SEC Warns Investment Companies and Their Service Providers of Common Deficiencies and Weaknesses

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The SEC’s Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert on November 7, 2019, identifying the most common weaknesses and deficiencies found in its examination of nearly 300 registered investment companies over the last two years. As previous Risk Alerts have foreshadowed the roll out of registered investment companies over the last two years, OCIE observed material misstatements or omissions in their registration and investment strategy changes. Consistency between service providers should heed OCIE’s warning and address these compliance gaps if they exist.

Fund Compliance Rule. Funds must adopt and implement written policies and procedures to prevent federal securities law violations. Among other things, these policies and procedures must provide proper oversight of the fund’s service providers (including its investment adviser, principal underwriter, administrator, and transfer agent) as approved by the fund’s board of directors and annually reviewed and updated by its chief compliance officer (CCO). According to the Risk Alert, OCIE observed that many policies and procedures did not account for the fund’s business activities or risks. For example, policies and procedures should be tailored to prevent the fund from violating its own investment limitations and guidelines, making misstatements and omissions in marketing materials, failing to oversee its service providers, and mispricing securities. This last observation is particularly important because valuation will continue to be a priority as evidenced by recent enforcement actions and public remarks by the Division of Investment Management that urge the consistent application of valuation procedures that maximize observable inputs and are auditable. Where policies and procedures were tailored, OCIE also observed funds not following them and, as a result, casting doubt on the fund’s compliance with various SEC rules, including the affiliated transaction rule. Given all this, these OCIE observations should guide funds because the failure to draft and implement proper policies and procedures is itself a technical violation that likely could result in other federal securities law violations. By complying with this rule, funds, therefore, can kill two birds with one stone.

Disclosures to Investors. Funds must not make any material misstatements or omissions in their registration statements, reports, and other investor documents and SEC filings. According to the Risk Alert, OCIE observed disclosures that were materially inconsistent with funds’ actual activities, including service provider compensation and investment strategy changes. Consistency between disclosures and practices is of paramount importance. And, as recent enforcement initiatives have shown, funds should be mindful that the SEC has little patience for “may” disclosures when a registrant knows the occurrence of a fact that should be disclosed.

Section 15(c) Process. The Investment Company Act of 1940 requires a majority of a fund’s independent directors to approve investment adviser and principal underwriter contracts. All board members must request and review all information reasonably related to this process, which must be retained thereafter by the fund or its administrator regardless of confidentiality claims by advisers. (In fact, as a signal of potential regulatory creep, at least one administrator was itself subject to an enforcement action for allegedly causing a violation by the fund where it failed to retain such documents as its was contractually required.) This evaluation process must be disclosed to investors in shareholder reports. According to the Risk Alert, OCIE observed funds not complying with each step of the evaluation process, including overlooking information relating to their investment adviser’s performance and fees, failing to disclose material factors relating to the board’s evaluation, and even failing to retain supporting documentation. Given these observations, funds and their boards should be mindful of their fiduciary duties to ensure that investment advisers are properly engaged and compensated. Among other things, the Risk Alert noted that boards may consider the profitability of the fund to the adviser, economies of scale derived from using the adviser, and advisory fee and performance comparisons as part of this process. Potential conflicts of interest should also be reviewed and disclosed where appropriate.

Fund Code of Ethics. Funds must adopt an ethics code to prevent access persons from engaging in fraud or manipulation vis-à-vis the securities the fund holds or acquires. According to the Risk Alert, OCIE observed that many funds failed to implement an ethics code, including failing to designate a separate individual to review the CCO’s personal holdings and activities. In other instances where ethics codes were implemented, OCIE observed funds failing to designate the proper individuals as access persons subject to the fund’s oversight. OCIE also observed funds that failed to collect and review the personal securities holdings and transaction reports of access persons. These observations warn funds to appropriately scope out their monitoring and reporting activities. After all, proper oversight of access persons is a baseline measure to fulfill a fund’s fiduciary duty to its investors, and one that will continue to be verified by OCIE in future examinations.