The 2021 priorities include the following nine areas:

1. **Retail investors, including seniors and retirement savers**
   The Division will continue to prioritize examinations of RIAs, broker-dealers, and dually registered or affiliated firms as more and more individuals rely on these financial intermediaries to gain access to the financial markets. Key areas include Regulation Best Interest (Reg BI); fraud, sales practices, and conflicts of interest; and securities products that pose elevated risks when marketed to retail customers.
   - **Regulation BI**
     Regulation Best Interest (Reg BI) and Form CRS remain front and center of the Division’s priorities. The Division noted the extensive work that it did in 2020, culminating in a December 2020 statement on recent and upcoming examinations. The Division intends to expand the scope of 2021 examinations to focus on specific requirements of the regulation and conduct enhanced transaction testing to determine whether broker-dealers have effectively implemented their written policies and procedures. Exam
components may include continued evaluation of firm policies and procedures and alterations to firm product offerings; consideration of costs in making a recommendation; processes firm personnel have used to make recommendations to new customers (e.g., rollovers); evaluation of the processes firm personnel have used to recommend complex products; and evaluation of the processes used to identify and address conflicts related to recommendations. The Division will assess documentation on these topics including whether there is documentation of how associated persons consider costs in making recommendations.

The Division noted that it will update its processes to enforce 2019's Regulation Best Interest, which requires broker-dealers and their representatives to act in the best interest of retail customers when making a recommendation of any securities transaction or investment strategy involving securities without placing their financial or other interests ahead of the interests of the retail customer. Prior examinations focused on the processes that broker-dealers relied upon to implement the regulation. Examinations now will focus on assessing compliance with Regulation Best Interest in practice, by assessing whether broker-dealers have a reasonable belief that recommendations are in a client's best interest based on specific circumstances, as well as through transaction testing.

The Division will also continue to assess whether RIAs have fulfilled their duties of care and loyalty in serving the best interests of their clients, based on their clients' objectives. This will include assessing fees and expenses, the complexity of products, best execution practices and whether compensation arrangements are adequately disclosed.

The Division will also prioritize examination of broker-dealers and RIAs to assess compliance with Form CRS. RIAs must provide Form CRS to retail investors, which describes the relationship and provides information about the firm. The form must also be filed with the SEC and posted on any publicly available website maintained by the firm.

- **Fraud, sales practices, and conflicts**
  The Division emphasized the critical importance of providing the disclosures required by federal securities laws, including those related to fees and expenses and conflicts of interest. Examinations will focus on the appropriateness of recommendations and advice provided to retail investors, with a particular emphasis on (1) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; (2) teachers; (3) military personnel; and (4) individuals saving for retirement.

  Areas of concentration include recommendations regarding account type, conversions, and rollovers, as well as the sales practices used by firms for various product types, such as structured products, exchange-traded products, real estate investment trusts, private placements, annuities, digital assets, municipal and other fixed income securities, and microcap securities. The Division will also examine broker-dealers to assess whether they are meeting their legal and compliance obligations when providing retail customers access to complex strategies, such as options trading, and complex products. The Division will also focus on how firms are complying with the accredited investor definition when recommending and selling certain private offerings.

  Another area of focus will be firms' disclosures regarding their conflicts of interest, including those related to fees and expenses. A particular area of priority will be the examination of RIAs operating and utilizing turnkey asset management platforms, which provide RIAs with technology, investment research, portfolio management and other outsourcing services. Examinations will assess whether such fees and revenue sharing arrangements are adequately disclosed. The staff also will review for: (1) advisory fee calculation errors; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts.

- **Retail-targeted investments**
  The Division will also prioritize the following retail targeted investments:

  - **Mutual funds and ETFs** — The Division will focus on financial intermediaries' recommendations and adequacy of risk disclosures involving ETFs, particularly in niche or leveraged/inverse ETFs. It will also continue to prioritize the examination of incentives provided to financial services firms and professionals that may influence the share class selection.
Municipal securities and other fixed income securities – The Division will focus on broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements.

