

Assessing the Adequacy and Effectiveness of a Fund's Compliance Policies and Procedures

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INTRODUCTION

The Investment Company Institute has prepared this paper to assist chief compliance officers (“CCOs”) and others in connection with the review and reporting requirements for fund compliance programs under Rule 38a-1 under the Investment Company Act of 1940. This paper discusses:

- The regulatory framework governing the annual review and report requirements;
- The process for planning annual reviews – the CCO’s role and issues to consider;
- The principal options available in conducting reviews, including interviews, observations, data testing, trend analysis, and reports;
- Considerations in evaluating the continued usefulness of prior assessments;
- Considerations regarding the types of tests and reports to use in future reviews;
- The process for preparing and presenting annual reports to fund boards; and
- Related recordkeeping requirements.

REGULATORY FRAMEWORK

Rule 38a-1 under the Investment Company Act of 1940 requires funds to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws.¹ The rule requires the fund’s policies and procedures to provide for the oversight of compliance by the fund’s investment adviser(s), principal underwriter(s), administrator(s), and transfer agent(s) (collectively “service providers”). Funds must review at least annually the adequacy of their and their service providers’ policies and procedures as well as the effectiveness of their implementation.

Rule 38a-1 requires funds to designate a CCO who is responsible for administering the fund’s compliance policies and procedures² and who must at least annually provide a written report to the fund’s board that addresses:

- The operation of the fund’s and its service providers’ policies and procedures;

¹ See *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, SEC Release Nos. IA-2204, IC-26299 (Dec. 17, 2003) (“Adopting Release”). A copy of the Adopting Release is available on the SEC’s website at <http://www.sec.gov/rules/final/ia-2204.htm>. The rule defines “federal securities laws” to include the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, rules adopted by the Commission under these statutes, and the Bank Secrecy Act and the rules thereunder as they apply to funds.

² Rule 206(4)-7 under the Investment Advisers Act of 1940 requires federally registered investment advisers to: adopt and implement policies and procedures reasonably designed to prevent violations of the Investment Advisers Act; conduct annual reviews of the adequacy of the policies and procedures and the effectiveness of their implementation; and designate a CCO responsible for administering the adviser’s policies and procedures. While this paper is designed to assist fund CCOs in conducting annual reviews under Rule 38a-1, the guidance may also be useful in meeting an adviser’s obligations under Rule 206(4)-7.

- Any material changes made to those policies and procedures since the CCO’s last report;
- Any material changes to the policies and procedures that were recommended as a result of the annual review; and
- Each material compliance matter³ that occurred since the date of the last report.

In addition, the rule imposes specific recordkeeping requirements. Among other things, funds are required to maintain any records documenting their annual compliance reviews as well as copies of the written compliance reports required to be provided by the CCO to the fund’s board.

Although Rule 38a-1 requires compliance reviews and reports to be undertaken *at least annually*, such reviews and reports may occur on a more frequent basis. For example, for some funds, compliance reviews may occur on an ongoing basis throughout the year. Similarly, some CCOs may provide reports to the fund’s board more frequently than annually. Because Rule 38a-1 contemplates *at least annual* reviews and reports, this paper generally refers to annual reviews and reports, notwithstanding that, for certain fund groups, such reviews and reports may occur more frequently.

PLANNING ANNUAL REVIEWS

Rule 38a-1 does not prescribe how funds should conduct compliance reviews or who should conduct them. As a result, funds have ample flexibility to design and carry out compliance reviews in a manner that best suits their particular circumstances.⁴ The level of a CCO’s direct involvement in the review of compliance policies and procedures will likely vary from fund complex to fund complex and may vary from year to year. A CCO’s involvement in the annual review process may depend on a number of factors, including, among other things, the size of the fund organization and the complexity of its operations. For example, in the case of certain small fund groups, the CCO may be directly involved in the review, including testing particular compliance functions. In many other cases, the CCO’s role will focus primarily on planning and coordinating compliance reviews, and reviewing the results of tests and analyses performed by others.

To facilitate annual reviews, CCOs may want to develop an overall review plan. Such a plan may assist CCOs in identifying those areas to be reviewed, how they should be reviewed, and the resources available in conducting the review. Developing an overall plan for the review may also assist CCOs in establishing a timetable to assure that the annual report to the fund’s board will be completed within the timeframe required by the rule.⁵

³ Rule 38a-1(e)(2), which defines “material compliance matter,” is discussed under “The CCO’s Annual Reports to the Board” on page 16.

⁴ As SEC Chairman Cox has noted, “‘one size fits all’ is not going to work when it comes to compliance – [n]o two advisory firms are exactly alike.” *Speech by SEC Chairman: Opening Message before the CCO Outreach National Seminar*, Washington, DC (November 8, 2005). Chairman Cox’s remarks are available on the SEC’s website at <http://www.sec.gov/news/speech/spch110805cc.htm>.

⁵ The rule requires CCOs to present the annual report to the board within 60 days of the completion of the annual review. The first annual review must be completed within 18 months of the date the fund’s board approved the fund’s policies and procedures.

