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Insights: Alerts

# SEC Risk Alert Highlights Registered Fund Compliance, Board Oversight, and Disclosure Obligations

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On October 26, 2021, the SEC's Division of Examinations (the "Division") released a risk alert (the "Risk Alert")[1] detailing observations from a series of examinations by the Division's staff ("Staff") that focused on certain registered mutual funds and exchange-traded funds ("Funds")[2] to assess industry practices and regulatory compliance in certain areas that Staff believed could have an impact on retail investors (the "RIC Initiatives").[3] Specifically, the Risk Alert summarized various weaknesses and deficiencies observed during examinations, and highlighted example practices that Staff believed could assist Funds and their advisers in designing and implementing their compliance programs and Fund boards in overseeing compliance programs. A summary of some of the Staff's observations in the Risk Alert is set forth below.

**I. Weaknesses and Deficiencies Flagged by Staff**

Examples of weaknesses and deficiencies flagged by Staff in the Risk Alert included the following:

- ***Compliance Programs.*** Failure of Funds and their advisers to establish, maintain, update, follow, and/or appropriately tailor their compliance programs to address various business practices, such as:
  - *Compliance Oversight of Investments and Portfolios*, including policies and procedures related to monitoring, addressing, and/or overseeing (i) trade aggregation, trade allocation, and best execution requirements, and senior securities and asset segregation; (ii) adherence to a Fund's investment restrictions; (iii) specific risks associated with a Fund's particular investments, such as particular asset classes with operational or other risks; (iv) compliance with the Fund Names Rule; (v) administration of liquidity risk management programs; and (vi) the viability of smaller and/or thinly traded ETFs and their liquidation (including communications with Fund shareholders);
  - *Compliance Oversight of Valuation Practices*, including maintaining (i) an adequate compliance program for the valuation of portfolio securities, including processes, controls, or both that provide for due diligence and oversight of pricing vendors used to calculate a Fund's daily net asset value, and (ii) policies and procedures to address potential conflicts of interests and issues (e.g., where portfolio managers are permitted to provide input on prices of securities in the Funds they manage);
  - *Compliance Oversight of Trading Practices*, including (i) addressing appropriate trade allocation among client accounts so that all clients, including Fund clients, are treated fairly; (ii) preventing

prohibited principal transactions with affiliates and/or prohibited joint transactions with affiliates; (iii) identifying and preventing violations of legal requirements related to cross trades and principal trades; and (iv) addressing sharing of soft dollars among clients to assess whether any client is disadvantaged;

- *Compliance Oversight of Conflicts of Interest*, including (i) addressing advisers' conflicts of interest with Funds and their service providers (e.g., where the adviser serves as both an investment adviser and index provider for a Fund), (ii) reviewing a Fund's index provider for conflicts of interest with the Fund's adviser (e.g., affiliate relationships, sharing personnel, revenue sharing, or other business relationships); and (iii) reviewing the sharing with, and potential misuse by, the Fund's index provider of material non-public information;
- *Compliance Oversight of Fees and Expenses*, including (i) monitoring the allocation of expenses between Funds and their advisers when fee waivers are present, and (ii) reviewing fee calculations for inconsistencies between contractual expense limitations and disclosures regarding expenses included in operating expenses, subject to an expense cap; and
- *Compliance Oversight of Fund Advertisements and Sales Literature*, including reviewing (i) fee and expense disclosures for whether they are fair, balanced, and not misleading within the context in which they are made, and, as applicable, the presentation of back-tested index returns, and (ii) affiliated index providers' websites to assess whether such websites could be deemed sales literature that should be filed with the SEC or FINRA.[4]

- ***Board Oversight.*** Failure of Funds to have appropriate policies and procedures related to board oversight of the Funds' compliance programs, including the following:
  - Not having appropriate policies, procedures, and processes for monitoring and reporting to Fund boards with accurate information, such as information regarding: (i) fees paid by Funds to financial intermediaries and other service providers for providing shareholder services; (ii) the type of services provided by service providers; (iii) pricing exceptions under Funds' valuation policies and procedures; (iv) an Adviser's recommendations with respect to whether a Fund's liquidation may be in the best interests of the Fund and its shareholders; and (v) portfolio compliance with senior securities and asset coverage requirements;
  - Not having appropriate processes as part of a Fund board's review and approval of advisory agreements under Section 15(c) of the Investment Company Act regarding the board's considerations as to whether the adviser has any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients;
  - Not completing the required annual reviews of Funds' compliance programs that addressed the adequacy of policies and procedures and effectiveness of their implementation;
  - Not ensuring that the Fund's chief compliance officer's annual report addressed the operation of the policies and procedures of the Fund's adviser, including whether the adviser had policies and procedures in specific risk areas; and
  - Not adopting or maintaining appropriate policies and procedures for Fund boards to exercise appropriate oversight in instances where the Fund's delegated responsibilities to its advisers are not reflect in the adviser's compliance program.[5]

