SEC Compliance Outreach Program National Seminar – Summary of Panel Discussions

On January 30, 2014, the SEC hosted a Compliance Outreach Program National Seminar for investment advisers and investment company senior officers. There were several panel discussions covering compliance issues facing private funds and registered investment companies. Panelists included personnel from several SEC divisions and a number of Chief Compliance Officers ("CCOs"). The seminar agenda can be found here. The accompanying slide presentation can be found here.

This report summarizes remarks from the conference that may be of interest to our clients. Please note that the report reflects the views of the participants on each panel, including both SEC staff and industry speakers, and should not be regarded as substantive advice from Ropes & Gray with respect to the topics addressed during the seminar. Please contact your usual Ropes & Gray advisor with respect to questions about any of the topics and remarks summarized below.

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Panel I: Program Priorities

Speakers:
Jane Jarcho, National Associate Director, National Exam Program
David Grim, Deputy Director, Division of Investment Management
Julie Riewe, Co-Chief, Division of Enforcement, Asset Management Unit

General Priorities of Each Division or Program

- **Division of Investment Management** – The policy initiatives of the Division include:
  - *Regulatory Flexibility Act*: reviewing more than 1,300 comments provided regarding the 2013 rule proposal designed to address susceptibility to heavy redemptions from money market funds;
  - *Form N-MFP Equivalent*: extending Form N-MFP (detailing the monthly schedule of portfolio holdings of money market funds investing in short-term debt such as U.S. treasury bills and commercial paper) or an equivalent from money market funds to a broader range of registrants overseen by the Division, such as open-end funds and ETFs, to capture the type of information currently provided on Form N-MFP to the SEC;
  - *Service Provider Oversight Issues*: in the registered fund context, affirming the diligence required for investments in "alternative strategies" and ensuring proper oversight of sub-advisers; and
  - *Guidance Initiative*: encouraging registrants to call the SEC for guidance.
- **Division of Enforcement, Asset Management Unit** – The enforcement priorities of the Asset Management Unit include:
  - *Hedge Funds*: principal transactions and best execution;
  - *Private Equity*: misallocation of funds, side-by-side management of multiple funds by a single adviser, valuation of fund assets, and static funds generating fees (so-called "zombie funds"); and
  - *Managed and Retail Accounts*: dual registrants (investment adviser and broker-dealer), undisclosed fees, and advertising.

Regulatory Priorities: The four regulatory priorities announced publicly in the Regulatory Flexibility Act agenda are:

- **Wrap-Fee Programs**: The SEC will review registrant policies and procedures to ensure that: (i) reviews are conducted to determine suitability of wrap accounts for clients; (ii) break-points are disclosed if provided; (iii) transaction fees are appropriately disclosed; and (iv) the practice of putting clients who trade infrequently in fee-based brokerage accounts ("reverse churning") is avoided.
- **General Solicitation Under the JOBS Act**: The SEC will train examiners through specialized modules with experts in marketing and sales. The areas of focus will include: (i) policies and procedures to avoid misleading and fraudulent advertising; (ii) practices within firms to verify accredited investor status; and (iii) by end of 2014, conducting a sweep across broker-dealers and private funds to verify accredited investor status.
- **Cybersecurity**: The SEC encourages registrants to ensure that cybersecurity policies are not only current, but regularly assessed for adequacy given the risks and fears in the marketplace. Issues are particularly likely to arise when departing employees or independent contractors have access to data. Policies must account for specific risks of the business model (*e.g.*, requiring independent contractors to have anti-virus software to prevent hacker intrusion). Firms should have some sort of cybersecurity policy that covers how to deal with breaches, including reporting to regulators and

other third parties. The SEC encourages firms that discover a data breach to take a proactive approach of promptly notifying clients and making them whole.

