



INDEPENDENT DIRECTORS COUNCIL

*The voice of fund directors at the Investment Company Institute*

# Board Oversight of Fund Compliance

Independent Directors Council  
Task Force Report  
September 2009



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Washington, DC 20005

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## EXECUTIVE SUMMARY

The adoption of the fund compliance program rule (Rule 38a-1 under the Investment Company Act of 1940) (the Rule) at the end of 2003 introduced new requirements for funds. It also presented fund boards with new tools for overseeing compliance, along with specific responsibilities. One of the most important additions is the chief compliance officer (CCO), who administers the fund's compliance program and whose designation is approved by the board.

After several years of experience with the Rule, the Independent Directors Council (IDC) created a task force, in part, to explore how funds have developed and implemented their compliance programs. In addition to discussing the variety of ways in which funds have implemented their programs, this report highlights what the task force believes to be certain core characteristics of a successful compliance function. The purpose of this report is not to set forth best practices or to suggest that there is a single way of structuring, evaluating, or pursuing compliance. Instead, the goal is to give board members and other readers a comparative tool to help them think about and evaluate compliance.

The report discusses some common themes among fund groups regarding the mission of compliance and the philosophy that drives it. First, we recognize that a fund board can be a significant and immediate influence in defining the goals and priorities of the fund's compliance function. Second, while compliance personnel oversee the compliance program, compliance is everyone's responsibility. Each business unit should "own" the portion of the fund's or adviser's compliance program that is applicable to it. Third, compliance should be structured as a collaborative function that enhances operations and controls, rather than as a "gotcha" function whose goal is to seek out and punish outliers. Finally, compliance should be proactive, anticipatory, and seek to educate all personnel who contribute to its effectiveness.

The report also discusses more specific matters relating to the fund CCO, including considerations relating to the employment of the CCO (such as whether the fund CCO should be the same person who serves as the adviser's CCO), as well as the CCO's relationship with the adviser's management and the fund board. Among the matters addressed are a variety of practices relating to (i) communications between the CCO and the board, both at and between board meetings; (ii) board evaluations of compliance and the CCO; and (iii) CCO compensation structures.

There are numerous ways in which fund complexes pursue the development and implementation of effective compliance programs, and there is no one "right" approach to compliance. There are, however, some characteristics that the task force believes evidence a strong compliance regime. They include:

***Tone at the top.*** The hallmark of a good compliance program is a strong, ethical, and compliance-oriented tone emanating from the adviser's leadership team and the fund's board.

**Collaboration.** CCOs who are able to undertake their role and responsibilities in a collaborative manner earn the board's confidence, garner management's respect, and run compliance programs that identify and address difficult compliance matters in a professional and effective manner.

**Risk-based compliance.** While every fund group's compliance program is tailored to monitor adherence to applicable laws and regulations, an effective compliance function is based on an understanding that fund compliance requires a continuous and thoughtful appraisal of risk areas that are specific to the fund and the adviser's business.

**Transparency and candor.** Transparency and candor are important in any discourse about compliance, whether it is between the CCO and the board, the CCO and management, or among all three. Anything short of it may detract from a relationship of trust.

**Effective people and resources.** Conscientious, knowledgeable, and resourceful compliance personnel (including the CCO), armed with appropriate resources, are key contributors to an effective compliance program. Indeed, many of the other characteristics of a strong compliance regime are achieved, in part, through the actions and leadership of highly effective compliance personnel.

The task force hopes that the various alternatives and practices identified in this report are helpful to fund boards, management organizations, and CCOs alike as they consider their own compliance undertakings.

## INTRODUCTION

For an industry entrusted with over \$10 trillion in assets invested on behalf of more than 93 million shareholders,<sup>1</sup> the need for strong compliance cannot be overstated. Indeed, a robust compliance program is an essential element of any successful fund business. Investor responses to the market timing and late trading cases that came to light in September 2003 demonstrate the value that investors place on compliance: in many instances, fund groups named in investigations experienced substantial net redemptions while those not named generally experienced an increase in flows.<sup>2</sup> The cases caused the fund industry, which had prided itself on having few compliance difficulties during its more than 60-year history, to re-examine existing compliance structures and how they were overseen. For its part, the Securities and Exchange Commission (SEC) responded by proposing a host of new regulations.

One of the most significant SEC regulatory actions was the adoption of rules requiring all registered funds and advisers to have specified compliance programs. The rule applicable to funds, Rule 38a-1 under the Investment Company Act of 1940, requires, among other things, that all funds:

- » adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws;
- » obtain the approval of the fund’s board of directors, including a majority of directors who are not interested persons of the fund, of the fund’s policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund (principal service providers);
- » review, no less frequently than annually, the adequacy of the policies and procedures and the effectiveness of their implementation; and
- » designate a single chief compliance officer (CCO) responsible for administering the fund’s policies and procedures.<sup>3</sup>

See Appendix A for the full text of the Rule.

While compliance has always been a cornerstone of the fund industry, from the board’s perspective, the Rule was revolutionary. The Rule presented fund boards with new tools for overseeing compliance and explicitly assigned them responsibilities relating to the compliance function. In particular, the Rule requires that (i) the board approve the fund’s policies and procedures, as well as those of the fund’s principal service providers;<sup>4</sup> and (ii) the board approve the designation, compensation, and removal of the CCO. In addition, the Rule requires the CCO, at least annually, to provide a written report to the board that, at a minimum, addresses the operation of the fund’s policies and procedures and each material compliance matter that occurred since the date of the last report, and to meet separately with the fund’s independent directors. In its release adopting the Rule, the SEC stressed that the Rule “provides fund boards with direct access to a single person with overall compliance responsibility for the fund who answers directly to the board” and noted that the Rule “strengthens the hand of compliance personnel by establishing a direct line of reporting to fund boards that is not controlled by management.”<sup>5</sup>

The Rule established the parameters of a newly formalized compliance regime but did not provide specific guidance to boards on how to undertake their enhanced oversight responsibilities. Boards found some useful direction in the SEC’s Adopting Release, which noted, for example, that boards “should consider the nature of the fund’s exposure to compliance failures . . . which may demonstrate weaknesses in the fund or service provider’s compliance programs.”<sup>6</sup> The release also stated that boards should “consider best practices used by other fund complexes, and . . . consult with fund counsel (and independent directors with their counsel), compliance specialists, and other experts familiar with compliance practices successfully employed by similar funds or service providers.” The release

suggested that the CCO “should be competent and knowledgeable regarding the federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund.” According to the SEC, the CCO “should have sufficient seniority and authority to compel others to adhere to the compliance policies and procedures.”

As fund groups worked to implement the Rule by its compliance date in October 2004, they built upon their existing compliance infrastructures and relied on their considerable industry knowledge, pronouncements on compliance from various members of the SEC’s staff, outside counsel and other resources, and significant proactive and creative thinking to implement the comprehensive set of compliance initiatives.

## **I. TASK FORCE GOALS**

Fund complexes now have almost five years of experience with the Rule. The non-prescriptive language of the Rule, together with the flexibility provided to funds in implementing its requirements, has resulted in fund groups implementing the Rule in decidedly different ways. This task force was created, in part, to explore how fund complexes have developed and implemented their compliance programs. (See Appendix B for a list of task force members.) As part of this exercise, we have focused on (i) how fund groups define the mission and goals of a compliance program, (ii) the role and functions of the CCO and compliance, and (iii) the CCO’s interactions with management and the fund board.

We have also identified what we believe to be certain core characteristics of a successful compliance program, while acknowledging that there is no one “right” approach to compliance. The manner in which a fund complex structures its compliance program and defines the role of the CCO will reflect a number of considerations, including: (i) the fund complex’s size, organizational structure, resources, product offerings, and compliance history; (ii) the CCO’s background and qualifications; and (iii) the fund board’s governance protocols.

