SEC Publishes Fund Compliance Shortfalls

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The SEC's Division of Examinations has released a risk alert warning of compliance "risks and issues" of mutual funds (including ETFs) and their advisers.

The alert derives from exams of 50 fund complexes — covering more than 200 funds and/or series of funds — and nearly 100 advisers. The exams assessed industry practices and regulatory compliance in areas that impact retail investors.

The exams focused on the following funds and advisers:

- Index funds that track custom-built indexes.
- Smaller ETFs and/or ETFs with little secondary market trading volume.
- Funds with higher allocations to certain securitized investments.
- Funds with aberrational underperformance relative to their peer groups.
- Funds managed by advisers that are relatively new to managing such funds.
- Advisers that provide advice to public funds and private funds, both of which have similar strategies and/or are managed by the same portfolio managers.

The exams uncovered "weaknesses" and "deficiencies" in compliance programs and board monitoring of compliance programs that are relevant to many types of funds — including funds supporting variable insurance products. Observed lack of oversight involved investments and portfolios, valuation, trading practices, conflicts of interest, fees and expenses, and advertising and sales literature.

An example of inadequate board monitoring is the failure, during the annual investment evaluation of advisory agreements, to consider whether the adviser has any financial circumstances that are reasonably likely to impair its ability to meet its contractual commitments to clients.

The exams also found that funds had "inaccurate, incomplete and/or omitted disclosures" in their filings with the SEC. One example is that statements of additional information lacked the required disclosure of board standing committees and the number of accounts and total assets managed by the portfolio managers.

Funds also had defective disclosure in advertising and sales literature. One example is that touting of awards received for fund performance lacked disclosure of the selection criteria for the award, the amount of any fee paid by the adviser to receive or promote the award, the number of other funds that applied and received the award, and whether the adviser was required to be a member of an organization to receive the award.

The division issued deficiency letters that caused funds and advisers to revise their compliance policies and procedures, amend disclosures, and change practices. The alert does not mention any enforcement action. Nevertheless, only a few of the problems cited in the alert are summarized above, and the entire alert provides a useful checklist of potential areas of improvement for funds and their advisers.

Regarding deficiency letters, the Division of Examinations has announced that it intends to be more precise in specifying the statutory section or SEC rule, form, or pronouncement that it believes has been violated. The alert bears this out with multiple footnote references to specific sections of the federal securities laws and rules, and forms thereunder.

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