- **IABD Harmonization**: The SEC has observed the popular migration away from the broker-dealer model and towards the investment adviser model. Dual registrants must understand the differences between the two regulatory regimes in supervisory responsibilities, books and records requirements, and fiduciary duties, including disclosure of potential conflicts. Examination of dual registrants may focus on: (i) weak oversight of branch offices and representatives; (ii) client confusion between commission-based brokerage and advisory accounts; and (iii) comparing disclosures between related investment advisers and broker-dealers.

Examination Initiative: Over the course of the next two years, the National Examination Program intends to review a "significant number" (25-40%) of those registrants that have been registered for more than three years but have not previously been examined. At its discretion, each regional office may choose to employ one of two methods: (i) the risk assessment exam; or (ii) the presence exam.

- **Risk Assessment Exam**: The exam will consist of a limited, non-extensive request including certain significant policy and procedure documents, and interviews with limited people at the firm which will permit the assignment of a "risk rating." The risk rating is only internal to the SEC and will not be provided to the examined firm.
- **Presence Exam**: The regional office will select four to six focus areas, at their discretion, and examine all focus areas in the firm examined.

Highlights from Question and Answer Session

- It is reasonable for firms to call exam staff and clarify specific items on an exam request list. The key to a smooth exam is the creation, review and periodic testing of strong policies and procedures. Outside of the exam process, self-reporting is encouraged. If the registrant has discovered errors and fixes them, it should report such matters to the SEC to build a good relationship of trust with the examination staff.
- The Rule 203A-2(f) internet adviser exception, which exempts certain advisers from the prohibition on registration for advisers with less than $25 million of assets under management, is a narrow rule for a specific business model. In adopting the rule, the Commission expected that the rule would apply to only twenty or so advisers.
- Custody violations are a continued priority in 2014. Observed violations include: (i) untimely provision of financial statements; (ii) failure to acknowledge custody as a general partner or individual with power-of-attorney; and (iii) failure to understand the broad meaning of "custody" (*e.g.*, online access to password-protected client accounts and ability to transfer money).
- There is no initiative to coordinate between the SEC and the National Futures Association (NFA) to avoid redundancy in information-filing for dual registrants. The information on Form PF is sensitive, and such sharing of information with the CFTC/NFA is done only on an *ad hoc* basis.
- Registrants are not selected at random for examination. The examination staff selects registrants based on internal risk assessment ratings, public filings, records from the Tips, Complaints, and Referrals (TCR) system, and recidivism.

Panel II: Private Fund Adviser Topics

Speakers:
Ashish Ward, Exam Manager, National Exam Program, Los Angeles Regional Office
Alpa Patel, Senior Counsel, Division of Investment Management
Igor Rozenblit, Specialist, Division of Enforcement, Asset Management Unit
James Capezzuto, General Counsel & Chief Compliance Officer, Cornerstone Capital Management LLC
Barbara Burns, Chief Compliance Officer, AEA Investors SBF LLC

Overview and Data

- There are about 4,000 registered investment advisers advising private funds. Roughly half of the assets under management for these advisers are in hedge funds, with the rest being split amongst various other private funds, including private equity and real estate funds.
- About 1,500 of these investment advisers registered after the passage of the Dodd-Frank Act in 2010.
- In 2012, the SEC began conducting "presence exams" of the newly registered investment advisers. A goal of these exams was to learn about the new investment advisers being added to the universe of registrants. The exams focus narrowly on a few key concerns, such as investment conflicts, marketing practices, valuation and custody.
- About 250 presence exams have been conducted so far. This puts the SEC on target for reaching its goal of examining 15-25% of the new registrant universe in the first two years of the presence exam initiative. About half of these exams have resulted in deficiency letters.
- A repeated theme of the presentation is the importance of CCOs understanding and being integrated with the business functions of their investment advisers.

