October 26, 2021

Observations from Examinations in the Registered Investment Company Initiatives*

I. Introduction

The Division of Examinations (the "Division") conducted a series of examinations that focused on mutual funds and exchange-traded funds (collectively, "funds") to assess industry practices and regulatory compliance in certain areas that may have an impact on retail investors ("RIC Initiatives" or "Initiatives"). The RIC Initiatives were announced in a Risk Alert in November 2018 and included in the Division's fiscal year 2019 priorities.[1] The RIC Initiatives focused on funds and/or their investment advisers ("advisers") that fell into one or more of the following six categories: (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 groups; (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, both of which have similar strategies and/or are managed by the same portfolio managers.

This Risk Alert provides observations made by Division staff during examinations conducted under the RIC Initiatives, including examinations of more than 50 fund complexes – covering more than 200 funds and/or series of funds – and nearly 100 advisers. In conducting these examinations, the Division issued deficiency letters to some firms, while other firms did not receive deficiency letters. However, the Division believes the observations in this Risk Alert can assist all funds in assessing compliance risks. The more frequent deficiencies and weaknesses are summarized below. This Risk Alert is intended to highlight risk areas and assist funds and their advisers in developing and enhancing their compliance programs and practices.

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* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

1 *See* Division, Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies (Nov. 8, 2018) and Division, 2019 Examination Priorities (December 18, 2018).

II. Focus of Initiatives

The scope of the examinations and focus areas selected for review were tailored to address the business practices, risks, and conflicts applicable to each of the six categories. However, across all examinations the staff generally assessed:

- *Effectiveness of the compliance policies and procedures of the funds and their advisers* to address certain risks – particularly in the areas of disclosures, portfolio management compliance, and conflicts of interest – and the efficacy of the oversight of funds' compliance programs by funds' boards.[2]

- *Disclosures by the funds to investors* in their prospectuses and other filings and shareholder communications, and by advisers to the funds' boards, regarding risks and conflicts in the highlighted areas.[3]

- *Fund governance practices*, particularly as they relate to the deliberative processes utilized by funds and funds' boards when exercising oversight of funds' compliance programs and assessing the practices and controls related to risks in the highlighted areas.[4]

III. Staff Observations from the Examinations

A. Compliance Program

Below are examples of deficiencies or weaknesses observed by the staff related to funds' and their advisers' compliance programs for portfolio management and other business practices, and board oversight of funds' compliance programs.

- *The staff observed funds and their advisers that did not establish, maintain, update, follow and/or appropriately tailor their compliance programs to address various business practices, including portfolio management, valuation, trading, conflicts of interest, fees and expenses, and advertising*. Examples include inadequate policies and procedures in the following areas:

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2 *See* Investment Company Act of 1940 ("IC Act") Rule 38a-1 and Investment Advisers Act of 1940 ("Advisers Act") Rule 206(4)-7. *See also* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IC-26299 (Dec. 17, 2003). Funds and advisers should adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws and the Advisers Act, respectively. Fund compliance programs should also include policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund (collectively, "service providers").

3 *See*, generally, IC Act Section 34(b), Securities Act of 1933 ("Securities Act") Section 17(a), Securities Exchange Act of 1934 Section 10(b), and Advisers Act Section 206(4) and Rule 206(4)-8 thereunder. Under the federal securities laws, it is unlawful to make untrue statements of material fact, or omit material information necessary to make other statements not misleading in registration statements, reports, and other documents filed with the Commission or provided to investors.

4 Each fund is required to have a board of directors, which is elected by shareholders to represent their interests. *See*, generally, IC Act Section 24(a) (requires a fund to file a registration under the Securities Act), Securities Act Section 6(a) (requires that a majority of the fund's directors sign the fund's registration statement), and IC Act Section 16(a) (requires that a director of a fund be elected by shareholders). A fund board's primary responsibility is to protect the interest of the fund and its shareholders, which may be adversely affected by any substantial ongoing conflicts of interest of the fund's investment adviser.

