

Board Oversight of Fund Compliance

The Independent Directors Council recently published a comprehensive task force report entitled "Board Oversight of Fund Compliance." The report highlights the task force's findings in the following areas: (i) compliance program goals, (ii) role of the chief compliance officer ("CCO"), (iii) compliance and fund management, (iv) compliance and the fund board, and (v) defining a successful compliance program. Some of the key findings set forth in the report are summarized below. A copy of the complete report is available on the Investment Company Institute's website at http://www.ici.org/pdf/idc_09_compliance.pdf.

Compliance Program Goals

It may be useful for fund boards, the adviser and the fund CCO to discuss and consider the mission and goals of the compliance program. The task force identified the following common themes regarding fund compliance:

- Compliance is everyone's responsibility.
- Compliance should be structured as a collaborative function.
- Compliance should be proactive and anticipatory.
- Compliance should seek to educate.

Role of the CCO

The task force identified a number of common CCO responsibilities. Certain of these responsibilities are regulatory requirements, while others may be specific to a particular fund group. These responsibilities may include:

- Annual review of the adequacy of fund compliance policies and procedures and those of the fund's principal service providers.
- Development and implementation of the compliance program testing and risk assessment.
- Preparation of compliance reports for inclusion with the board materials at each regular board meeting.
- Conducting board education sessions.
- Periodically providing the board with a confidential assessment of the adequacy of the resources allocated to the compliance function.
- Periodically reviewing with the board the level of cooperation provided by the fund's service providers in facilitating the fulfillment of the CCO's responsibilities.
- Communicating with the board chair between board meetings, as necessary.

The task force notes that one of the defining aspects of a CCO's role is whether the individual serves as the fund's and the adviser's CCO or only as the fund's CCO.

The task force noted that a person who serves as CCO of both the adviser and the fund may be better able to integrate into and understand the adviser's business and the CCO may have a large degree of transparency and access to the adviser's organization and employees. However, in this case the CCO has two constituents (the fund board and the adviser) who may not always agree on compliance issues and, as a result, the CCO's independence may be blurred. To address these concerns, the task force suggests that a fund and adviser CCO should communicate with both the fund board and the adviser to clarify expectations, particularly with respect to when, what and how information will be reported.

The task force also noted that CCOs may be employed in-house by the fund and/or adviser, or retained as a third-party service provider. Some fund groups may prefer to retain a third-party

The following is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

CCO so that they may take advantage of the CCO's expertise and resources without having to develop and maintain their own compliance infrastructure. However, an in-house CCO may have a better understanding of the fund group's risks and compliance needs.

Compliance and Fund Management

The task force suggests that a fund board can help to promote a strong "tone at the top" by asking the adviser, the fund CCO and itself certain questions, including the following:

- Is the compliance function treated as an important and legitimate part of the business or as a nuisance?
- Has the adviser fulfilled in a timely fashion all commitments it has made relating to compliance?
- How does the adviser's senior management team interact with the fund CCO?
- Does management appropriately consider and implement compliance-related recommendations made by the CCO?
- Does the CCO feel subject to undue influence from the adviser regarding board communications or potential findings of material compliance matters?

Compliance and the Fund Board

Many boards have established a reporting relationship with the CCO between board meetings. It is important to note that communications between a board member and the CCO are not privileged and counsel should be consulted to ensure that everyone involved has a clear understanding as to how best to protect sensitive communications.

Evaluating the Compliance Program and the CCO

Industry practices regarding board evaluations of the compliance program and the CCO are diverse. These evaluations may be formal (utilizing written questionnaires to be completed by board members) or informal (soliciting oral input from board members).

Common items that boards review in evaluating the CCO include:

- expertise and effectiveness;
- communications with and reporting to the board, responsiveness to questions raised by the board and proactive communication between board meetings;
- leadership and management skills; and
- independence.

CCO Compensation

Industry practices regarding how to structure a CCO's compensation are varied and there is little publicly available information that a board can use for comparative purposes. Considerations that boards should evaluate when approving CCO compensation include:

- the appropriate level of compensation in light of the CCO's experience, responsibilities and nature of the fund group;
- the form of compensation (e.g., base salary and bonus opportunities); and
- whether any or all of the CCO's compensation should be paid by the fund group.

Please do not hesitate to contact a member of the Godfrey & Kahn, S.C. Investment Management Practice Group if you have any questions regarding the IDC's report or your compliance program.

Investment Management Team Members

Carol Gehl
(cgehl@gklaw.com)

Ellen Drought
(edrought@gklaw.com)

Helge Lee
(hlee@gklaw.com)

Susan Hoaglund
(shoaglund@gklaw.com)

Christopher Cahlamer
(ccahlamer@gklaw.com)

Michele Racadio
(mracadio@gklaw.com)

Megan Bern
(mbern@gklaw.com)

Michael Conmey
(mconmey@gklaw.com)

Brian Grill
(bgrill@gklaw.com)

Alia Mendez
(amendez@gklaw.com)