A key part of the planning process is determining the scope and focus areas of the review. The SEC has indicated that the CCO's annual reports to the board should include a discussion of the fund's particular compliance risks.⁶ For that reason, CCOs may consider devoting particular attention in compliance reviews to those areas of the fund's operations that present the greatest potential risks. CCOs may find it useful to consider the following questions:

- Does the area pose higher compliance risks or higher risks of resulting in material compliance matters, such as in the case of determining the fund's net asset value?
- Does the area present a high likelihood of potential conflicts of interest, such as personal trading by portfolio managers or the allocation of trades involving initial public offerings, and if so, are internal controls in place that offset or mitigate any such risks?
- Have there been important changes in the policies and procedures governing the area during the last year?
- Has the area experienced compliance problems or issues since the last review or since applicable policies and procedures were last changed?
- What is the expertise and level of training provided to the staff responsible for implementing and/or reviewing the fund's policies and procedures?
- Has the area experienced changes in the management or staff responsible for implementing applicable policies and procedures?
- Has the area been the subject of feedback provided to the fund or its service providers in regulatory inspections?
- Has the area been affected by regulatory developments (*e.g.*, the SEC's adoption of a new rule)?

As part of the planning process, CCOs may want to identify any reviews conducted by others, such as by compliance, internal audit and/or risk management personnel, or by the adviser's CCO if different from the fund's CCO. CCOs may want to ascertain in particular:

- What reports (*e.g.*, trend analyses, exception reports) are currently being generated by the fund and its service providers for particular operational areas and the frequency of such reports;
- What types of reports can be produced by the fund and its service providers upon request and the amount of lead time needed for their production; and
- What types of transactional data are available (in the event the CCO decides transactional tests are warranted or appropriate).

This information may assist CCOs in evaluating the timing and expenditure of resources associated with the annual review and reporting obligations.

Although not required by Rule 38a-1, documenting the planning process may be useful to CCOs in connection with both the current and future reviews. It may also be beneficial to

⁶ Adopting Release at fn 82.

have this information available for the fund's board and regulators to reflect the process the CCO used to determine those areas that were reviewed or received greater scrutiny during the review. If CCOs elect to document the planning process, they can do so through a variety of means, including, for example, by creating risk matrices, bullet points, outlines, charts, or memoranda. Consistent with the rule's recordkeeping requirements, any records documenting the annual review should be retained.

OVERVIEW OF TESTING OPTIONS

Rule 38a-1 does not impose specific requirements on how annual reviews must be conducted – nor does it require any specific tests to be performed. Instead, the rule leaves this decision entirely to the fund's discretion, subject to the board's oversight. In conducting inspections, SEC staff can be expected to request documentation substantiating that a fund, as part of the annual review, has tested the effectiveness of its policies and procedures and control processes. For example, the SEC has required funds, as part of routine inspections, to provide documents that demonstrate the effectiveness of the fund's control processes, including, among other things, exception reports, completed compliance checklists, and supervisory approval of overrides. CCOs may wish to keep these requests in mind as they formulate and document their annual reviews.⁷

Discussed below are tests CCOs and others may consider using, either individually or in combination, to assess the effectiveness of policies and procedures. In reviewing these options, it is important to keep in mind that conducting compliance reviews under Rule 38a-1 is an evolving process. As those involved in the testing process gain more experience with the different testing methods, and as new or modified methods for testing policies and procedures develop over time, the number and types of tests used to review particular compliance functions may change. CCOs and others will continue to monitor and evaluate such developments and recommend changes to the testing process as circumstances warrant.

INTERVIEWS

Individual interviews may enable the interviewer to obtain specific information about an individual's or group's role in implementing particular policies and procedures. Interviews may play a role in annual reviews in a variety of ways. For example, they may enable the interviewer to:

- Determine whether the employees involved in implementing a particular procedure fully understand their roles and responsibilities;
- Assess how supervisors oversee the work of their employees;
- Evaluate, over the course of discussions with a variety of persons involved in a process, the consistency of responses to similar questions, so as to assess whether compliance

⁷ Because particular tests or reports in certain circumstances may have limitations, using a combination of tests may, depending upon the facts and circumstances, facilitate the corroboration of discrete test results, provide context to results, or confirm information in a report received from others.

policies and procedures in a given area are understood similarly by the employees charged with their implementation;

- Determine whether policies and procedures need to be revised to conform to actual practices, comply with applicable regulatory requirements, or address compliance concerns identified through the interview process; and
- Confirm and provide context to findings after a test has been completed or a compliance report has been reviewed and enable employees to provide feedback on the conclusions reached.

For those compliance areas that are intangible in nature, such as evaluating an employee's understanding of his or her compliance obligations, interviews may be a particularly well-suited assessment method. For example, using interview questions such as “describe for me how” or “what would you do if” may allow the interviewer to determine whether the interviewees understand and feel comfortable with their reporting and other obligations.

Persons conducting interviews may find it useful to create an agenda of the intended topics to be covered. Interviews, for example, might include questions focusing on the compliance responsibilities of the interviewee, whether and how violations would be detected if they exist, reporting lines and protocols should a compliance violation occur or a compliance issue arise, and the interviewee's opinion as to the effectiveness of the policies and procedures.

Records documenting annual reviews must be retained in compliance with the record-keeping obligations of the rule. In addition, CCOs and/or others responsible for the fund's recordkeeping obligations under the rule may want to evaluate whether any documentation relating to communications with in-house or outside counsel are protected under the attorney-client privilege and, as a result, may be earmarked or otherwise segregated from other records.

OBSERVING ACTIVITIES

Another type of test that may be used in connection with compliance reviews involves observing firsthand how particular policies and procedures are being implemented in the operating environment. In performing this type of test, the observer may want to ask “show me” or “how would you respond if” type of questions when observing activities as they take place. As with interviews, observation testing may play a role in annual reviews by providing the observer:

- An understanding of whether and how compliance exceptions may occur, including how they are identified, reported, and remediated;
- The opportunity to evaluate how staff and managers address both routine and non-routine issues (*e.g.*, exceptions to standard practice) as they arise, and the factors that impact their judgment in addressing and resolving such issues; and
- The ability to understand how particular reports are generated, including automated or manual controls relating to the creation, review, and maintenance of such reports.

