



MUTUAL FUND DIRECTORS FORUM

The FORUM for FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

The Board/CCO Relationship

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Introduction

When the Securities and Exchange Commission (SEC) first required a fund to have a chief compliance officer (CCO), the position was new to many in the industry. While compliance was not a new concept, the rule required for the first time that a fund board have direct access to a single person with responsibility for fund compliance. The rule's construction further empowered the directors with the authority to hire and fire the CCO and also to prevent the adviser from firing the CCO. The rule also gave fund boards the authority to approve the CCO's compensation.

While the board has significant influence on the relationship with the CCO, an effective CCO also relies on a strong relationship with the fund adviser's personnel. The board, CCO, and adviser are in a tri-party relationship, requiring a delicate balance of the needs of all three parties. The development and evolution of this relationship will be highly dependent on the unique facts and circumstances of the particular fund complex. The relationship will naturally evolve as the parties involved and needs of the fund complex change.

This report¹ is designed to assist boards in fostering an effective board-CCO relationship. The report will cover a wide range of issues, including common characteristics of effective CCOs, different models for the CCO relationship, the process of developing a compliance program, communication protocols, and specific examples of compliance focus.

The CCO's Fundamental Responsibilities

The role of a fund CCO was formalized by the SEC in the wake of the market timing and late trading scandals of the early 2000s. In describing the position, the SEC has stated that the CCO should be "competent and knowledgeable regarding the federal securities laws and empowered with the full responsibility and authority to develop and enforce appropriate policies and procedures for the fund."²

These written compliance policies and procedures "must provide for the oversight of compliance by the fund's advisers, principal underwriters, administrators and transfer agents."³ In particular, they:

- Must be reasonably designed to prevent violations of the federal securities laws by the fund and its service providers;
- Should consider the nature of the fund's exposure to compliance failures; and
- Must cover at least certain identified areas, including pricing of portfolio securities and fund shares, processing of fund shares, identifying affiliates, protecting non-public information, complying with the 1940 Act fund governance requirements, and disclosure regarding policies on market timing.⁴

The CCO's role is thus both broad and complex.

1 This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes over 887 independent directors, representing 122 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

2 Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204, IC-26299 (December 17, 2003) ("38a-1 Adopting Release").

3 *Id.* at 5.

4 *Id.* at 6.

Identifying an Effective CCO – Factors for Boards to Consider

In choosing a CCO, boards clearly look for an individual with the necessary technical expertise. However, boards often consider less tangible skills as well. A CCO's interpersonal skills and the ability to influence others typically prove as important as her technical qualifications.

Strong interpersonal skills can help the CCO remain in the loop regarding compliance issues.

While most boards have strong relationships with key individuals within the adviser, the structure of mutual funds results in an inherent tension between the independent directors and the management company. The board, therefore, should consider the CCO's ability to navigate this tension in order to address and effectively explain to the fund board the full spectrum of compliance matters – from issues that require little attention to material compliance matters.

In assessing the CCO's ability to provide the board with insight into the fund's compliance issues, the board may wish to consider the CCO's relationships with the business people at the adviser and other key service providers. The CCO must be "in the loop" and be made aware of issues as they arise across the organization and have the influence necessary to facilitate effective resolutions. Assessing the CCO's relationships with personnel at the adviser and other service providers can help the board evaluate whether the CCO has the information necessary to give an informed opinion regarding the complex's compliance program, particularly any challenges the complex faces. Moreover, from the CCO's perspective, fostering these relationships can help demonstrate to the board and the adviser's personnel that her goal is not obstruction, but rather to provide input in order to take account of and avoid potential regulatory issues.

The ability to influence others can help the CCO foster a strong compliance culture.

The board can consider whether the CCO has the ability to gain the cooperation of personnel within the adviser and other key service providers without necessarily having the benefit of a direct line of supervisory authority. Generally, the CCO lacks direct reporting lines from the units upon whom she relies for information. Instead, the CCO relies on the ability to influence others in the organization, often exhibiting a deep understanding of the business and demonstrating good judgment regarding how to address issues as a means of earning the trust and cooperation of individuals across the fund complex.