Private Equity Fund Compliance Risks and Issues

- **Fund Structures** – The panel identified what it considered to be the main causes of regulatory issues with private equity fund structures from its perspective to include what it characterized as vague limited partnership agreements, high barriers to action for disgruntled limited partners, and limited information rights for limited partners.
- **Industry Trends** – Trends in the private equity industry that concern the SEC include industry consolidation and its effect on adviser incentives, the increasing importance of separate accounts, the decreasing reliance of fund managers on the traditional carry structure, and new cost pressures in the industry.
- **Disclosure** – Presenters emphasized their view of the importance of disclosure of the policies and practices of private funds and their advisers.
    - In the panel's view, CCOs should not assume that the sophistication of limited partners allows fund managers to provide only minimal disclosure.
    - The panel also set forth its view that due to the burdens on limited partners, who often must manage relationships with many funds, thorough disclosure to all limited partners is necessary, even if a particular limited partner is sophisticated.
- **Fees and Expenses** – The panel also noted that from the SEC's perspective, compliance risks may potentially arise when investment advisers shift certain expenses away from the adviser and onto portfolio companies or the private equity fund itself, or when expenses are charged for unusual items.
    - In the panel's view, what it characterized as expense shifting undertaken by the investment adviser should be adequately disclosed.

  - They also noted that they believe that disclosure of unusual expenses is also important. As an example, if a social outing between firm personnel and the management of a portfolio company is expensed to the fund, this should be disclosed, with enough specificity for the limited partners to determine whether the expense is fair.
  - In assessing whether disclosure of an expense is adequate, the panel noted that the SEC will first look to the limited partnership agreement and the notes to financial statements for disclosure of the expense. If disclosure is not found from either of those sources, the examiner will then request an explanation of how the expense was disclosed. Other possible avenues of disclosure from the panel's perspective include capital call notices or materials provided to a Limited Partner Advisory Committee.
  - Examples of undisclosed expense shifting include:
    - Use of operating partners or senior partners who appear to be part of the adviser, but actually receive compensation that is separate from the management fee earned by the adviser.
    - Use of related party service providers that "kick cash back to the manager" (*e.g.*, some captive consulting firms and group purchasing programs).
    - Causing the fund, instead of the adviser, to pay for expenses related to the automation of recording transactions, including software used in connection with this automation.
  - Outsourcing of traditional back office functions (including accounting, risk and legal) to related parties, which are in turn paid by the fund instead of the investment adviser.
  - The SEC noted that the person getting the benefit of a product should pay for it, and investors should get what they are promised.
- **Ancillary Fees** – There can also be compliance risks when fees are charged to funds and portfolio companies outside the normal construct of the management and performance fees or carried interest.
  - In the panel's view, where limited partners are unaware of these ancillary fees, disclosure of the fees may be inadequate.
  - In the panel's view, particular attention should be given to the question of whether disclosure is adequate when monitoring fees are accelerated at the time an investment is exited.
- **Risks of Favoritism** – Another potential risk identified by the panel related to circumstances where the regulators could perceive that private equity funds may favor certain investors or funds over others without proper disclosure.
  - <u>Allocation Generally</u> – To avoid potential problems, the panel suggests that advisers adopt written policies for fair and equitable allocation of investment opportunities over the long term.
  - <u>Allocation of Co-Investments</u> – The SEC acknowledged that advisers do not owe a fiduciary duty directly to investors. However, not providing full disclosure to investors regarding practices followed may raise anti-fraud concerns. To avoid compliance risks, private equity investment advisers should develop written policies to govern the allocation of co-investment opportunities.
  - <u>Duties to Current Limited Partners</u> – In the panel's view, the adviser should also consider how appropriate a co-investment opportunity is for the fund itself. There is a potential fiduciary duty issue if opportunities are not being offered to the fund prior to being offered to limited partners or third parties as a co-investment.
  - <u>Disclosure of Co-Investments</u> – The SEC believes that a fund manager should disclose whether a fund will allocate co-investments to those limited partners whom the fund manager knows will invest in its next fund. Further, the SEC believes that when co-investments are actually allocated, this must be communicated in a timely enough way for a limited partner to

take action if the limited partner objects to the allocation (although the SEC recognized this may not always be practical). As an example, the SEC said that a limited partner should have an opportunity to "complain" about allocations that they find objectionable.

