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Evaluation of the Chief Compliance Officer

While Rule 38a-1 under the Investment Company Act requires a Board of Directors to approve the appointment, removal and compensation of a fund's Chief Compliance Officer ("CCO"), the rule is silent as to any requirement to annually review the performance of the CCO. However, Rule 38a-1 does require that a fund annually review the adequacy and effectiveness of its written compliance policies and procedures ("Compliance Program"), as well as the Compliance Program of each investment adviser, principal underwriter, administrator and transfer agent of the fund ("Fund Service Providers"). Because the CCO is an integral part of any Compliance Program, it is reasonable to expect a board to evaluate the effectiveness of a CCO as part of, or in connection with, the annual review of the Compliance Programs.¹

The following statement by the Securities and Exchange Commission ("SEC") serves as a useful starting point for evaluating the effectiveness of a CCO:

"A fund's chief compliance officer should be competent and knowledgeable regarding the federal securities laws and empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund."²

Although this is a relatively vague standard, the SEC staff has informally articulated a number of specific qualities and capabilities that it believes a CCO should possess.³ In addition to analyzing these qualities and capabilities, a CCO's effectiveness can be evaluated by reviewing the duties and functions actually performed by the CCO. This review should take into consideration the size, resources and business activities of the fund complex.

QUALITIES AND CAPABILITIES OF A CCO AND THEIR USE IN DETERMINING A CCO'S EFFECTIVENESS

Knowledge of Investment Company Regulation. A fund CCO should have a good understanding of the federal securities laws and related regulations, SEC no-action letters, SEC policy and interpretive statements, and any other laws and regulations impacting investment company operations and regulation. Consideration of these factors will assist a board in evaluating whether the CCO has the knowledge and background to effectively administer the fund's Compliance Program.

Stays Abreast of Regulatory Developments. A fund CCO should keep abreast of changes in regulatory requirements applicable to investment companies and their activities. A board evaluating this factor should inquire as to whether the CCO:

- Attends industry conferences and stays abreast of regulatory developments.
- Is active in industry groups that promote the development and implementation of good compliance practices. Such groups include the Investment Company Institute and the National Society of Compliance Professionals, Inc.
- Updates the fund's Compliance Program to take into account changes in regulatory requirements.
- Advises the Board regarding new or revised compliance requirements.

Understands the Compliance Function. A fund CCO should understand the compliance requirements applicable to investment companies and appreciate how effective Compliance Programs address and prevent violations of those requirements. This capability includes a familiarity with the steps required to create an effective



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compliance program, including the identification and assessment of risk, the creation of policies and procedures to address specific identified risks and the effective implementation of these policies and procedures. A CCO should be able to demonstrate that he or she:

- Has improved and strengthened the fund's Compliance Program and/or made the Compliance Program more comprehensive, robust and effective.
- Is familiar with the Compliance Programs of the Fund Service Providers.
- Has established a compliance calendar to ensure that important regulatory, client reporting, tax and compliance deadlines are not missed.
- Has contributed to the overall compliance culture of the fund and the Fund Service Providers.
- Has established objectives for the coming year with respect to the fund's Compliance Program and those of the Fund's Service Providers.
- Has analyzed compliance failures and the effectiveness of corrective actions taken in response to such failures.

Makes Effective Use of Resources. A fund CCO should be able to determine the appropriate level of resources necessary to implement and maintain an effective Compliance Program and to request the resources necessary to carry out compliance activities. The board should determine whether the CCO:

- Has been an advocate for allocating appropriate resources to the Compliance Program.
- Has used available resources to administer the fund's Compliance Program.
- Has requested additional resources when appropriate. Specific areas where additional resources have been requested should be identified.

