

MEMO# 32044

November 8, 2019

OCIE Publishes Risk Alert with Observations from Examinations of Mutual Funds, Money Market Funds, and Target Date Funds

[32044]

November 8, 2019 TO: ICI Members

Investment Company Directors

Chief Compliance Officer Committee

Internal Audit Committee

Money Market Funds Advisory Committee

Operations Committee SUBJECTS: Compliance

Money Market Funds RE: OCIE Publishes Risk Alert with Observations from Examinations of Mutual Funds, Money Market Funds, and Target Date Funds

Yesterday, the SEC's Office of Compliance Inspections and Examinations (OCIE) published its latest Risk Alert, which is the first one highlighting observations from examinations of investment companies.[\[1\]](#) As with all OCIE Risk Alerts, this one was published to provide registrants and others information about the most often cited deficiencies and weaknesses that OCIE's staff has observed in examinations. The observations in the Risk Alert relating to investment companies resulted from nearly 300 fund examinations over a two-year period. The Risk Alert also includes observations from 70 money market fund exams and exams of 30 target date funds. The Risk Alert notes that while "many of the funds examined were not cited for a deficiency or weakness," OCIE believes that the information in the Risk Alert "can assist all funds in assessing compliance risks. OCIE's observations are briefly summarized below.

Top Compliance Observations from Exams of Investment Companies

According to OCIE, the most often cited deficiencies in exams of investment companies fall into one of four categories. These categories and some of OCIE's observations relating to the are as follows:

Fund Compliance Rule

OCIE's observations relating to the fund compliance rule, Rule 38a-1 under the Investment Company Act include:

- Funds adopting compliance programs that did not take into account the nature of the funds' business (e.g., neglecting to have policies and procedures to prevent the funds from violating their own investment limitations and guidelines);
- Funds having policies and procedures they neglect to follow or enforce (e.g., failing to get multiple broker quotes as required by their policies and procedures);
- Funds failing to adopt and implement policies and procedures to oversee compliance by their service providers;
- Funds failing to have the fund's board approve the policies and procedures of the fund's subadvisers; and
- Funds either not conducting the annual review required by Rule 38a-1 or failing to address in their review the adequacy of the fund's policies and procedures and the effectiveness of their implementation.

Disclosure to Investors

OCIE observed funds with incomplete or potentially misleading information in their prospectuses, SAIs, or shareholder reports "when compared to the funds' actual activities." For example, OCIE observed funds identifying "principal investment strategies" that the fund did not implement or failing to disclose fees paid to service providers.

The 15(c) Process

The most common deficiencies in this area according to OCIE were:

- Boards failing to request or consider information that was reasonably necessary for the board to evaluate the fund's investment advisory agreement (e.g., profitability of the adviser, economies of scale, or peer group comparisons);
- Boards receiving incomplete materials without requesting the omitted information (e.g., performance data and profitability reports); and
- Funds' shareholder reports failing to adequately discuss the material factors and conclusions that formed the basis for the board's approval of the advisory contract.

OCIE also observed funds failing to keep copies of materials the board considered in the 15(c) process or failing to keep detailed minutes of the process.

Fund Codes of Ethics

The deficiencies OCIE noted here were funds failing to:

- Implement a code of ethics;
- Follow or enforce the fund's code of ethics (e.g., funds failing to enforce pre-clearance and holding periods);
- Have the board approve the code of ethics; and
- Provide the fund's boards the required annual report detailing violations of the code of ethics and the sanctions imposed.

OCIE's Money Market Fund Initiative

The Risk Alert notes the significant reforms made to the SEC's money market fund rules in 2016. In the wake of these reforms, OCIE examined more than 70 money market funds to assess how they had implemented them. The funds examined included "a wide range of fund categories, including Government, Prime, and Tax Exempt funds, as well as [money market funds] that were also designated as Retail [Money Market Funds], which are required to limit their beneficial owners to natural persons."

While OCIE observed that these funds “appeared to be in substantial compliance” with the revised rules, OCIE staff did observe some deficiencies or weaknesses. These included funds failing to:

- Include in their credit files the factors to be considered when determining that a security presents minimal credit risks;
- Periodically update their credit files to support the eligible security determination;
- Maintain records supporting a determination that investments in repos with non-government entities were fully collateralized;
- Provide stress test results to boards that included the required summary of significant assumptions used in the stress tests;
- Adopt or implement P&P tailored to the Rule 2a-7 requirements (e.g., policies testing or issuer diversification, filing Form N-MFP, limiting investors in retail MMFs to natural persons);
- Post on their website all information required by Rule 2a-7; and
- Include all required legends in their advertising materials.

OCIE’s Target Date Fund Initiative

With respect to its review of target date funds, the Risk Alert notes that OCIE examined over 30 of these funds, including those managed to a target date and those managed through such date. The focus of the reviews was to determine whether the funds’ assets were investment according to the asset allocations stated in the funds’ prospectuses, and whether the associated investment risks were consistent with fund disclosures, including those made in marketing materials.

As with the money market funds examined, OCIE observed that most target date funds reviewed “appeared to be in general compliance with the 1940 Act.” It did, however, observe instances of deficiencies or weaknesses related to the funds’ disclosures or compliance programs. These included funds having:

- Incomplete or potentially misleading disclosures in their prospectuses or ads (e.g., complete asset allocation or glide path information and a discussion of the conflicts of interest that may result from the use of affiliated funds and advisers); and
- Incomplete or missing policies and procedures for monitoring asset allocations, overseeing glide path changes and allocations, overseeing ads and sales literature, and monitoring whether disclosures regarding glide path deviations were accurate.

OCIE encourages all funds to review their practices, policies and procedures in the areas discussed in the Risk Alert and to consider any improvements in their compliance programs as may be appropriate.

Tamara K. Salmon
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endnotes

[\[1\]](#) See *Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives*, Risk Alert, SEC OCIE (Nov. 7, 2019), which is available at:

<https://www.sec.gov/files/Risk%20Alert%20-%20Money%20Market%20Fund%20and%20Target%20Date%20Fund%20Initiatives.pdf>.

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