

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and scattered numerical values in shades of blue and white.

K&L GATES

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CONFERENCE – November 12, 2019

Compliance Programs

Fatima S. Sulaiman, Partner, K&L Gates LLP
Melissa Tuarez Herr, Associate, K&L Gates LLP

DISCUSSION OVERVIEW

- Duty to Establish a Compliance Program
- Chief Compliance Officer (“CCO”)
- Written Policies and Procedures
- Annual Review Process
- SEC Exams and Enforcement
- Code of Ethics





Duty to Establish a Compliance Program



RULE 38a-1 REQUIREMENTS

- Adopt and implement written policies and procedures
 - Must be reasonably designed to prevent the fund and its service providers from violating federal securities laws
- Board designates a CCO
- Board initially reviews and approves the compliance program
- Annual written report to the board
- Maintain records
- Advisers Act Rule 206(4)-7 is a parallel compliance rule for investment advisers



BOARD APPROVAL

- Compliance program of the fund
- Compliance program of the fund's service providers
 - Adviser and Sub-Advisers, Principal Underwriter, Administrator, and Transfer Agent
- Reliance on summaries and third-party reports
- Amendments and annual re-approval not required
 - However, a board may have separate approval obligations under 1940 Act requirements



BOARD OUTREACH INITIATIVE

- In October 2017, the Independent Directors Council (“IDC”) sent a letter to the Director of the Division of Investment Management, highlighting the need to reassess board responsibilities, including in the context of Rule 38a-1
- IDC’s recommendations included:
 - Reassessing board responsibilities and governance requirements to address changes in the industry
 - Eliminating certain board obligations that are duplicative of the work performed by CCOs



IDC NO-ACTION LETTER

- SEC staff no-action letter to the Independent Directors Council (“IDC”) from October 12, 2018
- Allows the board to rely on CCO’s written representations that affiliated transactions complied with 1940 Act rules and related procedures
- Board need not review transaction data or make quarterly determinations itself
- Avoid duplicating work of the CCO





Chief Compliance Officer



CCO REQUIREMENTS

- Board must designate a CCO
- Competent and knowledgeable
- Empowered with full responsibility and authority
- Position of seniority and authority
- Duty to administer the compliance program



CCO DUTIES

- Ensuring compliance program is comprehensive and current
- Conducting annual compliance review
- Reporting to the board
- Implementing any material recommendations
- Advising senior management on compliance matters
- Being the “go to person” on compliance issues



INDEPENDENCE OF THE CCO

- Board hires and fires
- Board sets compensation
- Direct reporting line to the board
- Annual executive session meetings with the board



CCO COMPENSATION

- In practice, fund boards have taken various approaches to structuring a CCO's compensation
 - A significant number of fund boards have approved arrangements under which the funds pay at least a portion of a CCO's compensation, while other CCOs are compensated entirely by the investment adviser





Written Policies and Procedures



COMPLIANCE PROGRAM REQUIREMENTS

- Coverage of policies and procedures
 - Culture of compliance
 - Delegation of responsibility
 - Training
 - Monitoring and auditing
 - Response, prevention and evaluation
- One size does not fit all
- Risk assessments
- Must be dynamic



RULE 38a-1 ADOPTING RELEASE, MINIMUM EXPECTATIONS FOR AN ADVISER'S COMPLIANCE POLICIES AND PROCEDURES

- Portfolio management processes
- Trading practices
- Proprietary trading of the adviser and personal trading activities of supervised persons
- The accuracy of disclosures made to investors, clients, and regulators
- Safeguarding client assets from conversion or inappropriate use by advisory personnel
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction
- Marketing advisory services
- Processes to value client holdings and assess fees based on those valuations
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans



RULE 38a-1 ADOPTING RELEASE, MINIMUM ADDITIONAL EXPECTATIONS FOR A FUND'S COMPLIANCE POLICIES AND PROCEDURES

- “Funds’ ... policies and procedures should address the issues we identified for investment advisers above. In addition, we expect policies and procedures of funds (or fund service providers) to cover certain other critical areas.”
 - Pricing of portfolio securities and fund shares
 - Processing of fund shares
 - Identification of affiliated persons
 - Protection of nonpublic information
 - Compliance with fund governance requirements
 - Market timing





Annual Review Process



ANNUAL REVIEW

- Compliance rule requirements
- Testing schedule
- Identify high risk areas
 - A high risk area may exist where there is either a high **likelihood** that an error may occur (e.g., a manual process) or the **magnitude** of a potential error is great (e.g., improper valuation)
 - Higher risk exists wherever there is a strong incentive (financial or otherwise) to act against shareholders' best interests (e.g., personal trading)
- Remediation schedule
- Leverage work being done by others
- Maintain documentation



ANNUAL REPORT

- Written report to the board must discuss:
 - Operation of the program
 - Material changes to the program
 - Material compliance matters
- Annual report considerations
 - Discuss with the board the scope, content and structure of the report
 - Provide a “road map” of annual review process, rather than just focusing on results
 - Recordkeeping: retain reports and supporting documentation for at least five years and the past two years must be easily accessible