Microcap securities (market capitalization under $250 million) – In 2020, the Commission suspended trading of multiple securities due to concerns about the adequacy and accuracy of information in the marketplace about the issuers, including concerns related to testing and treatment of COVID-19. The Division will continue to monitor microcap issues, including transfer agent handling of microcap distributions and share transfers; broker-dealer sales practices and their consistency with Regulation Best Interest; and broker-dealer compliance with certain regulatory requirements, including the locate requirement of Regulation SHO, penny stock disclosure rules, and the obligation to monitor for and report suspicious activity and other AML obligations.

2. Information security and operational resiliency
The Division continues to view information security as critical to the operation of the financial markets and the confidence of market participants; the impact of a breach in information security may have consequences well beyond the compromised firm. The Division also noted increased concerns about, among other things, endpoint security, data loss, remote access, use of third-party communication systems, and vendor management as companies transitioned to remote work in response to the pandemic. As such, the Division will review whether firms have taken appropriate measures to (1) safeguard customer accounts and prevent account intrusions, including verifying an investor’s identity to prevent unauthorized account access; (2) oversee vendors and service providers; (3) address malicious email activities, such as phishing or account intrusions; (4) respond to incidents, including those related to ransomware attacks; and (5) manage operational risk as a result of dispersed employees in a work-from-home environment, including management of the use of online and mobile applications.

In addition, the Division will focus on examining registrants’ preparation for climate-related business disruptions. Similar to the work done by the Division and other regulators following Hurricane Sandy in 2012, the Division will assess whether registrants, particularly systemically important registrants, maintain business continuity and disaster recovery plans that account for the growing physical and other relevant risks associated with climate change.

3. Financial technology and innovation, including digital assets
With innovation in financial technology continuing to grow at a rapid pace and transforming customer interactions, the Division expressed its commitment to staying informed about how such technology affects registrants and investors. The Division recognized innovative and evolving services, such as providing advice to clients through automated investment tools and platforms (“robo-advisers”) or firms offering automated asset allocation, fractional share purchases, customized portfolios, and mobile applications. Examinations will focus on evaluating whether firms are operating consistently with their representations, whether firms are handling customer orders in accordance with customer instructions, and review compliance around trade recommendations made in mobile applications. Examinations will also focus on the use of technology to facilitate compliance with regulatory requirements (RegTech).

The Division also stated that alternative data (data gleaned from non-traditional sources) is increasingly being used by firms, including advisers to private funds and mutual funds, as part of their business and investment decision-making processes. Examinations will include examining whether firms are implementing appropriate controls and compliance around such information.

The Division plans to monitor the evolution of digital assets going forward. Examinations of market participants engaged with digital assets will continue to assess the following: (1) whether investments are in the best interests of investors; (2) portfolio management and trading practices; (3) safety of client funds and assets; (4) pricing and valuation; (5) effectiveness of compliance programs and controls; and (6) supervision of representatives’ outside business activities.

4. AML
The Division continues to highlight the importance of AML requirements that are used to detect and combat terrorist financing, public corruption, market manipulation, and other fraudulent behaviors. As such, the
Division will continue to prioritize examination of broker-dealers and registered investment companies for compliance with their anti-money laundering obligations. Specifically, the Division will assess whether firms have established appropriate customer identification programs and whether they are satisfying their Suspicious Activity Report filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs.

5. **LIBOR transition**

The Division recognizes that the discontinuation of LIBOR could present a material risk to many market participants. As such, the Division intends to engage with registrants through examinations to assess their understanding of any exposure to LIBOR, their preparations for the expected discontinuation of LIBOR, and the transition to an alternative reference rate, in connection with registrants’ own financial matters and those of their clients and customers.

6. **Additional focus areas involving RIAs and investment companies**

The Division will continue to examine compliance programs of RIAs in one or more core areas, including the appropriateness of account selection, portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, business continuity plans, and valuation of client assets for consistency and appropriateness of methodology. The Division will prioritize examination of RIAs that have not been examined for a number of years to assess whether their compliance programs remain effective in light of any growth or change in business models as well as RIAs that are dually registered as broker-dealers.

The Division also notes that, due to customer demand, RIAs have increasingly begun offering investment strategies focusing on environmental sustainability. The Division will review products in this area to assess the extent to which they align with disclosures and comply with advertising requirements; the Division will also review proxy voting procedures and votes to assess whether they align with the strategy. The Division also highlights the following products for examination.