The information gained from observing activities can then be compared to the fund's written policies and procedures to determine whether the activities observed conform to the policies and procedures and whether the policies and procedures are operating effectively.

TESTING TRANSACTIONAL DATA

Tests of transactional data (*e.g.*, reviewing securities trades) may provide firsthand knowledge of whether compliance policies and procedures are adequate and working as intended. Transactional testing may be conducted in two ways. One process involves an initial testing of data to confirm that policies and procedures are being implemented effectively. Another process involves retesting data or reperforming transactions to confirm either the results of tests conducted by others or the accuracy and completeness of the information included in reports.

Prior to conducting transactional testing – regardless of the type of test to be conducted – the person performing the test (the “tester”) may want to consider the following questions:

- What is the purpose of the test – *i.e.*, why is the test being conducted?
- What type of data is needed for the test?
- How much data is needed (*e.g.*, will a random sampling of data or a sample size be used)?
- What period of time should the data cover?
- Is the data readily available to the tester or will it need to be produced? If it needs to be produced, how much time will it take to perform the testing?
- In what form is the data maintained (*e.g.*, is the data automated or manual)?
- How will the data be tested and what resources will be necessary to conduct the test (*e.g.*, are there automated or manual processes that will be used)?
- Has the data been subjected to similar testing by others, such as an internal or external auditor? If so, to what extent can the results of that testing be used?
- Will the test, upon completion, enable the tester to determine the adequacy and effectiveness of particular procedures?

As an example, a member of the CCO's or Compliance Officer's staff may decide to test the controls in place relating to the fund's performance disclosures by recalculating fund performance. In applying some of the considerations outlined above, this may involve: (i) ascertaining where and how the performance data is maintained; (ii) identifying how and by whom performance calculations are performed; and (iii) determining whether the recalculation has been performed by other parties (*e.g.*, internal audit). Understanding these issues could help make the testing process more efficient.

Initial Testing

Testing data may determine whether particular policies and procedures have been followed. For example, assume a fund imposes a 2 percent redemption fee whenever a shareholder

redeems shares within 30 days of purchase. Testing whether the redemption fee was imposed in accordance with the fund's policies and procedures requires two pieces of information – those trades redeemed within 30 days of purchase and the redemption fees imposed on the trades. This information may be maintained in electronic files by the fund's transfer agent and made available for testing upon request.⁸ The person conducting the test could obtain from the transfer agent either all data for a specified period of time (*e.g.*, one month's trading records) or a random sampling of records for a different period of time (*e.g.*, data from the first calendar week of the most recent four quarters). Once the data is obtained, it can be reviewed to determine whether a 2 percent redemption fee was, in fact, imposed on shares redeemed within 30 days of purchase.

To conduct transactional testing, testers will need to determine the amount and type of data to be tested. There is no one definitive answer as to what constitutes a sufficient data sample. Testers will make that determination as part of the testing design process. One factor influencing this determination is the homogeneity of the transactions to be tested. With homogeneous sets of transactions or data, there are fewer variables that need to be considered and possibly tested. Thus, small sample sizes (in certain cases as few as 5 transactions) can generally be used for similar data. Alternatively, larger sample sizes may be used when there are greater variances in the data. For example, in evaluating best execution, the number and types of trades reviewed may tend to be larger if: (i) the fund holds both fixed-income and equity securities; (ii) the investment adviser uses a mix of trading methods rather than just full-service brokers; and (iii) the fund has more than one investment adviser. In other words, the more processes the fund utilizes that may impact a determination of best execution, the more likely it is that a larger sample of data will be used (in this example, potentially as many as 20 transactions) to ensure that the variety of processes are covered by the testing.

By comparison, external auditors frequently use transaction sample sizes of up to 60 items when testing the effectiveness of a specific set of internal controls. Sample sizes of this magnitude are based on statistical models and may not be necessary for annual reviews. An auditor's use of large sample sizes enables them to gain a level of certainty to issue an auditor's opinion, which is not required under Rule 38a-1.

Retesting Data

Retesting can be used to confirm either the results of tests conducted by others or the accuracy and completeness of information in reports prepared by others. This may be accomplished by reviewing documentation (*e.g.*, a periodic report) evidencing that a process has occurred in accordance with compliance policies and procedures. For example, assume the CCO wants to use retesting to determine whether personal securities trading activities are consistent with the fund's code of ethics. Assume also that the adviser's compliance staff produces a quarterly report summarizing the personal trades of the adviser's employees during the quarter. In retesting this information, the tester may select

⁸ In testing transactional data, CCOs may also want to understand how the data is created and maintained and what data checks or controls were applied to ensure that the universe from which the sample was taken captured and accurately processed the relevant data.

a sample of the individual trade reports filed by the adviser's employees during the quarter and reconcile those to the adviser's quarterly summary reports. Through this process, the tester may determine whether the quarterly reports are accurate and complete. As part of the review, the tester may also inspect individual filings for evidence that appropriate personnel of the adviser have reviewed the filings as required by the adviser's policies and procedures. By virtue of this additional step, the tester can evaluate whether the adviser's oversight process is working as intended and that required records are being maintained.