  - Client Status for Co-Investments – SEC personnel indicated that there is much debate over whether co-investors should be considered clients of the investment adviser. One view is that the investment adviser's discretion over when to liquidate the investment creates a client relationship between the adviser and the co-investors.
    - Structuring transactions to avoid client status may be possible, but it is unclear whether such structuring would be practical.
    - The SEC recognized that there is still much uncertainty over this issue, with no clear indication of how or when it may be resolved.
  - Allocation of Lending Business – In the SEC's view, favoritism issues can also arise when mezzanine or lending business is given to favored investors, particularly when this is done without proper disclosure.
- **Valuation** – SEC personnel indicated that interim valuations of private equity assets can be material, as they communicate the adviser's track record to investors and potential investors and may also be relevant to the calculation of management fees. Valuations should follow written policies, with involvement by internal compliance personnel.
  - Compliance issues can arise with respect to the process for interim valuations, especially given that auditors' oversight of the process for these valuations is often minimal.
- **Custody** – The SEC is devoting increased attention to custody. The panel noted its position that client funds must be properly segregated, and safekeeping and recordkeeping requirements must be met.
  - The panel noted that the private placement exception to certain custody rules may ease regulatory burdens. The SEC has issued guidance by which they have allowed certain private placement securities that are "certificated," to be eligible for an exception from the requirement that they be held by a qualified custodian. For more information on this guidance, please see this Alert.
  - Common problems related to custody are funds that fail to conduct required audits or fail to provide required reports from these audits to investors.
- **Marketing** – The SEC noted its concern that managers "stretching for capital" may overstate or misstate material facts. In particular, the SEC noted the following problems:
  - Improperly constructed interim valuations.
  - Improper attribution disclosures, especially in the cases of departing team members.
  - Key investment team departures that occur immediately after closing, where such departures were not disclosed to investors prior to closing.
- **Role of the PE CCO** – The SEC acknowledged the PE CCO is a "difficult job." CCOs should "know how their business works" to be able to mitigate risks and draft disclosures.
  - The SEC takes great comfort from CCOs who can demonstrate they understand their business.
  - The CCO should be integrated into the business and attend key meetings.
  - Senior support is key.

Hedge Fund Compliance Risks and Issues

- **Trading Conflicts** – Hedge funds should have processes in place for managing conflicts of interest, both among their clients and between their clients and the adviser. Issues are especially likely to arise when soft dollars are used. In the panel's view, it is important to ensure that redemptions and liquidations are processed fairly.

- **Material Non-Public Information** – The panelists also discussed their concern that compliance risks can arise when hedge fund personnel receive material non-public information, such as through expert networks. Additionally, from their perspective hedge fund clients should be sensitive to disclosing their own holdings and trading activity, to ensure that non-public information is not disclosed.
- **Marketing Practices** – SEC personnel identified marketing practices as a major source of compliance concern for hedge funds. In particular, compliance issues arise when fund performance is described in a misleading way. In addition, the sale of private fund interests without the involvement of a registered broker-dealer may raise compliance concerns.
- **Custody** – Custody is a compliance focus for both hedge funds and private equity funds (as discussed above).

<u>Other Private Fund Compliance Risks and Issues</u>

- **Conflicts of Interest** – The panel also discussed conflicts, noting that investment advisers should be aware of potential conflicts of interest when they manage several funds or accounts, and should exercise investment discretion in accordance with their fiduciary duties to all of their clients.
- **JOBS Act** – One of the SEC panelists believed that the rules on advertising for funds should be updated in light of the new JOBS Act rules permitting general solicitation in certain offerings.
  - The prohibition against general solicitation in certain Rule 506 offerings was lifted last July, but the SEC has not seen a wave of general solicitation. This is, at least in part, due to the fact that other regulators (including the CFTC and foreign regulators) still independently impose limits on general solicitation.
- **Form PF Revisions** – Form PF will probably change at some point, but that involves rulemaking so it will take time. Advisers should pay attention to the FAQs on Form PF. The SEC looks at Form PF responses before conducting an examination.

