



Risk Management Tip August 2007

Investment Companies: Fund Compliance Reminders

Ever since the market timing scandals, fund compliance remains at the forefront of current regulatory initiatives. As investment companies review their compliance programs in accordance with federal securities laws,¹ it is essential to focus on top deficiency areas that continue to be noted during regulatory exams; namely, *recordkeeping* and *adequacy of disclosure*. The following are risk management tips that investment companies may wish to consider.

Recordkeeping

Be sure that fund records contain the findings of the investment company's annual review *and* include recommendations for improvement on internal controls to address potential conflicts. Such records should be maintained for five years with the most recent two years readily accessible. The SEC seeks hardcopy proof of an active, risk-based approach to compliance and conflicts checks. Utilize a compliance checklist, meticulous documentation and proactive monitoring of potential conflicts of interest to ensure sufficient disclosure. Further implement or improve and test the business continuity plan developed for protection in the event of a disaster or major disruption to business. This is an area that is frequently forgotten and is one of the most common deficiencies noted in examination findings

Also, do not forget to document the process the fund undergoes for ensuring the presence of an "independent" board. A documented systematic approach is crucial to minimize and remedy competing interests between company service providers and shareholders. To minimize conflicts, regulators and clients will want to see that most investment company board members are unaffiliated persons of the fund.²

Adequacy of Disclosure

Fund companies must continue to enhance their disclosures of all potential conflicts of interest, with particular focus on:

- Fund fees and trading costs;
- Personal trading activities;
- Portfolio transactions and soft dollar arrangements;
- Fair pricing and valuation;
- Market timing practices; and
- Independence of the board of directors

Such disclosure must address actual and potential conflicts that may compromise the needs of the clients in order to benefit the fund.

By following these steps, fund companies will strengthen their internal controls, which is a hallmark to a solid compliance program.

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¹ 15 U.S.C. 80(38)(a)(1)

² *Id.* at 80(a)(9): *Ineligibility of certain affiliated persons and underwriters.*