NATIONAL EXAM PROGRAM
RISK ALERT

By the Office of Compliance Inspections and Examinations[*] *November 8, 2018*

Risk-Based Examination Initiatives
Focused on Registered Investment Companies

In this Alert:

Topic: *OCIE is conducting a series of examination initiatives focused on matters relevant to certain registered investment companies.*

Key Takeaways: *Examiners intend to focus on certain mutual funds and exchange-traded funds, the activities of their advisers, and boards of directors' oversight. Examinations will target circumstances in which retail investors could be disadvantaged and review whether registrants have met their regulatory and other legal obligations.*

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE") is conducting a series of examination initiatives 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.[1] OCIE is issuing this Risk Alert to provide additional information concerning these initiatives.

Specifically, examinations will focus on Funds and/or advisers that fall into one or more of the following categories:

- Index funds that track custom-built indexes;
- Smaller ETFs and/or ETFs with little secondary market trading volume;
- Mutual funds with higher allocations to certain securitized assets;
- Funds with aberrational underperformance relative to their peer groups;
- Advisers relatively new to managing mutual funds; and
- Advisers who provide advice to both mutual funds and private funds that have similar strategies and/or are managed by the same portfolio managers.

Examination scopes and focus areas will be tailored to address the business practices, risks, and conflicts applicable to each topic. However, the staff will generally assess:

- Policies and procedures of the Funds and/or their advisers, to validate that they are designed to address risks and conflicts, including Funds' boards oversight of the compliance program;

[*] The views expressed herein are those of the staff of OCIE. The Securities and Exchange Commission (the "SEC" or the "Commission") has expressed no view on the contents of this Risk Alert. This document was prepared by OCIE staff and is not legal advice.

[1] OCIE continues to prioritize the examination of matters of importance to retail investors. Mutual funds and exchange-traded funds ("ETFs") are the primary investment vehicles for many retail investors (i.e., Fund shareholders). *See* 2018 National Examination Program Examination Priorities (February 7, 2018).

- Disclosures by Funds to investors in their prospectuses and other filings and shareholder communications, and by advisers to the Funds' boards, regarding risks and conflicts; and
- Deliberative processes utilized by Funds, their advisers, and their boards exercising oversight, particularly when assessing practices and controls related to risks and conflicts, including disclosures, portfolio management compliance, and fund governance.

II. Specific Focus Areas Per Initiative

Below are additional details regarding the focus areas and risks that staff will assess for each of the initiatives identified above.

- ***Index Funds that track custom-built indexes.*** 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 is used to select the Fund's investments, and may allow for a more complex or targeted investment strategy than has been traditionally associated with index funds. The staff will assess the unique risks and challenges associated with the roles of advisers and index providers as they relate to the selection and weighting of the custom-built or bespoke index components, ongoing index administration, management of the Funds, and related performance advertising. During these examinations, staff will also seek to:
    - Review the manner in which the portfolios are managed compared to the Funds' disclosures to investors describing their strategy;
    - Understand the nature of services provided by the index providers, and the adequacy of disclosures made to the Funds' boards regarding the index providers;
    - Assess whether any conflicts of interest between the index providers and advisers are appropriately addressed; and
    - Review the effectiveness of the Funds' compliance programs for portfolio management and their boards' oversight of such programs.

- ***Smaller and/or thinly traded ETFs.*** Smaller ETFs and/or ETFs that have little secondary market trading volume may present risks to investors including, for example, increases in bid/ask spreads and increasing premiums/discounts to net asset value. These ETFs may also face the risk of being delisted from an exchange and having to liquidate their assets. If that should happen, the market price of the ETFs has the potential to rapidly decline and investors may bear the cost to liquidate the ETFs' assets. Some of the compliance risks, conflicts, and practices the staff will assess include whether:
    - Investment risks are adequately disclosed to investors, including risks associated with liquidating ETFs, as applicable;
    - Board oversight incorporates the ETF's ability to continue as an ongoing concern;
    - Tracking errors are effectively monitored;
    - Portfolios are appropriately liquidated for distribution to shareholders upon liquidation, as applicable; and
    - Delisting and associated liquidation proceedings have received the requisite board approvals and oversight, as applicable.