Panel III: Registered Investment Company Topics

Speakers:
Steven Dittert, Assistant Director, National Exam Program, Philadelphia Regional Office
Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management
John Farinacci, Specialist, Division of Enforcement, Asset Management Unit
Renee Esfandiary, Assistant Director, National Exam Program
Charles McCain, Chief Compliance Officer & General Counsel, Harbor Capital Advisors
Victor Frye, Chief Compliance Officer, ProFund Advisors LLC

<u>Payments for Distribution in Guise</u>

- The panelists noted that from their perspective, CCOs need to map the fees paid out to intermediaries against the services provided for those fees. This can be onerous because the intermediaries are often large broker-dealer organizations, each with its own boilerplate agreement. A tip for CCOs is to send confirmatory letters to intermediaries describing the services the intermediary has agreed to provide to the fund.
- A key question for the SEC is whether it is clear what portion of the fee is for distribution and what portion is for non-distribution services. It is easier for funds to address this division at the front end

during negotiations with the intermediary, rather than looking back at the boilerplate agreement and trying to divide the payments/services down the road.

- The SEC looks at a fund's payments to all of its intermediaries and becomes concerned when most service (non-distribution) payments are going to intermediaries that also distribute fund shares. The question for the SEC then becomes whether the non-distribution services are actually being performed.
- Advisers should begin self-remediation if they have concerns that certain payments should be included in Rule 12b-1 fees.

15(c) Process - The SEC wants to see a robust 15(c) process that takes into account all relevant factors and discloses all material facts to the board.

- The SEC recognizes that the amount of information that comes to the board in this process can be daunting, and urges there to be a balance in the amount of information that is presented to the board. There should be sufficient detail for the board to fulfill its 15(c) responsibilities, but the information presented to the board should be clear and concise. It is appropriate for someone to present a summary of available information to the board.
- It is not acceptable to have boilerplate 15(c) disclosure. It is fine to have a template, but it must be tailored each year to reflect negotiations with the adviser.
- The board is responsible for overseeing a sub-adviser to the same extent that it oversees an adviser. The board should be very clear on what the sub-adviser is providing for the fee it receives, even if that fee comes out of the amounts paid to the adviser.
- The CCO plays a crucial role in the 15(c) process. She must ensure the board has enough information to exercise its duties and that the 15(c) disclosure prepared by the lawyers accurately reflects the negotiations with the adviser. It is not enough for the CCO to provide the board with a stack of information. The CCO needs to give guidance to the board.
- When an adviser is charging a much higher fee to a retail account than to an institutional account, the SEC will look at whether the agreement is for administration and advisory services, or for purely advisory services. If the agreement covers both administration and advisory services, then the higher fee may be justified, but it is less likely to be justified if the agreement covers only advisory services.
- The SEC urges boards not to overly rely on the fees paid by similar funds in approving their own advisory fees. Fees paid by similar funds should not be the guidepost, because the board does not have access to much of the information underlying the services and fees. It could be that the funds being used as "similar" are not in fact similar, or that the services are not as similar as they appear. Thus, the advisory fees paid by similar funds should be merely one data point for the board to consider among others.

Alternative Mutual Funds – These are funds that use strategies typically employed by institutional investors and hedge funds, including trading in swaps, options, non-traditional bond strategies and commodities.

- The SEC's broad concern is that these alternative strategies often mean the presence of private fund managers who are new to registered mutual funds, fund managers who are new to these complex strategies, and boards who are new to overseeing these strategies. These alternative strategies may pose many risks, including risks related to liquidity, leverage, compliance, marketing, tax, suitability and valuation. Boards of these funds need to understand the strategies and their role in the portfolio. Essentially, as a fund makes greater use of alternative strategies, CCO and board oversight needs to increase accordingly.

