

What Separates the Best CCOs from the Rest?

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The passage of the Dodd-Frank Act in July 2010, along with regulators' increased emphasis on risk management, is heightening the importance of having the right person in the chief compliance officer role.

Red flags should go up if the investment advisor and the fund board have anything but full confidence in the CCO's ability to carry out compliance responsibilities in today's more stringent regulatory landscape. All signs indicate that demand for skilled CCOs will only continue to increase.

For example, the new whistle-blower rule under the Dodd-Frank Act may create an environment in which employees will be encouraged to bypass internal compliance programs in favor of going straight to the SEC with potential issues. The law provides a perverse incentive for sidestepping the CCO, in that whistle-blowers with original information leading to a successful enforcement action with sanctions of at least \$1 million can receive 10% to 30% of those penalties. It's safe to predict that CCOs with excellent skills will be needed to foster a firm-wide compliance culture where employees feel compelled to come to the compliance staff first. In light of these and other impending regulatory changes, investment advisors and boards would be wise to clearly define the skills that their CCO must have. Here are some essential characteristics.

Professional Skills

A firm knowledge of securities laws. Rule 38a-1 of the Investment Company Act and Rule 206(4)-7 of the Investment Advisers Act make clear that the CCO's underlying objective is to "to prevent, detect and correct violations of the securities laws." Consequently, it is of utmost importance that the CCO have a thorough working knowledge of the securities laws. That does not indicate that the CCO must be a trained '40 Act lawyer; the CCO could be an accountant or operations person who receives effective guidance from the general counsel's office.

A strong understanding of the fund business. Another important trait is a comprehensive and constantly evolving knowledge of the fund business. Often the CCO is an executive with many years of experience in the organization or at similar firms. The ability to understand the structure, procedures and process of the company is crucially important, as is the ability to collect information through informal channels.

Possesses analytical abilities. The CCO has to have excellent analytical skills. The SEC has placed considerable emphasis on "forensic" tests. Devising applicable and realistic tests to ensure early detection of breaches in the securities laws is a critical professional skill for the CCO.

Identifies risks and discusses them internally. The CCO must be able to recognize risk and communicate it effectively. The SEC has specified that compliance programs should be risk-based. Typically a successful compliance program starts with a comprehensive risk map that highlights which

processes are most susceptible to deliberate or inadvertent error. The CCO then puts a compliance program in place to ameliorate these risks.

The CCO's ability to assess investment risk is an interesting topic. This is often not emphasized, as investment risk is seen as being the province of portfolio managers and their staff. The best CCOs ensure that their professional development plans include the assessment of investment risk, even if such skills are not a current job requirement. They understand that investment risk assessments are quite different from evaluating compliance risk or even enterprise risk.

Deals effectively with regulators. The ability to reassure the SEC and other regulatory bodies that the compliance program is effective stands out as another crucial skill. In addition, the CCO has to command the respect of the board, which often relies on the analytical work of the CCO to enforce the tone at the top. Whenever the SEC visits a fund group or any other organization under its jurisdiction, the CCO is often the first and last person they talk to.

Personal Skills

Passionate about the job. The most important personal skill is to have a passion for ethical conduct and compliance. While some may consider the compliance process expensive or troublesome, the CCO must passionately believe that the fund business could not exist, and certainly could not command the trust of investors and regulators, without top-class compliance.

Inspires others within the company. The CCO has to have the ability to lead principally through inspiring confidence and respect among executives and staff who do not report directly to the CCO. Many successful compliance plans are based on the organizational principle of "decentralized compliance: centrally monitored." Within this structure, the CCO is the recipient of compliance information from departments within major business units of the organization. The CCO is unlikely to have a large staff and will rely instead on the cooperation of other personnel that do not report directly to the CCO. That makes qualitative skills such as leadership, team building and trustworthiness all the more important for this compliance operations structure.

Excellent interpersonal skills. While all of the professional skills are imperative, both the combination of the professional and personal skills are not effective unless the CCO is able to communicate effectively with all levels of the firm as well as the Board. Cohesiveness and interaction transforms the compliance function from an ineffective checklist that can create hostility, to a comprehensive risk assessment program that is effective for the current and future environment.

When senior executives and the board search for a CCO to undertake today's growing challenges, they should have these skills in mind. Not having a successful CCO and compliance program could have negative implications not only for the fund, but for employees, shareholders and all other stakeholders.