ADVISER AND FUND COMPLIANCE PROGRAMS

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This paper addresses the SEC's "compliance rules" -- Rule 206(4)-7 for investment advisers and Rule 38a-1 for funds -- which call for advisers and funds to adopt compliance programs. This paper is an updated version of a paper that first appeared in March 2004 under the title "The New and Improved Compliance Environment."

THE BASICS

Who is Covered by the SEC's Compliance Rules?

Rule 206(4)-7 under the Investment Advisers Act of 1940 covers investment advisers registered with the SEC ("advisers"). Rule 38a-1 under the Investment Company Act of 1940 covers registered investment companies and business development companies ("funds").

What are the Key Requirements Under the Compliance Rules?

The compliance rules basically require advisers and funds to adopt and implement a compliance program, meaning policies and procedures reasonably designed to prevent violations of the federal securities laws. As a result of the compliance rules, an adviser or fund that fails to have an adequate compliance program will have committed a regulatory violation independent of any other securities law violation.[1] In this way, the rules permit the SEC to address an adviser's or fund's failure to implement compliance controls <u>before</u> that failure harms clients or investors.

In addition, the compliance rules require advisers and funds to designate a chief compliance officer ("CCO") who bears responsibility for implementation of the organization's compliance program. For advisers, the CCO must be identified as such on the adviser's Form ADV, using the term "Chief Compliance Officer." For funds, a CCO meeting the definition of "officer" in the applicable registration statement form must be disclosed in the fund's Statement of Additional Information.

Whose Conduct Must a Compliance Program Cover?

An adviser's compliance program must be designed to cover conduct of the <u>adviser</u> itself and conduct of the adviser's "<u>supervised persons</u>." Under Section 202(a)(25) of the Advisers Act, a "supervised person" is any:

- partner
- officer
- director (or other person occupying a similar status or performing similar functions) or
- employee of the adviser, or
- any other person who provides investment advice on behalf of the adviser and is subject to the adviser's supervision and control.

A fund's compliance program must be designed to cover conduct of the <u>fund</u>. In addition, a fund's program must provide for the oversight of compliance by the fund's advisers, principal

[1] Indeed, the SEC has brought administrative proceedings against investment advisers for violating Rule 206(4)-7, the Advisers Act compliance rule. In one case, for example, the SEC found that the adviser willfully violated the compliance rule by failing to adopt any procedures that could have prevented false statements from appearing in the adviser's RFP responses, which statements served as the basis for separately alleged fraud violations. The SEC further found that the head of compliance at the adviser, who was also the head of marketing, had willfully aided and abetted the firm's violations. See <u>In the Matter of CapitalWorks Investment Partners, LLC and Mark J. Correnti</u>, Investment Advisers Act Release No. 2520 (June 6, 2006) (settled). See also <u>Bethelemy</u>, discussed below.

underwriters, administrators and transfer agents ("service providers") through which the fund conducts its activities.

What Violations Must a Compliance Program be Designed to Prevent?

An adviser's compliance program must be designed to prevent violations of the Advisers Act and the rules adopted under that act.

In contrast, a fund's program must be broader and be designed to prevent violations of the "federal securities laws" as defined in Rule 38a-1, which include:

- the Securities Act of 1933
- the Securities Exchange Act of 1934
- the Sarbanes-Oxley Act of 2002 (officer certifications)
- the Investment Company Act of 1940
- the Investment Advisers Act of 1940
- Title V of the Gramm-Leach-Bliley Act (privacy of personal information)
- any rules adopted by the SEC under any of the foregoing statutes
- the Bank Secrecy Act as it applies to funds (anti-money laundering), and
- any rules adopted under the Bank Secrecy Act by the SEC or the Department of the Treasury.

Are Compliance Programs Required to Prevent All Possible Violations?

No. The rules require that a compliance program be "*reasonably designed"* to prevent violations. Therefore, it need only encompass compliance considerations that are relevant to that particular adviser's or fund's own operations. This allows smaller organizations with simpler operations and fewer affiliations to adopt and maintain simpler compliance programs than larger organizations with more complex operations and affiliations.

Moreover, even a compliance program that conforms to the compliance rules will not necessarily prevent *every* violation. The SEC acknowledged this point in the release in which it adopted the compliance rules ("Adopting Release").[2] Nonetheless, the increased structure and scrutiny introduced by the compliance rules will likely result in a stronger compliance environment industry-wide as compared to periods prior to adoption of the rules.

Are Compliance Policies and Procedures Required to be in Writing?

