

Top Issues for Today's CCO

By: C. Meyrick Payne and Sara Yerkey of Management Practice Inc. (MPI)

After five full years of existence the responsibilities of the Fund CCO need reexamining. Of course, Rule 38a-1 of the Investment Company Act specifies that the CCO shall ensure that the Fund complies with all of the Securities Laws, but the practical problems associated with being accountable to the fund board, building an annual compliance plan, setting priorities, securing resources, and taking corrective action, have all changed since October 2004. This Bulletin will examine some of the professional and personal issues facing today's CCO.

PROFESSIONAL ISSUES

Probably the most important new concept to emerge in the past five years for CCOs has been the emphasis on risk-based compliance. The use of risk maps has become more popular; often these are a graphical representation of risk assessments for every step in the mutual fund process, from customer solicitation to fund redemption. From this map of basic risk, the compliance process (together with external and internal audit, and corporate and investment risk management) is plotted on the same map to provide a map of "residual risk".

Since 2004 CCOs have been asked to exercise substantial business judgment in support of the fund directors' legal obligations. Principal among these are compliance with all aspects of the prospectus, being mindful of the compatibility of portfolio investments, and participating in the valuation of portfolio assets (particularly with the advent of FASB 157).

Of particular import to the CCO is the oversight of numerous service providers, particularly the transfer agent, custodian and any sub-advisors or securities lending agents. CCOs are increasingly required to supplement standard compliance certification with in-depth site visits to the service provider locations.

Increasingly CCOs are expected to play a role in ensuring that the fund obtains "best execution". To do this the CCO must have a working knowledge of the trading process, ranging from the order management system to the allocation of brokerage. Of course, the oversight of aspects of trading which outside parties find valuable is particularly important; allocation of trading volume, assignment of "easy trades", and the first call when a security is offered for sale or sought for purchase.

As always the compliance process surrounding "soft dollars" is critical. Soft dollars are to mutual funds the way off balance sheet assets are to a commercial corporation. As such they have to be monitored very carefully. CCOs have to be mindful of the way in which soft dollars are created and how and for what they are expended, especially the redemption premium charged for third party research.

An aspect of the Securities Laws which has until recently been insufficiently monitored is the improper use of inside information. At the very least the CCO should obtain assurances, and subsequently test the veracity that inside information is not the basis of portfolio decisions. As the

Galleon hedge fund case is proving, CCOs and everyone else will have great difficulty in distinguishing between illicitly obtained inside information and cleverly assembled market intelligence. A root cause for the creation of the fund CCO position was related to raising fund assets; late trading, market timing and the sale of portfolio information all in exchange for “sticky” assets or other favors. Sometimes these favors take the form of revenue sharing or some other “quid pro quo”. Any such transaction can be construed as violations of the securities laws. As such they are very much within the purview of the CCO. Similarly the monitoring of fund sales practices is important for CCOs, including the appropriate imposition of investment suitability standards, the application of volume sales discounts, and the accurate portrayal of fund performance.

All of these professional responsibilities of the CCO require diligent monitoring and the active cooperation of compliance professionals within the advisor’s organization. A CCO cannot succeed unless he or she can build on a culture of compliance set from the very top of the fund manager’s team, and motivate the line executives (often referred to as business owners) to cooperate with agreed compliance procedures.

Even with good buy-in from the business owners, the CCO still has to secure adequate resources to complete a very large compliance task. Often the organizational choice comes down to a wholly centralized compliance function (in which case the CCO may have 20, 30 or even 100 staff in a very large complex) or a decentralized compliance function, which is centrally monitored. This latter organization model is more typical since it allows for the professional line executives, who have a fiduciary responsibility to the fund shareholders, to play a large role in the compliance function. In either case the CCO is expected to test and verify the compliance procedures.

PERSONAL ISSUES

The issue for the fund CCO personally amounts to this: does CCO stand for “career clearly over” or does it stand for “career changing opportunity”. One is distinctly bad; the other full of optimism and challenge.

By law the CCO is accountable to the fund board but in practice this is modified by everyday considerations. Who performs the CCO evaluation (especially if the fund CCO also serves as the advisor CCO)? Who determines the bonus and on what basis? To whom does the CCO report to administratively? What authority does the legal department have over the CCO? Is the CCO accountable to the CCO of the advisor’s parent company?

Then there are many compensation issues, such as: does the CCO qualify for any part of the long-term equity participation plan of the advisor or its parent company? Is there a career plan for the CCO? Is there a next step in the corporate ladder or has the CCO reached the top? Does the CCO have an employment contract? What severance provisions are in place if the CCO falls short of the ideals set by the board or the compatibility sought by the advisor?

In every case the CCO has one of the riskier positions in the industry. He or she can fail relatively easily to live up to the exceedingly difficult standards, and if he does it can be very difficult to secure another job. Furthermore the SEC and the plaintiff’s bar have a long memory and can unexpectedly reach back many years to jeopardize, or even terrorize, a CCO’s retirement.

Contact: C. Meyrick Payne
Management Practice Inc.
216 West Hill Road, Suite 200
Stamford, CT 06902

Phone: (203) 973-0535
Email: MPayne@MFGovern.com
Fax: (203) 978-9034
Website: www.MFGovern.com