- ***Disclosures to Investors.*** Deficiencies or weakness in Funds' filings, advertisements, sales literature, and other shareholder communications, including the following
    - Omitted disclosure regarding principal investment strategies and risks, potential conflicts relating to allocating investment opportunities, and changes in the broad-based indexes used for comparison of Fund performance.
    - Inconsistent or inaccurate disclosure concerning the Funds' net assets and net expense ratios, contractual expense limitations and operating expenses subject to the contractual expense limitation.
    - Inaccurate, incomplete or omitted disclosure on a variety of advertising and sales literature-related topics such as investment strategies and portfolio holdings, difference in investment objective between predecessor and successor funds, inception dates, fund expenses, contractual expense limitations and expense ratios, return information, performance information without the required legends, awards received for fund performance, and various information regarding the benchmark index used for performance comparisons.[6]

**II. Examples of Highlighted Compliance and Disclosure Practices**

Highlighted compliance programs, board oversight, and disclosure practices of Funds and advisers that the Staff believed may assist Funds and their advisers in designing and implementing their compliance programs and Fund boards in overseeing such programs included:

- ***Compliance Programs.*** Compliance programs that:
    - Review policies and procedures for consistency with practices (e.g., Funds reviewed their advisers' compliance manuals for specific policies and procedures addressing items specifically designated to the advisers);
    - Conduct periodic testing and reviews for compliance with disclosures (e.g., review compliance with the Fund's stated investment objective, investment strategies, restrictions and other disclosures) and assessing the effectiveness of compliance policies and procedures in addressing conflicts of interests;
    - Adequately addressing the oversight of key vendors; and
    - Have adopted and implemented policies and procedures to address: (i) compliance with applicable regulations; (ii) compliance with the terms and conditions of applicable exemptive orders and any disclosures required to be made under such orders; and (iii) undisclosed conflicts of interest, including potential conflicts between Funds and/or advisers and their affiliated service providers.[7]

- ***Board Oversight.*** Fund boards that provided oversight to compliance programs by assessing whether:
    - The information provided to the board was accurate, including information related to a Fund's (i) fees, expenses, and performance, and (ii) investment strategies, changes to the strategies, and risks associated with the strategies; and
    - A Fund was adhering to its processes for board reporting, including an annual review of the adequacy of the Fund's compliance program and effectiveness of its implementation.[8]

- ***Investor Disclosures.*** Policies and procedures that required the following:
    - Review and amendment of disclosures in Funds' prospectuses, SAIs, shareholder reports, or other investor communications consistent with the Funds' investments and investment policies and

restrictions;

- Amendment of disclosures for consistency with actions taken by the Funds' boards, as applicable;
- Update of Funds' website disclosures concurrently with new or amended disclosures in the Funds' prospectuses, SAIs, shareholder reports, or other communications;
- Review and testing of fees and expenses disclosed in Funds' prospectuses, SAIs, shareholder reports, or other client communications for accuracy and completeness of presentation; and
- Review and testing of Funds' performance advertising for accuracy and appropriateness of presentation and applicable disclosures.[9]

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The information provided in the Risk Alert is consistent with the SEC's increased focus in recent years on registrants' compliance programs, investor disclosures, and conflicts of interest. Thus, as recommended by Staff in the Risk Alert, we suggest that Funds and their advisers review their own practices, policies, and procedures in light of the deficiencies or weaknesses and recommendations identified in the Risk Alert. In addition, given the Risk Alert's heavy focus on the oversight of compliance programs by Fund boards of directors/trustees, we suggest that boards pay particular attention to matters of board oversight discussed in the Risk Alert, particularly in connection with their oversight of annual reviews of Funds' compliance programs and annual approvals of investment advisory and other service provider contracts. Further, in reviewing 15(c) materials prepared in connection with the annual approval of investment advisory and other vendor contracts, we encourage boards to pay particular attention to questions regarding the financial condition of the adviser as well as the adviser's relationship to service providers (including, without limitation, index providers).

If you have any questions about the Risk Alert, the duties and obligations of Funds and their boards, or the regulation of registered Funds and investment advisers generally, please feel free to contact us.

By the ***Investment Management and Broker-Dealer Team at Kilpatrick Townsend & Stockton***

**Footnotes**

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[1] *See* Division of Examinations, Observations from Examinations in the Registered Investment Company Initiatives (Oct. 26, 2021) (hereinafter, “Risk Alert”).

[2] In the Alert, Staff noted that the RIC Initiatives focused on Funds and their 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; and

(6) Advisers that provide advice to mutual funds and private funds that have similar strategies and/or are managed by the same portfolio managers.

*Id.* at 1..

[3]Staff first announced the RIC Initiatives in a Division risk alert in November 2018. SEC Division of Examinations, Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies (Nov. 8, 2018). The RIC Initiatives were again highlighted by Staff in the in the Division's fiscal year 2019 priorities. Division of Examinations, 2019 Examination Priorities (December 18, 2018).

[4]Risk Alert, supra note 1, at 2-5..

[5]*Id.* at 5-6..

[6]*Id.* at 6-7..

[7]*Id.* at 7-8..

[8]*Id.* at 8..

[9]*Id.* at 8-9.

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