Structure of the CCO Relationship

Funds have a variety of choices when considering the CCO's place within an organization. In adopting the fund CCO requirement, the SEC specifically allowed the CCO to be an employee of the adviser or the administrator. The SEC did not require that a CCO be employed solely by the fund because of the SEC's belief that a CCO integrated with the adviser or administrator may have better access to information and more capability to influence decision-making than an outside CCO, despite the potential for conflict.⁵ A board, therefore, has flexibility to choose the structure that is most appropriate for its particular circumstances.

The structure of the CCO relationship is highly dependent on the fund's own facts and circumstances, particularly the structure, size, and complexity of the organization. Boards can consider where the primary compliance risks lie when determining which structure may be most appropriate for a particular fund complex. For example, fund complexes with a significant number of hard-to-value securities may feel most comfortable with a shared fund-adviser CCO. A fund complex with a large number of sub-advisers or most of its operations outsourced may be more comfortable with a different structure. Size also can play a significant role – a very large fund complex or one that is part of a larger financial services organization may have compliance demands that dictate having a CCO who serves only the funds or even a specific subset of the funds managed by the firm. Finally, a small fund may be able to secure a qualified CCO only by hiring an independent consultant.

There is no perfect structure that will fit all funds in all circumstances. Like most other areas of oversight, the board, CCO and management should review the structure from time to time to determine whether the relationship still is appropriate for the organization as it evolves.

⁵ See Rule 38a-1 Adopting Release at 12.

CCO Model	Potential Advantages	Potential Challenges	Ways to Address Challenges
<p>Fund-Only</p> <p>The CCO works only for the funds (or certain funds within the complex)</p>	<ul style="list-style-type: none"> Complete independence from the adviser Undivided attention of the CCO on the compliance programs of the funds 	<ul style="list-style-type: none"> Lack of direct access to information Difficulties in influencing decision-making 	<ul style="list-style-type: none"> CCO works to develop relationships with advisory personnel CCO exhibits ability to influence personnel within the advisory organization
<p>Shared Fund/ Adviser</p> <p>The CCO serves as CCO both to the fund(s) and adviser</p>	<ul style="list-style-type: none"> Well integrated with fund operations Less dependent on adviser for information 	<ul style="list-style-type: none"> Competing demands on the CCO's time Possible conflict between the fund and adviser regarding compliance issues 	<ul style="list-style-type: none"> Open communication between the board and the CCO can help the board understand how the CCO reconciles any potential conflicts Open dialogue with the adviser about the CCO's performance and goals can help avoid surprises Board retains ultimate authority to dismiss the CCO as CCO to the fund
<p>Dual Function</p> <p>The CCO serves in another position at the adviser including chief risk officer, general counsel, etc.</p>	<ul style="list-style-type: none"> Well integrated with the adviser's organization Deep understanding of the adviser's business 	<ul style="list-style-type: none"> Competing demands on CCO's time Possible conflict regarding compliance issues Potential issues with attorney-client privilege if the CCO is general counsel 	<ul style="list-style-type: none"> Dialogue between board and CCO about balancing job responsibilities and reconciling conflicts Ultimate board authority to dismiss the CCO
<p>Outsourced (Service Provider)</p> <p>The CCO also is employed by the fund service provider, such as the administrator</p>	<ul style="list-style-type: none"> Enhanced understanding of service provider's operations (such as the administrator) Unique perspective on adviser Experience with more than one board 	<ul style="list-style-type: none"> Not onsite at the adviser daily Time demands because of other responsibilities Potential conflict on compliance issues between the fund and service provider 	<ul style="list-style-type: none"> Ascertaining culture at service provider extremely important for the board Dialogue with the CCO to understand how the CCO will reconcile any conflicts
<p>Outsourced (Consultant)</p> <p>An outside party serves as CCO to the funds and likely other unrelated funds</p>	<ul style="list-style-type: none"> Can provide small funds with a cost-effective way to secure a high quality CCO Experience with more than one board 	<ul style="list-style-type: none"> Lacks daily physical presence at adviser Time demands because of other responsibilities 	<ul style="list-style-type: none"> Board evaluation of the CCO's relationship building and communication skills Discussion regarding how the CCO will balance competing time demands More extensive reporting may be helpful to help evaluate the CCO's knowledge of fund issues Ask the CCO to work closely with fund outside counsel

Knowing What You Don't Know—Using the CCO “On the Ground” at the Adviser

“Tone at the top” and “culture of compliance” are common phrases in the fund industry. But how can a board, who is not present at the adviser on a daily basis, evaluate whether the compliance program at the fund is reasonably designed to prevent violations of the securities laws?