Actively Monitors Compliance Implementation. A fund CCO should actively monitor the implementation of the Compliance Program by managers and others throughout the fund complex. An effective CCO will:

- Ensure that all personnel in the fund complex with compliance responsibilities are competently and fully performing their assigned functions.
- Establish a schedule to test the effectiveness of each of the policies and procedures comprising the fund's Compliance Program.
- Provide adequate oversight of the Compliance Programs of the Fund Service Providers.
- Analyze recidivism and/or patterns of compliance violations. These patterns could indicate gaps or weaknesses in the Compliance Program or in the risk identification process and reveal the existence of undetected compliance issues.
- Ensure that the Compliance Programs of Fund Service Providers are effective so that the services provided by these firms are consistent with the fund's obligations to its shareholders.
- Provide to the Board a thorough written report on the annual review of the Compliance Programs that contains an articulate discussion of the operation of the Compliance Programs and well reasoned recommendations for material changes.
- Ensure the implementation of any recommendations resulting from the annual review that are designed to address compliance issues and strengthen the Compliance Programs in the coming year.

Familiarity with the Fund's Business Model. A fund CCO should be familiar with the fund's business model, distribution channels, shareholder base, vendor relationships, and investment strategy. Knowledge of the fund's business will help the CCO identify risks and gaps in the Compliance Program. An effective CCO will:



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- Update policies and procedures to take into account changes in a fund's business model or investment strategy.
- Be familiar with business operations of the Fund Service Providers.

Pro-Active. A fund CCO should be pro-active, inquisitive and have the ability to exercise professional skepticism. A board should attempt to determine whether the CCO:

- Has been pro-active and diligent.
- Has established working relationships with the Fund Service Providers.
- Frequently meets with, and provides substantive reports to, the board.
- Reports compliance violations on exception or management reports, promptly addresses the violations, and escalates issues to senior management when necessary.
- Has brought recurring or systemic violations to the attention of senior management and/or the board.
- Has implemented a compliance training and education program.

Possesses Sufficient Authority. A fund CCO should have sufficient authority within the fund complex to compel others to adhere to the firm's compliance policies and procedures. A fund CCO will, of course, report directly to the Board of Trustees. A fund CCO, however, also may be an employee of the fund's adviser or administrator. These CCOs should be a member of senior management and generally should report to the Chief Executive Officer (or an equivalent position) of the adviser or administrator. A board can determine whether a CCO has sufficient stature within an organization by evaluating:

- Whether the CCO is a member of senior management and the level of the person to whom the CCO reports.
- Whether the CCO confers with and advises senior management on significant compliance matters.
- Whether the CCO is considered the "go to person" on compliance matters.
- Whether CCO is involved in analyzing and resolving significant compliance issues.

CONCLUSION

The factors discussed in this bulletin will provide a Board of Directors with an outline for evaluating the effectiveness of a fund's CCO. These same factors, with some modifications, also can be used by senior management of an investment adviser to evaluate the effectiveness of the adviser's CCO under Rule 206(4)-7 under the Investment Advisers Act.

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¹ Many fund CCOs also serve as employees of a fund's adviser or administrator. These organizations generally evaluate employees and determine compensation (i.e., salary, bonuses, stock options, etc.) on an annual basis. Under Rule 38a-1, a board is required to approve any change in a CCO's compensation, even when the compensation is paid by a third party. This process, which may not occur in connection with the annual review of the Compliance Programs, presents the board with an additional opportunity to evaluate the effectiveness of the CCO.

² See COMPLIANCE PROGRAMS FOR INVESTMENT COMPANIES AND INVESTMENT ADVISERS, Release Nos. IA-2204; IC-26299 (February 2005) at p.11.

³ See SPEECH BY SEC STAFF; MANAGED FUNDS ASSOCIATION EDUCATIONAL SEMINAR SERIES 2005: PRACTICAL GUIDANCE FOR HEDGE FUND CCOs UNDER THE SEC'S NEW REGULATORY FRAMEWORK – A JOB DESCRIPTION FOR CCOs TO PRIVATE INVESTMENT FUNDS, by Gene Gohlke, Associate Director, Office of Compliance Inspection and Examinations, U.S. Securities and Exchange Commission, May 5, 2005.



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