Yes. However, this does not mean that all compliance policies and procedures are required to be consolidated into a compliance "manual" or any other single document. Nor does it mean that every action required to maintain compliance must be memorialized in writing. In cases, it may be sufficient for the written procedures to assign responsibility within the organization for a specific task without detailing every step necessary to accomplish that task.

Committing policies and procedures to writing makes it incumbent on firms to follow their policies *as written*. This will require allocating additional resources to ensure that written procedures match actual practice. Despite this added burden, written procedures offer a better tool for training personnel and better evidence to satisfy regulators that the appropriate internal controls have been considered and adopted.

[2] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204 and IC-26299 (December 17, 2003) (the "Adopting Release"), fn 16: "While we understand that compliance policies and procedures will not prevent every violation of the securities laws, we believe that prevention should be a key objective of all firms' compliance policies and procedures."

CONTENT REQUIREMENTS

What Specific Elements Must a Compliance Program Include?

The compliance rules do not enumerate specific areas or issues that a compliance program is required to cover. This is because advisers and funds are too varied in their operations for the rules to impose of a single set of universally required elements. Rather, each organization is expected to adopt policies and procedures that take into consideration the nature of that organization's operations.

Even though the compliance rules do not spell out specific required elements, the SEC has provided guidance in the Adopting Release on what it expects compliance programs to cover. It says that an adviser's compliance program should address, at a minimum, the following specific issues, to the extent relevant to that adviser:

- Portfolio management processes (such as allocating investment opportunities, adhering to account objectives and limitations and meeting regulatory restrictions);
- Trading practices (such as best execution, soft dollars, services for brokerage and aggregated trade allocations);
- Proprietary and personal trading (of the adviser and supervised persons);
- Accuracy and completeness of disclosures (to investors, clients and regulators), including account statements and advertisements;
- Safeguarding of client assets from theft or inappropriate use;
- Recordkeeping requirements;
- Marketing (including the use of solicitors);
- Valuation processes and assessing fees based on those valuations;
- Privacy of client information; and
- Business continuity plans (for example, in the event of a natural disaster or death or disability of key personnel).

For funds, the compliance program should address the same issues identified above for advisers, <u>plus</u> these additional "critical areas":

- Pricing of portfolio securities and fund shares, including:
    - monitoring for circumstances that may necessitate the use of fair value prices,
    - establishing criteria for determining when market quotations are no longer reliable for a particular portfolio security,
    - providing a methodology by which the fund determines the current fair value of the portfolio security, and
    - regularly reviewing the appropriateness and accuracy of the method used in valuing securities and making any necessary adjustments;

- Processing of fund shares, including procedures that segregate investor orders received before the fund prices its shares, which will receive that day's price, from those that were received after the fund prices its shares, which will receive the following day's price;[3]

- Identification of affiliates, to prevent self-dealing and unlawful affiliated transactions;

- Protection of nonpublic information, including:
    - guarding against insider trading by the adviser and its personnel,
    - preventing disclosure to third parties of material information about the fund's portfolio, its trading strategies or pending transactions and
    - preventing the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio;

- Compliance with fund governance requirements, including guarding against:
    - an improperly constituted board,
    - failure of the board to properly consider matters entrusted to it, and
    - failure of the board to request and consider information required by law from the adviser and other service providers;

- Market timing, including:
    - ensuring compliance with market timing disclosures,
    - monitoring of trading and inflows/outflows in order to detect market timing activity and for consistent enforcement of the fund's policies regarding market timing, preventing waivers that harm the fund or its shareholders or subordinate their interests to those of the adviser or its affiliates.[4]

What Other Features Should a Well-Designed Compliance Program Include?

Well-designed compliance programs address compliance from three distinct angles:

- PREVENTION: This should be the key focus of any compliance program.
- DETECTION: Detection methods should include on-going compliance monitoring and testing, as well as “forensic testing,” meaning analyzing information over time in order to identify patterns that raise concerns. This might include, for example:
    - an analysis of the quality of brokerage executions to monitor best execution,
    - an analysis of the portfolio turnover rate to determine whether portfolio managers are overtrading securities, or
    - an analysis of the comparative performance of similarly managed accounts to detect favoritism, misallocation of investment opportunities or other breaches of fiduciary responsibilities.
- CORRECTION: Steps should be established to rectify violations promptly, sanction the individuals involved where appropriate and avoid the violations occurring again.

Well-designed programs will also contain several other features:

[3] The Adopting Release specifically states that reliance on contractual provisions between the fund and its service providers alone would be insufficient to meet the requirements of Rule 38a-1. Funds should not only approve and periodically review the policies and procedures of their transfer agents, as required by the rule, but should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered.

