

Alert | Investment Management



November 2021

SEC Issues Risk Alert Regarding Registered Investment Companies

On Oct. 26, 2021, the Securities and Exchange Commission (SEC) Division of Examinations (“Division”) issued a Risk Alert (“Risk Alert”) in which it identified observations from examinations under its registered investment company initiative, first announced in 2018. The **Risk Alert** summarized examination conclusions from funds in the following six categories, although the staff noted that its observations “can assist all funds in assessing compliance risks”:

- 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 both mutual funds and private funds, both of which have similar strategies and/or are managed by the same portfolio managers.

The Risk Alert divided its key findings into two categories: Compliance and Disclosure.

Compliance

The first set of findings focused on the effectiveness of the compliance policies and procedures of the funds and their advisers to address certain risks – particularly in the areas of disclosures, portfolio management compliance, and conflicts of interest – as well as the oversight of fund compliance programs by fund boards. The Division identified two main areas where compliance issues were weak or deficient:

- funds and advisers that did not establish, maintain, update, follow and/or appropriately tailor their compliance programs to address various business practices; and
- policies and procedures established to ensure board oversight of the compliance programs.

Failures in Compliance Programs

There were many business practices that went unaddressed or were inadequately handled by the funds and advisers in their compliance programs. Several of these oversights involved failures to monitor or address the specific problems unique to their situation, including particular issues relating to investments and portfolios, valuation, trading practices, conflicts of interest, fees and expenses, and fund advertisements and sales literature.

Board Oversight of Compliance Issues

The Division also observed that some examined funds did not have appropriate policies, procedures, and processes for monitoring and reporting to their boards on certain information. They also found that funds did not have adequate processes for the board to review and approve the fund's investment advisory agreement; did not have the ability to complete annual reviews of the funds' compliance programs; did not ensure that annual reporting from the chief compliance officer addressed the operations of the fund's adviser; or did not adopt or maintain appropriate policies and procedures for the funds' boards to exercise appropriate oversight in certain circumstances.

Disclosure

The disclosure focus identified several inaccurate, incomplete, or omitted disclosures in both fund filings and sales literature.

Fund Filings

These issues included omissions in investment strategies and risks; potential conflicts with allocating investment opportunities among overlapping strategies; and changes in the indexes used for comparison. They also included inconsistent and inaccurate information regarding the funds' net assets and expense information, contractual expense limitations, and operating expense calculations. Additionally, the Division noted that there were often omissions in disclosure in fund statements of additional information (SAIs) regarding required information about board committees and information about number of accounts and total assets managed by portfolio managers.

Advertising and Sales Literature

The Division observed inaccurate, incomplete, and/or omitted disclosure regarding a number of topics, including investment strategies and portfolio holdings; investment objective differences between predecessor and successor funds; inception dates; fund expenses, including gross and net expenses; average total returns; performance information; awards received; weighting of index constituents in the

benchmark index; differences in the broad based and bespoke indexes used for performance comparison; and composition of indexes used for performance comparison.

Division Staff Recommendations

The Division recommended that funds and advisers should take several steps, including:

- reviewing compliance policies and procedures for consistency with practices;
- conducting periodic testing and reviews for compliance with disclosures;
- ensuring that compliance programs adequately address the oversight of key vendors; and
- adopting and implementing policies and procedures to address compliance with applicable regulations, compliance with terms and conditions of applicable exemptive orders, and compliance with issues relating to undisclosed conflicts of interest.

In a Q&A session before the Investment Company Institute Securities Law Conference on Nov. 1, 2021, Daniel Kahl, acting director of the Division, observed that funds should first “focus on the basics” and are frequently missing important compliance and disclosure issues due to reliance upon very general, non-applicable policies and disclosures.

Conclusion

The Division’s risk alerts often serve as key focal points in routine and other examinations and are followed by enforcement proceedings or other adverse actions against registrants failing to take responsive action. Therefore, registered investment companies and related advisers should review and revise their compliance and disclosure programs to ensure that such programs are adequately tailored for each fund, paying specific attention to the observations in the Risk Alert.

Authors

This GT Alert was prepared by:

- **Arthur Don** | +1 312.456.8438 | dona@gtlaw.com
- **Douglas W. Hathaway** | +1 312.456.8447 | hathawayd@gtlaw.com

Albany. Amsterdam. Atlanta. Austin. Boston. Chicago. Dallas. Delaware. Denver. Fort Lauderdale. Germany.† Houston. Las Vegas. London.* Los Angeles. Mexico City.+ Miami. Milan.‡ Minneapolis. New Jersey. New York. Northern Virginia. Orange County. Orlando. Philadelphia. Phoenix. Sacramento. Salt Lake City. San Francisco. Seoul.∞ Shanghai. Silicon Valley. Tallahassee. Tampa. Tel Aviv.^ Tokyo.* Warsaw.~ Washington, D.C.. West Palm Beach. Westchester County.

*This Greenberg Traurig Alert is issued for informational purposes only and is not intended to be construed or used as general legal advice nor as a solicitation of any type. Please contact the author(s) or your Greenberg Traurig contact if you have questions regarding the currency of this information. The hiring of a lawyer is an important decision. Before you decide, ask for written information about the lawyer’s legal qualifications and experience. Greenberg Traurig is a service mark and trade name of Greenberg Traurig, LLP and Greenberg Traurig, P.A. †Greenberg Traurig’s Berlin office is operated by Greenberg Traurig Germany, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. *Operates as a separate UK registered legal entity. +Greenberg Traurig’s Mexico City office is operated by Greenberg Traurig, S.C., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ‡Greenberg Traurig’s Milan office is operated by Greenberg Traurig Santa Maria, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ∞Operates as Greenberg Traurig LLP Foreign Legal Consultant Office. ^Greenberg Traurig’s Tel Aviv office is a branch of Greenberg Traurig, P.A., Florida, USA. ‡Greenberg Traurig’s Tokyo Office is operated by GT Tokyo Horitsu Jimusho and Greenberg Traurig Gaikokuhojimbengoshi Jimusho, affiliates of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ~Greenberg Traurig’s Warsaw office is operated by GREENBERG TRAUIG Nowakowska-Zimoch Wysokiński sp.k., an affiliate of Greenberg Traurig, P.A. and*

Greenberg Traurig, LLP. Certain partners in GREENBERG TRAURIG Nowakowska-Zimoch Wysokiński sp.k. are also shareholders in Greenberg Traurig, P.A. Images in this advertisement do not depict Greenberg Traurig attorneys, clients, staff or facilities. No aspect of this advertisement has been approved by the Supreme Court of New Jersey. ©2021 Greenberg Traurig, LLP. All rights reserved.