Compliance Oversight of Investments and Portfolios

- Monitoring for portfolio management compliance, including monitoring compliance requirements regarding trade aggregation, trade allocation and best execution, and senior securities and asset segregation.[5]

- Monitoring for adherence to each fund's specific investment restrictions (*e.g.*, investment concentration restrictions, limitations on investments in alternative investments, and/or restrictions on lower-rated securities).

- Monitoring for the specific risks associated with each fund's investments such as asset classes that present certain operational or other risks.

- Monitoring portfolios for compliance with the "Fund Names Rule," as applicable.[6]

- Addressing the administration of each fund's liquidity risk management program ("LRMP") and providing appropriate oversight of third-party vendors providing liquidity classifications of holdings for purposes of the funds' LRMP.[7]

- Providing appropriate oversight of the viability of smaller and/or thinly traded ETFs and oversight of their liquidation, as applicable, including communications with their shareholders.

Compliance Oversight of Valuation

- Maintaining an adequate compliance program for valuation of portfolio securities, including processes, controls, or both, that provide for due diligence and oversight of pricing vendors that provide evaluated prices for portfolio holdings for purposes of

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5 The Commission recently adopted new Rule 18f-4 for derivatives use by funds, which has a compliance date of August 19, 2022 (*see* Final Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (Nov. 2, 2020)). Prior to the compliance date for this new Rule, funds may choose to comply with Rule 18f-4 voluntarily, provided they no longer consider existing Commission and staff guidance and no-action letters that will be withdrawn on the compliance date.

6 *See also* IC Act Section 35(d) and Rule 35d-1 (requiring a fund to invest at least 80% of its net assets, plus any borrowings for investment purposes, in the particular type of investments, or in investments in the particular industry or industries, suggested by the fund's name).

7 *See* IC Act Rule 22e-4. *See also* Final Rule: Investment Company Liquidity Risk Management Programs, Release No. IC-32315 (Oct. 13, 2016). Open-end funds, including ETFs but not money market funds, are required to establish a written liquidity risk management program under Rule 22e-4 that will be overseen by the fund's board. Funds are required to classify the liquidity of each portfolio investment into one of four liquidity categories based on the number of days the fund reasonably expects the investment would be convertible to cash (or, in the case of the less-liquid and illiquid categories, sold or disposed of) without the conversion (or, in the case of the less-liquid and illiquid categories, sale or disposition) significantly changing the market value of the investment.

calculating the funds' daily net asset values.[8]

- Maintaining appropriate policies, procedures and/or controls for valuation of portfolio securities, including provisions that address potential conflicts and issues, such as where portfolio managers are permitted to provide input – as voting members of the valuation committee – on prices of securities in funds they managed.

Compliance Oversight of Trading Practices

- Addressing appropriate trade allocation among client accounts so that all clients are treated fairly, including instances where trades for fund clients are aggregated with trades for other client accounts, including sub-advised funds, wrap accounts, and other non-wrap client accounts.

- Preventing prohibited principal transactions with affiliates, prohibited joint transactions with affiliates, or both.[9]

- Identifying cross trades and preventing related violations of the legal requirements for cross trading and principal trading under the Advisers Act and the IC Act.[10]

- Addressing sharing of soft dollar commissions among clients to assess whether any client is disadvantaged.

Compliance Oversight of Conflicts of Interest

- Addressing advisers' conflicts of interest with funds and their service providers, such as certain "dual capacity" instances where the adviser to an index fund also acts as the index provider.

- Reviewing index providers and the services they provide for, among other things: (1) conflicts of interest with advisers, such as when they share personnel, are affiliated, and/or have business arrangements (*e.g.*, marketing support payments by index providers to advisers and/or revenue sharing payments by advisers to index providers); and (2) the sharing, or the potential misuse, of material non-public information.