We have not set out to identify one compliance model that works best because, in fact, we do not believe that one size fits all. We find that what works well for one fund group may not work well for another, and what is effective today may not be tomorrow. Our goal is to prompt critical thought and greater awareness of the differing practices that permeate the compliance landscape. The task force hopes that the various alternatives and practices discussed in this report are helpful to fund boards, management organizations, and CCOs alike as they consider their own compliance undertakings.

We recognize that the overall control environment in any fund organization will be influenced by many of the adviser’s internal functions, such as risk management and internal audit. While this report



does not focus on how and to what extent those functions affect, overlap with, or enhance compliance, the report does acknowledge their role and identify when they may exert particular influence.

## II. CONSIDERING THE MISSION AND GOALS OF A COMPLIANCE PROGRAM

A key requirement under the Rule is that funds “[a]dopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund, including policies and procedures that provide for the oversight of compliance by [the] investment adviser, principal underwriter, administrator, and transfer agent of the fund.”<sup>7</sup> But the Rule does not specify how funds are to fulfill this requirement, nor does it provide any details regarding the breadth or depth of the required policies and procedures. As a result, how fund groups satisfy this requirement varies widely. Moreover, compliance is not a static concept: to be effective, a compliance program must constantly evolve in response to changing regulatory requirements; market, industry, and business risks; new products or lines of business; updated technology; and changes in available resources and personnel. Compliance does not stand alone: it is one element of a larger control environment that may include risk management, internal audit, accounting, and legal functions.

Although not required by the Rule, it may be useful for fund boards, the adviser, and the fund CCO to discuss and consider what they believe should be the mission and goals of the compliance program. While the compliance program will generally reflect the needs and risks that are particular to an adviser’s business, as well as its organizational structure and corporate culture, the goals, priorities, and concerns of the fund board and the CCO can also represent a powerful influence on the development and implementation of the compliance program.

Fund boards may help define the mission and goals of the fund’s compliance function by:

- » maintaining an ongoing dialogue with management and the fund CCO regarding the board’s expectations, including how to address those expectations, and the level of resources available to the CCO;
- » emphasizing the need to maintain a strong culture of compliance that focuses on adherence to both the letter and spirit of the law;
- » providing meaningful feedback on the compliance program and the CCO’s performance, including when approving the CCO’s compensation; and
- » inquiring about the processes in place to address compliance problems when they arise, such as, for example, determining how the problems occurred, how and when they were discovered, how they are being addressed, what changes are proposed to minimize the

possibility that they will recur, and any broader lessons learned that might apply to similar functions or systems.

Despite the fact that compliance programs can and do vary significantly from firm to firm, there seem to be some common themes among fund groups regarding the mission of compliance and the philosophy driving it. For example:

***Compliance is everyone's responsibility.*** Compliance begins within each of the business units that make up the fund and investment advisory operations. Employees of the fund's adviser and other service providers, including portfolio management and back office personnel, represent, effectively, the front lines of all parts of the business, including compliance. While compliance personnel oversee the compliance program, each business unit should "own" the portion of the compliance program that is applicable to it.

***Compliance should be structured as a collaborative function that enhances fund operations, rather than as a "gotcha" function whose goal is to seek out and punish outliers.*** There is no question that part of the role of compliance is to identify violations or other concerns and address them promptly and appropriately. But the manner in which each concern is identified and each solution is pursued could have long-term implications for the way in which compliance is perceived in the organization. When compliance is approached in a constructive manner, even when confrontation may be required, it likely will be more effective than when approached punitively. (Of course, some violations, such as fraud or cover-ups by personnel may warrant punitive actions.) Also, because compliance inures to everyone's benefit (the fund and its shareholders, the adviser and the board), whenever possible, compliance should involve a team effort in which every relevant department and person plays a role and has a stake in its success. Conversely, everybody loses when significant compliance problems lead to a loss of confidence in the fund and its adviser.

***Compliance should be proactive and anticipatory.*** It is impossible to foresee every compliance issue that might arise. Yet a compliance program that relies on a thoughtfully developed testing program, is ever-evolving, and seeks to accommodate changing circumstances and anticipate tomorrow's concerns today, can help prevent compliance issues.

***Compliance should seek to educate.*** Effective compliance requires an understanding at all levels of the organization of the importance of compliance and the role of each person in preserving a compliant environment. CCOs should engage with business units on initiatives to maintain an appropriate level of compliance awareness regarding the fund complex. This is especially important as the fund organization changes, the business and regulatory environment evolves or becomes more complex, and new or existing staff take on new responsibilities.

### III. ROLE OF THE CCO

The Rule states that the CCO is responsible for: (i) “administering the fund’s policies and procedures,” and (ii) providing a written report to the board, at least annually, that, at a minimum, addresses the “operation of the policies and procedures of the fund and each investment adviser [and principal service provider], any material changes made to those policies and procedures since the date of the last report, and any material changes to the policies and procedures recommended as a result of the annual review.” While the Rule goes no further to explain how the CCO should satisfy these responsibilities, the SEC’s Adopting Release makes clear that it views the CCO as having “overall responsibility for management of a fund complex’s compliance program.”<sup>8</sup>

The Adopting Release also highlights provisions in the Rule designed to promote the independence of the CCO from the management of the fund, including provisions that (i) call for the CCO to serve at the pleasure of the fund’s board (the board must approve the CCO’s compensation and can prevent the adviser or another service provider from removing the CCO from his or her responsibilities); (ii) require the CCO to meet in executive session with the fund’s independent directors at least annually; and (iii) prohibit the adviser and any person acting under its direction from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence the fund CCO in the performance of his or her responsibilities under the Rule.

The implementation of the CCO requirement, including the role and responsibilities assigned to the CCO and the structure of the CCO position, varies widely among fund groups. The CCO’s responsibilities will depend on a number of factors, including the size and nature of the fund organization, the nature and extent of the fund’s relationships with third party service providers, the resources available to the CCO, and the preferences of the fund board. In addition to overseeing fund compliance generally, the fund CCO may lead board education sessions on topics of interest to independent directors; take on special projects assigned by the board to review certain aspects of the investment adviser’s operations; serve as an officer or employee of the adviser and, as a result, have to manage a concurrent set of responsibilities; serve as the CCO for the adviser; have compliance responsibilities with one or more of the fund’s affiliated service providers; and/or supervise and train other employees, whether by virtue of serving as the CCO or as a result of holding other positions with the adviser or its affiliates, as referenced above. Appendix C contains a sample CCO job description and list of responsibilities.

One of the defining aspects of a CCO’s role is whether the individual serves as the fund’s and adviser’s CCO or only as the fund CCO. These alternative frameworks are explored in more detail in the next two sections. In addition, the CCO may be employed in-house by the fund and/or adviser or outsourced and, thus, retained as a third-party service provider. For some fund groups,

outsourcing is appealing because they can access the expertise of compliance professionals and the resources of their organizations without incurring the significant costs of developing and maintaining a compliance infrastructure that is entirely self-supported. This model is also appealing to some because of the inherent independence that comes with a CCO who has no ties or affiliations to the management organization. On the other hand, fund groups with an in-house CCO see advantages in having a person who may be better integrated into the business and, therefore, may have a stronger understanding of the risks and compliance needs of the fund complex.

As we repeatedly emphasize in this report, there is no one compliance model that trumps another. The model chosen by each fund complex will be that which it believes is most compatible with and will work best for the complex. Regardless of the model followed by a fund group, it is important that the adviser, CCO, and board agree from the outset about the role and function of the CCO, where and how the CCO will co-exist with the adviser's business and, generally, the expectations for the CCO's role. And, from time to time, they may wish to review and revisit the model and make any adjustments they believe are appropriate based on their experiences.