[4] The Adopting Release also “strongly urges” fund boards to require advisers, or other persons authorized to waive market timing policies, to report to the board at least quarterly all waivers granted, so the board can determine whether the waivers were proper.

- FUNCTIONAL SEPARATION: The sole person overseeing a function should not be a person who has a vested interest in its outcome. Instead, appropriate checks and balances should be instituted.[5]

- "RED FLAG" FOLLOW-UP: Procedures should include guidance for tracking down and resolving any "red flags" or problems uncovered in compliance monitoring. Failure to follow up on a red flag can be as damaging as the failure to find it.

- TRAINING: Firm-wide compliance training should be instituted for all relevant personnel and should be undertaken annually, if not more frequently as circumstances warrant.

What Steps Should be Taken to Design a Compliance Program Conforming to the Compliance Rules?

<u>FIRST, advisers and funds should conduct a risk assessment</u>.
This step defines the contours of a properly designed compliance program. A risk assessment is the process by which advisers and funds analyze their businesses and identify the areas that present greater risk of compliance problems, in light of that organization's own particular circumstances. For a compliance program to be efficient and effective, it should focus resources in areas that present greater risk, rather than in areas that present little or no risk. Therefore, it is crucial to start the process of designing a compliance program with a risk assessment, to identify those key areas.

A risk assessment should be a collaborative process involving all key personnel helping to assess and identify the areas of greatest exposure.

- Use the bullet-point lists appearing above in this paper as guidance for what issues to cover and elements to include.
- Use the compliance program materials made available by the SEC Staff and posted on the SEC's website under the area for adviser and fund CCOs.[6]
- Use materials offered by industry-related organizations, such as the Investment Adviser Association, which makes available a Risk Assessment Guide, Questionnaire and Chart.[7]
- Consider any policies and procedures already in place in the organization. Are they still needed? If so, do they need to be updated or enhanced?
- Consider what additional areas should be addressed that are perhaps unique to an adviser's or fund's own circumstances.
- For funds, decide which areas of compliance will be integrated into the fund's own policies and procedures, and which will be handled by approving and overseeing a service provider's policies and procedures. This will require a clear dialogue between the fund and each of its service providers and their compliance personnel.

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[5] A lack of functional separate was at the heart of the 2012 fraud case brought by the Commodities Futures Trading Commission against PFGBest. According to the note left by the firm's founder when he attempted suicide (excerpted here http://blogs.wsj.com/deals/2012/07/17/excerpts-from-russell-wasenforf-sr-s-confession/), he was able to steal money from clients by forging bank statements that he intercepted in the mail from the bank before they reached anyone else who might be able to detect his wrongdoing.

[6] This includes a paper prepared by the SEC Staff entitled "Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs" and a hand-out referred to as "Investment Adviser Scenario Analysis/Risk Matrix" available on the SEC's website (follow the links to Information for Fund/Adviser CCOs). The SEC's Office of Inspections and Examinations/ National Exam Program also posts to its website periodic ComplianceAlerts and Risk Alerts discussing various compliance deficiencies and weaknesses that SEC examiners are finding during examinations, which can be another rich resource for advisers in tailoring their own compliance programs.

[7] See http://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PubDoc-RiskAssesment. See also the sample Adviser Risk Assessment Matrix and Risk Inventory made available in the "Forms, Tools & Templates" section of the July-August 2010 of *Practical Compliance & Risk Management for the Securities Industry*.

SECOND, policies and procedures should be designed that address the areas of greater risk.

- Areas of greater risk identified in the risk assessment should be "mapped" or correlated to the individual policies and procedures or controls that the organization has put into place to address those risks.
- As previously discussed, address measures for prevention, detection and correction of violations and, where appropriate, include provisions for functional separation, red flag follow-up and training.
- When committing procedures to writing, carefully consider the level of detail necessary to achieve clarity and effective compliance without the burden of unnecessary details that might themselves become a stumbling block.
- If an adviser or fund chooses to adopt commercially available model procedures ("canned" procedures or an "off the shelf" manual) rather than draft their own procedures from scratch, the procedures should be tailored to the adviser's or fund's own needs before use.[8]

The compliance rules do not require advisers and funds to have a "compliance manual" per se, or any similar manual or compilation. However, most advisers and funds find it convenient from an organizational standpoint to gather their policies and procedures into a compliance manual format, which they can make available to personnel internally, often in electronic form on the firm's internal computer system. A compliance manual format provides several advantages:

- it facilitates an on-going internal assessment of the compliance program in terms of scope and the need for updating and reduces the chance that something will be overlooked;
- it provides an integrated and convenient tool for training personnel; and
- it structures and may even speed up the regulatory examination process.