Evaluating the Adviser's Culture of Compliance

The adviser's commitment to compliance is fundamental and can serve as a first step to evaluating the adviser's compliance program. Evaluating such commitment, however, can be difficult – particularly for the board members who are not regularly present at the adviser. The CCO is in a position to walk the halls to observe fund operations and has relationships with key personnel and can therefore provide valuable insight into the adviser's culture. The board may find it useful to ask the CCO how the adviser treats compliance within its organization and if the adviser makes the CCO feel like part of the team. Discussing the adviser's reaction to a CCO's request for resources (or access to existing resources) also can provide insight into the adviser's commitment to compliance. If the board is unsatisfied with the CCO's response to these inquiries, both the CCO and the board may have work to do to elevate the adviser's views regarding the compliance function and the CCO.

In addition to these cultural indicators, a robust compliance program is itself an indicator of a commitment to compliance. The way the compliance program is structured can help the board ascertain the adviser's values and commitment to its fiduciary duty. The output from the program is another good indicator of cultural commitment, and the board can evaluate whether compliance matters are resolved in the best interest of the fund's shareholders.

Developing a Compliance Program

A robust process for developing compliance policies and procedures can help the board get comfortable that the adviser and CCO are working together in thinking about, executing, and documenting the steps that they are taking to mitigate risks to the fund. Beginning with a strong foundation built on each regulatory obligation of a fund can be helpful, and some CCOs may use a regulation map or matrix as a way to start the process.

Early input from the CCO on emerging issues and new initiatives can facilitate the development of a proactive compliance program. For example, by providing input at the outset of a new product launch, the CCO can help reduce the possibility of future surprises from a compliance perspective and address any compliance concerns before they become an issue. In addition, the fund CCO's participation in the adviser's risk committee may provide additional insight into emerging risks at the fund complex that could in turn be reflected in the fund's compliance policies and procedures. Beyond the identification of specific compliance issues, the CCO's participation on risk or other committees can give the CCO an additional opportunity to observe the adviser's processes, including whether the appropriate personnel are engaged in the decision-making process.

A robust compliance program requires both adopting appropriate policies and procedures and reviewing their implementation. By reviewing how the policies and procedures function, the CCO can evaluate whether there are areas in need of further attention. The CCO can also shed light on any patterns that develop in implementing the procedures.

Some boards and CCOs may find that engaging a compliance consultant is another useful way to review a fund's compliance program. A compliance consultant can review a fund's compliance policies and procedures, as well as how those procedures are implemented at a particular fund. The consultant's evaluation and recommendations can be helpful both to the CCO and the board as a means of validating the compliance program as well as providing ideas to enhance the program.

Fostering a Strong Culture of Compliance

While the board is not physically present at the adviser's place of business every day, the board nonetheless plays an important role in establishing the compliance tone at the organization. The board itself can set a tone during board meetings that compliance is a priority by addressing compliance and related breeches with an appropriate level of seriousness and weight. The board can work to establish and promote an environment at the adviser that supports the CCO, in part by making clear to the adviser that the CCO acts as the representative of the board. In addition, the board can help bolster the CCO's authority by:

- Providing the CCO with an appropriate title and position of authority;
- Setting the CCO's compensation appropriately;
- Facilitating a reporting structure for the CCO within the adviser that demonstrates the importance of compliance at senior levels within the adviser;
- Being responsive to the CCO's requests for additional resources;
- Establishing open communication between meetings; and
- Generally supporting the CCO's efforts.

Evaluating the Compliance Programs of Fund Service Providers

In addition to the fund's compliance program, boards rely on the CCO to review and provide insight into the compliance programs of the fund's service providers. Rule 38a-1 requires that the board approve the compliance policies and procedures of the fund's advisers, principal underwriter, administrator, and transfer agent.⁶ While the board is ultimately responsible for approving the compliance procedures, directors are able to rely on the CCO to provide summaries of the compliance programs. The summaries are required to provide directors "with a good understanding of how the compliance programs address particularly significant compliance risks."⁷ These summaries need to provide enough detail to the board to provide the board with an idea of how the policies actually function – providing only a conclusion from the CCO that the policies and procedures are sufficient or adequate will likely not satisfy the SEC staff that the directors received sufficient information.⁸

Oversight of key service providers is an ongoing process. While Rule 38a-1 enumerates key service providers, others including the custodian, pricing agents, omnibus and transfer agent providers, and proxy voting vendors, also are important to the day-to-day functioning of the fund. For example, when embarking on a new relationship, the CCO takes an active role in due diligence of the service provider. Responses to a Request for Proposal process can provide the CCO with important information about a service provider, and requests can

⁶ See Rule 38a-1(a)(2).

