

**MEMO# 33869**

October 28, 2021

## **SEC's Division of Examinations Publishes Risk Alert After Examining More Than 50 Complexes and 200 Funds**

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TO: ICI Members

Chief Compliance Officer Committee

Internal Audit Committee

SEC Rules Committee SUBJECTS: Compliance

Valuation RE: SEC's Division of Examinations Publishes Risk Alert After Examining More Than 50 Complexes and 200 Funds

The SEC's Division of Examinations has published a Risk Alert summarizing its review of more than 50 fund complexes (covering more than 200 funds and/or series of funds) and nearly 100 advisers. These examinations targeted the following six categories that had been announced by the Division in a November 2018 Risk Alert and in the Division's 2019 priorities as areas of interest for the Division:[\[1\]](#)

1. Index funds that track custom-built indexes;
2. Smaller ETFs and/or ETFs with little secondary market trading volume;
3. Mutual funds with higher allocations to certain securitized investments;
4. Mutual funds with aberrational underperformance relative to their peer group;
5. Mutual funds managed by advisers that are relatively new to managing such funds; and
6. Advisers that provide advice to both mutual funds and private funds that either have similar strategies and/or are managed by the same portfolio manager.

In conducting these reviews, the staff was focused on:

1. How effective the compliance policies and procedures of the funds and their advisers are to address certain risks;
2. The funds' disclosures - to investors and fund boards - relating to risks and conflicts; and
3. Fund governance practices, particularly as they relate to overseeing the funds' compliance programs and assessing the funds' practices and controls.

Below is a summary of the Risk Alert's discussion of deficiencies and weaknesses the staff observed as well as of those practices that may assist funds and their advisers in designing and implementing their compliance programs.

## **Deficiencies Discussed in the Risk Alert**

### ***Observations Related to Funds' Compliance Programs***

The Risk Alert groups the deficiencies or weaknesses the staff observed relating to registrants' compliance programs under six headings. These headings and the deficiencies and weaknesses observed under each are as follows:

- **Compliance Oversight of Investments and Portfolios.** The weaknesses in this area include registrants failing to:
  - Monitor for portfolio management compliance;
  - Monitoring for each fund's specific investment restrictions;
  - Monitoring for the specific risks associated with each fund's investments;
  - Monitoring funds for compliance with the "Funds Names Rule;"
  - Addressing the administration of each fund's liquidity risk management program (LRMP) and providing appropriate oversight of the third-party vendors that provide liquidity classifications of holdings for purposes of the LRMP; and
  - Providing appropriate oversight of the viability of smaller and/or thinly traded ETFs and/or their liquidation, including communications with shareholders.
- **Compliance Oversight of Valuation.** Deficiencies in this area include funds' failure to:
  - Maintain an adequate compliance program for the valuation of portfolio securities, including processes, controls, or both that provide for the due diligence and oversight of the pricing vendors that provide evaluated prices for portfolio holdings for purposes of calculating the funds' daily net asset values;[\[2\]](#) and
  - Maintain appropriate policies, procedures and/or controls for valuation of portfolio securities, including provisions that address potential conflicts of interest.
- **Compliance Oversight of Trading Practices.** Deficiencies listed under this heading include the failure to:
  - Address appropriate trade allocations among clients to ensure all clients are treated fairly;
  - Prevent prohibited principal transactions with affiliates or joint transactions with affiliates;
  - Identify cross trades and prevent related violations of the legal requirements for crossing trading and principal trading; and
  - Ensure that no client is disadvantaged in the sharing of soft dollar commissions.
- **Compliance Oversight of Conflicts of Interest.** The two areas involving conflicts of interest appeared to relate to the index providers funds use:
  - In "dual capacity" instances where the adviser to an index fund also acts as the index provider; and
  - Where the arrangement with an index provider might involve conflicts as a result of the sharing of personnel or where the index provider is a related entity or has business arrangements with the fund. This section of the Risk Alert also expresses concerns with the sharing or potential misuse of material non-public information.

- Compliance Oversight of Fees and Expenses. This area of the Risk Alert highlights deficiencies involving monitoring the allocation of expenses between funds and their advisers subject to fee waivers and ensuring the accuracy and consistency of fee calculations and what has been disclosed to investors about fund expenses.
- Compliance Oversight of Funds Advertisements and Sales Literature. During their review, the staff observed funds failing to review the accuracy of fund advertisements and file their advertisements. Also highlighted was funds failing, when the fund links to the website of an affiliated index provider, to determine whether the website disclosures are subject to FINRA's sales literature rules and, if so, to make sure they are in compliance with such rules.

