

**MEMO# 15596**

January 30, 2003

# **SEC ADOPTS RULES RELATED TO CERTIFICATION OF SHAREHOLDER REPORTS, CODES OF ETHICS AND AUDIT COMMITTEE FINANCIAL EXPERTS**

[15596] January 30, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 6-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 9-03 COMPLIANCE ADVISORY COMMITTEE No. 7-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 9-03 SEC RULES MEMBERS No. 12-03 SMALL FUNDS MEMBERS No. 4-03 UNIT INVESTMENT TRUST MEMBERS No. 2-03 RE: SEC ADOPTS RULES RELATED TO CERTIFICATION OF SHAREHOLDER REPORTS, CODES OF ETHICS AND AUDIT COMMITTEE FINANCIAL EXPERTS The Securities and Exchange Commission has adopted rule and form amendments under the Investment Company Act of 1940 and the Securities Exchange Act of 1934 to implement Sections 302, 406, and 407 of the Sarbanes-Oxley Act of 2002 (the "Act").<sup>1</sup> The Commission's adopted rules are intended to better implement for investment companies Section 302 of the Act (certification of shareholder reports), and implement the requirements of Section 406 of the Act (codes of ethics), and Section 407 of the Act (audit committee financial experts). The Commission's release is summarized below.

**I. SECTION 302 – CERTIFICATION REQUIREMENTS**

**A. Certified Shareholder Reports** The Commission has adopted an amendment to Rule 30b2-1 under the Investment Company Act to require a registered management investment company to file a report with the Commission on new Form N-CSR ("certified shareholder report") containing (i) a copy of any required shareholder report, (ii) additional information regarding disclosure controls and procedures, and (iii) the certification required by Section 302 of the Act.<sup>2</sup> In addition to the 1 Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release Nos. 34-47262; IC-25914 (January 27, 2003). The Commission's release is available from the SEC's website at <http://www.sec.gov/rules/final/34-47262.htm>.

<sup>2</sup> The Commission also has amended Rule 30a-2 to require Form N-CSR to include the certification required by Section 302 of the Act. The Commission's release also clarifies that the certification requirement applies to amendments of certified shareholder reports on Form N-CSR. <sup>2</sup> signature required on the certification, the report must be signed by the registrant, and on behalf of the registrant by its principal executive officer or officers and its principal financial officer or officers. The Commission has also adopted new Rule 30d-1 under the Investment Company Act to designate reports on Form N-CSR as periodic reports filed with the Commission under Section 13(a) or 15(d) of the Exchange Act.

**B. Elimination of Form N-SAR Certification Requirement** As the Institute recommended, the Commission

has eliminated the certification requirement from Form N-SAR for all registered investment companies. The Commission agreed with the Institute and other commenters who argued that the Form N-SAR contains only limited financial information, is not relied upon by investors, and if certified, would not satisfy the intent of Section 302 of the Act. Related to this modification, and consistent with the Institute's comments, the Commission has amended an instruction to Form N-SAR to eliminate the certification requirement for unit investment trusts. The Commission agreed with the Institute's view that Form N-SAR contains very limited information for UITs, is not required to be sent to investors, and if certified, would not produce any meaningful benefit to investors.

**C. Scope of Certification** The Commission has extended the scope of the certification requirement to all of the information filed on Form N-CSR, including all of the information in a shareholder report filed as part of Form N-CSR. The Commission disagreed with the views expressed by the Institute and others that some of the narrative disclosure in shareholder reports (e.g., Management's Discussion of Fund Performance, "President's letters" and interviews with portfolio managers) is subjective information that does not lend itself to meaningful personal certification, and that requiring certification of the entire shareholder report could have the unintended consequence of resulting in a reduction of the scope, or possible cessation, of narrative discussion provided voluntarily. The Commission pointed to various instances of insufficient MDFP disclosure relating to the factors that affected a fund's performance, and noted that certification of MDFP disclosure would encourage funds to include a more complete and accurate discussion of the factors that affected fund performance.

**D. Disclosure Controls and Procedures** The Commission has adopted new Rule 30a-3 under the Investment Company Act to require registered management investment companies to maintain, and regularly evaluate the effectiveness of, controls and procedures designed to ensure that the information required in filings on Form N-CSR is recorded, processed, summarized, and reported on a timely basis. The Commission has also adopted the provision in the rule that requires registered management investment companies to conduct an evaluation of their disclosure controls and procedures within the 90-day period prior to the filing of each Form N-CSR requiring certification under Investment Company Act Rule 30a-2. In the case of a series fund or family of funds, as the Institute recommended, Rule 30a-3 permits the use of a single evaluation of the effectiveness of disclosure controls and procedures in multiple certifications for the funds or in the series or family, as long as the evaluation has been performed within 90 days of the date of the report on Form N-CSR.