How Often Must a Compliance Program be Reviewed?

Every well-designed compliance program should provide for a periodic assessment and update of its content. Under the compliance rules, advisers are required to review their compliance policies and procedures at least annually to determine their adequacy and the effectiveness of their implementation.[9] At a minimum, the review should consider these issues:

- any compliance matters that arose during the previous year;
- any changes in the business activities of the adviser or its affiliates; and
- any changes in the law that might suggest a need to revise the policies or procedures.

Under the compliance rules, funds too are required to review their compliance policies and procedures at least annually. A fund's review should consider the same issues as an adviser's and should consider its service providers' policies and procedures as well as its own. The review is not required to be conducted by the fund board. However, the results of the review must be included in a report required to be submitted annually to the fund board by the CCO.

[8] Violations in one case were based on allegations that an adviser adopted a compliance manual almost verbatim from where the principal used to work – a broker-dealer firm. There were references to FINRA throughout the manual, but no references to the Advisers Act. The manual mentioned suitability and fairness, but did not mention an adviser's fiduciary duty. It also contained provisions about commission-based compensation, broker-dealer filings, and BD books and records requirements, none of which applied to an adviser. No annual reviews were ever conducted. See In the Matter of Evens Barthelemy and Barthelemy Group LLC, Investment Advisers Act Release No. 3503 (November 20, 2012) (settled) (Barthelemy). See also In the Matter of Anthony Fields, CPA d/b/a Anthony Fields & Associates and d/b/a Platinum Securities Brokers, Investment Adviser Act Release No. 3348 (January 4, 2012), alleging that an adviser failed to adopt adequate compliance policies and procedures by not tailoring an electronic template downloaded from an outsourced compliance firm entitled "Investment Adviser Policies and Procedures Manual."

[9] How to conduct a compliance review is itself an extensive topic addressed in more depth in other seminars and commentary. In addition, the Investment Adviser Association conducts an annual survey addressing adviser compliance testing and reviews: https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB.

In addition to annual reviews, advisers and funds should be mindful of the need for interim reviews in response to developments such as:

- significant compliance events,
- changes in business arrangements, and
- regulatory developments.

THE CHIEF COMPLIANCE OFFICER

Is the CCO Required to be an Employee?

No. Under Rule 206(4)-7, an adviser's CCO is required to be an officer, director, employee or other "supervised person" of the adviser. (The "supervised person" definition is discussed under the "The Basics" heading above.) Under this broad definition, the CCO is not required to be a traditional employee and, indeed, there are advisory firms (particularly smaller firms) that use outsourced CCOs.[10] The SEC permits advisers to outsource the CCO function using the rationale that once a person is appointed as Chief Compliance Officer, the person becomes an "officer" of the adviser within the "supervised person" definition and is therefore falls within the category of persons permitted to be a CCO.

Similarly, a fund's CCO is not required to be a fund employee under Rule 38a-1 and, indeed, is often an employee of the fund's adviser or administrator. Or, similar to the case with advisers, many funds, particularly smaller funds, have opted to use outsourced CCOs.

Is a CCO Required to Have Any Specific Background, Training or Qualification?

No. The compliance rules do not spell out specific requirements for qualification or training of a CCO. However, the Adopting Release states that a CCO should be "competent" and "knowledgeable" regarding the laws their compliance programs cover. This means that a CCO should have at least a certain amount of training or experience to properly discharge their responsibilities.

The Adopting Release also says that a CCO should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the organization. Ostensibly, this would require the CCO to have a position of sufficient seniority and authority within the organization to be able to compel others to adhere to the compliance policies and procedures.

What Are a CCO's Responsibilities Under the Compliance Rules?

An adviser's CCO is responsible for administering the adviser's compliance policies and procedures.

A fund's CCO is responsible for administering the fund's policies and procedures and for overseeing compliance of the fund's service providers, as discussed more fully under the "Fund Service Providers and Boards" heading below. A fund's CCO must also keep the fund board apprised of significant compliance events at the fund or its service providers and for advising the

[10] Approximately 1% of the respondents to an industry compliance survey said they outsource the CCO role. See the 2013 Investment Adviser Association annual survey addressing adviser compliance testing and reviews: https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=PN_RB.

board of needed changes in the fund's compliance program. This is accomplished in part by submitting a required annual report[11] to the fund board, addressing at least the following matters:

- the operation of the policies and procedures of the fund and each service provider since the last report;
- any material changes to the policies and procedures since the last report;
- any recommendations for material changes to the policies and procedures as a result of the annual review of the fund's compliance program; and
- any material compliance matters[12] since the date of the last report.

