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Key Elements of CCO Oversight of Service Providers

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On October 5, 2004, Rule 38a-1 under the Investment Company Act of 1940 was implemented. This rule requires that investment companies adopt comprehensive compliance programs including, among other things, written policies and procedures reasonably designed to prevent a violation of federal securities laws and designation of a chief compliance officer (CCO). A CCO's primary responsibilities are to administer the policies and procedures and to report annually to the fund board regarding the adequacy of the compliance program.

For fund companies that outsource back office activities, such as fund accounting and administration, transfer agency and/or distribution, Rule 38a-1 also requires the CCO to conduct oversight of the service provider's compliance program, including its policies and procedures. There are several key methods CCOs can employ to comply with this requirement as well as the multiple tools service providers offer to assist CCOs with their oversight responsibilities.

CCO SITE VISITS AND FORUMS

Most CCOs conduct in-person due diligence visits to their service providers, usually in preparation for their annual 38a-1 reports to their fund boards. During these visits, which may take a day or more, CCOs will generally meet with the client service teams assigned to their funds. A formal agenda is usually coordinated between the CCO and the service provider to ensure that all applicable topics are covered in the allotted timeframe. Often times in advance of a visit, a service provider is asked by a CCO to complete a detailed due diligence questionnaire, which is then reviewed during the visit. Alternatively, some CCOs have developed score cards which may rank the service provider using a high-medium-low, green-yellow-red or exceeds expectations-meets expectations-needs improvement scheme. The detailed results are provided and discussed with the service

provider. Other CCOs prefer to conduct their own testing, such as reviewing internal checklists and files, listening to customer calls for those clients that use the service provider's call center, and meeting with staff functions such as internal audit, legal and compliance.

In addition to due diligence visits, many service providers host annual forums for the CCOs of their clients. These events are planned specifically for the CCO and allow an opportunity for interacting with other CCOs as well as management of the service provider. Forum agendas are designed to discuss issues important to the CCO, such as the service provider's approach to risk management and business continuity, recent and proposed regulatory changes, and any anticipated modifications to policies and procedures, key personnel or other items that would be important to the CCOs in fulfilling their oversight responsibilities under Rule 38a-1.

POLICIES AND PROCEDURES

In order to assist CCOs with their oversight duties, service providers have compiled policies and procedures that are applicable to the services being provided and that fall under the Rule 38a-1 umbrella. Service providers provide CCOs with their detailed policies and procedures as well as summaries. CCOs are given access to the policies and procedures via hard copy manuals with updates sent to the CCO for inclusion in the manual, or electronically on a secure website, which is available to the CCO 24x7. When a website approach is utilized, CCOs are usually notified via email of updates, material and otherwise, to the policies and procedures website. With respect to the testing and monitoring of the adequacy and effectiveness of the service provider's policies and procedures, service providers may use more than one approach. For example, in addition to utilizing internal sources such as compliance, risk management and internal audit departments, many service providers engage independent third parties, such as

accounting and compliance consulting firms, to conduct in-depth annual reviews of their policies and procedures and the control environment. Results of the independent review are provided in a written report which is distributed to CCOs and often becomes part of a CCO's annual report to the fund board.

CERTIFICATIONS

Rule 38a-1 certifications are another important element for the CCO's oversight of the service provider. Such certifications, which are generally distributed quarterly or at a frequency agreed upon with the CCO, provide a CCO with the service provider's confirmation of compliance with its policies and procedures or acknowledgement of any compliance breaches and their resolution.

CONCLUSION

It is important to remember that service providers fulfill an important function for fund clients that have limited resources or choose not to build the infrastructure needed to comply with all requirements of Rule 38a-1. How the service provider ultimately assists CCOs in meeting their oversight requirements under Rule 38a-1 varies from provider to provider and depends on the needs of the CCO as well as the capabilities of the service provider. Whether CCOs work individually with their day to day contacts or through a centralized compliance group that the service provider has designated, the goal is always to ensure that CCOs have the tools, information and insights they require to comply with their oversight obligations under Rule 38a-1.

BNY Mellon Asset Servicing has a centralized compliance support services group offering a comprehensive 38a-1 compliance program for clients of its fund accounting and administration, regulatory administration, transfer agency, distribution/underwriting and alternative investment services. For more information on BNY Mellon's 38a-1 compliance program contact assetservicingmarketing@bnymellon.com.