



NATIONAL EXAM PROGRAM

RISK ALERT

By the Office of Compliance Inspections and Examinations (OCIE)¹

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In this Alert:

Topic: *Never-Before-Examined Registered Investment Company Initiative*

Key Takeaways: *NEP staff intends to focus on certain never-before-examined registered investment companies. Such examinations will focus on the following topics: compliance programs; annual contract review; advertising and distribution of fund shares; valuation of portfolio assets and net asset value calculations; and leverage and use of derivatives.*

OCIE’s Never-Before-Examined Registered Investment Company Initiative

I. Introduction

OCIE previously announced that its 2015 Examination Priorities include a focus on risk-based examinations of certain SEC-registered investment company complexes that have not previously been examined by the SEC.² OCIE is issuing this Risk Alert to provide additional information concerning its initiative to examine such registrants.

II. Background

OCIE examines registered investment companies (funds) and their advisers to assess whether they are operating in a manner consistent with the federal securities laws.³ Consistent with its mission and objectives, OCIE, through the National Examination Program (NEP), is launching the Never-Before Examined Investment Company (NBE IC) Initiative to examine funds in complexes that have not previously been examined. The primary focus is on the following types of funds: open-end funds (*i.e.*, mutual funds); closed-end funds; and underlying insurance funds. The emphasis will be on registered investment company complexes that were launched one or more years ago.

¹ The views expressed herein are those of the staff of OCIE, in coordination with other staff of the Securities and Exchange Commission (SEC or Commission), including staff from the Division of Investment Management (IM). The Commission has expressed no view on the contents of this Risk Alert. This document was prepared by the SEC staff and is not legal advice.

² OCIE, “[Examination Priorities for 2015](#)” (January 13, 2015). In particular, the staff is focusing on fund complexes where none of the funds in the complex have been examined by SEC staff.

³ The primary law that governs investment companies is the [Investment Company Act of 1940](#). The SEC has adopted [regulations under this Act](#) that further govern investment company operations. These regulations are published in [Title 17 of the Code of Federal Regulations \(FR\)](#), [Part 270](#). Investment companies are also subject to [other federal securities laws](#) (*e.g.*, the [Securities Act of 1933](#) and the [Securities Exchange Act of 1934](#)) and rules the SEC has adopted under those laws.

Investment advisers that manage the portfolios of registered investment companies must register with the Commission as investment advisers under the [Investment Advisers Act of 1940 \(Advisers Act\)](#). See [General Information on the Regulation of Investment Advisers](#). The [Advisers Act](#), and [regulations adopted by the Commission under the Advisers Act](#), governs registered investment advisers. The regulations are published in [17 CFR, Part 275](#).

III. Examinations

The NBE IC Initiative consists of conducting focused, risk-based examinations of two or more of the higher-risk areas described below for the funds examined.

- **Compliance Program.** [Rule 38a-1 under the Investment Company Act](#) requires each fund to adopt and implement policies and procedures reasonably designed to prevent the fund from violating the federal securities laws. The policies and procedures must provide for the oversight of compliance by the fund’s investment advisers, principal underwriters, administrators, and transfer agents (collectively, “service providers”) through which the fund conducts its activities. The rule requires the fund’s board of directors (Board), including a majority of its independent directors, to approve the compliance program of the fund and of each of its service providers. NEP staff will assess fund and adviser compliance programs, primarily to review their: (i) proxy voting policies and procedures for portfolio securities; (ii) proxy voting policies and procedures for fund shares; (iii) timeliness and accuracy of registration statement and other required periodic report filings; and (iv) codes of ethics for identifying and mitigating conflicts of interest.
- **Annual Contract Review.** [Section 15 of the Investment Company Act](#) imposes certain requirements regarding investment advisory contracts with a registered investment company. NEP staff will review a fund’s investment advisory contract, including any sub-advisory contracts, to assess: (i) the adequacy of the basis for the Board’s determination of whether the advisory fee is fair and reasonable; and (ii) the management of any adviser’s conflicts of interest with respect to its obligations to the fund and the fees it receives.
- **Advertising and Distribution of Fund Shares.** Funds’ marketing materials are subject to the statutory and regulatory restrictions under the Securities Act of 1933, unless they are eligible for an exemption or exception from this Act (*see, e.g.*, the exemptions created in [Rule 135a](#) and [Rule 482](#)), and are also subject to [Rule 34b-1 of the Investment Company Act](#). Additionally, broker-dealers and other distributors that sell fund shares are subject to restrictions imposed by the Financial Industry Regulatory Authority (FINRA). NEP staff will review a fund’s advertisements and distribution of fund shares to: (i) assess the policies, procedures, and controls in place to review and approve advertising material; and (ii) review fund disclosure of breakpoints and the practical application of any procedures in place to assess whether and to what extent breakpoints are correctly applied and monitored.
- **Valuation of Portfolio Assets and NAV Calculation.** [Section 2\(a\)\(41\) of the Investment Company Act](#), and [Rule 2a-4 thereunder](#), require that a fund’s current “net asset value” (NAV) be calculated using, for portfolio securities for which market quotations are readily available, the current “market value” of those securities and, for other securities and assets, the “fair value” as determined in good faith by the fund’s Board. Because shares of open-end investment companies (commonly referred to as “mutual funds”) are sold and redeemed at or based on the NAV that is typically calculated daily, these funds should have adequate internal controls and verification processes to ensure the accuracy of their NAVs. The fund’s NAV calculation is driven by the valuation of the fund’s portfolio securities and other instruments. To properly compute the fund’s portfolio value, each security must be priced properly. NEP staff will review fund policies and procedures and practices related to valuation of holdings and NAV calculation methodology and the Board’s processes for carrying out its valuation oversight responsibilities.

- **Leverage and Use of Derivatives.** [Section 18 of the Investment Company Act of 1940](#) (Investment Company Act) restricts the amount of borrowing by open-end and closed-end funds. One of the primary goals of Section 18 is to protect fund investors from excessive borrowing by funds that would increase the speculative character of fund shares, and to ensure that funds operate with adequate reserves. NEP staff will review the funds to assess: (i) compliance with asset coverage requirements of Section 18; (ii) asset segregation in relation to SEC staff-issued guidance;⁴ and (iii) whether the funds' disclosures appropriately convey the funds' use of derivatives and the associated risks with such investments.

While these are the primary focus areas for the NBE IC Initiative, examiners may select additional topics based on operational and other risks identified by the staff during the course of the examination.

IV. Conclusion

In sharing the focus areas for the NBE IC Initiative, the NEP hopes to encourage funds and their advisers to reflect upon their own practices, policies, and procedures in these areas and to promote improvements in investment company compliance programs.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified. In addition, this Risk Alert describes factors 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. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. 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.

⁴ See "[Registered Investment Company Use of Senior Securities – Select Bibliography](#)" (February 12, 2013). As an aid to registered investment companies and their counsel, the staff has published this bibliography of relevant authority and precedent relating to registered investment company use of senior securities. The bibliography references materials issued by both the Commission and SEC staff and provides positions and guidance for fund compliance with the asset coverage and other requirements of sections 18(a)(1) and 18(f)(1).