TREND ANALYSIS

One way to review the effective implementation of policies and procedures over time is through the use of trend analysis. Trend analysis involves the review of data or reports over time from an operational or compliance area to identify whether there is an increase or decrease in a selected occurrence (*e.g.*, the number of failed trades).⁹ The Adopting Release refers to trend analysis in connection with its discussion of an adviser's policies and procedures, and notes that firms may use this method of testing as a means to detect unusual patterns that may be indicative of compliance issues requiring attention.¹⁰

There are several ways to conduct trend analyses. On the one hand, the person interested in performing a trend analysis in a particular area may want to determine if a trend analysis already exists. If the fund's adviser or another one of the fund's service providers has prepared a trend analysis, that analysis could be reviewed to evaluate whether trends exist that suggest potential compliance issues. The analysis also could help to determine whether a change is warranted in the fund's or a service provider's policies and procedures or in the way they are being implemented.

On the other hand, if a trend analysis for an area has not been prepared, a trend analysis can be performed by using existing reports or raw data. Using available reports may be one of the most common ways to conduct trend analyses. Under this approach, a tester may gather reports for a specified time period and compare information from the reports to identify any unusual patterns. For example, a tester could gather a series of exception reports (described on page 10) that identify potential breaches of a fund's investment policies and restrictions. The tester could examine these reports with a view toward identifying a pattern suggesting a change may be appropriate in the fund's policies or procedure or their implementation.

⁹ A trend analysis may be based on a selected statistic, "risk metric" (*i.e.*, a statistic that managers capture to indicate whether the level or risk related to a process is changing), or other indicator.

¹⁰ The Adopting Release states that:

Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the adviser's fulfillment of its duty of best execution), or an analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance information of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities).

Adopting Release at fn 15. In speeches and public statements, the SEC staff have used the term "forensic testing" to refer to trend analysis testing.

A trend analysis may also be conducted by collecting raw transactional data in a given area for a specified period of time (*e.g.*, the number of pre-clearance violations under the fund's code of ethics that occurred in previous quarters). A tester could use the results of this type of trend analysis in the same way described above.

USING REPORTS

There are a variety of reports that may be useful to CCOs in conducting annual reviews, the most common of which are discussed in this section, including the following:

- Periodic Compliance Reports
- Management Reports
- Special Purpose Reports
- Exception Reports
- Reconciliation Reports
- Compliance Certifications
- Internal Audit Reports
- Reports Provided by Third-Party Experts
- Service Provider Reports
- Attestation Reports

Reports vary in their subject matter, their contents, the time periods covered, the persons responsible for their production, and the standards and controls used to produce them. These factors may help in determining whether a particular report demonstrates that policies and procedures were effectively implemented for purposes of conducting annual reviews.

Periodic Compliance Reports

A periodic compliance report is a report that is routinely produced by compliance or other personnel responsible for implementing the compliance function in a particular area. These reports document the compliance function on an ongoing basis, and may consist of a narrative assessment, a compilation of tabulated data, a compliance checklist, or a combination of these. For example, advisory personnel may produce brokerage reports that show that commission payments comply with guidelines established by the fund or that soft dollar usage is consistent with fund policies. These reports may be used, individually or collectively as part of a trend analysis test, in evaluating a particular compliance area.

Management Reports

Management reports are reports produced by the management responsible for a particular function, either at the fund or its service provider. These reports provide an assessment – that may be objective or subjective – of how a particular process or compliance function

is operating. Among other things, management reports may report on the results of operational audits, department reviews, information system audits, investigative audits or reviews, and follow-up audits.

Special Purpose Reports

A special purpose report is a non-routine report that is created specifically to gain insight into a particular process or compliance area. Unlike periodic reports, special reports typically may be produced as a result of the occurrence of a specific event, such as a new regulatory requirement, an emerging area of industry concern, or a compliance failure. For example, in response to concerns over frequent trading in fund shares, some firms used special reports prepared by service providers to assess the impact of market timing on their funds. When available, the results of a special purpose report may provide specific guidance on whether the compliance policies and procedures in a particular compliance area are being followed.

Exception Reports

As the name implies, exception reports are reports that are designed to capture and document activity that departs from, or is inconsistent with, certain defined parameters (e.g. policies and procedures) established by the fund or its service providers.

For example, instead of creating a periodic report detailing all persons who have complied with a fund's code of ethics, the fund's investment adviser may instead produce an exception report, such as a quarterly report that identifies all personnel who have not filed initial, quarterly, or annual holdings reports within the timeframes specified by the fund's policies and procedures. Such reports may be useful in evaluating the effective implementation of the fund's code of ethics.

As another example, assume a fund has a policy of requiring all new hires to sign an acknowledgment of the code of ethics within 30 days of employment. For larger funds, exception reports may be generated quarterly that list all employees who did not provide the acknowledgment within the 30-day period. These reports may be used to determine whether the fund's policies and procedures in this area are adequate and being implemented effectively.

Notwithstanding these examples, the fact that an item is identified on an exception report does not mean that the item is necessarily a compliance violation (e.g., exception reports that identify the number of "as of" trades at the fund's transfer agent within a certain time period). Based on the parameters exception reports are designed to capture, exception reports can be used as a tool to cull through a large amount of data to identify the data that may require further attention or review. In addition, exception reports, when reviewed over time, may be particularly useful in conducting trend analyses. For example, to the extent exception reports indicate a change in the number or substance of exceptions

being reported, this could indicate a possible change (improvement or weakening) in the processing controls governing the area where the exceptions are occurring.