⁷ Rule 38a-1 Adopting Release at 6.

⁸ See In the Matter of Northern Lights Compliance Services, LLC et al., Investment Company Act Release No. 30502 (May 2, 2013).

be tailored to allow comparisons among service providers. CCOs and boards may find in-person due diligence visits by the CCO to be beneficial. In fact, while the CCO may not learn any concrete information from the visits that is not available through other channels, the visits may help the CCO assess the service provider's commitment to compliance by seeing how employees react to her questions and generally getting a sense of the environment at the particular organization. Finally, the CCO reviews oversight protocols embedded in the contracts with the service providers. For example, the audit rights and expected reports are often included in the contractual language governing the relationship with the service provider.

As in other areas, the CCO cannot be everywhere at once. A risk-based review of service providers may be the best way for the CCO to choose which service providers should be subject to deeper inspection. A discussion between the board and CCO can help establish expectations regarding the risk-based approach to testing – and can help the board recall that the CCO is unable to test everything all the time.

Compliance Resources

A CCO cannot be effective – and thus cannot work effectively with the board – without adequate resources. As a threshold issue, many of the resources the CCO needs to test compliance are actually housed in the business units and not “owned” by the CCO. The lack of supervisory authority over the resources makes it especially important that the CCO possess the interpersonal skills and ability to influence others in order to obtain information from the business units regarding compliance related issues.

Leveraging the resources of other control functions within the fund complex can help the CCO administer the fund's compliance program. For example, internal audit is a natural ally of the fund CCO. Internal audit routinely reviews various control issues within an organization including cybersecurity, prospectus issues, and compliance controls. By working together, the CCO and internal audit can make the most of the resources each has to help identify issues and get ahead of emerging compliance matters.

Independent legal counsel also can serve as an important resource for the CCO and help to foster the CCO's relationship with the Board. In particular, by serving as a sounding board on compliance issues, independent counsel can help both the board and the CCO put issues into context. An independent legal counsel's experience across a number of different fund groups enhances her ability in this area, and also can help evaluate a particular CCO's strengths and weaknesses.

Assessing whether the CCO has adequate resources to administer the fund's compliance program

Asking whether the CCO feels that she has the resources necessary to administer the fund's compliance program can help the board assess whether the CCO may need additional resources. In addition, the board may look at any compliance failures experienced by the fund. Asking whether these compliance failures could have been avoided or mitigated with additional resources may provide insight to the board regarding the compliance staff's resources. In addition to the resources necessary to administer the compliance program on a day-to-day basis, the board may inquire whether the CCO and compliance staff need additional training, particularly with respect to emerging areas of focus.

Addressing financial constraints affecting the compliance department

Even advisers with a deep commitment to compliance may experience declines in profits that in turn place pressure to reduce costs across the organization, including compliance. The CCO can help the board assess whether the compliance function will remain adequately resourced following the proposed cuts. Further, the CCO can assist the board to work with management to cut costs without reducing the effectiveness of the compliance function.

Common resource cuts include replacing people with technology or by replacing more senior individuals with junior personnel. While a number of technological advances may indeed help a CCO do her job, there are areas where technology cannot effectively replace personnel. The CCO can discuss the right balance between automation and flexibility afforded by personnel when evaluating the use of technology to aid compliance.

With respect to personnel issues, the CCO should raise with the board any concerns and whether changes are likely to impact negatively compliance in the short or long run. The CCO's participation in the hiring process may help the CCO get comfortable that the new employee's skills are appropriate for the position. In addition, the CCO may wish to provide the new personnel with additional training and supervision, at least until they get up to speed.

Working with the CCO to Address Compliance Resource Issues

CCOs face a delicate balance when addressing resource issues. While CCOs work for the board, they have to preserve relationships with the adviser's personnel in order to be effective. Depending on the CCO model as well as the concern at hand, the CCO may approach the adviser directly with requests for additional resources. In situations where the adviser has not responded to the CCO's resource requests, the CCO should bring those concerns to the board. The board then can initiate a dialogue with the adviser to find a way to meet the resource needs of the compliance department. Part of the board's dialogue with the adviser can include a discussion of who pays for certain items. For example, if a fund's advisory agreement does not stipulate that the advisory fee includes costs for the compliance program, the board may agree that the fund should pay a portion of the salary of a key compliance staff member.

