The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC PROPOSALS RELATING TO INVESTMENT COMPANY AND INVESTMENT ADVISER COMPLIANCE PROGRAMS; COMMENT REQUESTED ON ADDITIONAL APPROACHES TO ENHANCE COMPLIANCE

[15651] February 12, 2003 TO: INVESTMENT ADVISERS COMMITTEE No. 3-03 RE: SEC PROPOSALS RELATING TO INVESTMENT COMPANY AND INVESTMENT ADVISER COMPLIANCE PROGRAMS; COMMENT REQUESTED ON ADDITIONAL APPROACHES TO ENHANCE COMPLIANCE The Securities and Exchange Commission has proposed new rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to require each investment company and investment adviser registered with the Commission to (1) adopt and implement policies and procedures designed to prevent violations of the securities laws, (2) review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and (3) designate a chief compliance officer responsible for administering the policies and procedures.1 In addition, the SEC is soliciting comment on other ways to involve the private sector in fostering compliance by investment companies and investment advisers with the federal securities laws. These additional alternatives are: (1) periodic third-party compliance reviews of funds and advisers; (2) an expansion of the scope of the fund audits performed by independent public accountants; (3) the formation of one or more self-regulatory organizations; and (4) a fidelity bonding requirement for advisers. The proposals and additional compliance alternatives are discussed below. Comments are due to the SEC by April 14, 2003. If you have comments that you would like the Institute to consider including in its comment letter, please provide them by February 20, 2003, to the undersigned at 202/326-5825 or by email at tamara@ici.org or to Amy Lancellotta at 202/326- 5824 or by email at amy@ici.org. A. Adoption and Implementation of Policies and Procedures The proposed rules would require funds and advisers to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws. They would have to be written and, in the case of a fund, approved by the fund's board of directors, 1 SEC Release Nos. IC-25925, IA-2107 (February 5, 2003) (the "Proposing Release"). A copy of the Proposing Release is available on the SEC's website at http://www.sec.gov/rules/proposed/ic-25925.htm. 2 including a majority of the fund's independent directors. Under the proposals, a fund's policies and procedures would have to be designed to prevent violation of the federal securities laws by the fund, its investment adviser, principal underwriter and administrator

in connection with their provision of services to the fund. An adviser's policies and procedures would have to be designed to prevent the violation of the Advisers Act by the adviser and its supervised persons. The proposed rules do not enumerate specific elements that funds and advisers would be required to include in their required policies and procedures. The Proposing Release states that they should be designed to prevent violations (by, for example, separating operational functions such as trading and reporting), detect violations (by, for example, requiring a supervisor to review employees' personal securities transactions), and correct promptly any material violations. The Proposing Release lists a number of areas that the SEC would expect that fund policies and procedures and (to the extent relevant) advisers would, at a minimum, address.2 B. Annual Review Under the proposed rules, each fund and adviser would have to review its policies and procedures at least annually to determine their adequacy and the effectiveness of their implementation. C. Chief Compliance Officer The proposals would require each fund and adviser to designate an individual responsible for administering the compliance policies and procedures. A fund's board of directors, including a majority of the independent directors, would have to approve the chief compliance officer. The proposal would require the chief compliance officer to furnish the fund's board of directors annually with a written report on the operation of the fund's policies and procedures, including (1) any material changes to the policies and procedures since the last report, (2) any recommendations for material changes to the policies and procedures as a result of the annual review, and (3) any material compliance matters requiring remedial action that occurred since the date of the last report. Thus, according to the Proposing Release, the rule would require board oversight of the fund's compliance program, but would not require directors to become involved in the day-to-day administration of the program. 2 These areas are: (1) portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures and regulatory requirements; (2) trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates trades among clients; (3) proprietary trading of the adviser and personal trading activities of supervised persons; (4) the accuracy of disclosures made to investors, including information in advertisements; (5) safeguarding of client assets from conversion or inappropriate use by advisory personnel; (6) the creation and maintenance of required records; (7) processes to value client holdings and assess fees based on those valuations; (8) safeguards for the protection of client records and information; and (9) business continuity plans. The Proposing Release states that fund procedures would ordinarily cover the following additional areas: (1) pricing of portfolio securities and fund shares; (2) processing of fund shares; (3) identification of affiliated persons with whom the fund cannot enter into certain transactions, and compliance with exemptive rules and orders that permit such transactions; (4) compliance with fund governance requirements; and (5) prevention of money laundering. 3 D. Recordkeeping Under the proposals, funds and advisers would be required to maintain a copy of their policies and procedures. Funds would have to keep the annual written reports submitted to the board by the chief compliance officer. Advisers would have to keep records documenting their annual review. The required documents would have to be kept for five years. E. Request for Comment on Further Private Sector Involvement The Proposing Release requests comment on additional approaches that would rely more heavily on the private sector to enhance compliance by investment companies and investment advisers with the federal securities laws, which are summarized below. In addition to requesting comment on specific items relating to each of the approaches, the Commission requests that commenters address the Commission's authority to effect through rulemaking each of the approaches. 1. Compliance Reviews – One possible approach described in the Proposing

Release might be to require each fund and adviser to undergo periodic compliance reviews by a third party that would produce a report of its findings and recommendations. These reports could help the examination staff identify quickly areas that require attention, permitting the staff to allocate examination resources better and, as a result, to increase the frequency with which the staff could examine funds and advisers. 2. Expanded Audit Requirement – Another approach discussed in the Proposing Release would be to expand the role of independent public accountants that audit fund financial statements to include an examination of fund compliance controls. Funds auditors are currently required to submit internal control reports to fund boards in which the auditor must identify any material weaknesses in the accounting system, the system of internal accounting controls, and the procedures for safeguarding securities of which they become aware while planning and performing the audit on the fund's financial statements. Under this approach, the auditor's responsibilities could be augmented to require the identification of material weaknesses in the internal controls or a report on other aspects of the internal controls that are not required to be reviewed in planning and performing an audit of the financial statements. 3. Self-Regulatory Organization – Another means to involve the private sector in support of the Commission's regulatory program, according to the Proposing Release, might be the formation of one or more self-regulatory organizations (SROs) for funds and/or advisers. An SRO would function in a manner analogous to the national securities exchanges and registered securities associations under the Securities Exchange Act of 1934 by (1) establishing business practice rules and ethical standards, (2) conducting routine examinations, (3) requiring minimum education or experience standards, and (4) bringing its own actions to discipline members for violating its rules and the federal securities laws. The Proposing Release notes that proposals to create SROs have been considered previously by Congress, the Commission and members of the investment management industry. Past Commission initiatives reflected its concern that its resources were inadequate to address the growth of investment advisers and funds. 4 The Proposing Release states that any SRO would be subject to the pervasive oversight of the Commission. The Commission would examine its activities, require it to keep records, and approve its rules only if it concluded that they further the goals of the federal securities laws. The Commission's staff would continue to examine the activities of funds and advisers, both to ensure adequate examination coverage and to provide oversight of the SRO examination program. 4. Fidelity Bonding Requirement for Advisers – Another approach mentioned in the Proposing Release would be to require investment advisers to obtain fidelity bonds from insurance companies. The Proposing Release states that this would result in additional oversight of advisers by insurance companies, which are unwilling to issue bonds to advisers that place their assets at risk by having poor controls or that hire employees with criminal or poor disciplinary records. Tamara K. Salmon Senior Associate Counsel

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