Reconciliation Reports

Certain compliance processes of a fund or its service providers may be regularly reconciled by the parties involved in the process and documented in reconciliation reports. Examples of the areas covered by these reports include a fund's daily reconciliation of its aggregate share transactions to the fund's net cash transactions recorded by the fund's custodian, and the fund's daily reconciliation of its accounting records relating to the aggregate number of shares outstanding to the share balances in individual shareholder accounts. In reviewing compliance processes that require daily or regular reconciliation, reconciliation reports may be used to identify discrepancies and evaluate whether existing processes are adequate and being effectively implemented. To the extent these reports indicate repeated reconciliation discrepancies, this may suggest a need to change the policies and procedures of the fund or its service provider or their implementation to reduce or eliminate such discrepancies.

Compliance Certifications

Management or other persons responsible for producing various reports (*e.g.*, periodic and exception reports) may formally or informally certify that the contents of the report are accurate and complete (*e.g.*, by signing off on the report). Certifications may provide additional assurances when reviewing particular compliance functions. When applicable, it may be useful to confirm that any required certifications are occurring as and when contemplated by the policies and procedures governing that function.

Internal Audit Reports

Internal audit reports are prepared by Internal Audit Departments. Internal audit reports provide an assessment of how specific areas within a fund complex are operating from an internal controls perspective. While internal audit reports may focus on operational and management controls, they may also address issues relating to compliance and regulatory controls. When available, internal audit reports may be useful in determining the amount, type, and results of testing that have been conducted in a particular area.

The ability to use internal audit reports in connection with annual reviews, however, may depend on a number of factors. First, while Internal Audit Departments may be more common in diversified financial services companies, not all investment management firms have Internal Audit Departments. For firms that have Internal Audit Departments, the areas audited and access to internal audit reports may depend on how the Department is structured in terms of reporting lines, which differs from firm to firm. For example, in some firms, internal auditors report to the corporate (adviser's) audit committee, while in others, they report to the fund's audit committee, or to both. As a result of these reporting structures, it may not be feasible to direct the focus or efforts of the internal audit function for purposes of annual reviews. The reporting structure of Internal Audit Departments

may also affect the availability of internal audit reports. For example, internal audit reports may be strictly limited to those audited and to certain other designated individuals (*e.g.*, members of the audit committee). These factors may determine the extent internal audit reports may be used in connection with compliance reviews under Rule 38a-1.

Reports Provided by Third-Party Experts

Compliance reports may be prepared by third parties with specialized expertise (*e.g.*, consultants, auditors, or attorneys). These reports may be commissioned by CCOs, the adviser's personnel, or by one or more of the fund's service providers. Reports prepared by third-party experts may, for example, focus on a service provider's policies and procedures and/or their implementation. These types of reports may also be produced to focus on a specific compliance area. For example, some advisers use reports prepared by firms that specialize in evaluating the quality of a firm's trade execution.

Service Provider Reports

To effectively communicate with a number of fund organizations, service providers may have created reporting systems that generate reports or standard sets of information relating to the service provider's compliance program. These reports, which may be prepared by the service provider or a third party, may be useful in evaluating the effectiveness of a service provider's policies and procedures as they relate to the services provided to the fund. Factors that may be helpful to consider in assessing the information contained in a service provider's report include the following:

- The type and level of detail of the report, including whether the contents of the report are quantitative (*e.g.*, contains transactional information) or qualitative (*e.g.*, contains the service provider's judgment regarding the effectiveness of its policies and procedures);
- The period covered by the report;
- Who was responsible for the report's preparation (*e.g.*, the service provider or a third-party retained by the service provider) and what level of review did management perform of its contents;
- The length of the fund's relationship with the service provider, including the CCO's and/or other personnel's overall knowledge of and experience with the service provider;
- The service provider's responsiveness to the fund's request for information or transactional data;
- The service provider's compliance history, controls, and tests;
- Whether the report provides information on any compliance violations by the service provider, material changes to the service provider's policies and procedures since the last review, and any recommended changes for the future; and

- If compliance violations are noted in the report, whether the report contains information about how they were detected, whether they were material, and any corrective actions taken by the service provider.

Based on these factors, a determination can be made as to whether or not further analysis of the information covered by the report is appropriate.¹¹ The Adopting Release indicates that the use of third-party reports for unaffiliated service providers that provide similar services to a large number of funds will satisfy the annual review requirement if the report describes the service provider's compliance program as it relates to the types of services provided to the fund, discusses the types of compliance risks material to the fund, and assesses the adequacy of the service provider's compliance controls.¹² When using a third-party report, the Adopting Release additionally notes that a fund must also gather and take into account other relevant information, such as the fund's experience with the service provider.¹³

In the case of reports provided by affiliated service providers, additional analysis may or may not be appropriate. On one hand, CCOs and/or others may have firsthand knowledge of the persons responsible for the report, their reporting lines, and how the information in the report was compiled. There may also be greater access to information from the affiliate on an ongoing basis. Based on these considerations, additional information may not be necessary. On the other hand, reports prepared by affiliates may be viewed with greater scrutiny by the SEC staff. As such, additional analysis may be determined to be appropriate.

Attestation Reports

COMPLIANCE ATTESTATIONS

Generally speaking, a compliance attestation refers to an opinion rendered by an auditor on a written assertion provided by management regarding the effectiveness of an entity's internal controls over compliance with specified requirements. For example, management may engage an accounting firm to provide a compliance attestation on management's assertion about the effectiveness of its compliance controls related to the valuation of fund securities. In doing so, management provides a written assertion to the accounting firm describing the compliance controls that govern the valuation process and the objectives of those controls (*e.g.*, that they provide assurance that fund securities are priced accurately and completely using authorized sources). In turn, the auditor expresses an opinion, based on testing, as to whether management's assertion is being achieved. The auditor's opinion can be provided to third parties and, when available, used in connection with annual reviews.