Equally troubling for the board can be a situation where the CCO is experiencing resource issues but does not notify the board. The board may discover these issues when discussing compliance "failures" or notice that the CCO seems overworked or lacks the information to discuss a key compliance issue. In these situations, encouraging an open dialogue between the board and CCO, where the board conveys its expectations that the CCO will come forward with her challenges and negative reports can help the CCO feel comfortable approaching the board about resource issues. Encouraging these discussions during executive sessions may further promote candor from the CCO.

Fostering an Effective Board—CCO Relationship

Building Trust with the CCO

One of the keys to fostering an effective board-CCO relationship is creating an environment of open communication with the CCO. The board has to be open with the CCO regarding its expectations and trust that the CCO will provide the board with the information necessary for the board's oversight of compliance. Often when the CCO provides information to the board, she is not asking that the board act on that information. The board can facilitate open lines of communication by listening to the CCO's concerns, asking questions about how she plans to proceed, and following up as appropriate rather than jumping to conclusions regarding the issue at hand.

An effective relationship requires an environment where the CCO can come to the board regarding compliance failures (such as not having a procedure in place to address a compliance issue or not administering that procedure appropriately) without fear. In addition to providing necessary information to the board, such a culture can help personnel in the business units understand that they can approach the CCO with issues without fear as well.

Finding the Right Balance – Keeping the Board Informed

The board should work with the CCO to establish a protocol for reporting material compliance matters, with a materiality trigger that favors reporting these types of issues to the board. An open discussion between the board and the CCO in executive session regarding materiality triggers can be helpful for both parties. The board can let the CCO know of its expectations regarding reporting – particularly in circumstances where the board feels that it is getting too much or too little information.

With confidence that the CCO will bring material compliance issues to the board's attention, the board can allow the CCO time to address issues with the adviser. Doing so can in turn improve the quality of information the CCO can give to the board because the CCO likely will have a better understanding of the context, the significance, and the potential resolution of the particular compliance matter. Excluding management from potential solutions to compliance issues can unintentionally increase risk taking by encouraging personnel to hide issues or develop solutions without input from the CCO.

Even if a particular incident is not material, patterns of behavior can be important to bring to the board's attention. While one incident of a particular compliance failure may not be significant, a repeated failure in the same area can indicate a deficiency in the policies and procedures or identify an issue with a particular business unit or employee. Therefore, trends can help the CCO determine when to elevate particular compliance issues to the board's attention, even where a particular incident on its own would not ordinarily be disclosed.

Executive Sessions with the Board

Rule 38a-1 requires that the CCO meet in executive session with the board at least annually. However, many boards and CCOs favor more frequent communications and meet in executive session at every regularly scheduled board meeting. These sessions can follow a somewhat informal agenda, particularly where no material compliance issues have arisen since the last session. The sessions can include a general discussion of the concerns of the board and CCO. Further, the executive sessions provide an opportunity for the CCO to provide a preliminary perspective to the board on emerging issues.

In addition to facilitating the information flow between the board and management, the sessions can have the added benefit of empowering the CCO. Without representatives of management present, the CCO is free to discuss a broad range of issues the CCO has observed. Thus, the meetings can allow the board to gain a deeper understanding of the adviser's compliance culture and any related issues. Further, the sessions demonstrate to management the close relationship between the CCO and the board.

Between-Meeting Communications

Compliance issues do not conveniently coincide with board meetings. As a result, the board and CCO can work together to develop a guideline for between-meeting communications designed to keep the board appropriately informed about compliance developments. The board and CCO may decide that it works best to designate one member of the board, such as the board chair or the chair of a committee responsible for compliance matters, to be the point person for between-meeting communications. The between-meeting communications can help the CCO perform her functions and prevent the board from learning about material compliance issues for the first time during board meetings.

A less formal, regular telephone call between the CCO and a designated member of the board also can help facilitate the board-CCO relationship. These phone calls, often once a month or once a quarter, can allow both the board member and the CCO to discuss emerging compliance issues and other matters that do not necessarily rise to the level of a special phone call.