The Adopting Release states that having the designation of CCO does not, in and of itself, carry supervisory responsibilities. Accordingly, funds and advisers have the flexibility to decide internally whether their CCO's responsibilities will include supervising any other individuals. Of course the CCO is not required to perform every compliance function alone and may rely on other individuals inside and outside the organization for assistance. The CCO will nonetheless bear overall responsibility for administering the compliance program.

Would a CCO be Personally Liable if a Compliance Violation Occurs on Their Watch?

Great concern has been expressed that simply by virtue of their position, CCOs could be held personally responsible for compliance violations committed by someone else in their organization on, for example, a "failure to supervise" or similar theory. For that theory to work, individuals within the organization would have to be viewed as under the CCO's "supervision" in some sense, at least as to compliance matters. Unfortunately, the SEC has raised the specter of exactly that, by defining a "supervisor" in past failure to supervise cases as <u>any person who</u> under the relevant facts and circumstances <u>has the requisite degree of responsibility, ability or authority to affect the conduct of the employee</u> whose behavior is at issue. See, e.g., *In the Matter of John H. Gutfreund, et al*., 51 S.E.C. 93, 113, Exchange Act Release No. 31554 (Dec. 3, 1992). That definition poses considerable concern when read alongside statements in the Adopting Release for the compliance rules, where the SEC says:

> "An adviser's [CCO] should be competent and knowledgeable…and… empowered with <u>full responsibility and authority to develop and enforce</u> appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of <u>sufficient seniority and authority within the organization to compel others to adhere</u> to the compliance policies and procedures."
> (Adopting Release No. IA-2204, at II.C.1., emphasis added)

Under the *Gutfreund* definition, then, would CCOs who have the requisite authority and influence that the Adopting Release says they should have be viewed as "supervising" individuals within the firm and therefore be potentially subject to a "failure to supervise" claim as a result of compliance violations committed in the firm?

Despite *Gutfreund*, the SEC Staff has said that the answer to that question is no. The Adopting Release says that the CCO designation does not <u>in and of itself</u> carry supervisory responsibilities and that, therefore, a CCO would not necessarily be subject to a sanction for failure to supervise

[11] The Adopting Release specifically states that all reports required by SEC rules, including the CCO's report under Rule 38a-1, are meant to be made available to the SEC and, thus, are not subject to the attorney-client privilege, the work-product doctrine or other similar protections.

[12] In general, a material compliance matter is one about which the fund's board reasonably needs to know in order to oversee fund compliance, such as violations of the federal securities laws or compliance policies or procedures by the fund or its service providers, or the discovery of a weakness in their compliance systems. It may also include the discovery of individual compliance matters that taken in isolation may not be material, but which collectively may suggest a material compliance matter, such as a material weakness in the overall compliance program.

other firm personnel. In public remarks, the SEC Staff has reiterated this view, calling it a "myth" that every CCO has accountability for all violations. (Bob Plaze, Associate Director of the SEC's Division of Investment Management at the CCOutreach National Seminar in Washington, DC, November 8, 2005.) Rather, according to the Staff, the cases where CCOs have been pursued by the SEC for compliance failures are where either:

- the CCO has some other role in the organization in addition to being CCO, and it is in that other role where the individual has gotten into trouble, or
- the CCO is held accountable for participating in, facilitating or covering up a fraud or compliance failure -- in other words, for being personally involved in the violation in some way.

Certain SEC cases seem to bear this out. For example, in In the Matter of CapitalWorks Investment Partners, LLC and Mark J. Correnti, Investment Advisers Act of 1940 Release No. 2520 (June 6, 2006) (settled administrative proceeding), the SEC found that the adviser willfully violated the compliance rule by failing to adopt any procedures that could have prevented false statements from appearing in the adviser's RFP responses, which statements served as the basis for separately alleged fraud violations. In that case, the SEC also pursued personally the firm's head of compliance -- who had a dual role as the adviser's head of marketing -- asserting that he had willfully aided and abetted the firm's violations.

Another case tending to bear this out is SEC v. The Nutmeg Group LLC, Randall Goulding and David Goulding, et al., USDC ED IL (Case No. 09CV1775) (filed March 23, 2009), in which the SEC charged an adviser along with several officers personally, including the CCO, for various violations stemming from a scheme they allegedly conducted, in which they misappropriated client assets, made misrepresentations to clients, failed to comply with custodial obligations and violated books and records requirements.

