

MEMO# 31472

November 9, 2018

OCIE Publishes Risk Alert Announcing Focus During Its Risk-Based Exams of Registered Investment Companies

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November 9, 2018 TO: Chief Compliance Officer Committee
Chief Risk Officer Committee

Internal Audit Committee RE: OCIE Publishes Risk Alert Announcing Focus During Its Risk-Based Exams of Registered Investment Companies

The SEC's Office of Compliance Inspections and Examinations (OCIE) has published a Risk Alert announcing the six types of funds it will focus on in examining registered investment companies.[\[1\]](#) These funds and the focus of reviews related to them are listed below. As a general matter, however, OCIE expects, as part of these reviews, to assess the funds':

- Policies and procedures to "validate that they are designed to address risks and conflicts, including Funds' boards oversight of the compliance program;"
- Disclosures – including prospectus disclosures, shareholder communications, and information presented to fund boards – regarding risks and conflicts of interest; and
- Deliberative processes utilized by funds, their advisers, and their board in overseeing practices and controls relating to risks and conflicts, including disclosures, portfolio management compliance, and fund governance.

The six types of funds OCIE intends to examine and the focus of their reviews, are as follows:[\[2\]](#)

1. Index Funds that Track Custom-Built Indexes

The staff plans to assess the unique risks and challenges associated with the roles of advisers and index providers as they relate to the selection and weighting of custom-built or bespoke index components. The staff will also review ongoing administration, management of the funds, and related performance advertising.

2. Smaller ETFs and/or ETFs with Little Secondary Market Trading Volume

In light of the bid/ask spread risks that smaller and thinly traded ETFs may present to investors, the staff will review the compliance risks, conflicts, and practices associated

with these funds. They will also review the adequacy of disclosures made to investors, tracking error monitoring, and board oversight, including the board's consideration of potential delisting and liquidation proceedings.

3. Mutual Funds with Higher Allocations to Certain Securitized Assets

According to the Risk Alert, funds that invest in securitized assets such as auto loans, student loans, credit card receivables, or mortgage-backed securities, may expose investors to unanticipated or nondisclosed risks, especially during times of market stress. Accordingly, the staff will review these funds to ensure they have adequate compliance, risk, and board oversight – particularly as it relates to pricing and valuation. They will also review disclosures to investors.

4. Funds with Aberrational Underperformance Relative to their Peer Groups

The staff's focus during these reviews will be on understanding the factors for the funds' aberrational underperformance relative to their peer groups, including asset allocation and the security selection process. These reviews will also focus on the adequacy of the funds' compliance program and board oversight of the funds.

5. Advisers Relatively New to Managing Mutual Funds

The focus of these reviews, which are not new to the list, is on ensuring that managers new to managing registered investment company portfolios have sufficient knowledge about the Investment Company Act of 1940 and are acting in conformity with all applicable legal requirements.

6. Side-by-Side Management of Mutual Funds and Private Funds

The Risk Alert notes that this is an area the staff have previously reviewed and, during such reviews, they have observed conflicts of interests associated with these arrangements. Among other things, the staff's focus during these reviews will be on these conflicts and how they are managed. The staff expects to review allocation of investment opportunities, trades, fees, and expenses; the fund's brokerage and best execution practices; and disclosures to fund boards.

The above is a summary the focus of these reviews. Complexes with funds that may be subject to them may want to read the Risk Alert for more detail regarding issues the staff will explore in conducting them. The Risk Alert notes that, in publishing it, OCIE encourages registrants "to reflect upon their own practices, policies, and procedures, as applicable, and to consider improvements in their supervisory, oversight, and compliance programs, as may be appropriate."

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endnotes

[\[1\]](#) See *Risk-Based Examination Initiatives Focused on Registered Investment Companies*, National Examination Program Risk Alert (November 8, 2018), which is available at

https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20RIC%20Initiatives_0.pdf.

[2] Of the reviews listed, we are aware that the staff has already begun those relating to index funds, ETF, and securitized assets.

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