In addition, some boards may find it helpful to have a pre-meeting and/or post-meeting discussion with the CCO. A pre-meeting conversation with a relevant board member (or potentially the whole board) will allow the CCO to preview the issues likely to come up during the meeting. These discussions can allow all relevant parties more time to discuss important issues, outside the time constraints imposed by board meetings and may in turn lead to more productive meetings. A post-meeting discussion can help the board and CCO prioritize the action items that arose at the meeting and provide a good basis for follow up at the next board meeting. Some boards may find it helpful to invite independent legal counsel to participate in these sessions.

The CCO Annual Report

Rule 38a-1 requires the CCO to provide the board with an annual written report that discusses:

- The operation of the policies and procedures of the fund and each covered 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; and
- Any material compliance matters since the last report.

These reports are important, but a long report does not necessarily equate to a quality report. The board can provide feedback to the CCO to identify the format and content that is most helpful to the board within the confines of the rule's required disclosure. Follow up on the material compliance issues identified in the report is crucial. Therefore, the CCO should develop a procedure to catalogue and track these issues. While the report is important, as discussed above, it is far from the only information a CCO provides to the board regarding a fund's compliance program.

Evaluating the CCO

Performance Evaluations

Given the significance of the board's relationship to the CCO (and because the evaluations can be an important factor in the CCO's compensation), it is important for the board to understand, and be involved in, the CCO's performance evaluation. However, the nature and extent of the board's input into this evaluation will likely depend on the structure of the relationship. In all instances, the board should provide timely feedback on its view of the CCO's performance, and the conversation should include the goals for the coming year. An open dialogue between the board and CCO's supervisor can help avoid surprises, particularly in circumstances where either the board or the adviser (or other service provider) wishes to discontinue the relationship. In addition, the discussion can give the board input into the CCO's annual compensation adjustment.

CCO Compensation

Rule 38a-1 puts the authority for hiring, firing, and approving the compensation of the CCO with the fund's board of directors. Nonetheless, CCO compensation remains a challenge for fund directors. Given the different structures of the CCO position, the board may not, as a practical matter, have complete discretion over the CCO's compensation. Generally, the compensation of the CCO has to fit within the adviser's pay scale. Compensating the CCO more than peers within the adviser's organization can create issues for the CCO's relationships with other adviser personnel. However, if the CCO is compensated at a lower rate than colleagues, the CCO may be unhappy and retention may become an issue.

Even though the board often lacks an unfettered ability to set the compensation for the CCO, the board does retain ultimate control over the approval of that compensation. In considering the CCO's compensation, the board has an interest in establishing a compensation structure that is sufficient to attract and retain a highly qualified CCO.⁹ A board may wish to compare its CCO's compensation to CCOs of similar fund complexes. Understanding the market and the market demands is important in compensating the CCO fairly and facilitating her retention at the firm. While this information may be difficult to ascertain, some boards have found it helpful to engage an outside consultant for assistance.

In considering the CCO's compensation, the board may question whether the compensation structure potentially interferes (or gives the appearance that the compensation interferes) with the CCO's objectivity. For example, if the CCO's compensation plan includes compensation based on the performance of the adviser or stock options in the adviser, the board may be concerned that the compensation structure negatively affects the CCO's objectivity and decision-making. Many boards, however, realize that stock options may be an important piece of the CCO's compensation. If the board has concrete concerns about the amount or structure of the CCO's compensation it can choose to discuss those concerns with the adviser or other service provider to address them. In addition, the ultimate ability to terminate the CCO may provide the board with comfort because it retains ultimate authority to determine whether the CCO's loyalty lies with the funds.

⁹ For additional information on CCO compensation, see Meyrick Payne, *Creativity with Compensation Can Build Strong CCO Ties*, BoardIQ, October 21, 2014.

Oversight of Sub-Advisers

A fund's advisers are covered by Rule 38a-1. Funds using sub-advisers may present unique compliance challenges, and boards, therefore, may find the fund CCO's input valuable. While ordinarily each sub-adviser has its own compliance program and CCO who reports to the fund's board, the fund's own CCO can provide an additional layer of insight to the board during all phases of the sub-advisory relationship. Prior to engaging a sub-adviser, the CCO may wish to visit the sub-adviser and report to the board regarding the sub-adviser's compliance environment. The CCO also can help establish expectations regarding compliance for the sub-adviser. By maintaining open lines of communication with her CCO counterpart at the fund's sub-advisers and being up-to-date on possible compliance issues at the various sub-advisers, the fund CCO can provide valuable information to the board. Periodic in-person visits to sub-advisers can allow the CCO to provide an ongoing assessment of the sub-adviser's compliance environment to the board.