Note, however, that CCOs can and have been held personally liable for an adviser's failure under Rule 206(4)-7 to merely establish and implement a compliance program reasonably designed to prevent violations, even in the absence of actual violations resulting from that failure. See, for example, In the Matter of Consulting Services Group, LLC, and Joe D. Meals, Release Nos. IA-2669 and 34-56612 (October 4, 2007), which sends the message that the CCO bears some measure of personal responsibility for ensuring that the adviser's compliance program meets the Rule 206(4)-7 standards, wholly aside from whether the program actually prevents violations in practice.[13]

Despite the SEC Staff's statements about failure to supervise, the industry was roiled over claims brought against Ted Urban, a General Counsel and executive officer of a broker-dealer firm for failure to reasonably supervise a rogue broker. It was unclear why Urban's actions in that case would – or should – have caused him to be viewed as the broker's "supervisor," as he was by an administrative law judge in 2010 even though the judge also found that Urban acted "reasonably" in his role as supervisor.[14] On appeal, the Commission ordered the case dismissed without resolving whether Urban was a supervisor, or whether he acted "reasonably" in that case, leaving great uncertainty surrounding the law in this area.[15]

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[13] See also In the Matter of Wunderlich Securities, Inc., Tracy L. Wiswall, and Gary K. Wunderlich, Jr., Investment Advisers Act of 1940 Release No. 3211 (May 27, 2011) (settled), which included 206(4)-7 aiding and abetting claims brought against the CCO of an advisory business (among others) who allegedly failed to adopt adequate policies and procedures, failed to adopt and distribute an adequate Code of Ethics and failed to implement recommendations of a compliance consultant that had pointed out various requirements and made various recommendations for improvement.

[14] See In the Matter of Theodore W. Urban, Initial Decision Release No. 402 (September 8, 2010).

[15] See In the Matter of Theodore W. Urban, Order Dismissing Proceeding, Investment Advisers Act of 1940 Release No. 3366 (January 26, 2012), which merely states that the Commission is evenly divided as to whether the allegations in the proceeding have been established and that therefore the proceeding is dismissed. See also In the Matter of Charles L. Rizzo and Gina M. Hornbogen, Investment Advisers Act Release No. 3321 (November 28, 2011), in

There are sound reasons why CCOs should not be "automatically" liable – under any theory -- simply because a compliance violation has occurred somewhere in the organization. Without doubt, the CCO would be among those who come under scrutiny in the wake of a violation when tough questions are being asked about how and why the violation occurred. But saddling CCOs with strict liability for violations would be counterproductive to recruiting good, qualified individuals to serve as CCOs and thereby weaken the overall regulatory aim of protecting clients. In short, CCOs should not risk liability for violations in which they were not personally involved and which were committed by a person for which they do not clearly bear responsibility. Instead, individuals should be encouraged to step up and step in to rectify problems in their firms without the fear that doing so would cause them to become a "supervisor" and potentially liable for others' failures.

Of course, a compliance violation by itself is not evidence that the CCO failed to meet a regulatory responsibility. Human frailty being what it is, slip-ups will occasionally occur in any organization, including one with a reasonably designed, implemented and administered compliance program. The SEC Staff has even acknowledged that in compliance "everyone hits bumps in the road" and that the compliance rules call for "reasonable" policies and procedures, not "perfect" policies and procedures. (Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, Remarks Before the National Society of Compliance Professionals National Membership Meeting, Washington, DC, October 25, 2005.) Moreover, all too often violations are committed by individuals bent on working the system to their advantage no matter what, who may do everything possible to hide their wrongdoing. CCOs diligently fulfilling their responsibilities would become nothing more than insurers if held responsible for violations in those cases.

At least one SEC Commissioner seems to agree with this general sentiment and has made public remarks about the SEC's approach to "failure to supervise" in the wake of the Urban case discussed above. Commenting on the 'disturbingly murky' question of when compliance and legal personnel may be deemed to be supervisors and therefore potentially liable for failure to supervise, he noted that robust participation by legal and compliance in resolving issues is in everyone's interest, although the more robust the participation, the greater the risk that 'supervisory' status will be found. He noted: "We must strive to ensure, however, that the fear of failure-to-supervise liability never deters legal and compliance personnel from carrying out their own critical responsibilities. Such a result could only be described as perverse."[16] It remains to be seen how this will bear out in future SEC enforcement actions.