## **A. FUND-ONLY CCO**

Some fund groups have a CCO who serves in that capacity only for the fund and not the adviser.

Boards that work with a fund-only CCO have found the model appealing, in part, because:

(i) whether in reality or as a matter of perception, the CCO's potential conflicts of interest in serving dual roles are minimized if not altogether eliminated; and (ii) the fund CCO can serve as a useful complement or counterpoint to the adviser's CCO.

While the fund-only CCO model has appealing characteristics, it also faces certain unique challenges. Most notably, a fund-only CCO could be viewed as an outsider—even with suspicion—by the investment adviser's employees. If this occurs, the CCO's access to employees and information could be limited as the adviser's employees may be more likely to go to the adviser's compliance or legal staff to discuss possible concerns. CCOs without adequate access to and trust of the adviser's employees may find their effectiveness compromised. To avoid this, fund-only CCOs may work to cultivate relationships necessary to oversee a functional, open, and successful compliance program. Successful fund-only CCOs take steps to achieve a positive and productive integration into the investment advisory organization.

## **B. FUND AND ADVISER CCO**

A person who serves as CCO of both the adviser and the fund may be better able to sufficiently integrate him or herself into and understand the adviser's business. The CCO may have a large degree of transparency and access to the adviser's organization and employees, and, because the CCO is

viewed as part of the adviser's team, the adviser's employees may be more willing to seek the CCO's help or guidance, all of which contributes to the success of the compliance program. To the extent the adviser has a business that extends beyond mutual funds (for example, separate accounts or hedge funds), it is also possible that a fund and adviser CCO may have a better understanding of risks or conflicts that could affect registered funds.

The fund and adviser CCO model, however, is not devoid of challenges. One of these is that the CCO has two constituents (the fund board and the adviser) who may not always see eye to eye on compliance issues or how to address them. Also, each may wish to be the CCO's first point of contact when a compliance issue does arise. While this scenario could unfold for a fund-only CCO, it may be more likely when a CCO must serve two masters. Also, as a matter of perception, if not reality, the CCO's independence may be blurred and some may question the independence of a person who serves constituents whose interests may not always be aligned.<sup>9</sup>

A CCO can address most of the concerns involving dual reporting lines by communicating with both constituencies (the board and management) to clarify expectations, particularly with respect to when, what, and how information will be reported to each. This approach should also help assure that the CCO can appropriately balance and accommodate the preferences of the board and management. It also should help allay concerns about the CCO's independence.

## **IV. COMPLIANCE AND MANAGEMENT**

### **A. TONE AT THE TOP**

While in this report we repeatedly reference the fund's compliance function, the fact is that fund compliance is closely tied to (and for some fund groups is almost indistinguishable from) the adviser's compliance structure. Consider, for example, that: (i) the fund's CCO may serve as the adviser's CCO, as previously discussed; (ii) there may be considerable overlap of the compliance staff charged with overseeing the fund's and adviser's compliance functions; (iii) the adviser typically compensates the compliance staff used by the fund CCO; (iv) the fund CCO regularly interacts with the adviser's internal legal group, risk management personnel, internal audit department, accounting personnel, and operations staff, all of which share responsibility for assuring a strong control environment; and (v) funds often adopt many of the adviser's policies and procedures as their own, on the theory that a fund operates principally through its adviser and it is, therefore, duplicative and possibly risky to have two sets of policies addressing the same matters.

The inextricable link between the fund's and adviser's compliance functions means that management has a significant ability to influence the effectiveness and success of the fund's compliance program. This makes it imperative for the adviser's senior management to support, with words and action, a

robust compliance environment—management should lead with a strong tone at the top. Moreover, as noted earlier, a robust compliance program is simply good for the adviser’s business.

SEC staff has frequently expressed the importance of that tone. Lori Richards, former Director of the SEC’s Office of Compliance Inspections and Examinations, noted in a speech a few months after the Rule was adopted that:

[There is a] need to instill a ‘Culture of Compliance’ within firms . . . establishing, from the top of the organization down, an overall environment that fosters ethical behavior and decision-making. This notion certainly goes beyond having good policies and procedures, beyond having a dedicated compliance staff, and beyond having sufficient compliance resources and electronic exception reports, although the absence of those things can certainly indicate a poor culture of compliance. [The SEC’s] Chairman has talked about the need to instill an ethical culture as part of the ‘essential DNA’ of the corporate body itself.<sup>10</sup>

In a speech a few months later, Richards explained that firms with a culture of compliance:

question past practices, even those that while technically legal, may not be ethical; identify conflicts of interest or potential conflicts of interest; engage in dialogue with all business units and service providers about their activities; review [their] disclosures to . . . clients; inventory [their] obligations under the securities laws and [their] disclosures; match the inventory to [their] policies, procedures and controls; throw out practices, policies and procedures that did not serve [well]; adopt new policies, test them out; and educate employees on conflicts, on the culture of the firm, and their responsibilities within it.<sup>11</sup>

Management’s tone is critical to an effective compliance function, and the fund board can help to promote that tone through its evaluation and advocacy of a strong compliance culture. A board’s evaluation of that tone will be a judgment call based on the totality of experiences the board has had with management. Among the questions a board might ask management, the fund CCO, and/or itself are:

- » What are the amount and quality of resources that the adviser dedicates to compliance and are they effectively utilized?
- » How effectively do the various areas of the organization that are most related to compliance interact with compliance personnel (these include areas such as internal audit, legal, risk, accounting, and fund operations)?
- » How well do the CCO and compliance personnel interact with the service providers?

- » Is the compliance function treated as an important and legitimate part of the business or a necessary evil (a nuisance)?
- » How has the adviser responded to and resolved previous compliance violations?
- » Has the adviser fulfilled in a timely fashion all commitments it has made relating to compliance?
- » How does the adviser’s senior management team (and, if applicable, the adviser’s CCO) interact with the fund CCO?
- » Does management appropriately consider and, as applicable, implement compliance-related recommendations made by the CCO?
- » Is the CCO free to speak with employees, including senior management, and conduct reviews and investigations or inquiries when he or she deems it necessary?
- » Does the CCO feel subject to undue influence from the adviser regarding his or her communications with the board or potential findings of material compliance matters?

The board can communicate its expectations for a strong tone at the top, as well as its support for the CCO, by asking such questions. These types of questions can also be used by the board (or the CCO) to evaluate the tone of the fund’s service providers. The answers to the board’s questions, coupled with the board’s experience with the adviser’s management during and between board meetings, should provide the board with an appropriate “feel” for the tone at the top of the management organization. The board’s continuous expressions of interest about compliance matters and support of the CCO’s compliance efforts should help establish and reinforce the tone at the top.

## **B. ASSESSING THE ADVISER’S SUPPORT OF THE CCO**

Just as the adviser’s tone and treatment of the compliance function are critical to assuring the success of that function, so too is the adviser’s support of the CCO, whether the CCO is a fund-only CCO, also serves as the adviser’s CCO, or is outsourced. As previously noted, the release adopting the Rule states that the fund CCO should be “empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund” and have “sufficient seniority and authority to compel others to adhere to the compliance policies and procedures.”<sup>12</sup>

Boards can consider management’s view and support of the CCO and the CCO’s seniority in the organization in a variety of ways. They can consider, for example, the stature of the person to whom the CCO reports. Reporting lines are important even when there are different CCOs for the adviser and the fund because the fund CCO’s day-to-day interactions with the adviser’s personnel may require



the development of something akin to an internal “dotted” communications line. This practical approach creates a liaison (usually a senior officer) within the adviser’s organization who is asked to facilitate the CCO’s job by providing ready access to various parts of the organization and helping to trouble shoot impediments to the CCO’s work, which may arise from time to time. Thus, while a fund and adviser CCO may report directly to the adviser’s general counsel, the parent organization’s chief compliance officer, or other senior officer, it is not uncommon for a fund-only CCO to have a “dotted” communications line arrangement with the same types of officers.

