SEC'S OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS ANNOUNCES RISK-BASED EXAM INITIATIVES FOCUSED ON REGISTERED FUNDS AND INVESTMENT ADVISERS

Date: 5 December 2018

Investment Management Alert

By: Vincente L. Martinez, Shane C. Shannon, Trayne S. Wheeler

The Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert on November 8, 2018, stating that it is conducting a series of examination initiatives focused on matters relevant to mutual funds and exchange-traded funds ("ETFs"). The Risk Alert states that the OCIE staff ("Staff") will generally assess practices, risks, and conflicts regarding: (1) policies and procedures of funds and advisers, including board oversight of the compliance program; (2) disclosures by funds to investors and by advisers to boards; and (3) the deliberative processes utilized by funds, advisers, and boards.

According to the Risk Alert, examinations will focus on funds and/or advisers that fall into one or more of the following categories:

1. **Index funds that track custom-built indexes.** The Staff will assess the unique risks and challenges associated with advisers and index providers as they relate to the selection and weighting of a custom-built or bespoke index [1], ongoing index administration, management of the fund, and related performance advertising. The Staff plans to: (1) review the manner in which funds are managed relative to their disclosures; (2) understand the adequacy of disclosures made to the funds' boards regarding the index providers; (3) assess whether any conflicts of interest between the index providers and advisers are appropriately addressed; and (4) review the effectiveness of the funds' compliance programs and board oversight of such programs.

Takeaways: Under existing ETF exemptive relief, index-based ETFs with affiliated index providers are subject to certain regulatory requirements not applicable to ETFs with unaffiliated index providers. In many instances, the adviser and any affiliated index provider are required to adopt procedures forbidding such persons who receive information relating to the index constituents from improperly using or disseminating such information and using this information to influence changes to the affiliated indexes. In light of this information, advisers may want to ensure that any such procedures currently in place are adequate.

2. **Smaller and/or thinly traded ETFs.** Smaller ETFs and/or ETFs with little secondary market trading volume are subject to specific risks such as increases in bid/ask spreads, increases in premiums/discounts to net asset value, and the risk of being delisted from an exchange. The Staff will assess whether: (1) such risks are adequately disclosed to investors; (2) board oversight incorporates the ETF's viability; (3) tracking errors are effectively monitored; (4) funds are appropriately distributed to shareholders upon liquidation; and (5) delisting and associated liquidation proceedings have received requisite board approvals and oversight.

Takeaways: The Staff may review information provided to a fund board in connection with the board's approval of a fund's liquidation. This may result in the increased scrutiny of other options presented to a fund's board, such as a potential merger, changes to the fund's investment strategy, and changes to the fund's portfolio managers or subadvisers, among others.

3. Mutual funds with aberrational underperformance relative to their peer groups. The Staff will review the effectiveness of mutual fund compliance programs and whether fund boards are exercising appropriate oversight of their compliance programs. In particular, the Staff will focus on portfolio management processes, including whether funds or their advisers are: (1) investing in a manner consistent with the funds' disclosed investment objectives and/or investment strategies; (2) using advertising and marketing materials that contain complete and accurate disclosure of a funds' investment objectives, policies, risks, and/or restrictions; (3) allocating investment opportunities to the funds in a manner consistent with their advisers' fiduciary duties; and (4) adhering to applicable requirements when borrowing or investing in instruments that may leverage funds.

4. Mutual funds with higher allocations to certain securitized assets. With respect to funds that invest in certain securitized assets, such as auto loans, student loans, credit card receivables, or mortgage-backed securities, the Staff will assess whether the funds and/or their advisers have appropriate: (1) policies, procedures, and practices, and related oversight, specifically relating to portfolio management activities and investment risks; (2) portfolio management activities, including risk identification, monitoring, and mitigation practices to evaluate how advisers are managing securitized assets and the liquidity of such assets; (3) valuation and pricing policies and procedures; (4) governance and board oversight practices, particularly those regarding pricing/valuation; and (5) disclosures to investors, particularly risk disclosures.

Takeaways: The Staff cited concerns that retail investors are not receiving adequate disclosure relating to the risks of securitized assets, such as the risks of accelerating delinquency rates and unexpected market stresses. Such assets also may be subject to increased valuation risk and liquidity risk, as well as the risk that investors are less familiar with securitized assets. Advisers and fund complexes should ensure that the disclosure regarding a fund's investments in securitized assets is adequate and that policies and procedures are in place to address their unique risks.

5. Side-by-side management of mutual funds and private funds. The Staff will target advisers that manage both registered funds and private funds with similar investment strategies and/or the same portfolio managers. The Staff will evaluate advisers': (1) policies and procedures for addressing conflicts of interest and other risks associated with side-by-side management; (2) controls for ensuring appropriate brokerage, best execution, and trade aggregation and allocation practices; (3) allocation practices for various fees and expenses; and (4) disclosures to investors and fund boards.

Takeaways: The Staff noted that, based on observations from prior exams, it has identified conflicts of interest associated with side-by-side management. In light of this information, advisers may want to review their procedures to ensure they are adequate, including that any aggregation be consistent with its duty to seek best execution for its clients and that no advisory client will be favored over any other advisory client.

6. Funds managed by advisers that are relatively new to managing registered investment companies. The Staff will evaluate: (1) fund governance to ensure that boards are provided with sufficient information; (2) the effectiveness of advisers' and funds' compliance programs; and (3) marketing and distribution efforts related to funds.

Takeaways: The Staff is concerned about new advisers' knowledge of the Investment Company Act of 1940. Advisers that are relatively new to managing registered funds should ensure that they have proper compliance resources and policies and procedures in place to address these Staff's concerns.

Finally, the Risk Alert encourages funds to review their own practices, policies, and procedures and to consider enhancements to their supervisory, oversight, and compliance programs. Funds are required to review, at least annually, the adequacy of their policies and procedures. This Client Alert provides brief "takeaways" that fund complexes may wish to consider in response to the Risk Alert or, at the very least, items that fund complexes should carefully review in connection with the annual review of their compliance programs.

NOTE

[1] A custom-built or bespoke index is one that is created and/or maintained by an index provider for a single fund or sponsor. It may allow for a more complex or targeted investment strategy than has been traditionally associated with funds that track generally disseminated market indexes.