MATERIAL COMPLIANCE MATTER

- Compliance rule definition
 - any compliance matter about which the board would **reasonably** need to know to oversee fund compliance
 - violations of federal securities laws
 - violations of policies and procedures
 - weakness in design or implementation of policies and procedures





SEC Exams and Enforcement



REGULATORY ENVIRONMENT

- Aggressive enforcement environment even as “broken windows” recedes for mutual funds and advisers
- Increasing use of big data
 - Monitoring and Analytics GUI for Investment Management Companies (MAGIC)
- New reporting requirements result in more information available to regulators
- Enforcement Division – Asset Management Unit
- Division of Economic and Risk Analysis (DERA)
- Increasingly complex regulatory environment
- SEC Staff guidance details compliance expectations
- OCIE Risk Alerts



CCO LIABILITY

- SEC Commissioner Peirce's 2018 statements
 - She does not support holding compliance officers individually responsible in the case of "honest mistakes"
 - She believes CCOs should be held accountable when they help to commit or cover up fraud
- SEC actions against CCOs have tended to involve compliance officers who:
 - affirmatively participated in the underlying misconduct,
 - helped mislead regulators,
 - wear multiple hats including as CCO while engaging in misconduct, or
 - had clear responsibility to implement compliance programs and wholly failed to carry out that responsibility.



SEC STAFF GUIDANCE UPDATES ON COMPLIANCE MATTERS

- SEC Staff issues Guidance Updates that include expectations of compliance with Rule 38a-1, and address compliance issues that are relevant to many investment advisers and funds
- Business Continuity (June 2016)
- “Distribution in Guise” (January 2016)
- Cybersecurity (February 2015)
- Gifts and Entertainment (February 2015)
- Compliance with Exemptive Orders (February 2013)





Code of Ethics



RULE 17j-1

- Prohibits any affiliate of a fund or its adviser or principal underwriter from engaging in fraudulent conduct in connection with the purchase or sale of a “Covered Security” held or to be acquired by the fund.



RULE 17j-1: “COVERED SECURITY” DEFINED

- The rule applies to any “Covered Security” which includes all securities, except:
 - U.S. government securities;
 - Banker’s acceptances or CDs;
 - Commercial paper and high quality short-term debt instruments; and
 - Shares of registered open-end funds.



RULE 17j-1: CODE REQUIREMENT

- Each fund, adviser and affiliated principal underwriter must adopt a written code of ethics to prevent “Access Persons” from engaging in prohibited conduct.
- Fund board of directors/trustees (including a majority of the independents) must approve such codes.
- Fund board also must approve any material changes to such codes within 6 months.



RULE 17j-1: “ACCESS PERSON” DEFINED

- “Access Person” of a fund or adviser generally includes:
 - Any director, officer, general partner or employee of the fund or adviser who, in connection with his/her regular duties, makes, participates in, or obtains information regarding, transactions in Covered Securities by a fund, or whose functions relate to the making of any recommendations with respect to such transactions; and
 - Any natural person in a control relationship to the fund or adviser who obtains information concerning recommendations made to the fund with regard to fund transactions in Covered Securities.



RULE 17j-1: “ACCESS PERSON” DEFINED

(CONTINUED)

- “Access Person” of a principal underwriter generally includes any director, officer or general partner who, in the ordinary course of business, makes, participates in or obtains information regarding, fund transactions in Covered Securities, or whose functions or duties in the ordinary course of business relate to the making of any recommendations to the fund regarding fund transactions.



RULE 17j-1: CODE ADMINISTRATION

- Funds, advisers and affiliated underwriters are required to:
 - Use reasonable diligence and institute procedures to ensure code compliance;
 - Furnish a written report to the fund's board at least annually describing any issues and material violations arising under the code since the last report;
 - Certify at least annually that they have adopted procedures reasonably necessary to prevent "Access Persons" from violating the code; and
 - Maintain records required by the rule.



RULE 17j-1: REQUIRED REPORTS

- Access Persons must submit the following reports:
 - Initial Holdings Report;
 - Annual Holdings Reports; and
 - Quarterly Transaction Reports.
- Independent directors/trustees generally do not have to submit reports, but are required to submit Quarterly Transaction Reports under certain circumstances.



RULE 17j-1: REQUIRED PRE-APPROVALS

- “Investment Personnel” (i.e., those who make purchase and sale recommendations) must obtain approval from the fund or the fund’s investment adviser for purchases in any IPO or private placement.



RULE 17j-1: DISCLOSURE

- A fund must disclose in its prospectus or SAI whether:
 - The fund and its adviser and underwriter have adopted codes of ethics; and
 - The codes permit personnel subject to the codes to invest in securities for their own accounts, including securities in which the fund may invest.
- A fund and its adviser and underwriter also must file their codes of ethics with the SEC as an exhibit to the fund's registration statement.





Questions?



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