



# RISK ALERT

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

November 7, 2019

## Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives

### I. Introduction

The Office of Compliance Inspections and Examinations (“OCIE”)\* is issuing this Risk Alert to provide investment companies, investors, and other market participants with information on the most often cited deficiencies and weaknesses that the staff has observed in recent examinations of registered investment companies (“funds”).<sup>1</sup> In addition, this Risk Alert includes observations by the staff from national examination initiatives focusing on money market funds and target date funds.

### II. Top Compliance Observations from Examinations of Investment Companies

This Risk Alert reflects the most often cited deficiencies and weaknesses observed in nearly 300 fund examinations over a two year period. These examinations were conducted pursuant to examination initiatives, including initiatives from OCIE’s annual priorities, or as a result of being selected through OCIE’s risk assessment program. As further discussed below, the most often cited deficiencies and weaknesses are those related to the fund compliance rule, disclosure to investors, the board approval process involving advisory contracts, and the fund code of ethics rule. Even though many of the funds examined were not cited for a deficiency or weakness, OCIE believes the following information can assist all funds in assessing compliance risks.

#### Fund Compliance Rule

The fund compliance rule requires a fund to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance for each investment adviser, principal underwriter, administrator, and transfer agent of the fund (collectively, “service providers”).<sup>2</sup> In addition, the fund board must approve the policies and procedures of the fund’s service providers.<sup>3</sup> The rule also requires that each fund annually review the adequacy and effectiveness of the policies and procedures of the fund and its service providers and the

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\* The views expressed herein are those of the staff of OCIE. 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 OCIE staff and is not legal advice.

<sup>1</sup> The examples in this Risk Alert are illustrative only and do not reflect all types of deficiencies or weaknesses.

<sup>2</sup> The Investment Company Act of 1940 (“1940 Act”) Rule 38a-1(a)(1).

<sup>3</sup> 1940 Act Rule 38a-1(a)(2).

effectiveness of their implementation.<sup>4</sup> The fund's chief compliance officer must also annually provide a written report to the fund board that addresses, among other things, the operation of the policies and procedures and material changes to those policies and procedures.<sup>5</sup>

Below are the most often cited deficiencies or weaknesses OCIE staff observed in connection with the fund compliance rule:

- *Compliance programs that did not take into account the nature of funds' business activities.* The staff observed funds' compliance programs that did not take into account business activities or risks specific to the fund. For example, staff observed funds that did not have policies and procedures reasonably designed to prevent the funds from violating their own investment limitations and guidelines. In other examples, funds lacked procedures to review the appropriateness and accuracy of the methods used in pricing securities, or lacked procedures to ensure disclosures made in advertisements or other sales literature are accurate and not materially misleading.
- *Policies and procedures not followed or enforced.* The staff observed funds that did not follow or enforce their compliance policies and procedures. For example, even where funds' policies and procedures required the fund's board to approve or ratify the fair valuations determined by the valuation committee, certain funds did not follow or enforce these policies and procedures. Similarly, staff observed funds that did not follow their policies and procedures regarding the funds' obligations to obtain multiple broker quotes in connection with cross trades to allow the fund's board to properly evaluate whether the trades had complied with the exemptions under the affiliated transaction rule.
- *Inadequate service provider oversight.* The staff observed funds that did not adopt and implement policies and procedures that were reasonably designed to oversee compliance by service providers. For example, certain policies and procedures did not provide for any ongoing monitoring or due diligence of providers' services relating to pricing of portfolio securities and fund shares. Additionally, the staff observed funds where the policies and procedures of the funds' subadvisers had not been approved by the fund's board.
- *Annual reviews were not performed or did not address the adequacy of the funds' policies and procedures.* The staff observed that certain funds did not conduct annual reviews of their policies and procedures, or the lack of supporting documentation was such that it was unclear if these annual reviews were completed.<sup>6</sup> The staff also observed that certain funds conducted annual reviews of their policies and procedures, but those reviews did not address the adequacy of the funds' policies and procedures and the effectiveness of their implementation.

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<sup>4</sup> 1940 Act Rule 38a-1(a)(3).

<sup>5</sup> 1940 Act Rule 38a-1(a)(4).

<sup>6</sup> 1940 Act Rule 38a-1(a)(3).

## Disclosure to Investors

The federal securities laws make it 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 otherwise provided to investors.<sup>7</sup> In connection with funds' disclosures to investors, the most often cited deficiencies or weaknesses OCIE staff observed involved funds that provided incomplete or potentially materially misleading information in their prospectuses, statements of information, or shareholder reports when compared to the funds' actual activities that the staff observed during examinations. For example, certain funds did not disclose the payment of fees made to service providers, or disclose a change to an investment strategy. In other examples, funds' disclosures identified strategies as principal investment strategies even though the funds had not implemented (or did not expect to implement) these strategies.