Regardless, even an adviser CCO who <u>does</u> <u>have</u> supervisory responsibilities over other individuals in their firm may have an affirmative defense to a "failure to supervise" claim stemming from a violation committed by someone under their supervision, so long as the adviser had an adequate compliance program in place. This is because Section 203(e)(6) of the Advisers Act says that a person will not be deemed to have failed to reasonably supervise another person if:

- procedures were established that would reasonably be expected to prevent and detect, insofar as practicable, any such violation by the other person;
- a system was in place for applying the procedures; and
- the supervising person had reasonably discharged their supervisory responsibilities in accordance with the procedures and had no reasonable cause to believe the procedures and system were not being complied with.

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which a 37-year-old non-principal CCO is alleged to have had "supervisory responsibility" over the 51-year-old co-founder and principal of the firm whose misappropriation was at the heart of the case.

[16] See Remarks at "The SEC Speaks in 2012" by SEC Commissioner Daniel M. Gallagher (February 24, 2012) at: http://www.sec.gov/news/speech/2012/spch022412dmg.htm.

What Provisions Exist to Promote Independence of the CCO from Fund Management?

Four principal measures appear in Rule 38a-1 to promote a fund CCO's independence from fund management in order to strength the fund's hand vis-à-vis its adviser and other service providers. They are:

- First, the CCO will serve at the pleasure of the fund's board of directors. The fund board -- including a majority of independent directors -- must approve the designation of the CCO and the CCO's compensation, including any changes in compensation. The board can remove the CCO at any time and can prevent the adviser or another service provider from doing so.

- Second, the CCO will report directly to the board of directors and must furnish the board annually with the written report discussed above under "The Chief Compliance Officer" heading on the operation of the fund's policies and procedures and those of its service providers.

- Third, the CCO must meet in separately with the independent directors at least once each year. This gives the CCO and the independent directors an opportunity to speak freely about any sensitive compliance issues, including any concerns about the cooperativeness or compliance practices of fund management.

- Fourth, the fund's officers, directors, employees and its adviser, principal underwriter and any person acting under the direction of these persons, are prohibited from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence a CCO in the performance of their responsibilities under the rule. This is intended to protect the CCO from undue influence by those who may seek to conceal their or others' non-compliance.

The need for independence in the fund context is heightened because a fund's CCO is not required to be employed by the fund. Indeed, as mentioned previously, a fund's CCO will often be employed by the fund's adviser or administrator and, in cases, may have a dual appointment, serving as the adviser's or administrator's CCO as well. This will raise inevitable conflicts of interest, highlighting the importance of the independence measures contained in the rule.

FUND SERVICE PROVIDERS AND BOARDS

How Will a Fund be Expected to Oversee Compliance by its Service Providers?

Most fund operations are carried out by service providers, which have their own compliance policies and procedures. Under Rule 38a-1, a fund will NOT be required to adopt, as its own, the policies and procedures of its service providers. At the other extreme, a fund may NOT simply rely on its service providers' policies and procedures to ensure compliance, totally absolving the fund and its board of responsibility. Instead, Rule 38a-1 cuts a middle ground and requires a fund's board to approve the policies and procedures of the fund's service providers to the extent they are not integrated into the fund's own policies and procedures, and requires the fund's policies and procedures to include provisions for the fund to oversee its service providers' compliance.

Exactly how a fund must interface with its services providers to oversee their compliance is not dictated by the rule. Rather, funds are provided with flexibility to apply the rule in a manner best suited to their organizations. The Adopting Release cites these examples as potentially acceptable arrangements:

- The fund adopts compliance policies and procedures that encompass the activities of the fund, the adviser and affiliated underwriters and transfer agents, while approving the policies and procedures of other service providers, such as subadvisers, over which the fund has oversight responsibility under the rule. OR

- The fund adopts policies and procedures that would cover solely activities of the fund, and approves the policies and procedures of its adviser and each of its other service providers.

The Adopting Release envisions that the fund's CCO will oversee the fund's service providers, which will have their own compliance officers. The fund's CCO should take the necessary steps to ensure that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The CCO should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks. The fund's CCO should maintain an active working relationship with and have direct access to each service provider's compliance personnel, who should provide the CCO with periodic reports and special reports in the event of compliance problems.

As part of its oversight system, a fund might contractually require its service providers to certify periodically that they are in compliance with relevant laws. The contract might also require third-party or internal audits or statistical analyses to evaluate the effectiveness of a service provider's compliance controls and help detect failures.