- **Registered funds, including mutual funds and ETFs:** The Division intends to prioritize examining mutual funds and ETFs, the activities of their RIAs, and oversight practices of their boards of directors for regulatory compliance and valuation issues. With respect to valuation, the Division will review for investments in market sectors that experienced, or continue to experience, stress due to the pandemic, such as energy, real estate, or products such as bank loans and high yield corporate and municipal bonds. The Division will also prioritize examinations of mutual funds or ETFs that have not previously been examined or have not been examined in a number of years, and will generally focus on funds’ compliance programs and financial condition, particularly where funds have instituted advisory fee waivers or sought exemptive relief.

  In addition, the Division will focus on liquidity risk management programs and liquidity classifications, to determine whether they are reasonably designed to assess and manage the funds’ liquidity risk and appropriate in light of the recent stresses in the market due to the pandemic. The Division also intends to focus on money market funds’ compliance with stress-testing requirements, website disclosures, and board oversight.

- **RIAs to private funds:** The Division will continue its focus on RIAs to private funds, noting that such funds often have significant investments from pensions, charities, endowments, and families. The Division will review such RIAs for preferential treatment of certain investors by advisers to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; portfolio valuations and the resulting impact on management fees; adequacy of disclosure and compliance with regulatory requirements for cross trades, principal investments, or distressed sales; and conflicts around liquidity, such as adviser led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund. The Division will also focus on RIAs to private funds that have a higher concentration of structured products, such as collateralized loan obligations, that are at a higher risk of holding non-performing loans or material impacts due to recent economic conditions, such as real estate related investments.
7. **Additional focus areas involving broker-dealers and municipal advisors**

In addition to the Regulation Best Interest, the Division will also focus on the safety of customer cash and securities, best execution, trading strategies, and the operation of alternative trading systems. The Division highlighted the following areas.

- **Broker-dealer financial responsibility:** The Division will examine whether broker-dealers meet their obligations to safeguard customer cash and securities in compliance with the Customer Protection Rule and Net Capital Rule. In addition, the Division stated that examinations will assess compliance with requirements for borrowing securities from customers. The Division may also assess broker-dealer funding and liquidity risk management practices to assess whether firms have sufficient liquidity to manage stress events.

- **Broker-dealer trading practices:** The Division will focus on best execution obligations in a zero-commission environment and compliance with the recently amended Rule 606 order routing disclosure rules. The Division will continue its prior initiative in the area of payment for order flow and its possible effect on order routing and best execution obligations. Examinations will also focus on market maker compliance with Regulation SHO, including the rules regarding aggregation units and locate requirements. The Division will also examine the operations of certain alternative trading systems for consistency with their disclosure requirements.

- **Municipal advisors:** The Division noted the impact of COVID-19 on many municipal issuers and will examine the extent to which such issuers and municipal advisors have adjusted their practices in response to the pandemic. The Division will also examine whether municipal advisors have met their fiduciary duty obligations to municipal entity clients, as well as their registration, professional qualification, continuing education, and supervision requirements and whether municipal advisors have relied on relief from Form MA annual update filing requirements, or the temporary broker exemptive order permitting certain activities in connection with direct placements of municipal securities.

8. **Market infrastructure**

The Division remains focused on entities that provide services that are critical to the functioning of the capital markets, including clearing agencies, exchanges, alternative trading systems, and transfer agents.

- **Clearing agencies:** As required by law, the Division will conduct at least one risk-based exam of each clearing agency designated as systemically important and for which the SEC serves as the supervisory agency. The Division will focus on (1) compliance with the SEC’s Standards for Covered Clearing Agencies and other federal securities laws applicable to registered clearing agencies; (2) whether clearing agencies have taken timely appropriate corrective action in response to prior examinations; and (3) other areas identified in collaboration with the SEC’s Division of Trading and Markets and other regulators. Examinations of registered clearing agencies may also include assessment of legal, recovery and wind down, margin, back-testing, settlement and operations, liquidity risk management, effect of the LIBOR transition, and cybersecurity and resiliency.

- **Exchanges:** The Division will focus on exchanges’ operations to monitor, investigate, and enforce member and listed company compliance with, as applicable, exchange rules and the federal securities laws.