## Section 15(c) Process

Section 15(c) of the 1940 Act requires a majority of the fund's independent directors to approve the fund initially entering into, or renewing, a contract or agreement with a person who undertakes regularly to serve or act as an investment adviser of or a principal underwriter for such fund.<sup>8</sup> As part of this approval process, all board members of the fund have a duty to request and evaluate information that may be reasonably necessary for the board to evaluate the terms of the adviser's contract.<sup>9</sup> In addition, the fund is required to preserve any documents or other written information its board considered in approving the terms or renewal of the contract or agreement between the fund and the adviser. Following a board's approval or renewal of an advisory contract, a fund's next shareholder report must discuss in reasonable detail the material factors and conclusions that formed the basis for the board's approval or renewal.<sup>10</sup>

Below are the most often cited deficiencies or weaknesses OCIE staff observed in connection with the Section 15(c) process:

- *Reasonably necessary information not requested or considered.* The staff observed that fund boards may not have requested or considered information reasonably necessary to evaluate the fund's investment advisory agreement. For example, certain boards did not appear to consider relevant information such as information related to the profitability of the fund to the adviser, economies of scale, or peer group comparisons for the advisory fee. The staff also observed fund boards that received incomplete materials, but did not request the omitted information, such as performance data for the fund and other accounts managed by the adviser and profitability reports.
- *Inadequate discussion forming the basis of board approval.* The staff observed funds' shareholder reports that did not appear to discuss adequately the material factors and

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<sup>7</sup> 1940 Act Section 34(b), Securities Act Section 17(a) and Exchange Act Section 10(b).

<sup>8</sup> 1940 Act Section 15(c).

<sup>9</sup> *Id.*

<sup>10</sup> See [Form N1-A, Item 27\(d\)\(6\)\(i\)](#) and related instructions.

conclusions that formed the basis for the board's approval of an investment advisory contract. In addition, staff observed instances in which boards' advisory contract review process may not have complied with Section 15(c). In some instances, funds did not keep copies of written materials the board considered in approving advisory contracts.<sup>11</sup> In other instances, because of the lack of supporting documentation, such as board minutes, it was unclear what information fund boards requested and considered.

## Fund Code of Ethics

The fund code of ethics rule requires funds, in addition to other entities, to adopt a written code of ethics containing provisions reasonably necessary to prevent their "access persons"<sup>12</sup> from engaging in any fraudulent, deceptive, or manipulative acts in connection with the purchase and sale of securities held or to be acquired by the fund.<sup>13</sup> The rule also generally requires access persons to report their personal securities holdings and transactions in "covered securities" to the fund.<sup>14</sup>

Below are the most often cited deficiencies and weaknesses OCIE staff observed in connection with the fund code of ethics rule:

- *Failure to implement code of ethics.* The staff observed funds that failed to implement procedures reasonably necessary to prevent violations of their codes of ethics. For example, certain funds' codes of ethics lacked procedures adequate to prevent access persons from misusing material non-public information such as procedures designating a separate individual to review the CCO's personal securities holdings and transactions reports, or procedures for determining and documenting that an access person was eligible for an exception. In addition, certain funds had implemented codes of ethics, but did not designate the proper individuals as access persons.
- *Failure to follow or enforce code of ethics.* The staff observed funds that failed to use reasonable diligence to prevent violations of their codes of ethics. For example, the staff observed funds that did not collect or review personal securities holdings and transactions reports of its access persons or did not enforce the pre-clearance and holdings period restrictions contained in its code of ethics.
- *Code of ethics approval and reporting.* The staff observed funds that failed to comply with their approval and reporting obligations with respect to their codes of ethics. For example, the staff observed codes of ethics that had not been initially approved by the fund's board. In other examples, the staff observed that fund boards had not been

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<sup>11</sup> 1940 Act Rule 31a-2(a)(6). In the adopting release, the Commission provided that this requirement was designed "to improve the documentation of a fund board's basis for approving a contract, which would assist [the Commission's] examination staff in determining whether fund directors are fulfilling their fiduciary duties when approving advisory contracts." See Investment Company Governance, 1940 Act Release No. 26520 (July 27, 2004) (final adopting amendments requiring funds that rely on certain exemptive rules to adopt certain governance practices).

<sup>12</sup> 1940 Act Rule 17j-1(a)(1).

<sup>13</sup> 1940 Act Rules 17j-1(b) and (c).

<sup>14</sup> 1940 Act Rule 17j-1(d).

provided the required annual report regarding code of ethics violations and sanctions or were provided reports that were inaccurate.

### **III. Observations from Certain National Examination Initiatives – Money Market Funds (MMFs) and Target Date Funds (TDFs)**

As part of OCIE’s assessment of market-wide risks and matters of importance to retail investors and investors saving for retirement, the staff recently conducted national examination initiatives focusing on MMFs and TDFs.<sup>15</sup> The staff’s observations from each of these examination initiatives are described below.

#### **MMF Initiative**

OCIE staff examined MMFs for compliance with the amendments to the rules governing MMFs that became effective in October 2016.<sup>16</sup> These amendments made significant changes to the manner in which MMFs operate and the matters for which fund boards have oversight responsibility. The staff examined more than 70 MMFs as part of the MMF Initiative across a wide range of fund categories, including Government, Prime, and Tax Exempt funds, as well as MMFs that were also designated as Retail MMFs, which are required to limit their beneficial owners to natural persons.

