

OCIE Announces Risk-Based Exam Initiatives for Mutual Funds—Part 1

Recently, the Office of Compliance Inspections and Examinations ("OCIE") issued a [Risk Alert](#) (the "Alert") identifying six categories of mutual funds and mutual fund advisers it plans to examine: (i) index funds tracking custom-built indexes; (ii) smaller and thinly-traded exchange traded funds ("ETFs"); (iii) funds with aberrational underperformance relative to their peers; (iv) funds with higher allocations to securitized assets; (v) advisers "new" to managing mutual funds; and (vi) advisers who also manage private funds with similar strategies or that share managers with the mutual funds. The Alert provides a list of practices, risk and conflicts for each specific type of fund, but also notes OCIE will also look at standard fund examination topics. This post reviews the first three specific categories of funds identified in the Alert. A subsequent post will discuss the final three categories, general examination issues mentioned in the Alert and additional considerations for any exam.

Protecting Retail Investors in Mutual Funds

The Alert reiterates [OCIE's 2018 exam priority](#) of protecting retail investors, as mutual funds and ETFs are important investment vehicles for retail investors. For the mutual fund industry, the Alert serves as guideposts for funds and advisers to consider when reviewing their compliance programs, regardless of whether OCIE examines them. The Alert also identifies some key issues that trustees and directors of these funds may want to address.

Custom Indexes

For funds using custom or "bespoke" indexes designed by an index provider for a single fund or sponsor, examinations will focus on the roles of the adviser and index provider in selecting and weighting the index components, as well as how the provider administers the index and the adviser manages the funds and advertises their performance. Examinations will seek to:

- Compare actual portfolio management practices to fund disclosures;
- Review the nature of services provided by index providers and the disclosures made about them to fund boards;
- Assess and address potential conflicts of interest between index providers and advisers; and
- Generally, review fund compliance programs for sufficient oversight by the board, with an emphasis on portfolio management controls covered (or not) in fund policies and procedures.

Less-Liquid ETFs

The Alert notes certain risks of smaller ETFs and ETFs with small trading volumes to their shareholders — increased spreads; increased premiums or discounts to net asset value; and exchange delisting risk. These risks could cause rapid declines in market prices or liquidation costs being borne by investors, which is why OCIE exams will focus on, as applicable:

- The adequacy of risk disclosure to investors, including risks associated with ETF liquidation;
- The board oversight process, including consideration of whether an ETF can continue as an "ongoing concern;"
- The effectiveness of tracking error monitoring;
- The process for liquidating an ETF and whether its portfolio is liquidated and distributed to shareholders appropriately; and
- Board oversight of delisting and liquidation proceedings.

"Aberrational Underperformance" Relative to Peers

Examinations of these funds will review the asset allocation and security selection processes and the effectiveness of the fund's compliance program and of the board's oversight. The Alert explains that OCIE staff will evaluate whether these funds and their advisers are:

- Investing consistently with disclosed investment objective(s) and strategies;
- Completely and accurately disclosing, in advertising and marketing materials, investment objectives, policies, risks and restrictions;
- Properly allocating investment opportunities to the fund as consistent with fiduciary duties; and
- Effectively overseeing leverage, specifically adherence to requirements around fund borrowings and investments in leveraged instruments.

Return for Part 2 for a review of the remaining mutual funds and advisers targeted in the Alert, as well as general areas of focus noted therein.

Explore more in

[Investment Management](#)

Blog series

Asset Management ADVocate

The Asset Management ADVocate provides unique analysis and insight into legal developments affecting asset managers in the United States.

[View the blog](#)