### ***Observations Related to Fund Governance***

The deficiencies observed relating to fund governance include funds failing to:

- Have appropriate policies, procedures, and processes for monitoring and reporting to fund boards accurate information relating to:
  - Fees paid by the funds to financial intermediaries and other service providers that provide shareholder services;
  - The types of services provided by the fund's service providers;
  - Pricing exceptions under the fund's valuation policies and procedures;
  - Adviser recommendations relating to fund liquidation; and
  - Portfolio compliance with senior securities and asset coverage requirements.
- Provide appropriate processes, as part of the respective fund board's annual review and approval of the fund's investment advisory agreement under Section 15(c) of the Investment Company Act, regarding board consideration relating to the adviser's financial condition;
- Ensure that the required annual review of the funds' compliance programs address the adequacy of the funds' compliance policies and procedures and the effectiveness of their implementation;
- Ensure that the fund's compliance report addresses the adviser's compliance policies and procedures; and
- Adopt or maintain appropriate policies and procedures for the fund's board to exercise appropriate oversight when the fund delegates responsibilities to their adviser and the adviser's policies and procedures do not mention such responsibilities.

### ***Deficiencies Related to Disclosure to Investors***

According to the staff, they observed disclosure failures involving disclosures relating to:

- Certain principal investment strategies;
- Risks of investing in the fund;
- Potential conflicts of interest associated with allocating investment opportunities among overlapping investment strategies;
- Changes in the broad-based indexes used for comparison of fund performance;
- Funds' net assets, net expense ratios, contractual expense limitations, and/or operating expenses subject to a contractual expense limitation;
- In the SAI, failing to disclose information relating to standing committees of the fund's board; and
- An accurate number of accounts and total assets managed by the portfolio managers.

With respect to advertising and sales literature, the staff observed funds using inaccurate, incomplete, or missing disclosure relating to:

- Investment strategies and portfolio holdings;
- The differences in investment objectives between predecessor and successor funds;
- Inception dates;
- Funds' expenses, contractual expense limitations, and/or expense ratios;
- Average total returns and/or gross expenses and net expenses;
- Performance information not disclosed with required legends;
- Details relating to awards the fund received for fund performance;
- Weighting of index constituents in the benchmark index;
- Methodologies for calculating the performance of the benchmark index;
- Differences in holdings, risk, and volatility between the broad-based and bespoke indexes used for performance comparisons; and/or
- The composition of an index used for performance comparison.

## **Beneficial Practices**

As noted above, as with most of the Division's Risk Alerts, following a discussion of deficiencies observed during the Division's review, the current Risk Alert also discusses "practices that may assist funds and their advisers in designing and implementing their compliance programs." The practices identified in this portion of the Risk Alert include funds and/or their advisers:

- Reviewing compliance policies and procedures (the fund's and adviser's) for consistency with their practices;
- Conducting periodic testing and reviews for (i) compliance with disclosures and (ii) to assess the effectiveness of compliance policies and procedures to address conflicts of interest;
- Ensuring the compliance program adequately addresses the oversight of key vendors, including pricing vendors;
- Adopting and implementing policies and procedures to address:
  - Compliance with applicable regulations;
  - Compliance with the terms and conditions of applicable exemptive orders; and
  - Undisclosed conflicts of interest;
- Assessing the accuracy of information provided to fund boards;
- Complying with the funds' processes for board reporting;
- Reviewing the accuracy of all of the funds' disclosure documents;
- Ensuring fund disclosures are up-to-date;
- Reviewing and testing fees and expenses disclosed in fund documents for accuracy and completeness; and
- Reviewing and testing funds' performance advertising for accuracy and appropriateness of the presentation and applicable disclosures.

The Division encourages funds and their advisers to review their practices, policies, and procedures in the areas discussed in the Risk Alert to consider improvements in their compliance programs and disclosure practices as appropriate.

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## endnotes

[1] See Risk-Based Examination Initiatives Focused on Registered Investment Companies (Division of Examinations Risk Alert, Nov. 8, 2018), which is *available at* <https://www.sec.gov/ocie/announcement/ocie-risk-alert-registered-investment-company-initiative>. See, also, the 2019 Priorities of the National Examination Program *available at* <https://www.sec.gov/files/OCIE%202019%20Priorities.pdf>.

[2] Footnote 8 to the Risk Alert lists examples of due diligence and oversight processes that funds may use in overseeing their pricing vendors.

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