Understanding the resources available to the CCO is also an important way to gauge management’s support of the CCO (as well as the effectiveness of the compliance policies and procedures). The question is not so much one of absolute numbers, but of the appropriate support and resources in light of the CCO’s responsibilities and the nature, complexity, and size of the fund complex. Because the adequacy of resources may not be readily apparent to a board, it is appropriate for a board to ask the CCO periodically whether he or she feels the experience and size of the staff and resources available to the CCO, including resources found in other parts of the investment advisory operation, such as the internal audit or risk management functions, are suitable. The question of resources may be a particularly important one to ask if the adviser is downsizing and personnel cuts are expected to affect the staff on which the CCO relies (whether or not that staff is part of the compliance group) or result in an expansion of the CCO’s responsibilities. During difficult economic times, the board should be especially attuned to resources available to the CCO and comfortable that, whatever their level, the CCO is satisfied with their adequacy.

Boards can also evaluate management’s support of the CCO by confirming the CCO’s access to the investment adviser’s operations. It would be difficult for a CCO to effectively oversee compliance, evaluate the fund’s and investment adviser’s compliance program, and meet the expectations of regulators without a solid, in-depth understanding of the fund’s and adviser’s business. It may be beneficial, therefore, for the CCO to be involved, at some level, in day-to-day operations of the adviser. For example, a CCO or his or her staff might attend meetings of committees that impact directly on the operations of the fund, including (to the extent an adviser has them) those of the pricing/valuation, risk or compliance, trading practices, and operating committees. CCOs or their staff may also participate in meetings of the investment adviser’s internal audit staff or at least have input into the auditor’s work plan or access to the auditor’s reports. Many CCOs that attend meetings of the adviser’s committees prefer not to be voting members (or even members at all) of the committees. (The risk/compliance committee might be an exception to this general rule.) CCOs reason that part of their role is to evaluate, from a compliance perspective, the role and function of those committees, and their objectivity could be compromised if they are part of the process and influence the results that are the subject of their review.



Another important element of management's interaction with the CCO is the CCO's ability to tap into the expertise of the adviser's legal and internal audit staff. For example, a fund CCO with a legal background may rely, to some degree, on the adviser's internal audit group in developing or identifying tests for certain aspects of the adviser's operations. This is especially true when the CCO does not have staff members with a strong background in the development and implementation of testing plans. Conversely, CCOs with an auditing background may rely more heavily on the adviser's internal legal group when compliance questions or issues arise that involve legal interpretations. This is particularly the case when the CCO's staff does not include attorneys. It can be valuable for boards to understand the extent to which and how the fund CCO relies on various parts of the adviser's organization in administering the fund's compliance program.

## **V. COMPLIANCE AND THE FUND BOARD**

### **A. ROLE OF THE BOARD**

The Rule assigns specific responsibilities to the fund board, including that it (i) approve the policies and procedures of the fund and each adviser and principal service provider based on the finding that they are reasonably designed to prevent violation of the federal securities laws by them, and (ii) approve the designation, compensation, and removal of the CCO.<sup>13</sup> In addition, directors oversee a fund's compliance program as part of their overall oversight responsibilities.

The Rule also requires certain CCO-board communications; namely, that "no less frequently than annually," the CCO: (i) provide a written report to the board that, at a minimum, addresses the operation of the policies and procedures of the fund and each adviser and principal service provider and any material compliance matters that occurred since the date of the last report; and (ii) meet separately with the fund's independent directors.

The task force finds that directors largely fulfill their responsibilities through the exercise of their business judgment and common sense due diligence. Independent directors generally are not compliance experts, nor are they expected to be. Even so, they should take steps to gain a fundamental understanding of how the compliance regime operates to assist them in their discussions with the adviser and CCO about the soundness, needs, or challenges of the compliance program. Directors must have a reasonable basis to rely on the adviser and CCO, and that reasoned reliance should be supported by the directors' experience with these parties.

Because in law and in practice, a board's understanding of the fund's compliance program will derive primarily from its interaction with the CCO, it is important for the board to frequently consider the CCO's effectiveness in overseeing compliance. While this may be achieved in part through formal, regularly scheduled reviews of the CCO (which we address further below), each board member should

also develop an opinion of the CCO's and compliance program's effectiveness through his or her periodic interactions with the CCO, both written and oral. For example, directors might consider whether the CCO is an effective communicator, organized, resourceful, committed, rigorous, and a respected and valued participant in the identification and resolution of compliance matters when they arise.

## **B. COMMUNICATIONS AT BOARD MEETINGS**

Though the Rule requires the CCO to provide the written report to the board and to meet separately with the independent directors “no less frequently than annually,” it is not uncommon for a CCO to attend every board meeting—in many cases, for the full length of the meeting. In addition, many independent directors meet with their fund CCO in executive session at every regularly scheduled board meeting.

Many of the CCO's communications at board meetings will take place in open sessions that include the adviser's officers and representatives. The task force believes that communicating in this open fashion is constructive and sets a collaborative tone that yields fewer surprises and assures that all parties are working in concert to achieve the goal of strong compliance. While many matters may be addressed in open session (indeed, material compliance matters must be reported to the full board), independent directors sometimes appreciate the opportunity to address those same matters or even new topics in executive session.

Items that may be addressed in executive sessions (but not necessarily every executive session) with the CCO include:

***Material Compliance Matters.*** The Rule requires that the CCO inform the board of all “Material Compliance Matters.” A matter is deemed material under the Rule if the “board of directors would reasonably need to know [about it] to oversee fund compliance.”<sup>14</sup> In deciding whether to characterize a matter as “material,” the CCO should consider whether the board would deem it an important piece of information in the board's oversight of compliance. To facilitate this determination, it can be helpful for the board and CCO to discuss the circumstances under which a matter may be deemed “material” as well as the extent to which the board should play a role in that determination. While the CCO and the board may agree in advance as to certain matters that always might be deemed material, there is circularity to the definition of material compliance matters that may cause it to be a recurring topic of discussion.

***Significant compliance matters.*** Frequently, boards want to know about matters that may not rise to the level of “material” but may nevertheless be important. In light of this, CCOs may err on the side of over-inclusion if they have any doubt whether to bring a matter before the board, and it is

common for a board to engage in a frequent dialogue with the CCO about the board's expectations in relation to extraordinary or significant compliance matters.

***Potential and existing conflicts of interest.*** Regulators have persistently emphasized the need for CCOs and boards to focus on existing or potential conflicts of interest. Often, compliance challenges arise in connection with these conflicts. To the extent the conflicts are identified in advance, it may be possible to anticipate and address potential compliance concerns before they materialize. It is not uncommon for the fund CCO to periodically make presentations to the board regarding where conflicts may exist and what controls are in place to mitigate them.

***The CCO's staffing and support.*** The executive session offers the board the opportunity to hear the CCO's views regarding the adequacy of the staffing and support the CCO receives in fulfilling his or her duties.

***The CCO's relationship with the adviser's management.*** The executive session also provides the opportunity for the board and CCO to discuss the effectiveness of the CCO's reporting relationships within the advisory organization, access to the investment adviser's operations and personnel, and other elements of the CCO's relationship with the adviser's management.

***Confirmation that the CCO has not been subject to undue influence.*** Under the Rule, "[no officer, director, or employee of the fund, its investment adviser, or principal underwriter, or any person acting under such person's direction may directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence the fund's chief compliance officer in the performance of his or her duties." The executive session provides the CCO the opportunity to address any concerns impacting this prohibition.

The matters discussed in executive session—including those noted in the last three bullets—may also be helpful to the board in considering management's tone at the top.