- CCOs should ensure that an Investment Company Act compliance grid is fully in place before the alternative product is launched. This is becoming a bigger issue for CCOs as management is becoming more interested in alternative strategies and the CCOs are sometimes tasked with simply "making it work."
- As to marketing, an issue arises as to the extent to which a sponsor can use prior performance of a private fund to advertise a mutual fund that will seek to replicate the same or similar strategy. The strategy used in the private fund often needs to be "watered down," so performance will presumably be watered down as well. No-action letters in this area should be followed closely. Marketing of these instruments must not be oversimplified, as investors need to understand the level of complexity involved.
- Most of the existing alternative mutual funds were organized after the 2008 downturn, which means these funds are untested as to how they will behave in a stressed market. Asset segregation and coverage requirements are key here, as there need to be enough liquid assets to satisfy redemptions.

Exchange Traded Products

- A key issue for ETFs is precise compliance with the terms of their exemptive orders. The SEC has seen some "near misses." Another issue is compliance with the terms of the listing application with the exchange and the ongoing conduct rules of the exchange. ETFs need to be sure that they are following the exact terms of the applicable exemptive orders.
- The SEC is concerned with consumers investing in unsuitable ETFs, especially geared (leveraged and inverse) ETFs. Financial intermediaries are the ones that are supposed to guide investors, but CCOs need to ensure that their funds' websites post adequate information.

Highlights from Question and Answer Session

- The SEC is not close to finalizing 12b-1 reform. The SEC wants more information before taking this on.
- CCOs do not need to fully understand the alternative investment strategies used by alternative mutual funds, but they need enough understanding to monitor the strategies.
- The SEC examination staff will request emails in connection with examinations, so the CCO should periodically review a sampling of employee emails. This could be monthly, quarterly, etc., but the CCO should have a process in place to review emails and identify red flags.
- Large firms need to have best execution policies tailored to each asset class. Some asset classes may prioritize speed or anonymity over fees, which is fine, but there must be a system for selecting brokers and counterparties for execution.
- When the exam staff sees a trade error, they are going to want to see documentation explaining how the firm dealt with the error and that it has been resolved.

Panel IV: Valuation Issues

Speakers:
Matthew O'Toole, Senior Special Counsel, National Exam Program, San Francisco Regional Office
Leo Chan, Senior Specialized Examiner, National Exam Program, San Francisco Regional Office
Sarah ten Siethoff, Senior Special Counsel, Division of Investment Management
Jaime Eichen, Chief Accountant, Division of Investment Management
Jeffrey Blockinger, Chief Legal Officer & Chief Compliance Officer, Och-Ziff Capital Management Group

Overview

The panelists gave a brief overview of the law and stressed that there are many similarities in good valuation practices between registered funds and private funds. They explained the major areas where poor valuation can raise issues. First, advertising is based on performance record, and advisers can use valuation to present an overly rosy picture of performance. Second, an inflated NAV due to poor valuation can lead to inflated fees. Third, poor valuation can mean some investors redeeming at inflated prices or entering the fund at deflated prices, in both cases causing unfairness to other investors. The panel then discussed the following points:

- Valuation guidance by the SEC is not imminent. There are other pressing issues that take priority.
- The Investment Company Act says the board is responsible for valuation, but the SEC understands that it is not feasible for the board to do the "nitty gritty" of valuation. So the SEC expects the board to implement methodologies for valuation, to oversee the execution of those methodologies, and to determine when the methodologies should be updated. A key lesson from the Morgan Keegan case is that funds must have appropriate valuation methodologies tailored to what they invest in.