- ***Mutual funds with aberrational underperformance relative to their peer groups.*** The staff will seek to understand the factors for the mutual funds' aberrational underperformance relative to their peer groups, including asset allocation and security selection processes. In addition, the staff will review the effectiveness of the mutual funds' compliance programs and whether the mutual funds' boards are exercising appropriate oversight of their compliance programs. In particular, when reviewing the mutual funds' compliance programs, the staff will focus on the funds' portfolio management processes, including whether the funds or their advisers are:

  - Investing in a manner consistent with the mutual funds' investment objectives and/or investment strategies, as disclosed in their prospectuses and other filings with the Commission and shareholder communications;
  - Using advertising and marketing materials that contain complete and accurate statements related to the mutual funds' investment objectives, policies, risks, and/or restrictions;
  - Allocating investment opportunities to the mutual funds in a manner that is consistent with their advisers' fiduciary duty; and
  - Adhering to applicable requirements when borrowing or investing the mutual funds' portfolios in instruments that may leverage the funds.

- ***Mutual funds with higher allocations to certain securitized assets.*** Mutual funds investing in certain securitized assets (e.g., securitized auto loans, student loans, credit card receivables, or mortgage-backed securities) may expose retail investors to risks that may not be adequately disclosed to investors, or investment risks not anticipated by the investment adviser given potential changes in market condition (e.g., accelerating delinquency rates) and unexpected market stresses. During the examinations, staff will assess whether the mutual funds' and/or their advisers' have appropriate:
  - Policies, procedures, and practices, and related oversight, specifically those addressing portfolio management activities and investment risks;
  - Portfolio management activities including risk identification, monitoring and mitigation practices to evaluate how advisers are managing the mutual funds' portfolio holdings and liquidity;
  - Valuation and pricing policies and procedures, that include understanding the mutual funds' pricing practices and use of vendors, especially with respect to illiquid securities and other securities or asset classes that are potentially difficult to value;
  - Governance and board oversight practices, particularly those regarding pricing/valuation; and
  - Disclosures to investors, particularly with respect to investment risks.

- ***Side-by-side management of mutual funds and private funds.*** The staff has identified, based on observations from prior examination efforts, conflicts of interest associated with advisers who provide advice to both mutual funds and private funds, particularly when managed pursuant to similar strategies and/or by the same portfolio managers, which may present certain risks to retail investors. The staff will evaluate advisers':
  - Policies and procedures for addressing conflicts of interest and other risks associated with side-by-side management, particularly those related to certain portfolio management and portfolio construction practices;

  - Controls for ensuring appropriate brokerage, best execution, and trade allocation practices, including trade aggregation and allocation of investment opportunities in a manner consistent with the advisers' fiduciary duty;
  - Allocation practices for various fees and expenses; and
  - Disclosures to investors and Funds' boards.

- ***Funds managed by advisers that are relatively new to managing registered investment companies.*** Although advisers that are relatively new to managing Funds may not be new to the investment management industry, there is the potential for these firms to lack experience or sufficient knowledge regarding the Investment Company Act of 1940. Lack of adequate compliance support increases the risk of not complying with Fund-specific regulatory requirements, engaging in prohibited transactions, and/or omitting information required to be disclosed to investors. The staff will evaluate:
  - Fund governance to ensure that boards are provided with sufficient information to perform their duties;
  - The effectiveness of advisers' and Funds' compliance programs; and
  - Marketing and distribution efforts related to the Funds.

While these are the primary focus areas for the initiatives, the staff may select additional topics based on operational and other risks identified during the course of the examinations.

III. Conclusion

In sharing the focus areas for these initiatives, OCIE is encouraging registrants to reflect upon their own practices, policies, and procedures, as applicable, and to consider improvements in their supervisory, oversight, and compliance programs, as may be appropriate.

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) 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.