Although the rule requires the CCO to annually provide a written report and report any material compliance matters, many also provide quarterly reports to their boards. Topics commonly addressed in these quarterly reports include: compliance with exemptive rules relied on by the fund; testing results; code of ethics violations; actions taken vis-à-vis personnel in connection with compliance violations; and matters that the board has requested be addressed quarterly.

While quarterly reports are not typically as lengthy as the annual report, when a fund complex uses subadvisers, they can be voluminous. The length of these combined subadviser reports will depend, in part, on the number of subadvisers and whether the CCO has worked with the subadvisers to develop a universal reporting template. Developing a template so that the information the board receives

from each subadviser is synthesized, condensed, and reported in the same format, regardless of who the subadviser is, can initially require a great deal of advance work. The result, however, tends to be a “user-friendly” report that enables the board efficiently to focus on the most important compliance matters related to each subadviser.

Whatever form a CCO’s quarterly report takes, it should provide the board with an important tool to consider the work and organizational skills of the CCO and to gauge how the compliance program is working during the course of the year. A cautionary word: it may be tempting for a CCO to provide, or a board to request, lengthy compliance reports to evidence the due diligence of the CCO and the board. Boards, however, are responsible, and potentially liable, for being familiar with any and all information in whatever report they receive. Prudent practice suggests that compliance reports (both quarterly and annual) be concise, well-organized, understandable, and accompanied by an executive summary. More may not always be “more,” and information “dumps” should be avoided.

### **C. COMMUNICATIONS BETWEEN BOARD MEETINGS**

While the Rule only requires the CCO to provide a written report to the board, and to meet with the independent directors in executive session annually, many boards have established a reporting relationship with the CCO that extends beyond the board room. Depending on the particular risks, compliance history, and characteristics of the fund complex, this expanded relationship may provide an appropriate level of interaction.

For many boards, the first step in implementing a reporting relationship between board meetings is to assign a member of the board to serve as liaison with the CCO. That way, communications with the CCO can be channeled through a single individual who can manage the relationship between the board and the CCO in an efficient and effective manner. For some boards, the liaison is the independent chair or lead independent director. Boards that have compliance committees may appoint the chair of that committee to serve as the liaison with the CCO. For a board that does not have a compliance committee, the audit committee chair may be a logical candidate to assume this role.

Because the nature of a board’s relationship with its CCO is not dictated by rules or regulations but, instead, reflects the preferences of the board and the CCO as well as the particular compliance program and challenges of a fund complex, the look and feel of that relationship—especially as it unfolds between board meetings—seems to vary significantly among fund groups. Many boards have some contact with their fund CCO between board meetings. Some boards (or the director liaison with the CCO) speak with the CCO once between board meetings. Others have monthly, bi-weekly, or even intra-weekly contact with their CCO. Some directors prefer to meet with the CCO in person. Others do so telephonically. Others pursue a combination of the two, holding some meetings in person

and some telephonically. In some cases, a director liaison and counsel may have a pre-meeting call with the CCO to plan for the CCO's presentation at the board meeting.

While it appears that most communications with the CCO between board meetings are oral rather than written, the CCO may provide periodic written updates to the liaison or the full board as a matter of course or may do so upon request when the fund complex is facing non-recurring compliance matters. Topics addressed in these communications might range from the routine (staffing, support, testing) to the more significant (SEC exams, material compliance matters, conflicts of interest). Also, if the board is being asked to vote on a specific action affecting the adviser or one or more funds, the CCO may be requested to comment upon any compliance issues relating to such action.

It is important to keep in mind that communications between a board member and the CCO are not privileged (even if the CCO is an attorney). For that reason, many boards insist that independent directors' counsel (and if there is none, fund counsel) be copied on all written communications, including emails, involving compliance matters. To the extent that outside counsel also represents the CCO, the attorney-client privilege may exist or another basis for protected communication may apply. A board should discuss these matters with counsel to be sure everyone involved has a clear understanding as to how best to protect sensitive communications. Another legal implication to keep in mind is that written communications with the CCO may be subject to recordkeeping requirements under the Investment Company Act, which is one reason some boards prefer that communications with the CCO between meetings be oral whenever practicable.<sup>15</sup>

#### **D. EVALUATING THE COMPLIANCE PROGRAM AND THE CCO**

Under the Rule, at least on an annual basis, the fund must review "the adequacy of the policies and procedures of the fund" and of each adviser and principal service provider. Also, as previously mentioned, the CCO must provide a written report to the board that addresses the operation of those policies and procedures and any material changes made to or recommended for those policies and procedures.

Although not required by the Rule, it is not uncommon for a board and the CCO to evaluate the compliance program more broadly, and for the board to evaluate the CCO, sometimes on an annual basis. Indeed, the CCO's annual report to the board presents the board with an opportunity to not only discuss, evaluate, and consider changes to the fund's and service provider's policies and procedures, but to also discuss and evaluate the effectiveness of the compliance program. Given the many different compliance models in the industry and the variety of ways in which boards interact with the CCO, it should be no surprise that industry practices regarding board evaluations of the compliance program and the CCO are equally diverse.

## 1. Evaluation Process

Practices for reviewing compliance programs and the CCO vary. Some boards undertake informal evaluations whereby the independent chair or lead independent director will solicit input from the rest of the board. Other boards have a more formal process and consider written questions about compliance and the CCO in connection with the board's annual self-assessment.<sup>16</sup> The most formal process may also include completing separate, written evaluations (using either their own evaluation form or a form used by the adviser if the fund CCO is also the adviser's CCO) of the CCO and the compliance program. Boards with a compliance committee may have that committee take the lead; other boards may have the audit committee take the lead.

Because the adviser's management will have regular interaction with the CCO—indeed, they generally have more frequent interaction with the CCO than the board—boards sometimes consider management's opinion of the CCO's performance as part of their evaluation of the CCO. This is even more common where the fund CCO is also the adviser's CCO or also holds another position within the advisory organization.

Finally, some boards will work with a CCO to develop a list of goals against which the compliance program and the CCO will be evaluated (and compensation determined) at the end of the year. Appendix D contains a sample list of CCO goals.

## 2. Evaluating the Compliance Program

Whether or not a board has a formal or informal process in place to evaluate the compliance program of the fund and its service providers, as a practical matter, boards generally consider and evaluate those programs on a frequent and ongoing basis. While not all boards consider the same matters, among the items commonly reviewed by a board in evaluating the fund's and service providers' (including the adviser's and sub-advisers') compliance programs are:

***The nature and frequency of significant or material compliance matters.*** Every fund complex (and its service providers) will experience compliance challenges from time to time. A board can gauge the efficacy of a compliance program by considering how compliance violations are identified, the seriousness of those violations, how frequently they arise, and whether they seem to recur within a specific business unit or arise more broadly in different parts of the organization.

***The existence of a thoughtful testing protocol.*** As noted previously, directors are not compliance professionals and should be entitled to rely on the CCO's assessment of the fund's and each service provider's compliance programs. Yet, a director's reliance on the CCO's evaluation has to be based on a rule of reason. As such, it is important for directors to have a fundamental understanding of and comfort with the CCO's testing and other due diligence, including, for example, site visits to or

reasonable reliance on certifications from services providers or auditor reports<sup>17</sup> that forms the basis of the CCO's conclusions.

***The formulation of an effective risk assessment.*** It is impossible to predict with certainty when and from where a compliance matter may arise. Risk-based compliance programs, however, can often anticipate and help prevent compliance problems by virtue of the resources and attention that are focused on parts of the organization that are deemed to involve the highest risk. Understanding the extent to which the fund CCO considers risks that are particular to a fund service provider when evaluating that service provider's compliance program can be a useful tool for the board in its own periodic review of the service provider's compliance program.