- **Regulation systems compliance and integrity (SCI):** SEC Regulation SCI requires entities such as exchanges, clearing agencies, FINRA, the MSRB, alternative trading systems, and certain other entities to establish, maintain, and enforce written policies and procedures designed to ensure that their system capacity, integrity, resiliency, availability, and security is adequate to maintain operational capability and promote fair and orderly markets. When certain events occur, these entities must take appropriate corrective action as soon as reasonably practicable and immediately notify the SEC. Areas of focus will include IT governance, IT asset management, cyber threat management/incident response, business continuity planning, and third-party vendor management, including utilization of cloud services.

- **Transfer agents:** Noting the critical role of transfer agents in the settlement of securities transactions, the Division will examine transfer agents’ core functions including timely turnaround of items and transfers, record-keeping and retention, and safeguarding of funds and securities. The Division will also consider a firm’s business continuity and disaster recovery programs, as well as their cybersecurity measures and account takeover precautions, in light of the COVID-19 pandemic. The Division has identified transfer agents that present the greatest possible risks to investors and investment channels.
(ie, where/how retail investors are more likely to invest), as well as transfer agents that service microcap or municipal bond issues, use novel technological applications (eg, blockchain or online crowdfunding portal applications), or engage in significant paying agent activity, as candidates for examination.

9. Regulating the regulators: FINRA and MSRB

The Division conducts risk-based oversight examinations of FINRA’s major regulatory programs as well as oversight exams of FINRA’s examinations of certain broker-dealers and municipal advisors. From these observations, the Division makes detailed recommendations to improve FINRA’s program, risk assessment processes, and its future examinations. Last year, the Division completed over 150 examinations of FINRA. The Division uses similar processes with the MSRB.

Key takeaways

In sum, the 2021 Priorities reflect the Division’s assessment of risks, issues, and policy matters derived from developments in the markets and in the regulation of those markets, information gathered during examinations and from tips, complaints, and referrals, and coordination with other SEC Divisions and Offices, as well as other regulators. Our key takeaways are:

- Climate and ESG risks and the risks posed by the growing digital asset industry emerged as new priorities for the Division going into the 2021 examination season. Examiners will scrutinize firms’ climate and ESG disclosures to assess whether disclosures are consistent and adequately addressing areas of critical import to investors, whether firms’ internal processes and practices align with their disclosures, whether fund advertising is accurate, and whether the voting policies and processes align with stated strategies. Similarly, examiners will scrutinize digital asset investments to ensure they are serving investors’ interests and adequate controls exist to protect those interests.
- Expanded coordination efforts within the SEC and with other regulators will continue to allow the Division, FINRA, and others to conduct more focused examinations on issues of key interest to the SEC.
- The Division’s December 2020 statement on recent and upcoming Regulation BI examinations is a roadmap to what firms should expect and market participants should review it carefully. Firms should also expect the Division to incorporate data analytics as part of its transaction testing as it assesses whether firms are truly acting in the best interest of their clients. The transition period for “good faith” efforts to implement Regulation BI is likely over.
- There will be enhanced focus on how firms address potential market disruption issues such as those that emerged during recent volatile trading events where some investors were unable to have trades executed for a period of time.
- Perennial priority repeats from past years include information security and operational resiliency, AML, and a continuing focus on retail investors.
- There is significant consistency in the Division’s priorities for broker-dealers with those announced by FINRA, including Reg BI, AML, cybersecurity, fixed income markup disclosure, private placements, and net capital and liquidity management.

As in prior years, the Division’s list of priorities should not be viewed as exclusive areas of focus. Examiners can—and will—explore other areas that they believe pose risks to investors, including new risk areas that may emerge as a result of feedback from the public regarding potential activity that may violate federal securities laws or otherwise harm investors, as well as market or policy shifts. “Our priorities reflect the complicated, diverse, and evolving nature of the risks to investors and the markets, including climate and ESG,” Division Director Pete Driscoll said in the press release announcing the priorities. “In this unprecedented time, the Division is committed to continuing to adapt examination processes and find innovative ways to enhance the effectiveness of examinations and our risk-based approach. However, the bedrock of our examination program remains unchanged. The work we do, from examinations to publishing risk alerts and conducting outreach, serves our mission to promote compliance and protect investors.”

If you have any questions regarding the 2021 Priorities, need assistance in preparing for a regulatory exam, or would like to discuss your firm’s compliance and supervisory policies and procedures, please contact one of the authors.
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