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[8] Examples of due diligence and oversight processes concerning pricing vendors include, but are not limited to, processes for reviewing variance reports on stale or outlier prices and formal price challenges. *See* Division of Investment Management, Valuation Guidance Frequently Asked Questions ("FAQs") (Feb. 11, 2016) and Final Rule: Money Market Fund Reform; Amendments to Form PF ("money market reforms release"), Rel. No. IC-31166 (July 23, 2014) regarding oversight of mutual fund pricing service providers (FAQs provide responses to questions related to valuation guidance for all mutual funds provided in the money market reforms release). *See also* IC Act Rule 2a-5 and Final Rule: Good Faith Determinations of Fair Value, Rel. No. IC-34128 (Dec. 3, 2020) (adopting Rule 2a-5). New Rule 2a-5, which has a compliance date of Sept. 8, 2022, updates the regulatory framework on valuation practices and a board of director's role in valuating securities of a registered investment company or business development company. Under this new regulatory framework, funds may choose to comply with Rule 2a-5 voluntarily prior to the compliance date, provided they no longer consider Commission and staff guidance and no-action letters that will be withdrawn on the compliance date.

[9] *See* IC Act Sections 17(a) and 17(d), respectively.

[10] *See* Advisers Act Section 206(3) and IC Act Section 17(a). The staff also observed cross trades where the funds did not comply with the requirements under IC Act Rule 17a-7 (if certain conditions are met, Rule 17a-7 permits trades between a fund and certain affiliated persons, where the affiliation arises solely because the two have a common adviser, directors, and/or officers).

Compliance Oversight of Fees and Expenses

- Monitoring allocation of expenses between funds and their advisers, subject to any fee waivers by the adviser.

- Reviewing fee calculations for any inconsistencies between a fund's contractual expense limitation and its disclosures regarding expenses included in operating expenses, subject to the expense cap.

Compliance Oversight of Fund Advertisements and Sales Literature

- Reviewing and filing fund advertisements and sales literature, including review of fee and expense disclosures for whether they are fair, balanced and not misleading within the context in which they are made,[11] and, as applicable, the presentation of back-tested index returns (*e.g.*, the characteristics of back-tested index returns when compared to a fund's actual returns).

- Reviewing affiliated index providers' websites – accessible through hyperlinks in the statements of additional information ("SAIs") of self-indexing funds – to assess whether the websites may be deemed fund sales literature that should be filed with the Commission or FINRA.[12]

- *The staff observed issues with funds' policies and procedures for their boards' oversight of the funds' compliance programs*. For example, the staff observed funds that did not:

  - Have appropriate policies, procedures and processes for monitoring and reporting to their boards with accurate information, such as information regarding: (1) fees paid by the funds to financial intermediaries and other service providers for providing shareholder services; (2) the type of services provided by service providers; (3) pricing exceptions under the funds' valuation policies and procedures; (4) adviser's recommendation whether a fund's liquidation may be in the best interests of the fund and its shareholders;[13] and (5) portfolio compliance with senior securities and asset coverage requirements.[14]

  - 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 IC Act

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11 *See* FINRA Rule 2210(d).

12 *See* IC Act Section 24(b) and Rule 24b-3 (making it unlawful for any registered open-end investment company to transmit any advertisement, pamphlet, circular, form letter or other sales literature addressed to or intended for distribution to prospective investors unless the material has been filed with the Commission; filing of such material with FINRA is deemed to be filing with the Commission). *See also* SEC Interpretation: Use of Electronic Media, Investment Company Act Rel. No. IC-24426 (April 28, 2000) and Commission Guidance on the Use of Company Websites, Investment Company Act Rel. No. IC-28351 (August 1, 2008).

13 Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers, which includes both a duty of care and a duty of loyalty. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (Jun. 5, 2019).

14 *Supra* note 6.

regarding the board's considerations as to whether the adviser has any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients.[15]

- Complete required annual reviews of the funds' compliance programs that address the adequacy of policies and procedures and effectiveness of their implementation.[16]

- Ensure that the annual report from the respective fund's chief compliance officer addressed the operation of the policies and procedures of the fund's adviser,[17] including whether the adviser had policies and procedures in specific risk areas.