Although the term "service providers" for purposes of Rule 38a-1 is limited to advisers, principal underwriters, administrators and transfer agents, the Adopting Release makes it clear that a fund is not relieved of its responsibility to consider compliance as part of its decision to employ other entities, such as pricing services, auditors and custodians.

What Process is Required for Fund Boards to Approve a Compliance Program?

Approval of a compliance program of the fund or any of its service providers requires the vote of the board, including a majority of its independent directors. Rule 38a-1 explicitly states that the 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 its service providers.

If the policies and procedures of a service provider are included within the policies and procedures adopted by the fund, separate approval by the board is not required. 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 fund.

In the approval process, directors are not expected to review lengthy compliance manuals. Rather, directors may satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by persons familiar with the programs, such as the CCO or legal counsel. The summaries should familiarize directors with the key features of the relevant programs and provide them with a good understanding of how the compliance programs address salient compliance risks.[17]

[17] In one case, the SEC alleged Rule 38a-1(a)(1) violations against a "turn-key" fund services organization and the funds' Trustees, stating that they failed to implement the funds' policy on approving its advisers' compliance procedures as specified in the funds' own compliance manual. The compliance manual required the service organization (which provided CCO services to the funds) to furnish the Trustees with materials upon which the Trustees could rely in order to approve the policies and procedures of the funds' advisers, either: (1) copies of the advisers' policies and procedures; or (2) a summary of the advisers' compliance programs that familiarized the Trustees with the salient features of the compliance programs. Instead, the Trustees relied primarily upon a written statement prepared by the service organization at the conclusion of its compliance review, noting that the advisers' compliance manuals were "sufficient and in use" and also indicating that the code of ethics and proxy voting policies and procedures were "compliant," along with a representation by the provider at the relevant board meeting that the advisers' policies and procedures were adequate. See In the Matter of Northern Lights Compliance Services, LLC, Gemini Fund Services, LLC, Michael Miola, Lester M. Bryan, Anthony J. Hertl, Gary W. Lanzen, and Mark H. Taylor, Investment Company Act of 1940 Release No. 30502 (May 2, 2013) (settled).

In the case of third-party service providers to a fund, it may be impractical for the fund or its CCO to directly review all of the service provider's policies and procedures. In those cases, the fund may use a third-party report on the service provider's procedures instead of the procedures themselves when the board is evaluating whether to approve the service provider's compliance program. The third-party report must describe the service provider's compliance program as it relates to the types of services provided to the fund, discuss the types of compliance risks material to the fund and assess the adequacy of the service provider's compliance controls. This report might include, for example, a so-called “SSAE 16” engagement report[18] or similar report addressing compliance controls in place at the service provider organization. This type of third-party report may also be used in the required annual review of service providers and in preparing the CCO’s required annual report to the board. However, if the fund uses a third-party report in any of these circumstances, the fund must also gather and take into account other relevant information, such as its experience with the service provider.

When deciding whether to approve a fund's or service provider's compliance policies and procedures, boards should consider the following issues in addition to any other salient factors. Prudent funds will reflect the board’s consideration of these factors, to the extent relevant, in their board minutes:

- the nature of the fund's exposure to compliance failures;
- the adequacy of the policies and procedures in light of their recent compliance experiences, which may demonstrate weaknesses in the fund’s or service provider's compliance programs; and
- best practices or successful compliance practices used by similar fund complexes.[19]

Rule 38a-1 does not require fund boards to approve each and every amendment to a compliance program. Instead, the rule requires the fund's CCO to discuss material changes to relevant compliance policies and procedures in the annual report submitted by the CCO to the fund board. Of course, serious compliance issues should be raised with the board immediately.

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This paper provides an overview of the requirements facing advisers and funds under the compliance rules. Following the steps outlined for designing a compliance program will help advisers and funds to design a more effective and efficient compliance system.

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[18] “SSAE 16” refers to the Statement on Standards for Attestation Engagements No. 16, Reporting on Controls at a Service Organization, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) in January 2010, which effectively replaced the old “SAS 70” as the authoritative guidance for reporting on service organizations.

[19] Industry best practices and similar practical guidance have begun to be developed, assisting Boards in their oversight function under Rule 38a-1 and otherwise. See, for example, Board Oversight of Certain Services Providers, Independent Directors Council Task Force Report (June 2007); Practical Guidance for Directors on the Oversight of Sub-Advisers, Report of the Mutual Fund Directors Forum (April 2009); Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight, Mutual Fund Directors Forum (April 2010); Fund Board Oversight of Risk Management, Independent Directors Council and Investment Company Institute (September 2011), and numerous others of a similar nature covering various topic areas.