**3 Consistent with the Institute's comments, the Commission has determined not to extend the disclosure controls and procedures requirement to filings under the Securities Act of 1933 and the Investment Company Act. The Commission recognized that this would impose a larger burden on investment companies than on operating companies, which pursuant to Section 302, are only required to maintain disclosure controls and procedures with respect to their Exchange Act reports.**

**3 E. Extension of Time for Filing Form N-CSR** The Commission has amended Rule 12b-25 under the Exchange Act to require an investment company to file a Form 12b-25 if it will be unable to file a report on Form N-CSR in a timely manner. Filing this form provides an automatic extension of time to file Form N-CSR of up to 15 calendar days following the prescribed due date.

**II. SECTION 406 – CODES OF ETHICS**

**A. Contents and Filing of Codes of Ethics** The Commission has adopted requirements for registered management investment companies to disclose in Form N-CSR whether they have adopted a code of ethics that applies to the company's principal executive office and senior financial officers.

**4 The rules define code of ethics the same for investment companies as for operating companies.**

**5 Specifically, code of ethics means written standards that are reasonably designed to deter wrongdoing and to promote, among other things, honest and ethical conduct, and compliance with applicable laws. The release states that while Rule 17j-1 under the**

Investment Company Act currently has a code of ethics requirements, the new code of ethics requirement addresses a broader range of conduct and therefore it is appropriate to apply these requirements to investment companies. Consistent with the proposal and the Institute's comments, investment companies may either design a new code of ethics or incorporate the new code requirements into existing codes. An instruction to Form N-CSR indicates that companies may have separate codes of ethics for 3 The release announces the Commission's decision to defer to a later date the adoption of final rules to implement Section 404 of the Act relating to internal controls reports for operating companies, and certain technical amendments to Commission rules and forms implementing Section 302 of the Act for registered investment companies. 4 The final rules exclude UITs from the code of ethics disclosure requirements. The release explains that as unmanaged, passive investment vehicles, UITs typically do not have principal executive officers, principal financial officers, or controllers. Thus, consistent with the Institute's comments, neither sponsors, depositors, trustees, nor principal underwriters of UITs are subject to the new code of ethics requirements (unless these entities are themselves reporting companies subject to the requirements of Section 406 irrespective of their relationship with the investment company). 5 The release directs investment companies to the Commission's recent release in which it adopted disclosure requirements for operating companies related to codes of ethics and audit committee financial experts for more information concerning these requirements. See Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes- Oxley Act of 2002, SEC Release Nos. 33-8177, 34-47235 (January 23, 2003), available from the SEC's website at <http://www.sec.gov/rules/final/33-8177.htm>. 4 different types of officers and that the newly required code of ethics may be part of a broader code that addresses additional issues and applies to additional persons. B. Disclosure of Codes of Ethics Item 2 of Form N-CSR requires registered management investment companies to disclose annually whether the investment company has adopted a written code of ethics that applies to the investment company's principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions, regardless of whether these individuals are employed by the investment company or a third party. If the investment company has not adopted a code of ethics, it must provide an explanation of why it has not done so. The rules provide investment companies with three alternative methods for making their codes publicly available: (1) filing the code as an exhibit to the investment company's reports on Form N-CSR; (2) posting the code on the company's website subject to certain conditions; or (3) providing an undertaking in the company's most recent report on Form N-CSR to provide a copy of the code to any person without charge upon request. In a significant development, the Commission has adopted the Institute's recommendation not to require disclosure of codes of ethics of an investment company's investment adviser or principal underwriter. The Commission explains that in large financial service organizations, the principal executive officer and senior financial officers may have little to do with the operations or financial reporting of the investment company, but are instead responsible principally for the adviser's or underwriter's own operations and financial reporting. C. Waivers and Amendments Items 2(c) and 2(d) of Form N-CSR require registered management investment companies to describe briefly the nature of any amendments to, or waivers from provisions of, the investment company's code of ethics. In the alternative, an investment company may disclose this information on its website within five business days after the occurrence of the waiver or amendment, if the investment company (1) has disclosed in its most recently filed report on Form N-CSR its intention to provide disclosure in this manner and its website address, (2) makes the information available on its website for a 12-month period, and (3) retains the information for at least six years following the end of the fiscal year in which the amendment or waiver occurred. Instruction 5(a) and (b) for Item 2 of Form N-CSR define "waiver" as the approval

by the registrant of a material departure from a provision of the code of ethics and “implicit waiver” as the investment company’s failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer of the investment company. Thus, consistent with the Institute’s comments, the rules make clear that the waivers required to be disclosed are those that involve action or inaction on the part of a company with respect to known violations of the code. In addition, the rules state that investment companies need not disclose technical, administrative, or other non- substantive amendments to their codes. 5

