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OCIE Targeting Certain Mutual Funds, ETFs and Advisers in New Compliance Inspection Initiatives

By Nancy P. O'Hara and Thomas J. Keefe

On November 8, 2018, the Securities and Exchange Commission's Office of Compliance Inspections and Enforcement (OCIE) announced in a risk alert (the "Risk Alert") that it is targeting certain mutual funds, exchange-traded funds (ETFs) and investment advisers for risk-based compliance examinations.¹ The new initiatives are focused on the business practices, risks and conflicts of interest applicable to registered funds and/or investment advisers that fall into any of the following categories:

- i. Index funds that track custom indexes.
- ii. Smaller ETFs and/or ETFs with low secondary market trading volume.
- iii. Mutual funds that invest substantially in securitized assets.
- iv. Mutual funds with "aberrational underperformance" relative to peers.
- v. Advisers that are relatively new at managing mutual funds.
- vi. Advisers to mutual funds and private funds that have similar strategies and/or are managed by the same portfolio manager(s).

Although OCIE examiners have broad discretion to determine the scope of compliance examinations, the new initiatives generally involve review of applicable funds' and advisers' policies and procedures, funds' disclosures to shareholders, advisers' disclosures to fund boards, and the processes employed by funds, advisers and boards in assessing certain risks and conflicts of interest. Each inspection initiative is described in more detail below.

i. Index Funds Tracking Custom Indexes

OCIE staff members are examining the practices of funds that track custom indexes, which are indexes created and/or maintained by an index provider for a single fund or sponsor. Specifically, OCIE examiners are (a) reviewing whether the management of indexed funds is consistent with funds' disclosures to investors; (b) seeking to

understand the nature of index providers' services and the adequacy of those disclosures to the funds' boards; (c) assessing whether conflicts of interest between investment advisers and index providers are adequately addressed; and (d) evaluating the effectiveness of indexed funds' compliance programs with respect to portfolio management and board oversight thereof.

ii. Smaller ETFs and/or ETFs with Low Trading Volume

Citing risks to investors, including increased bid/ask spreads, wider premium/discounts to net asset value and the potential for delisting from exchanges and liquidation, OCIE examiners are targeting smaller and/or thinly traded ETFs. As part of this examination initiative, OCIE staff are evaluating (a) the adequacy of ETFs' investment risk disclosures, particularly with regard to the risk of liquidation; (b) ETF boards' oversight of the continued economic viability of ETFs; (c) the systems used to monitor ETF tracking error and, if applicable; (d) the appropriateness of the liquidation and distribution processes used to wind down an ETF; and (e) whether delisting and liquidating proceedings received adequate board oversight and approvals.

iii. Mutual Funds Investing Substantially in Securitized Assets

OCIE examiners are also inspecting mutual funds that invest substantially in securitized assets, including securitized auto loans, student loans, credit card receivables and mortgage-backed securities. Citing concerns that retail investors are not receiving adequate disclosure relating to the risks of securitized investments, such as the risks of accelerating delinquency rates and unexpected market stresses, OCIE is looking at whether mutual funds and/or advisers have appropriate (a) policies, procedures, practices and oversight relating to these portfolio management activities and investment risks; (b) portfolio risk identification, monitoring and mitigation practices; (c) valuation and pricing policies and procedures, especially with respect to illiquid and other difficult-to-value securities; (d) governance and board oversight, particularly relating to pricing and valuation; and (e) disclosures to investors, particularly with regard to investment risks.

¹ The full text of the OCIE Risk Alert announcing the new initiative is [available here](#).

iv. Underperforming Funds

OCIE examiners are also conducting compliance examinations of funds with “aberrational underperformance” relative to peers. As part of these inspections, OCIE staff are assessing underperforming funds’ compliance programs and whether their boards are exercising appropriate oversight thereof. In particular, OCIE is focusing on funds’ and their advisers’ management processes, including whether (a) investments are made consistently with the investment objectives and strategies described in funds’ filings; (b) advertising and marketing materials contain complete and accurate information about fund objectives, policies, risks and/or restrictions; (c) advisers allocate investment opportunities to the funds appropriately; and (d) funds and advisers adhere to requirements relating to borrowing or investing in instruments that might leverage fund assets.

v. Advisers New at Managing Mutual Funds

Citing the increased likelihood that investment advisers with little mutual fund experience lack knowledge regarding the Investment Company Act of 1940, OCIE is also evaluating whether (a) applicable funds have sufficient governance structures to ensure that boards receive necessary information to perform their duties; (b) advisers’ compliance programs are effective; and (c) fund marketing and distributions efforts are appropriate.

vi. Advisers to Mutual Funds and Private Funds with Similar Strategies and/or the Same Portfolio Manager(s)

OCIE examiners are targeting advisers that manage both mutual funds and private funds with similar strategies and/or overlapping portfolio managers. In particular, OCIE staff are evaluating advisers’ (a) policies and procedures for addressing conflicts of interest and other risks associated with side-by-side portfolio management; (b) controls for ensuring that brokerage, best execution and trade allocation practices fulfill advisers’ fiduciary duties to investors; (c) allocation practices for fees and expenses; and (d) adequacy of disclosures to investors and fund boards.

Practice Points

Through its release of the Risk Alert, OCIE is “encouraging registrants to reflect upon their own practices, policies, and procedures.” Funds and/or advisers that fall into any of the six categories described above should consider acting upon that encouragement by reviewing and strengthening their own compliance programs and supervisory mechanisms in response to the Risk Alert.

Investment Management Group

Primary Contacts



Nancy P. O'Hara

Partner

Philadelphia
(215) 988-2699
nancy.ohara@dbr.com



Thomas J. Keefe

Associate

Philadelphia
(215) 988-2641
thomas.keefe@dbr.com

Drinker Biddle

www.drinkerbiddle.com

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Jonathan I. Epstein and Andrew B. Joseph, Partners in Charge of the Princeton and Florham Park, N.J., offices, respectively.