

SEC Division of Examinations Releases Observations from Registered Investment Company Initiatives Examinations

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The Securities and Exchange Commission’s Division of Examinations (the “Division”) has conducted its annual series of examinations to evaluate industry practices that may impact retail investors—commonly referred to as RIC Initiatives (for Registered Investment Companies). The examinations focused on mutual funds and exchange-traded funds and/or their investment advisers in 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.
6. Advisers that provide advice to both mutual funds and private funds, which have similar strategies and/or are managed by the same portfolio managers.

The RIC Initiatives, introduced in the Division's November 2018 Risk Alert, is an annual report that provides observations from examinations of more than 50 fund complexes that cover more than 200 funds and/or series of funds and nearly 100 advisers. Although some firms received deficiency letters, the Division released a summary of its discoveries in a Risk Alert designed to help all funds assess compliance risks.

The Division's staff highlighted business practices, risks and conflicts pertaining to the six identified categories, with an emphasis on three areas of focus:

1. Effectiveness of the compliance policies and procedures of the funds and their advisers.
 1. The Division investigated whether policies and procedures led funds and their advisers to address certain risks, especially in the areas of disclosures, portfolio management compliance and conflicts of interest, as well as the value of the oversight of funds' compliance programs by funds' boards.
2. Disclosures by the funds to investors.
 1. Staff studied the fashion in which funds disclose information about risks and conflicts in their prospectuses, other filings and shareholder communications.
3. Fund governance practices.
 1. Each fund is required to have a board of directors that serves in the best interest of the shareholders who elected them. The staff's examination studied the deliberative processes funds and funds' boards utilize while exercising oversight of their compliance programs.

Staff Observations from the Examinations

The staff observed compliance program deficiencies related to funds and advisers, including the following examples:

Oversight of Investments and Portfolios

- Monitoring for portfolio management compliance, including requirements

focused on trade aggregation, trade allocation and best execution, as well as senior securities and asset segregation.

- Monitoring for adherence to funds' specific investment restrictions, as well as monitoring risks associated with specific investments classes that present certain operational risk, and for compliance with the "Fund Names Rule," as applicable.
- Evaluating how each fund's liquidity risk management program (LRMP) is administered and providing appropriate oversight of third-party vendors providing liquidity classifications of holdings for the purposes of the funds' LRMP.
- Providing appropriate oversight of the practicality of smaller and/or thinly traded ETFs and oversight of their liquidation including communications with shareholders.

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 calculating the funds' daily net asset values.
- Maintaining policies, procedures and or controls for valuation of portfolio securities that include provisions that address potential conflicts and issues (e.g., portfolio managers providing input on prices of securities in funds they managed as voting members on the valuation committee).

Oversight of Trading Practices

- Addressing appropriate trade allocation among client accounts to ensure all clients are treated fairly, including instances where trades for fund clients are aggregated with trades for other client accounts, including sub-advised funds and wrap accounts.
- Preventing prohibited principal transactions and/or joint transactions with affiliates.
- Identifying cross trades and preventing any associated violations under the

Advisors Act and the IC Act.

- Assessing whether a client is disadvantaged through the sharing of soft-dollar commissions.

Oversight of Conflicts of Interest

- Addressing conflicts of interest advisers face with funds and their service providers, including certain “dual capacity” instances that require an adviser to an index fund to also serve as an index provider.
- Addressing conflicts of interest when advisers share personnel or are affiliated with and/or have business relationships, as well as the sharing or misuse of sensitive non-public information.

Oversight of Fees and Expenses

- Monitoring the allocation of expenses between funds and their advisers; reviewing the fee calculations for inconsistencies between a fund’s contractual expense limitation and the expenses noted in its disclosures.

Oversight of Fund Advertisements and Sales Literature

- Reviewing advertisements and sales literature, particularly fee and expense disclosures to decipher whether they are fair, balanced, and not misleading within the context in which they are made.
- Assessing whether affiliated index providers’ website links accessible through the statements of additional information (“SAI”) may be deemed fund sales literature and thus be filed with the Commission or FINRA.

Staff Observations of Funds’ Policies and Procedures

The staff observed funds that did not have the correct policies, procedures and processes in place to properly monitor and report information about fees and pricing, as well as the services provided by service providers and advisers’ recommendations on whether a fund’s liquidation may be in the best interest of the fund and its shareholders.

Staff Observations of Compliance and Disclosure Practices

Certain funds and their advisers implemented compliance programs that examined whether compliance policies and procedures are consistent, in addition to conducting periodic testing and reviews for compliance while also ensuring that programs address oversight of key vendors.

Conclusion

In response to the Division staff's observations, many funds and advisers should consider revising their compliance policies and procedures, updating disclosures and other practices. If you have questions about how this might impact your fund, please reach out to [David Horton](#) or your Anchin Relationship Partner.