Valuation Methodologies

- Fair value is the price at which a fund could reasonably expect to sell the instrument – the exit price. Under the three level fair value hierarchy, it is important to understand that level two securities should not give investors a false sense of security. Level two is very broad, as it covers anything priced using observable inputs. For example, both money market and high yield bond funds can fall under level two.
- The SEC provided cautions regarding pricing service vendors. If firms do use pricing services, then management needs to understand what is behind the prices provided by the pricing service. Management should understand the pricing services' methods, inputs and assumptions. Firms should scrutinize the pricing services they use, and should know a pricing service's background, business continuity plan, technology infrastructure, and specific staff who are valuing the fund's instruments. Firms should know whether they need to implement additional controls on the prices delivered by the pricing service. The fund or manager should have a price challenge process that specifies who can challenge prices calculated by the pricing service and under what circumstances prices will be challenged. The policy should ensure that prices are challenged on a consistent basis. Boards should consider whether there is a challenge bias; it is a problem when a fund is challenging only prices that are considered too low.
- The examination staff will review a fund's or manager's valuation policies and procedures and whether they are being applied consistently. Common observations include missing policies, policies that are not followed, or policies that are not specific enough to each asset class. The examiner needs to understand the assumptions behind the valuation calculations. Inflated valuation is problematic, but so is overly conservative valuation.
- For fixed-income securities, a big theme is firms defaulting to valuation at cost or par. The SEC stresses that the notion of holding a security to maturity is not relevant because fair value is the exit price.

Private Equity and Hedge Funds

- For private equity investments, it is not always sufficient to take the average of valuations of comparable companies. A wide range of comparable valuations may signal the need for additional analysis.
- Funds of hedge funds need to have a robust due diligence process to understand the valuation process of the hedge funds in which they invest. It is insufficient to simply accept the valuation that the hedge fund emails at the end of each month.

Panel V: CCO Compliance Obligations

Speakers:
Mark Dowdell, Assistant Director, National Exam Program, Philadelphia Regional Office
Janet Grossnickle, Assistant Director, Division of Investment Management
Marshall Sprung, Co-Chief, Division of Enforcement, Asset Management Unit
Chris Marzullo, General Counsel & Chief Compliance Officer, Brandywine Global Investment Management LLC
Judy Werner, Executive Director, National Society of Compliance Professionals

- The SEC understands that new advisers need time to develop their compliance programs. Established firms are held to a higher standard in exams. The SEC wants to see an empowered CCO – someone with the "ear of management." CCOs should have access to information across the firm and should be knowledgeable about the applicable rules, regulations and guidance. The CCO should also be a bit cynical.
- The CCO's obligations can fit into four categories: first, facilitating compliance with federal securities laws by all employees of the firm; second, educating the firm on fundamental legal requirements; third, advising the firm as issues arise; and fourth, "pulling the brakes" when serious issues arise by contacting senior management and ensuring that the issues are addressed.
- The SEC stresses that it is not "out to get" CCOs. While CCOs have been charged in some SEC actions, this usually happens either (i) when CCOs are wearing multiple hats and getting sued for conduct in one of their other capacities or (ii) when CCOs are responsible for or aided the violation or failed to heed the SEC's warnings. The SEC does not view CCOs as targets, but rather as partners. A routine question asked by the SEC when there is a violation is, "Where was the CCO on this?" As long as the CCO is diligent and knowledgeable, then she has nothing to worry about. The CCO needs to be asleep at the switch to get into trouble.
- One of the CCO's biggest concerns is knowing the business – what her firm does and how it does it. The compliance manual needs to be tailored to the business.
- As to liability for failure to supervise, the SEC emphasizes that this is very much a facts- and-circumstances determination. The SEC will look at the multiple hats worn by the CCO and see if there is a supervisory role among them. Merely having the title of CCO does not make someone a "supervisor."
- Funds that outsource their CCO responsibilities need to ensure that the outside CCO has enough time, knowledge and understanding of the business. Delegating a compliance obligation to an outside CCO does not relieve the adviser of the fiduciary obligation to ensure compliance. The SEC is concerned about how engaged an outside CCO is with the firm. If an outside CCO is servicing 20 different advisers, the SEC will wonder whether the CCO can fulfill her responsibilities to each adviser.
- Most of the CCOs in the industry do an excellent job. The outliers are the ones that give CCOs a bad name.

- In annually updating policies, CCOs should document the data behind the updates. The best compliance programs have year-round testing, so that all they have to do at the end of the year is compile their reviews. CCOs should talk with firm employees to see if the existing policies still make sense given how the firm is actually operating.