Subject-specific areas for CCO Involvement

The following discussion includes some areas where the CCO's input can be helpful to a board. The areas of focus for a particular CCO will depend on the facts and circumstances at a particular fund complex as well as current issues in the marketplace.

Risk Oversight

The CCO may play an essential role in risk oversight.¹⁰ While CCOs are directly responsible for compliance risk issues, the CCO's role may go beyond compliance risk into other risk areas at the fund complex. Prior to expanding the CCO's responsibilities beyond compliance risk, the board and the CCO should work together to identify those areas where the CCO has appropriate knowledge and training in order to add value to the risk oversight process. Otherwise, the board and CCO inadvertently can increase the fund's risk exposure by asking the CCO to take responsibility for tasks beyond her skill set or by diverting the CCO's time and attention from core compliance responsibilities to the funds.

Many CCOs have found that developing a risk inventory or risk matrix can be helpful in guiding the board's risk oversight process. The process typically begins by identifying the areas of risk applicable to the funds and adviser. The input of the business units and internal audit can add value to the ultimate inventory. The risk inventory can serve as a basis for examining the quality of control processes and compliance policies and procedures. The CCO can use the risk matrix to rate risks and identify red flags.

As in many other areas, the role of the CCO is to determine whether fund management has processes in place to manage risk. The CCO can help the board understand how the various business departments are responsible for risk management. The CCO can also facilitate meetings between the board and the individuals responsible for various areas of risk.

Valuation

In adopting Rule 38a-1, the SEC required that fund policies and procedures cover valuation.¹¹ As a result, the CCO plays an important role in the valuation process by thoroughly understanding

¹⁰ For more information regarding risk oversight, see the Forum's publication, *Risk Principles for Fund Directors* (April 2010) (available at http://www.mfdf.org/images/uploads/resources_files/MFDFRiskPrinciplesforFundDirectorsApril2010.pdf)

¹¹ See 38a-1 Adopting Release at 6.

the regulatory requirements, understanding the processes used to value portfolio securities (including how the portfolio managers and other business people are involved in the process), and testing the quality of valuations such as through back testing.¹²

As the board and the CCO identify the key valuation risks that the complex faces, the board may wish to leverage the CCO's role in the valuation process by also having the CCO address potential issues with new products and new types of securities in which the fund invests. Playing a role in evaluating new products can help the CCO develop policies and procedures for new instruments. Through early involvement, the CCO can question the adviser regarding the adviser's understanding of how a particular investment works – an important factor in determining both how a particular instrument may fit into a fund's existing valuation methodologies as well as evaluating the adviser's knowledge of a particular type of security.

CCOs also play an integral role in monitoring the implementation of the fund's valuation policies and procedures. For example, the CCO can play a key role in the oversight of the fund's pricing vendors. As part of the process, the CCO can look at overrides that, though a common and important part of the valuation process, could present patterns that merit further review. If overrides are typically only pursued when they are in management's favor, the CCO and board may need to take a closer look at the fund's policies and procedures to determine whether the valuation process is working appropriately.

Another important consideration in reviewing the fund's valuation process is the extent of the CCO's involvement on the adviser's valuation committee. Most boards and CCOs agree that the CCO should attend the meetings regularly in order to gain insight into how the adviser's valuation process functions in practice. However, the CCO may not wish to be a voting member of that committee. First, the CCO is typically not a subject matter expert on valuation. Further, holding a position as a voting member of that committee may make it difficult for the CCO to evaluate decisions that she had a role in making.

The board and CCO work together to establish a reporting cycle that is appropriate based on the fund's facts and circumstances. Like many decisions in the oversight process, the decision is not made only once; facts and circumstances such as the fund adding new types of investments or market events may dictate a change. For an example, an unusual market event may prompt the CCO and the board to decide to change the reporting cycle and ask the relevant personnel to provide information to the board regarding what the market change might mean for the fund. Doing so will allow the CCO and board to stay abreast of an emerging situation.