¹¹ If additional information is deemed to be appropriate, the service provider may be asked for back-up data (*e.g.*, exception reports, trend analyses), the service provider's employees' may be interviewed (*e.g.*, those responsible for the report or the compliance function that is the subject of the report), observational testing may be performed (*e.g.*, on-site due diligence), or an outside party may be retained to conduct a more in-depth review.

¹² Adopting Release at fn 35-36 and accompanying text.

¹³ *Id.* at fn 35.

AGREED-UPON PROCEDURES REPORTS

Another type of report that is produced by accounting firms is an agreed-upon procedures (“AUP”) report. With AUP engagements, the auditor and the client firm agree on the procedures to be performed in a particular area to be reviewed. The auditor then prepares a report in the form of procedures and findings that contains, among other things, a list of the procedures performed (or reference thereto) and related findings.

While AUP reports can provide assessments, based on testing, of all or specified parts of a compliance program, the usefulness of these reports for purposes of the annual review requirement may depend on several factors. First, reliance on an AUP report generally is limited to the firm whose procedures form the basis of the report. In other words, if the AUP was commissioned by a party other than the fund, the report may only be provided to the fund if the fund representative, such as a CCO, provides written acknowledgment agreeing to the procedures performed.¹⁴ In addition, the assurance provided by an AUP report is limited in that the findings relate only to the specific procedures performed on the transactions tested. As such, AUP reports do not address other aspects of the compliance area.

SAS No. 70 REPORTS

SAS No. 70 (“SAS 70”) reports are a type of report that has been approved by the AICPA pursuant to Statement on Auditing Standards No. 70. Generally speaking, SAS 70 reports provide an accounting firm’s opinions regarding whether the internal controls of an audited firm’s operations are designed appropriately, given the internal control objectives specified by the audited firm. The report may also include the accounting firm’s views as to whether the controls underlying the audited firm’s control objectives operated effectively during a specified period so that the control objectives were achieved.¹⁵

The result of a SAS 70 audit is an auditor’s report, which may be one of two types. In a Type I SAS 70 report, the auditor expresses an opinion on whether the audited firm’s description of its controls presents fairly, in all material respects, the relevant aspects of the firm’s controls that had been placed in operation as of a specific date and whether these controls were suitably designed to achieve specified control objectives. A Type II SAS 70 report contains, in addition to the opinion provided in a Type I report, the auditor’s opinion as to whether the controls that were tested were operating with sufficient effectiveness to provide reasonable – but not absolute – assurance that the control objectives were achieved during the period specified. It is only the Type II SAS 70 that involves detailed testing of the firm’s controls, which testing typically covers a minimum six-month period.

¹⁴ See American Institute of Certified Public Accountants (AICPA) Codification of Statements on Standards for Attestation Engagements, AT Section 600.38.

¹⁵ Foreign-based accounting firms may have similar reports for non-U.S. service providers (e.g., the FRAG 21 in the United Kingdom).

While the Adopting Release contemplates the use of SAS 70 reports,¹⁶ these reports may have certain limitations in connection with the annual reviews required under Rule 38a-1. First, the objective of SAS 70 reports has traditionally been to assess controls relating to financial statement reporting. As such, these audits may not be well-suited to assessing non-financial controls. Second, SAS 70 reports – even Type II SAS 70 reports – do not provide assurances that the internal controls of a service provider meet the requirements of Rule 38a-1 (*i.e.*, prevent violation of the federal securities laws). SAS 70 reports, however, can provide meaningful insight into whether the specified internal controls, which may be relevant to the service provider’s policies and procedures, are being effectively implemented either at a point in time or for a longer period. Accordingly, it may be useful in connection with annual reviews to determine whether a service provider has engaged an audit firm to perform a SAS 70 review of its internal controls.¹⁷

THE CONTINUED USEFULNESS OF PRIOR ASSESSMENTS

In preparing annual reports, CCOs may need to evaluate the continued usefulness of assessments that were previously conducted to determine whether additional, more current efforts should be undertaken. For example, assume the annual review period is based on a calendar year, and in March, a compliance review is performed relating to policies and procedures in attaining best execution. May the findings from this review be used in preparing this year’s annual report? The answer may depend on a variety of considerations, including whether there have been any changes since the March review to:

- The fund’s policies and procedures governing best execution;
- The fund’s operations relating to trade execution;
- The management or key personnel responsible for selecting broker-dealers and executing fund trades; or
- Regulations or regulatory interpretations that impact determinations regarding what constitutes best execution.

Consideration may also be given as to whether there have been any compliance issues or other events that might impact the results of the March review. To the extent any of these factors apply, their impact can be evaluated to determine whether additional steps should be taken in completing that year’s annual review.

ONGOING ASSESSMENTS AND REPORTS

As CCOs conduct annual reviews under Rule 38a-1, they may want to consider the types of compliance testing and reporting processes that might be put in place to facilitate future reviews or provide periodic feedback on particular compliance areas. For example, if the

¹⁶ Adopting Release at 7-8.