In general, OCIE staff observed that the MMFs examined appeared to be in substantial compliance with the amended MMF rules. However, as discussed below, the staff also observed instances of deficiencies or weaknesses related to MMFs’ portfolio management practices, compliance programs, and disclosures.

- *“Eligible securities” and minimal credit risk determinations.* Some MMFs did not:
  - Include in their credit files one or more of the factors required to be considered when determining whether a security presents minimal credit risks and is an eligible security, as defined under Rule 2a-7.
  - Adequately document the periodic updating of their credit files to support the eligible security determination.
  - Maintain records that adequately support their determination that investments in repurchase agreements with non-government entities were fully collateralized by cash or government securities (for Government MMFs).
- *Summary of significant stress testing assumptions.* Some MMFs provided stress test results to their boards that did not include the required summary of significant assumptions used in the stress tests.

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<sup>15</sup> OCIE, [NEP Examination Priorities for 2017](#). The SEC’s website contains additional information about [MMFs](#) and [TDFs](#).

<sup>16</sup> MMFs are regulated primarily under the 1940 Act and the rules adopted under that Act, particularly [Rule 2a-7](#) (“Rule 2a-7”). The referenced amendments were adopted in July 2014 (*see*, Money Market Fund Reform, [Rel. No. IC-31166](#) (Jul. 23, 2014)).

- *Policies and procedures.* Some MMFs had not adopted and implemented compliance policies and procedures reasonably designed to address certain requirements under Rule 2a-7 and other areas. For example, some funds did not have policies and procedures that addressed:
  - Periodic board oversight of the MMFs’ written guidelines and procedures under which the adviser, when delegated by the MMFs’ board, analyzes credit risks and makes minimal credit risk determinations.
  - Periodic board oversight of certain MMF information, including the MMFs’ net asset value deviation methods and the amount of the deviation.
  - Limiting investors in Retail MMFs to natural persons.
  - Testing for issuer diversification to ensure that no more than 5% of the funds’ assets were invested in any one issuer (other than government securities).
  - Incorporating all required elements for considering, imposing and lifting liquidity fees and/or gates if the funds’ weekly liquid assets were less than 30% of their assets.
  - Filing accurate and timely information with the Commission, such as Form N-MFP.
  - Providing that the master fund shall make the fee and gate determinations in master/feeder fund arrangements.
  
- *Websites and advertising materials.* The staff observed certain instances in which MMFs did not post on their websites all information required under Rule 2a-7 and/or posted inaccurate information on their websites. The staff also observed certain instances in which MMFs did not include all required legends in their advertising materials.

## **TDF Initiative**

OCIE staff examined over 30 TDFs, including both “to” and “through” funds,<sup>17</sup> to review whether the TDFs’ assets were invested according to the asset allocations stated in the funds’ prospectuses, and whether the associated investment risks were consistent with fund disclosures (including representations made in marketing materials).<sup>18</sup>

OCIE staff observed that most TDFs appeared to be in general compliance with the 1940 Act in the areas reviewed; however, instances of deficiencies or weaknesses related to TDFs’ disclosures and compliance programs were noted. For example:

- *Some TDFs had incomplete and potentially misleading disclosures in their prospectuses and advertisements, including disclosures regarding:*

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<sup>17</sup> A fund that is managed “to” its target date (typically, the investor’s retirement date) tends to be more conservative by reducing the fund’s equity exposure over time to its most conservative asset allocation at the target date. In contrast, a fund that is managed “through” its target date will typically reach its most conservative asset allocation years later.

<sup>18</sup> Many of the TDFs examined were intended for retail investors saving for their retirement. For example, the majority of examined TDFs reported that over 75% of their investor accounts were individual retirement accounts (IRAs), pension plan accounts (including defined contribution and defined benefit plans), or accounts of pension plan participants. The majority of TDFs had marketing efforts that targeted retail clients and retirement accounts. In addition, many TDFs designed websites, presentations, and other general advertising particularly towards attracting investment advisers, financial advisors, and retirement plan sponsors.

- Asset allocations, both current and prospective over time. For example, the TDFs had marketing materials with asset allocation disclosures that differed from the TDFs' prospectus disclosures.
- Glide path changes and the impact of these glide path changes on asset allocations.
- Conflicts of interest, such as those that may result from the use of affiliated funds and affiliated investment advisers.
- *Many TDFs had incomplete or missing policies and procedures, including those for:*
  - Monitoring asset allocations, including on-going monitoring.
  - Overseeing implementation of changes to their current glide path asset allocations.
  - Overseeing advertisements and sales literature, which resulted in advertising disclosures that were inconsistent with prospectus disclosures and were potentially misleading.
  - Monitoring whether disclosures regarding glide path deviations were accurate.

#### **IV. Conclusion**

In sharing the information in this Risk Alert, OCIE encourages funds to review their practices, policies, and procedures in these areas and to consider improvements in funds' compliance programs, as may be appropriate.

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*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.*

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