

MEMO# 17002

January 23, 2004

DRAFT INSTITUTE COMMENT LETTER ON PROPOSED REVISIONS TO RULE 38A-1 TO ENHANCE THE INDEPENDENCE OF CHIEF COMPLIANCE OFFICERS

[17002] January 23, 2004 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 3-04 COMPLIANCE ADVISORY COMMITTEE No. 10-04 SEC RULES COMMITTEE No. 9-04 SMALL FUNDS COMMITTEE No. 6-04 UNIT INVESTMENT TRUST COMMITTEE No. 5-04 RE: DRAFT INSTITUTE COMMENT LETTER ON PROPOSED REVISIONS TO RULE 38a-1 TO ENHANCE THE INDEPENDENCE OF CHIEF COMPLIANCE OFFICERS As we previously advised you, in December, the Securities and Exchange Commission adopted new Rule 38a-1 under the Investment Company Act of 1940 to require each registered investment company ("fund") and registered investment adviser to adopt and implement a compliance program.* The Commission's Adopting Release also sought comment on provisions added to the rule to: (1) promote the chief compliance officer's ("CCO's") independence from fund management while still maintaining her effectiveness; and (2) define the term "material compliance matter," which are those matters that must be reported annually to the board by the CCO. Attached is a copy of the Institute's draft comment letter on these two issues, which is summarized below. Comments on the proposal are due to the Commission by February 6th. Please provide comments on the draft letter to the undersigned no later than Friday, January 30th by phone [(202) 326-5825], fax [(202) 326-5839], or e-mail [tamara@ici.org].

INDEPENDENCE OF THE CCO With two exceptions, the Institute's letter supports the provisions the Commission has added to the rule to better ensure the independence of the CCO. These two exceptions are the provisions that would (1) require the fund's board to approve the compensation of the CCO and (2) vest in the board the sole authority to remove the CCO from his or her position. As regards (1), the draft letter states that requiring the board to approve the CCO's compensation is * See Institute Memorandum to Closed-End Investment Company Committee No 67-03, Compliance Advisory Committee No. 112-03, SEC Rules Committee No. 105-03, Small Funds Committee No. 35-03, and Unit Investment Trust Committee No. 25-03 [16904], dated Dec. 19, 2003, summarizing SEC Release Nos. IA-2204 and IC-26299 (Dec. 17, 2003) (the "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>. 2 unnecessary to preserve the independence of the CCO in light of other provisions added to the rule that would prohibit any person from coercing or fraudulently influencing the CCO in the course of his or her responsibilities. In addition, such a requirement would raise various logistical issues, which are discussed in the letter. Accordingly, the letter recommends that, in lieu of having the board approve the CCO's compensation, the SEC require that the board receive periodic reports of such

compensation, which will enable the board to determine whether the CCO's compensation has been used to unduly coerce or influence the CCO. With respect to the rule vesting in the board the exclusive authority to remove the CCO from his or her position, the draft letter recommends that the Commission revise this provision to permit the entity that employs the CCO to terminate such person for cause, so long as such termination would not violate the rule's prohibition against coercing or fraudulently influencing the CCO. This recommendation is intended to address situations in which the CCO's employer wants to fire the CCO for cause, but is precluded from doing so by the board, perhaps leaving the employer with exposure to liability under state or federal employment laws for the conduct of the CCO. The Institute is particularly interested in the view of members regarding the letter's discussion of this issue. MATERIAL COMPLIANCE MATTERS The Institute's letter recommends that the proposed definition of "material compliance matter" be revised to use the term "material" within the definition to qualify the matters that must be reported to the board. It also recommends that the Commission clarify that the only material compliance matters that must be reported to the board are those of which the CCO becomes aware during the reporting period. This recommendation is intended to address the CCO's failure to report matters that may have occurred during the reporting period but were not known to the CCO and to ensure that material compliance matters that arose prior to the current reporting period but that were not known by the CCO until the current reporting period are reported. Tamara K. Salmon Senior Associate Counsel Attachment (in .pdf format)