### III. SECTION 407 – AUDIT COMMITTEE FINANCIAL EXPERT A. Definition of Audit Committee Financial Expert

The Commission has adopted requirements for registered management investment companies<sup>6</sup> to disclose whether they have at least one “audit committee financial expert” serving on its audit committee. Specifically, Item 3 of Form N-CSR requires the company to disclose annually: (i) the name of one person that the board of directors has determined to be an “audit committee financial expert”<sup>7</sup> serving on the investment company’s audit committee; (ii) whether the audit committee financial expert is independent<sup>8</sup>, and if not, an explanation of why he or she is not; and (iii) if the investment company does not have an audit committee financial expert serving on its audit committee, the fact that there is no such expert and an explanation of why not. The final rules permit, but do not require, an investment company to disclose that it has more than one audit committee financial expert. The Commission explained that once a company’s board determines that a particular audit committee member qualifies as an audit committee financial expert, it may, but is not required to, determine whether additional audit committee members also qualify as financial experts. The final rules apply a similar definition of “audit committee financial expert” for investment companies as that adopted for all other companies. The final definition of “audit committee financial expert” differs in several significant respects from the definition of “financial expert” initially proposed by the Commission. It was significantly revised in response to the concerns expressed by the Institute and other commenters that, among other things, requiring a financial expert to have had direct experience preparing or auditing financial statements was overly restrictive and potentially unduly burdensome. The Commission’s revisions reflect the recognition that people actively engaged in industries such as investment banking and venture capital investment and professional financial analysts, that regularly work with financial statements, could be effective audit committee members. As a result, the final rules define “audit committee financial expert” as a person who has: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with accounting for estimates, accruals, and reserves; (iii) experience preparing, auditing, analyzing, or evaluating certain financial statements or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal controls and procedures for financial reporting; and (v) an understanding of audit committee functions. The rules require a person to have acquired such attributes through: (i) education and experience as a principal financial officer, controller, public accountant, or principal accounting 6 The audit committee financial expert requirements do not apply to UITs. 7 The Commission replaced the term, “financial expert” in its original proposal with “audit committee financial expert” to make clear that the designated person must have characteristics that are particularly relevant to the functions of the audit committee rather than traditional “financial” matters such as capital structure and cash flows. 8 An investment company audit committee financial expert would be considered to be independent if he or she does not accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer (except in the capacity as a member of the audit committee, the board of directors, or any other board committee) and is not an “interested person” of the investment company as defined

in Section 2(a)(19) of the Investment Company Act. 6 officer, or experience in one or more positions that involve the performance of similar functions; (ii) experience actively supervising a principal financial officer, principal accounting officer, controller or public accountant; (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or (iv) other relevant experience. B. Safe Harbor from Liability for Audit Committee Financial Experts In response to the concerns expressed by the Institute and other commenters, the Commission has provided protection from liability for audit committee financial experts. Specifically, Instruction (d) for Item 3 of Form N-CSR provides that an audit committee financial expert will not be deemed an “expert” for any purpose, including for purposes of Section 11 under the Securities Act of 1933, and that the designation of a person as an audit committee financial expert does not impose on such person any liability greater than the liability imposed on such person as a member of the audit committee or the board of directors in the absence of such designation. IV. TRANSITION PROVISIONS AND COMPLIANCE DATES The Commission’s new rules, rule and form amendments, and Form N-CSR become effective on March 1, 2003. The effective date of the removal of the certification requirement from Form N-SAR for registered management investment companies is May 1, 2003.<sup>9</sup> In addition, if the investment company has a fiscal annual or semi-annual period ending on or before March 31, 2003, then the company may choose either to file Form N-CSR or to continue to comply with the certification requirements of Form N-SAR.<sup>10</sup> Moreover, a registered management investment company that has a fiscal annual or semi-annual period ending on or after April 1, 2003, is required to file Form N-CSR for that period. Under the final rules, registered management investment companies must comply with the code of ethics disclosure requirements in their annual reports on Form N-CSR for fiscal years ending on or after July 15, 2003. They also must comply with the requirements regarding disclosure of amendments to, and waivers from, their ethics codes on or after the date on which they file their first annual report on Form N-CSR in which disclosure of their code of ethics is required. Registered management investment companies similarly must comply with the audit committee financial expert disclosure requirements in their annual reports on Form N-CSR for fiscal years ending on or after July 15, 2003. Barry E. Simmons Associate Counsel Dorothy M. Donohue Associate Counsel 9 The release makes clear, however, that beginning immediately, a UIT may omit the certification from Form N-SAR. 10 A company that elects to file Form N-CSR for a fiscal annual or semi-annual period ending on or before March 31, 2003, is not required to comply with paragraphs (b)(4), (5), and (6) of Investment Company Act Rule 30a-2, Item 9(a) of Form N-CSR, or paragraph (b) of Exchange Act Rules 13a-15 and 15d-15 and Investment Company Act Rule 30a-3 with respect to that Form N-CSR (i.e., provisions relating to disclosure controls and procedures).

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