

may have felt they were not in a position to approach the board.

To address these concerns, rule 38a–1 provides fund boards with direct access to a single person with overall compliance responsibility for the fund who answers directly to the board. The rule provides the board with a powerful tool to exercise its oversight responsibilities over fund compliance matters. The new rule also strengthens the hand of compliance personnel by establishing a direct line of reporting to fund boards that is not controlled by management.⁸⁷ We have observed that compliance failures have occurred when a fund service provider has denied information to the fund's board, or has been less than forthright, because the service provider viewed full disclosure as detrimental to its own interests. Under the new rule, the chief compliance officer will be responsible for keeping the board apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund's compliance program.

We expect that a fund's chief compliance officer will often be employed by the fund's investment adviser or administrator.⁸⁸ We are not adopting a requirement that the chief compliance officer be employed by only the fund because we believe that such a provision would actually weaken her effectiveness. Funds today typically have no employees, and delegate management and administrative functions, including the compliance function, to one or more service providers. If we were to preclude the chief compliance officer from being an employee of an adviser or any other service provider, she would be divorced from all fund operations.⁸⁹ The adviser's chief compliance officer would continue to administer the adviser's compliance programs, and the role of the fund's chief compliance officer would be limited to oversight of the service

providers' compliance policies and providing advice to the board on their operation. As a result, the fund's chief compliance officer would be almost entirely dependent on information filtered through the senior management of the fund's adviser rather than, for example, information received directly from a trading desk. Moreover, fund management would be unlikely to consult with an "outside" compliance officer on a prospective business decision to ascertain the compliance implications.

We recognize, however, that a chief compliance officer who is an employee of the fund's investment adviser might be conflicted in her duties, and that the investment adviser's business interests might discourage the adviser from making forthright disclosure to fund directors of its compliance failures. The rule, as adopted, is designed to address these concerns by requiring a fund's chief compliance officer to report directly to the board. The board, and the board alone, can discharge the officer if she fails to live up to the position. Thus, a chief compliance officer who fails to fully inform the board of a material compliance failure, or who fails to aggressively pursue non-compliance within the service provider, would risk her position. She would also risk her career, because it would be unlikely for another board of directors to approve such a person as chief compliance officer.⁹⁰

The chief compliance officer, in exercising her responsibilities under the rule, will oversee the fund's service providers, which will have their own compliance officials. A chief compliance officer should diligently administer this oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The chief compliance officer should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks. She should maintain an active working relationship with each service provider's compliance personnel. Arrangements with the service provider should provide the fund's chief compliance officer with direct access to these personnel, and should provide the compliance officer with periodic reports and special reports in the event of compliance problems. In addition, the fund's contracts with its service

providers might also require service providers to certify periodically that they are in compliance with applicable federal securities laws, or could provide for third-party audits arranged by the fund to evaluate the effectiveness of the service provider's compliance controls.⁹¹ The chief compliance officer could conduct (or hire third parties to conduct) statistical analyses of a service provider's performance of its duties to detect potential compliance failures.⁹²

D. Recordkeeping

New rule 38a–1 (for funds) and amendments to rule 204–2 (for advisers) require firms to maintain copies of all policies and procedures that are in effect or were in effect at any time during the last five years.⁹³ In addition, new rule 38a–1 will require funds to maintain materials provided to the board of directors in connection with their approval of the fund's and its service providers' policies and procedures and the annual written reports by the fund's chief compliance officer.⁹⁴ New rule 38a–1 and amended

⁹¹ Mutual funds already rely on these types of measures in connection with their responsibility to ensure that their service providers carry out anti-money laundering compliance programs. Rules under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107–56 (USA PATRIOT Act) require funds to maintain procedures reasonably designed to prevent them from being used for money laundering or the financing of terrorist activities. *See, e.g.,* Anti-Money Laundering Programs for Mutual Funds, 67 FR 21117, 21119 (Apr. 29, 2002) (mutual fund may contractually delegate functions under 31 CFR 103.130 to a service provider, but must take steps to ensure that the service provider's compliance program is reasonably designed, and to monitor its implementation and ensure its effectiveness).

⁹² In the case of an insurance company separate account, the principal service providers typically will be the sponsoring insurance company. Therefore, the chief compliance officer must oversee the insurance company's compliance program with respect to the separate accounts, including the processing of new account applications, premium payments, and exchanges.

⁹³ Rules 38a–1(d)(1) and 204–2(a)(17)(i). As discussed above, the required policies and procedures do not all need to be contained in a single document. *See supra* text following note 22. We understand many firms issue policies and procedures in loose-leaf form, distributing revised sections periodically within their firms. These firms may comply with the recordkeeping requirements by keeping the current policies and procedures and retaining the superseded section(s) for the requisite period of time, so long as the firm can indicate to our examining staff the version of compliance policies and procedures that were in effect as of a given date.

⁹⁴ Rule 38a–1(d)(2). In a change from proposed rule 38a–1, funds will have to maintain materials provided to the board of directors in connection with their approval of service providers' policies and procedures in addition to the annual compliance report. These records must be maintained for at least five years after the end of the fiscal year in which the documents were

⁸⁷ Rules 38a–1(a)(4)(ii) (providing that the board's approval is required to remove the chief compliance officer) and 38a–1(a)(4)(iii) (requiring the chief compliance officer to provide a written compliance report to the board).

⁸⁸ Indeed, she is likely to be the chief compliance officer of that organization inasmuch as the duties of the positions will have significant overlap. Alternatively, the chief compliance officer of the fund may be another member of the adviser or administrator's legal or compliance departments.

⁸⁹ Internalizing the compliance function while retaining an externalized management function would also raise a number of practical issues, such as whether the chief compliance officer could use the adviser's office space and other resources, including support staff. In addition, it would be costly for funds, particularly small funds, to hire a chief compliance officer and pay her benefits. Those costs would be borne by investors.

⁹⁰ If such a person were approved by another fund, our staff would enhance its scrutiny of the fund accordingly.