***The results of regulatory examinations and responses to findings.*** The soundness of a compliance program can be considered against the backdrop of the results of recent regulatory examinations and a fund service provider's response to those results.

### **3. Evaluating the CCO**

In evaluating the CCO, boards often consider the CCO's:

- » Expertise and effectiveness, including:
  - » whether the CCO appears to be sufficiently familiar with the operations of the fund and its service providers and with applicable law;
  - » the CCO's success in identifying and addressing compliance concerns;
  - » the CCO's ability to identify and monitor conflicts of interest;
  - » whether the CCO is proactive or reactive in fulfilling his or her responsibilities; and
  - » the quality and appropriate focus of testing conducted by the CCO of the fund's, adviser's, and other service providers' policies and procedures.
- » Communications with and reporting to the board, including:
  - » the substance and organization of the CCO's written and oral reports to the board;
  - » whether the CCO responds appropriately to questions and concerns raised by the board; and
  - » whether the CCO is proactive in communicating with the independent chair (or appointed board liaison) between board meetings.
- » Leadership and management skills, including:

- » the CCO’s ability to work with management and effectively use the resources available to him or her;
  - » the CCO’s leadership skills and ability to develop and/or work within a team;
  - » the CCO’s organizational and managerial skills; and
  - » the CCO’s integrity and ability to remain composed and measured under pressure.
- » Independence

Because independence often reflects a state of mind, a key question for a board is whether the CCO’s actions and demeanor evidence the requisite independence. Also important for the board is to consider whether the compliance function is structured in a way to promote and protect the independence of the CCO. To this end, a board may consider some of the matters previously addressed in this report, such as the CCO’s seniority, reporting lines, resources, and compensation.

Another consideration for boards is how their feedback is communicated to and received by the CCO. Fund boards may not wish for their evaluation of the CCO’s ability to identify compliance concerns either to inadvertently encourage zealous efforts to identify every breach at the expense of attention to the overall program or to discourage identifying and addressing compliance matters.

## **E. CCO COMPENSATION**

Under the Rule, a board must approve the CCO’s compensation. As in other areas, the Rule offers little guidance on how to implement the requirement. The result is that boards have developed, in consultation with counsel and management, their own framework for evaluating and approving the amount and form of CCO compensation.

### **1. What is the “Right” Amount?**

For a board that is evaluating and approving the CCO’s compensation, one of the initial steps is to try to consider what level of compensation is appropriate for the CCO in light of his or her experience, the responsibilities associated with the position, and the nature of the fund complex. Some boards ask that the investment adviser’s human resources group gather comparative information on compensation. Other boards review industry compensation studies that are published periodically—typically, once a year.

### **2. How Should the CCO be Compensated?**

The second step is to understand what form the compensation might take or, if the compensation structure already exists, whether that structure continues to be appropriate. While all CCOs likely receive a base salary, many CCOs also receive additional annual compensation. For some, the



additional compensation is a bonus, which can serve as an incentive for the CCO to achieve any goals set by the board (and the adviser's management if the fund CCO is also the adviser's CCO). When a CCO's base compensation is low by industry standards, the bonus can help to provide the CCO with a level of total compensation that is commensurate with the total compensation received by CCOs of similar fund groups.

Additional compensation or a bonus may take the form of stock options or restricted stock. Stock options and restricted stock can play an important role in retaining the CCO, especially when rights vest over time. While this is not an uncommon arrangement, boards may worry about the optics of a CCO who has a financial interest in the adviser or its parent. After all, independent directors are not allowed to own a single share of the adviser or its parent if they wish to retain their independence; yet there is nothing to preclude the CCO from having a significant percentage of his or her net worth invested in the adviser. For this reason, some boards do not permit their CCO to participate in an options or restricted stock program. Nevertheless, to provide CCOs with long-term retention incentives, some are compensated with bonuses (or portions thereof) that vest or accrue over time.

There are boards for whom the potentially problematic optics of a CCO's financial ties to the adviser are outweighed by the need to retain the CCO in the face of competing job opportunities or the desire not to strip the CCO of an opportunity that is available to senior officers of the adviser (this latter consideration tends to carry more weight when the fund CCO is also the adviser's CCO). In the view of some CCOs, owning securities of the adviser serves as a strong financial incentive to them in monitoring compliance. They note that advisory firms with significant (and often public) compliance problems are punished swiftly and meaningfully by regulatory and market forces and that a CCO who has an interest in the adviser's financial health has every reason to identify and address problems promptly so that they are neither tolerated nor become more severe. While some boards have found this persuasive, others feel that a CCO who has financial ties to the adviser may have an incentive to try to hide a compliance problem that the CCO believes could have significant, negative consequences to the financial health of the adviser.

The question of how to structure a CCO's compensation often is particularly challenging for boards because practices are so varied. Also, there is little public information a board can use to compare the compensation structure of its fund CCO with that of other fund complexes. As with other aspects of compliance, it is important for boards to trust their instincts and business judgment and to make reasoned and informed decisions with which they are comfortable based on the relevant facts and circumstances.

### 3. Who Pays the CCO?

Another decision faced by fund boards is whether any or all of the CCO's compensation should be paid by the fund. Some boards feel that the most practical means of ensuring the CCO's allegiance and a clearly delineated reporting relationship is for the fund to pay at least a portion of the CCO's compensation. This is especially true when one considers that the CCO's benefits (such as a health insurance or a retirement account) likely come from the investment adviser.

Where a fund CCO is also the adviser's CCO, there may be a discrepancy in the board's and adviser's view of the appropriate level of the CCO's compensation. Using fund assets to provide additional compensation to the CCO is an option exercised by certain boards if they believe that the adviser's compensation of the CCO is insufficient or inadequate. Other boards have concluded that the wording of the fund's investment advisory agreement precludes the fund from paying any of the CCO's compensation. In addressing these issues, a board may want to familiarize itself with any provisions in the investment advisory agreement that may impact these decisions.

## VI. DEFINING SUCCESS

It is clear that when it comes to compliance, practices vary widely. Despite the many ways in which fund complexes can and do pursue the development and implementation of effective compliance programs, there are some characteristics that the task force believes evidence a strong compliance regime (which were highlighted in the Executive Summary of this report). They include:

***Tone at the top.*** As noted previously in this report, regulators and industry professionals have touted the importance of evaluating an investment firm's compliance culture and the extent to which it reflects the attitudes (for better or worse) of the firm's top executives. The task force agrees that the hallmark of a good compliance program is a strong, ethical, and compliance-oriented tone emanating from the adviser's leadership team and the fund's board. The task force also believes that periodically and conscientiously engaging in an evaluation of that tone provides a board with a helpful backdrop against which to consider the effectiveness of the compliance function.

***Collaboration.*** In our collective experience, CCOs who are able to undertake their role and responsibilities in a collaborative manner earn the board's confidence, garner management's respect, and run compliance programs that identify and address difficult compliance matters in a professional and effective manner. Conversely, without collaboration, interactions can become dysfunctional, mistrust might develop, the CCO's access to information may become more constrained, and, ultimately, the effectiveness of the compliance program may be jeopardized. Our emphasis on collaboration should not be interpreted to mean that the CCO should shy away from asking the necessary, difficult questions or from pursuing compliance-related changes to business

practices if the CCO believes them to be necessary. Nor do we mean to suggest that, for the sake of harmony, the CCO should neglect to bring to the board important compliance matters. We do wish to underscore, however, that whenever possible, collaboration and not confrontation should define the CCO's administration of the compliance program.