¹⁷ As a result of current limitations of SAS 70s for compliance auditing purposes, accounting firms have been working with the AICPA to develop another type of report tailored to evaluating the effectiveness of a fund’s or its service providers’ compliance policies and procedures. This new report, which is not yet named and has not yet been sanctioned by the AICPA, would reflect the results of an audit of management’s assertions regarding internal compliance controls.

fund has not utilized periodic testing in a particular area, and such testing would benefit the CCO in conducting annual reviews, the CCO may want to consider requesting periodic testing for that area. Similarly, if the CCO determines that as part of the review process it would be beneficial to have more frequent reports from a service provider, or a different type of report to facilitate future reviews, the CCO may want to consider making such requests of the service provider. Incorporating changes such as these may also enable CCOs to become aware of compliance issues as they arise throughout the year. While the rule requires annual reports to the board to discuss material compliance matters that occurred since the date of the last report, the Adopting Release notes that the reporting to the board of all such compliance matters cannot necessarily be delayed until the next annual report.¹⁸

In this regard, CCOs may want to use the annual review as an opportunity to verify that processes are in place to ensure that compliance matters are brought to the CCO's attention as soon as practicable. Such processes will enable CCOs to assess the seriousness of compliance matters to determine whether they indicate material weaknesses in the fund's or its service providers' compliance programs and whether they need to be reported to the board prior to the next annual report.

Finally, as discussed below, CCOs are required to include in their annual reports to the board information regarding material changes made or recommended to the fund's or its service providers' policies and procedures. To facilitate compliance with these requirements, CCOs may want to ensure that processes are in place to receive notification whenever such material changes are made or recommended throughout the year. In addition to ensuring that CCOs are aware of any material changes for reporting purposes, implementing notification processes would enable them to understand on a timely basis why the change is necessary or appropriate. Additionally, CCOs could use the information to determine whether enhanced scrutiny of an area would be appropriate in connection with a particular compliance review.

THE CCO'S ANNUAL REPORTS TO THE BOARD

Rule 38a-1 requires CCOs, at least annually,¹⁹ to provide written reports to fund boards that, at a minimum, address:

- The operation of the fund's and its service providers' policies and procedures;
- Any material changes made to those policies and procedures since the CCO's last report;
- Any material changes to the fund's and its service providers' policies and procedures that were recommended as a result of the annual review; and
- Each material compliance matter that occurred since the date of the last report.

¹⁸ Adopting Release at fn 84.

¹⁹ The report requirement may be satisfied by providing periodic reports to fund boards. For example, CCOs may provide reports on a quarterly basis that cover a rolling 12-month period, or provide quarterly reports over the course of the year that focus on different aspects of the funds' compliance program.

The Rule does not impose content or format requirements on annual reports, but rather leaves this decision to a CCO's discretion, subject to the board's oversight.

Although the contents and level of detail included in annual reports may vary depending on the nature of a fund's operations and the fund's potential compliance risks, annual reports that provide fund boards with meaningful and concise information in understandable language may be particularly helpful in assisting the board in its evaluation of the fund's compliance program. In addition, annual reports that reflect the CCO's attempt to synthesize and analyze the fund's compliance program may provide the board with a tool for the further development and refinement of that program. In contrast, an annual report that is merely a "data dump" of all changes to compliance policies and procedures and a listing of any and all violations of those policies and procedures occurring over the last year may not be useful to the board in helping to identify potential weaknesses or deficiencies in the fund's compliance program.

To facilitate the annual report's serving as a useful tool for the board, a CCO may want to consider discussing the scope, contents, and format of the report with the fund's board or a representative of the fund's board prior to preparing the annual report. This discussion can alert the CCO to the board's expectations or particular concerns regarding the fund's compliance policies and procedures, and provide the board with advance notice of the matters the CCO anticipates covering in the report.²⁰

The scope and contents of annual reports may depend not only on the desires of the fund's board, but also on the nature and contents of other compliance reports the board may have received during the year. It would seem unnecessary for the annual report to restate all of the information previously provided to the board so long as the annual report includes the items listed above that are required under the Rule.

The process of documenting annual reviews as well as the format, scope, and contents of annual reports may vary over time. Several factors may influence the format, scope, and content of annual reports and cause their evolution from year to year, including:

- Guidance from the SEC regarding the contents of annual reports;
- Development of industry practices for annual reports;
- Changes in the nature, size, and activities of the fund complex overseen by CCOs; and
- Comments or suggestions from the board or its representative regarding the annual report.

²⁰ The board and CCO may also wish to consider whether to retain a consultant or special legal counsel to assist in the preparation of the annual report. By its terms, Rule 38a-1 does not require or contemplate the use of such a consultant or special legal counsel. Whether to engage such a professional may depend on a number of factors, such as the nature and complexity of the fund's operations and its compliance risks, the expertise and experience of the CCO, and the CCO's resources and other special circumstances, such as any regulatory deficiencies or other issues that surfaced during the year.

The Operation of Compliance Policies and Procedures

Under Rule 38a-1, annual reports must address the operation of the fund's and its service providers' compliance policies and procedures. CCOs have flexibility in meeting this requirement, as Rule 38a-1 does not specify how a CCO must meet the requirement.

CCOs may want to consider meeting the requirement by including in annual reports a summary of the fund's compliance oversight program. The summary may include some or all of the following topics:

- The duties and functions of personnel responsible for compliance with policies and procedures;
- An overview of the manner in which such personnel identify, resolve, and document compliance issues;
- An explanation of the methods and resources used by the CCO and others in monitoring the fund and its service providers; or
- An explanation of the methods and resources used by the CCO and others in conducting the annual review.

Alternatively, CCOs may want to consider including in annual reports a brief overview of the CCO's assessment of the adequacy and effectiveness of the fund's and its service providers' policies and procedures. This overview may include:

- The CCO's conclusions regarding the overall state of the fund's compliance program;
- An identification of the significant compliance risks faced by the fund; or
- A description of matters the CCO believes would be useful to the board in gaining an understanding of the major compliance issues faced by the fund and its service providers.