Distribution

Oversight of distribution is another area where the CCO may provide valuable information. Fund boards are charged with annually approving the 12b-1 plans for the funds they oversee. In addition, fund directors receive quarterly reports outlining the expenditures under the plan. CCOs can help boards understand the fund's 12b-1 plan, including the purposes of the plan, the parties being paid under the plan, the amounts received by any fund affiliate, as well as how the plan is generally being used. The CCO also works with the board and adviser to establish policies and procedures regarding the use of 12b-1 fees.

¹² The Forum's publication, Board Oversight of Valuation, contains more information regarding fund valuation processes. The report is available at <http://www.mfdf.org/images/uploads/newsroom/Valuation-web.pdf>.

The SEC's distribution sweep has brought sub-transfer agent agreements to the forefront. The CCO's work with the board on the fund's 12b-1 plan can help the board in this area as the fund can only use Rule 12b-1 fees to pay for any activity primarily intended to result in distribution of fund shares. For example, the fund can use 12b-1 fees to pay the portion of the supermarket fee primarily intended to result in the sale of fund shares.

The supermarket fee also can be for services other than distribution – which the fund can pay from its own assets. In performing the evaluation, the contracts governing the arrangements may identify the nature of the services provided, whether the services provide distribution benefits, the non-distribution benefits of the services, as well as the characterization of the services by the fund's adviser, distributor, or transfer agent. The CCO can assist the board in its review of these contracts in connection with the board's oversight of the Rule 12b-1 payments. Like virtually all areas of oversight, the board and CCO may find it helpful to review periodically these arrangements to determine whether the payments are consistent with Rule 12b-1 and avoid payments for services already performed for the fund by another party or paid with another fee.

Brokerage and Trading

Mutual fund trading has once again become a focus of fund directors given the significant changes in the post-financial crisis environment to the fixed income markets as well as the attention given by regulators, the media, and others to market structure issues in the equity and fixed income trading markets. There are areas where the CCO can assist the board in its oversight responsibilities.

Brokerage commissions are fund assets; therefore, board oversight can help determine whether those assets are used in a way that benefits the fund and its shareholders. The CCO can help implement and monitor the procedures that govern best execution as well as the reporting required under those procedures. The CCO can help the board understand the adviser's process for selecting brokers to execute the fund's portfolio transactions. If the adviser has a trading practices, best execution, soft dollar, or other trading-related committee, the board and CCO may find it helpful for the CCO to attend committee meetings at least as an observer to gain additional insight into the functioning of the committee.

Trade allocation is another important area of concern around trading. This issue may be especially acute given the rise in alternative funds managed by advisers with little or no 1940 Act experience, requiring CCOs to pay special attention to the procedures of those advisers. Trade allocation is a special concern if the adviser earns a higher fee managing some funds than others – a possibility where the adviser manages both a 1940 Act product and a hedge fund. The CCO can monitor the procedures governing trade allocation to see if they are fair and reasonable for the registered funds.

The CCO also can provide the board insight into the functioning of the fund's policies and procedures designed to prevent directed brokerage. Testing can help the CCO determine whether there is any correlation between the sale of fund shares and brokers that may indicate agreements between the fund and the broker for the sale of fund shares.

The CCO can also aid the board in its oversight of soft dollar arrangements. Section 28(e) of the 1934 Act governs the use of soft dollars. The section provides a safe harbor for the use of fund assets in the form of brokerage commissions to purchase research services. The CCO can monitor the use of soft dollars to determine whether the fund's transactions fall within the

safe harbor. In appropriate circumstances, the board may find it helpful to ask the CCO to compare soft-dollar transactions with transactions in execution-only venues to evaluate the value the fund receives.

CCOs also can provide further insight into the adviser's trading practices by conducting due diligence visits both to the adviser's trading floor as well as any new trading venues used by the fund. These visits allow the CCO to see first hand the environment at the venue. In addition, the CCO can ask questions of the personnel directly involved in trading and receive responses without the buffer that may be present in formal reports provided to the funds.

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One of the most transformative changes to the mutual fund industry in recent years, particularly for the day-to-day functioning of mutual fund boards, is the requirement that a fund have a CCO. While compliance was not a new concept, Rule 38a-1 for the first time required that fund boards have access to a single person with responsibility for fund compliance. The rule vests significant power with the board – including the ability to hire and fire the CCO and the ability to set the CCO's compensation. Building a relationship of open communication and trust with the CCO can help a fund board meet its compliance obligations, and in turn, better serve fund shareholders.



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