***Risk-based compliance.*** While every fund group's compliance program is tailored to monitor adherence to applicable laws and regulations, an effective compliance function is based on an understanding that fund compliance requires a continuous and thoughtful appraisal of risk areas that are specific to the fund and the adviser's business. It is important for a CCO to focus not just on strict legal requirements but on (i) the conflicts of interest that exist or may arise, (ii) areas that previously experienced compliance shortcomings (which, for example, may have been identified by regulators), (iii) unique aspects of the fund that may require special attention (as may be the case, for example, with funds that are heavily invested in derivatives), (iv) business and operational developments at the adviser, and (v) industry issues, such as SEC enforcement cases that highlight particular regulatory concerns. A thoughtful, diligent, and methodical process is central to effective compliance. It is important, however, not to lose sight of the goals of compliance when focusing on the process. In our view, successful compliance programs are those that have clearly articulated goals, the attainment of which underlies every risk-based test, protocol, and control.

***Transparency and candor.*** Transparency and candor are important in any discourse about compliance, whether it is between the CCO and the board, the CCO and the adviser's management, or among all three. Anything short of complete transparency may detract from a relationship of trust. Some boards prefer to hear of an issue once the CCO has ascertained all the important details (assuming, of course, that the CCO is able to do so in a reasonably short period of time), while others may prefer to learn of potential problems earlier (even before the CCO has finished gathering the facts). Regardless of a board's preference in this regard, it is critical that (i) the adviser allow the CCO access to the necessary information and employees to develop an understanding of the circumstance underlying any potential or known problems, (ii) the CCO proactively and promptly communicate his or her understanding of those facts to the board, and (iii) the board feel reasonably confident that the CCO has the necessary access and is communicating fully with the board. Transparency and candor require collaboration among all parties.

***Effective people and resources.*** Conscientious, knowledgeable, and resourceful compliance personnel, including the CCO, armed with appropriate resources, are key contributors to an effective compliance program. Indeed, many of the other characteristics of a strong compliance regime are achieved, in part, through the actions and leadership of highly effective compliance personnel possessing these traits.

## CONCLUSION

Compliance programs and CCOs make up a diverse compliance landscape. There are numerous ways in which to fashion compliance programs, address compliance issues, nurture the relationships that represent key partnerships in the compliance infrastructure, and evaluate the effectiveness of a compliance program and the CCO who oversees it. The task force's goal with this report has been to explore certain aspects of compliance that seem to be common to all fund groups, or explore different means for achieving similar goals, and to underscore that there are many different compliance models that work. The compliance universe is sufficiently large and sophisticated to accommodate many different perspectives and practices.

A board's oversight of the compliance program and the fund CCO will be based on the particularities of the fund group that the board oversees. The compliance function should work well for all fund groups as long as it is based on the understanding that strong compliance is good for everyone, including the adviser and fund shareholders.

Finally, we are struck by an irony of evaluating compliance: sometimes the best measure of success is the absence of anything uncommon or particularly interesting to report. Unlike with most evaluations, where good marks come from standing out or clearly beating the field, it may be that the succession of recurring, routine reports, uninterrupted by unexpected developments, are the best indication of an excellent compliance program.

## **APPENDIX A: RULE 38a-1: COMPLIANCE PROCEDURES AND PRACTICES OF CERTAIN INVESTMENT COMPANIES**

- (a) Each registered investment company and business development company (fund) must:
- (1) Policies and procedures. Adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund;
  - (2) Board approval. Obtain the approval of the fund's board of directors, including a majority of directors who are not interested persons of the fund, of the fund's policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund, which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund;
  - (3) Annual review. Review, no less frequently than annually, the adequacy of the policies and procedures of the fund and of each investment adviser, principal underwriter, administrator, and transfer agent and the effectiveness of their implementation;
  - (4) Chief compliance officer. Designate one individual responsible for administering the fund's policies and procedures adopted under paragraph (a)(1):
    - (i) Whose designation and compensation must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund;
    - (ii) Who may be removed from his or her responsibilities by action of (and only with the approval of) the fund's board of directors, including a majority of the directors who are not interested persons of the fund;
    - (iii) Who must, no less frequently than annually, provide a written report to the board that, at a minimum, addresses:
      - (A) The operation of the policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent of the fund, any material changes made to those policies and procedures since the date of the last report, and any material changes to the policies and procedures recommended as a result of the annual review conducted pursuant to paragraph (a)(3) of this rule; and

(B) Each Material Compliance Matter that occurred since the date of the last report;  
and

(iv) Who must, no less frequently than annually, meet separately with the fund's independent directors.

(b) Unit investment trusts. If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the fund's policies and procedures and chief compliance officer, must receive all annual reports, and must approve the removal of the chief compliance officer from his or her responsibilities.

(c) Undue influence prohibited. No officer, director, or employee of the fund, its investment adviser, or principal underwriter, or any person acting under such person's direction may directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence the fund's chief compliance officer in the performance of his or her duties under this rule.

(d) Recordkeeping. The fund must maintain:

(1) A copy of the policies and procedures adopted by the fund under paragraph (a)(1) that are in effect, or at any time within the past five years were in effect, in an easily accessible place; and

(2) Copies of materials provided to the board of directors in connection with their approval under paragraph (a)(2) of this rule, and written reports provided to the board of directors pursuant to paragraph (a)(4)(iii) of this rule (or, if the fund is a unit investment trust, to the fund's principal underwriter or depositor, pursuant to paragraph (b) of this rule) for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and

(3) Any records documenting the fund's annual review pursuant to paragraph (a)(3) of this rule for at least five years after the end of the fiscal year in which the annual review was conducted, the first two years in an easily accessible place.

(e) Definitions. For purposes of this rule:

(1) Federal Securities Laws means the Securities Act of 1933 (15 U.S.C. 77a-aa), the Securities Exchange Act of 1934 (15 U.S.C. 78a-mm), the Sarbanes-Oxley Act of 2002 (Pub. L. 107-204, 116 Stat. 745 (2002)), the Investment Company Act of 1940 (15 U.S.C. 80a), the Investment Advisers Act of 1940 (15 U.S.C. 80b), Title V of the Gramm-Leach-Bliley Act (Pub. L. No. 106-102, 113 Stat. 1338 (1999)), any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act (31 U.S.C. 5311-5314; 5316-5332) as it applies to funds, and any rules adopted thereunder by the Commission or the Department of the Treasury.

(2) A Material Compliance Matter means any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance, and that involves, without limitation:

- (i) A violation of the Federal Securities Laws by the fund, its investment adviser, principal underwriter, administrator or transfer agent (or officers, directors, employees or agents thereof),
- (ii) A violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent, or
- (iii) A weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent.





## APPENDIX B: TASK FORCE MEMBERS

Ashok Bakhru, Task Force Chair	Independent Chair, Goldman Sachs Funds
James H. Bodurtha	Independent Director, BlackRock Funds
Joanna M. Haigney	Chief Compliance Officer, Rydex Funds
Edith E. Holiday	Independent Director, Franklin Templeton Funds
Philip L. Kirstein	Independent Compliance Officer for the Funds and Senior Officer, AllianceBernstein Funds
Virginia L. Stringer	Independent Chair, First American Funds
Gary Wilner	Independent Chair, Oakmark Funds
Anita M. Zagrodnik	Chief Compliance Officer, Ariel Investment Trust



## APPENDIX C: SAMPLE JOB DESCRIPTION

Below is a sample CCO job description as it relates to serving as the fund CCO. The description encompasses both requirements of Rule 38a-1 under the Investment Company Act as well as certain other responsibilities with which CCOs sometimes are charged. The task force is neither recommending adoption of these responsibilities nor endorsing them. This appendix is a compilation of responsibilities that some funds have vested in the CCO.