Material Changes Made to Policies and Procedures

Rule 38a-1 requires annual reports to describe any material changes made to the fund's or its service providers' policies and procedures since the date of the last report provided to the board. The Adopting Release states that a change is "material" for these purposes if it is a change that a fund director would reasonably need to know to oversee fund compliance. To ensure that all material changes are captured and to lessen burdens at the time annual reports are prepared, CCOs may want to consider implementing a process for identifying and reporting material changes to policies and procedures as the changes are made, rather than at the time of preparing annual reports.

Rule 38a-1 does not describe the specific information or level of detail that CCOs must provide to boards regarding material changes to the fund's policies and procedures or those of its service providers. CCOs may want to consider providing a succinct explanation of the particular policy or procedure that has been adopted or amended and the reason for the adoption or amendment. To facilitate the preparation of annual reports, CCOs may wish

to request from service providers a brief description of any material changes to their policies and procedures, which could be integrated into the annual report.

CCOs may want to consider how to best organize the information regarding material changes to policies and procedures. For example, CCOs may want to consider organizing this information according to:

- The general subject matter implicated by the change (*e.g.*, code of ethics or IPO allocation);
- The entity whose policies or procedures have been amended (*e.g.*, the fund, the adviser, the administrator);
- The reason for the new or amended policy or procedure (*i.e.*, changes in applicable law, identification of a compliance weakness or deficiency, changes to fund structure or service provider relationships); or
- The date the policy or procedure was added or amended.

In addition, CCOs may want to consider whether it would be helpful to present information about material changes in a chart or table that is either part of the body of the annual report or an appendix to the annual report.

Recommendations for Material Changes to Policies and Procedures

Rule 38a-1 requires CCOs to address in annual reports any recommendations for material changes to the fund's or its service providers' policies and procedures. The Adopting Release states that, in recommending any material changes to policies and procedures, annual reports should discuss the fund's particular compliance risks and any changes that were made to the policies and procedures to address newly identified risks.²¹ In meeting this requirement, CCOs may want to consider including in annual reports a succinct description of any recommended material changes and the reason for the recommendation. CCOs may also consider presenting this information in a chart or table that is either part of the body of the annual report or an appendix to the annual report.

Material Compliance Matters

Rule 38a-1 requires annual reports to address each material compliance matter with respect to the fund that occurred since the date of the CCO's last board report. Rule 38a-1(e)(2) defines "material compliance matter" as any compliance matter about which the fund's board would reasonably need to know to oversee fund compliance *and* that involves, without limitation:

- a violation of the federal securities laws by the fund or its service providers;
- a violation of the fund's or its service providers' compliance policies and procedures; or
- a weakness in the design or implementation of the fund's or its service providers' compliance policies and procedures.

²¹ Adopting Release at fn 82.

The definition of material compliance matter under Rule 38a-1 limits the term to matters about which the board would *reasonably* need to know to *oversee* fund compliance. Use of these terms would seem to suggest that annual reports are not required to include each and every possible violation, mistake, error, weakness, or deviation in connection with the fund's and its service providers' compliance policies and procedures. At the same time, in assessing the materiality of compliance matters, CCOs may want to keep in mind that the Adopting Release states that, although individual compliance matters taken in isolation may not be material, such matters may collectively indicate a material compliance matter.²²

Rule 38a-1 does not specify the information that must be provided to the board regarding material compliance matters. When describing any such matters, CCOs may want to consider that this information may facilitate the board's ability to evaluate the adequacy and effectiveness of the fund's and its service providers' policies and procedures, and to take appropriate action to address any potential weaknesses or deficiencies in the fund's compliance program as deemed necessary. CCOs and fund boards may find useful concise, understandable descriptions of any material compliance matter and the manner in which the matter has been, or will be, addressed. The board may request, and the CCO could provide, additional follow-up information regarding the matter as appropriate.

RECORDKEEPING REQUIREMENTS

As CCOs conduct their annual reviews or undertake oversight and testing efforts throughout the year, they should keep in mind the recordkeeping requirements in Rule 38a-1(d). This provision requires funds to maintain:

- A copy of the policies and procedures adopted by the fund under the rule that are in effect or were in effect at any time during the past five years;
- Any documents created relating to the annual review (*e.g.*, transactional data test results, notes from interviews or observations, and reports utilized by the CCO);²³ and
- Copies of annual reports provided to the board, as well as materials provided to the fund's board in connection with its approval of the fund's and its service providers' policies and procedures.

Funds must maintain each of these records for at least five years. The fund's policies and procedures must be maintained in an easily accessible place for the duration of the five-year period. Documents relating to annual reviews and annual reports to the board must be maintained in an easily accessible place for the most recent two years of the five-year period.

²² Adopting Release at fn 84 (stating that such matters may collectively indicate a material weakness in the compliance programs of the fund or its service providers).

²³ While the rule does not require funds to create records documenting annual reviews, if records documenting the fund's annual review are created, they must be maintained.

CONCLUSION

Performing annual reviews under Rule 38a-1 involve determining whether a fund's policies and procedures, and those of its service providers, are reasonably designed and implemented to prevent violation of the federal securities laws. From planning the review to preparing the annual report and presenting it to fund boards, CCOs may have a number of issues to consider and address. While these steps may present certain challenges, CCOs have many options available to them to help to complete this process — a process that is likely to continue to evolve over time as CCOs, boards, and others gain more experience with the annual review requirement. We hope that CCOs find this paper helpful in their efforts to develop effective and practical approaches to conducting annual reviews that best fit their firm's particular circumstances.



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