- Adopt or maintain appropriate policies and procedures for the funds' boards to exercise appropriate oversight in instances where the funds' delegated responsibilities to their advisers that were not reflected in the advisers' compliance programs.[18]

B. Disclosure to Investors

Below are examples of deficiencies or weaknesses observed by the staff related to the funds' disclosures to investors in fund filings, advertisements, sales literature and/or other shareholder communications.

- *The staff observed funds had inaccurate, incomplete and/or omitted disclosures in their filings*. Examples include:

  - Omitted disclosures regarding: (1) certain principal investment strategies and/or risks of investing in the funds;[19] (2) potential conflicts associated with allocating investment opportunities among overlapping investment strategies;[20] and (3) change in the broad-

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15 *See* IC Act Section 15(c). For example, the board's considerations may include review of the adviser's responses to the 15(c) questionnaire provided to the adviser by counsel to the fund and/or counsel to the fund's independent directors.

16 *See* IC Act Rule 38a-1(a)(3).

17 *See* IC Act Rule 38a-1(a)(4)(iii)(A). The staff also observed a number of instances of inaccurate Form ADV disclosures by advisers, including: (1) disclosure of investment allocation practices and trade monitoring practices inconsistent with actual practices; (2) inadequate disclosure of differences between a private fund and a mutual fund with similar, if not identical, investment strategies and overlapping investment managers; (3) omission of sub-advised funds from the investment company advisory business; (4) omission of certain advisory client accounts over which the adviser or a related person had custody; (5) failure to disclose change in ownership following spin-off of broker-dealer affiliate; and/or (6) inaccurate disclosure concerning receipt of soft dollar benefits.

18 The staff also observed advisers that did not have annual reviews of their compliance program that were consistent with Advisers Act Rule 206(4)-7(b).

19 *See* Item 9(b)(1) of Form N-1A, which requires a fund to disclose its principal investment strategies (including the type or types of securities in which the fund invests or will invest principally). Instruction 2 to Item 9(b)(1) of Form N-1A states that a fund shall, in determining whether a strategy is a principal investment strategy, consider, among other things, the amount of the fund's assets expected to be committed to the strategy, the amount of the fund's assets expected to be placed at risk by the strategy, and the likelihood of the fund's losing some or all of those assets from implementing the strategy. *See also* Item 9(c) of Form N-1A, which requires a fund to disclose the principal risks of investing in the fund, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return.

20 The staff also observed instances where advisers that managed mutual funds and private funds with similar strategies or were managed by the same portfolio managers did not disclose conflicts, including failure to disclose conflicts associated with their allocation of investment opportunities. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (Jun. 5, 2019).

based indexes used for comparison of funds' performance.[21]

- Inconsistent and/or inaccurate disclosure concerning the funds' net assets and net expense ratios, contractual expense limitations, and/or operating expenses subject to the contractual expense limitation.

- Did not disclose in the funds' SAIs required information concerning standing committees of a fund's board and accurate information regarding the number of accounts and total assets managed by the portfolio managers within each of the required categories.[22]

- *The staff observed funds that had inaccurate, incomplete, and/or omitted disclosures on a variety of advertising and sales literature-related topics*, such as: (1) investment strategies and portfolio holdings; (2) the differences in investment objective between predecessor and successor funds; (3) inception dates; (4) funds' expenses, contractual expense limitations, and/or expense ratios; (5) average total returns and/or gross expenses and net expenses;[23] (6) performance information not disclosed with the required legends;[24] (7) awards received for fund performance;[25] (8) weighting of index constituents in the benchmark index; (9) methodologies for calculating the performance of the benchmark index; (10) differences in holdings, risk, and volatility between the broad-based and bespoke indexes used for performance comparisons; and/or (11) composition of index used for performance comparisons.

C. Staff Observations Regarding Compliance and Disclosure Practices

The staff observed various practices with respect to funds' and their advisers' compliance programs, the boards' oversight of funds' compliance programs, and disclosure practices that funds and their advisers may find helpful in their compliance oversight practices. Below is a sampled list of practices that may assist funds and their advisers in designing and implementing their compliance programs.

- *Certain funds and their advisers adopted and implemented compliance programs that provided for the following:*

  - Review of compliance policies and procedures for consistency with practices (*e.g.*, funds reviewed their advisers' compliance manuals for specific policies and procedures addressing various risk areas for which the funds had delegated responsibility to their

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21 *See* Instruction 2(c) of Item 4 of Form N-1A.

22 *See* Item 17(b)(2) and Item 20 of Form N-1A, respectively (Item 20 requires accounts and assets managed information by the following three categories: registered funds, other pooled investment vehicles, and other accounts).

23 *See* Securities Act Rule 482(d)(5) (requires that total returns and any non-standardized performance be disclosed with equal prominence). *See* FINRA Rule 2210(d)(5) and FINRA Notice to Members 06-48, "SEC Approves Amendments to NASD Rules 2210 and 2211 to Require Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material" (gross and any net operating expense ratios should be disclosed in a fair and balanced manner).

24 Securities Act Rule 482(b)(3).

25 The staff observed instances where funds did not disclose material facts regarding awards received for fund performance, *e.g.*, the selection criteria for the award, the amount of any fee paid by the adviser to receive or promote the award, the number of other funds that applied and received the award, or whether the adviser was required to be a member of an organization to receive the award.

advisers).

- Conducting periodic testing and reviews for compliance with disclosures (*e.g.*, review whether funds are complying with their stated investment objectives, investment strategies, restrictions, and other disclosures) and assess the effectiveness of compliance policies and procedures in addressing conflicts of interests (*e.g.*, review trade and expense allocation policies and procedures in light of potential conflicts that may exist among the various types of accounts managed by the adviser).

- Ensuring compliance programs adequately address the oversight of key vendors, such as pricing vendors (*e.g.*, written pricing vendor oversight processes include reviewing variance reports on stale or outlier prices and price challenges).

- Adopting and implementing policies and procedures to address: (1) compliance with applicable regulations (*e.g.*, to identify cross trades, where applicable, and prevent related violations); (2) compliance with the terms and conditions of applicable exemptive orders and any disclosures required to be made under the order; and (3) undisclosed conflicts of interest, including potential conflicts between funds and/or advisers and their affiliated service providers.

- *Certain funds' boards provided oversight of funds' compliance programs by assessing whether:*

  - The information provided to the board was accurate, including whether funds' and their advisers were accurately disclosing to the boards: (1) funds' fees, expenses and performance, and (2) funds' investment strategies, any changes to the strategies, and the risks associated with the respective strategies.

  - The funds were adhering to their processes for board reporting, including an annual review of the adequacy of the funds' compliance program and effectiveness of their implementation.

- *Certain funds adopted and implemented policies and procedures concerning disclosure, such as those that required:*

  - Review and amendment of disclosures in funds' prospectuses, SAIs, shareholder reports or other investor communications consistent with the funds' investments and investment policies and restrictions.

  - Amendment of disclosures for consistency with actions taken by the funds' boards, as applicable.

  - Update of funds' website disclosures concurrently with new or amended disclosures in funds' prospectuses, SAIs, shareholder reports or other client communications.

  - Review and testing of fees and expenses disclosed in funds' prospectuses, SAIs, shareholder reports or other client communications for accuracy and completeness of presentation.

- Review and testing of funds' performance advertising for accuracy and appropriateness of presentation and applicable disclosures.

III. Conclusion

In response to these observations, many of the funds and their advisers revised their compliance policies and procedures, amended disclosures, or changed certain practices. In sharing the information in this Risk Alert, the Division encourages funds and their advisers to review their practices, policies, and procedures in these areas and to consider improvements in their compliance programs and disclosure practices, as appropriate.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.