- » At least annually, the CCO shall review the adequacy of the fund compliance policies and procedures and those of the fund's principal service providers. The CCO shall take steps to ascertain whether each service provider has implemented effective compliance policies and procedures administered by competent personnel.
- » At least annually, the CCO shall provide a written report to the board that addresses, at a minimum, (i) the adequacy and effectiveness of implementation of the fund compliance policies and procedures and those of the fund's principal service providers since the last such report; (ii) any material changes to such policies and procedures that have not been previously reported to the board; (iii) the results of the CCO's annual review referred to in the preceding paragraph; (iv) any material changes to such policies and procedures; and (v) any material compliance matter that has not previously been reported to the board.
- » The CCO shall test, provide input on tests, or oversee tests to obtain information necessary to fulfill the CCO's responsibilities under the preceding bullet.
- » The CCO shall oversee the fund's compliance program to assure that it continues to be reasonably designed to prevent, detect, and promptly correct violations of the federal securities laws by the fund.
- » At each regular meeting of the board, the CCO shall report to the board on any material changes to compliance policies of the fund or any of its principal service providers since the last such meeting as well as on any compliance issues warranting the board's attention.
- » At least once a year, and more frequently as requested by the board, the CCO shall meet separately with the board's independent directors to discuss current compliance issues affecting the fund and any other matters that the CCO or board wish to discuss.
- » From time to time, as requested by the board or as deemed appropriate by the CCO, the CCO shall provide the board with his or her confidential assessment of the adequacy of the

resources allocated to the compliance function by the fund, the fund's investment adviser, and other service providers.

- » Periodically, the CCO shall review with the board the level of cooperation provided by each of the fund's service providers in facilitating the CCO's fulfillment of his or her responsibilities.
- » At least annually, the CCO will report to the board on the risks to which the fund complex may be particularly susceptible and how the fund and/or its service providers are addressing those risks.
- » The CCO will meet or communicate with the board chair (or any other director designated by the board) between board meetings as necessary to discuss compliance issues.
- » The CCO will develop with the board a set of objective criteria and expectations on which the board will evaluate the CCO annually.

## APPENDIX D: SAMPLE LIST OF CCO GOALS

Below is a “menu” of goals that a board can consider if working with the fund’s CCO to jointly develop a list of long-term expectations. This list should not be considered exhaustive or limiting. The decision of whether to develop a list of CCO goals is a matter to be decided by the board and, to the extent a list is developed, it may include one or more of the goals outlined below (or none of them). Many fund groups have determined not to adopt a list of goals.

In addition to complying with the requirements of Rule 38a-1 under the Investment Company Act of 1940 and all relevant aspects of any CCO job description, the CCO shall individually or with the help of other compliance professionals under the CCO’s supervision:

- » Develop and update, at least annually, a risk matrix that shows how the fund’s compliance program addresses risks posed by various parts of the investment adviser’s organization.
- » Ensure that the fund’s compliance program addresses existing and potential risks, including any material conflicts of interest identified in the risk matrix.
- » Develop and implement (or oversee) a plan that includes testing protocols to oversee the adequacy and effectiveness of the fund’s compliance policies and procedures.
- » As part of its service provider oversight, periodically visit the fund’s principal external service providers and evaluate the effectiveness of selected compliance procedures that the CCO deems appropriate or necessary.
- » Assist the board in evaluating and considering any comments made orally or in writing by the staff of the SEC in connection with any routine or special inspection or inquiry.
- » Review regulatory statements, actions, and settlements affecting other fund complexes and assess the compliance controls in place at this fund complex to address any relevant compliance matters involved in those other regulatory statements, actions or settlements.
- » Review periodically with the board the process by which the CCO assesses business practices to identify risks and/or potential conflicts of interest and the processes in place to mitigate or oversee those potential conflicts.
- » Ensure that the fund and its service providers, as necessary or appropriate, conduct training sessions to educate employees on the fund’s compliance program applicable to them, and report to the board annually on such training sessions.

- » Take steps to establish a culture of compliance covering all persons/entities providing services to the fund.
- » Develop with the board's input initiatives to establish and reinforce a "tone at the top" that emphasizes the fiduciary duties of the fund and its service providers and an ethical tone throughout those organizations.
- » Undertake any other compliance-related projects requested by the board.

## NOTES

- <sup>1</sup> Source: Investment Company Institute.
- <sup>2</sup> See Reid, Sevigny, and Silli. 2004. "Mutual Fund Economic Developments in 2003," Investment Company Institute Perspective [10], no. 1 (March); see also McCabe, "The Economics of the Mutual Fund Trading Scandal" (2009-06) (available at <http://www.federalreserve.gov/pubs/feds/2009/200906/200906pap.pdf>).
- <sup>3</sup> Similarly, Rule 206(4)-7 under the Investment Advisers Act of 1940 requires registered advisers to (i) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws; (ii) review, no less frequently than annually, the adequacy of the policies and procedures and the effectiveness of their implementation; and (iii) designate a single CCO responsible for administering the policies and procedures.
- <sup>4</sup> Under the Rule, the policies and procedures of the fund's investment adviser (and any subadviser), principal underwriter, administrator, and transfer agent must be reviewed. Though fund custodians are not included in the list of service providers addressed by the Rule, many fund boards review the custodian's compliance program with the same degree of rigor they apply when reviewing that of the fund's other principal service providers. For a discussion of board oversight of service providers, see IDC's *Task Force Report on Board Oversight of Certain Service Providers* (June 2007), available at <http://www.idc.org/pdf/21229.pdf>. IDC will also publish a task force report on board oversight of subadvisers soon.
- <sup>5</sup> See Compliance Programs of Investment Companies and Investment Advisers, SEC Release Nos. IA-2204 and IC-26299 (Dec. 17, 2003) (Adopting Release).
- <sup>6</sup> Id.
- <sup>7</sup> Rule 38a-1(a)(1) under the 1940 Act.
- <sup>8</sup> Id.
- <sup>9</sup> The blurring of roles may also arise if the CCO has other duties and responsibilities in addition to serving as CCO (e.g., if the CCO also is the general counsel or chief operating officer of the adviser). In such instances, the board may want to consider, with the CCO, any conflicts this may raise and how to address them.
- <sup>10</sup> *The Need for More Proactive Risk Assessment*, Lori Richards, Director, Office of Compliance Inspections and Examinations, SEC, NRS Annual Spring Compliance Conference, April 14, 2004.
- <sup>11</sup> *The New Compliance Rule: An Opportunity for Change*, Lori Richards, Director, Office of Compliance Inspections and Examinations, SEC, Investment Company Institute/Independent Directors Council Mutual Fund Compliance Programs Conference, June 28, 2004.
- <sup>12</sup> Adopting Release, supra no. 5.
- <sup>13</sup> In the Adopting Release, the SEC clarified that "A fund that is approving policies and procedures of service providers is required to make findings only with respect to activities of the service provider that could affect the funds." See Adopting Release, supra no. 5, at note 32.
- <sup>14</sup> The Rule clarifies that among those matters that should be considered material are those that the board would reasonably need to know to oversee fund compliance, and that involve, without limitation:
- » A violation of the federal securities laws by the fund, its adviser, principal underwriter, administrator or transfer agent (or their officers, directors, employees, or agents);
  - » A violation of the policies and procedures of the fund, its adviser, principal underwriter, administrator, or transfer agent; or
  - » A weakness in the design or implementation of the policies and procedures of the fund, its adviser, principal underwriter, administrator, or the transfer agent.
- <sup>15</sup> It should also be noted that the Rule imposes specific recordkeeping requirements to better enable regulators to determine compliance with its provisions.

<sup>16</sup> Boards generally conduct annual self-assessments in compliance with Rule 0-1(a)(7) under the Investment Company Act of 1940, which sets forth fund governance standards that must be satisfied by funds relying on any one of 10 common exemptive rules.

<sup>17</sup>The American Institute of Certified Public Accountants Auditing Standards Board's Statement of Position 07-2, adopted in October 2007, enables auditors to examine and report on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectivity.