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SEC ADOPTS FUND AND ADVISER COMPLIANCE RULES AND SEEKS COMMENT ON TWO ISSUES; CONFERENCE CALL SCHEDULED FOR JAN. 6TH

[16904] December 19, 2003 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 UNIT INVESTMENT TRUST COMMITTEE No. 25-03 RE: SEC ADOPTS FUND AND ADVISER COMPLIANCE RULES AND SEEKS COMMENT ON TWO ISSUES; CONFERENCE CALL SCHEDULED FOR JAN. 6th The Securities and Exchange Commission has adopted new Rules 38a-1 and 206(4)-7 under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, respectively, to require each registered investment company ("fund") and registered investment adviser to: (1) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws; (2) review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation; (3) designate a chief compliance officer who is responsible for administering the policies and procedures; and (4) maintain specified records relating to compliance with the rules.1 The requirements of these new rules are detailed below. In addition to adopting these rules, the Adopting Release seeks comment on two issues discussed below. Comments must be filed with the Commission no later than Thursday, February 5, 2004. The Institute will hold a conference call on Tuesday, January 6th at 1:30 p.m. Eastern Time to discuss these issues. The dial-in number for the call is 888-426-8928, and the pass code is 54551. If you plan to participate in the call, please send an e-mail to Deborah Washington at deborah@ici.org. If you are unable to participate in the call, before the call please provide your comments to Marguerite Bateman by phone (202-326-5813), fax (202-326- 5839) or e-mail (bateman@ici.org) 1 See 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. Page cites in this memorandum to the Adopting Release are to the version available on the SEC's website. 2 I. REQUEST FOR COMMENT A. Independence of the Chief Compliance Officer The Commission seeks comment on provisions added to Rule 38a-1 that were not included in the proposed rule. These provisions, which are designed to promote the chief compliance officer's ("CCO's") independence from fund management while still maintaining her effectiveness, include: • Requiring the fund's board to approve the CCO's compensation (in addition to her designation as was included in the Proposing Release); • Providing the board sole power to

remove the CCO from her position; • Requiring the CCO to report directly to the board and meet with the independent directors in executive session at least annually; • Prohibiting persons from coercing or fraudulently influencing her in the course of her responsibilities. Comment is also requested on whether there are other measures or refinements to these provisions that would further enhance the independence and effectiveness of CCOs under the rule. B. The Meaning of "Material Compliance Matters" The term "material compliance matters" is used in the rule to refer to those matters that must be reported to a fund's board by a CCO. The Commission seeks comment on whether the definition of "material compliance matters" in Rule 38a-12 adequately addresses the Commission's concern that fund boards receive compliance information they reasonably need to know in order to oversee fund compliance. II. COMPLIANCE DATE While the new rules are effective February 5, 2004, the compliance date of the new rules is October 5, 2004. Accordingly, on or before the compliance date: • All funds must have: (1) designated a CCO; (2) had the CCO approved by the fund's board; (3) adopted compliance policies and procedures that satisfy the new rule's requirements; and (4) had the policies and procedures approved by the fund's board.3 • All investment advisers must have: (1) designated a CCO; and (2) adopted compliance policies and procedures that satisfy the new rule's requirements. 2 As defined in the rule, "material compliance matters" would mean any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance and that involves: (i) a violation of the federal securities laws; (ii) a violation of the required compliance policies and procedures of the fund or its service providers; or (iii) a weakness in the design and implementation of the required compliance policies and procedures. 3 In the case of a unit investment trust, the principal underwriter or depositor must approve the CCO and the compliance policies and procedures. See infra Section III.E. 3 The first annual review funds and advisers must conduct under the rules, which is discussed below, must be completed no later than eighteen months after the adoption or approval of the compliance policies and procedures. A fund's CCO must submit the first annual report to the board within 60 calendar days of the completion of the annual review. The Adopting Release notes, however, that the nine-month transition period "does not reduce the immediacy of the need for all funds, including those that already have compliance policies in place, to undertake a review of their policies and procedures in light of recent revelations of unlawful practices involving market timing, late trading, and improper disclosure of nonpublic portfolio information." III. SUMMARY OF RULE 38a-1, COMPLIANCE PROCEDURES AND PRACTICES OF CERTAIN INVESTMENT COMPANIES A. Adoption and Implementation of Policies and Procedures 1. Generally; Service Providers' Policies and Procedures As mentioned above, Rule 38a-1 requires fund boards to adopt written policies and procedures reasonably designed to prevent the fund from violating the federal securities laws.4 These procedures must provide for the oversight of compliance by the fund's advisers, principal underwriters, administrators, and transfer agents (collectively, the fund's "service providers"). 5 The rule does, however, provide fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization.6 With respect to a service provider's policies and procedures, the rule requires fund boards to approve such policies and procedures and requires a fund's policies and procedures to include provisions for the fund to oversee the service providers' compliance. The Adopting Release clarifies that funds may not simply rely on their service providers policies and procedures. The Adopting Release acknowledges that in certain instances it may be impractical for the fund or its service providers to "directly review" all of the service provider's policies and procedures.7 In such cases, the Commission "will consider a fund's policies and procedures to have satisfied the requirements of [the] rule if the fund uses a third-party report on the service provider's procedures instead of the procedures themselves when the board is evaluating 4 As defined in the rule, "federal securities laws" means the Securities Act of

1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act, the Advisers Act, Title V of the Gramm-Leach- Bliley Act (relating to privacy), any rules adopted by the Commission under any of these acts, and the Bank Secrecy Act as its applies to funds and any rules adopted thereunder by the Commission or the Department of the Treasury. 5 Note that, as originally proposed, this list of service providers did not include transfer agents. See SEC Release Nos. IC-25925 and IA-2107 (Feb. 5, 2003) (the "Proposing Release"). According to the Adopting Release, transfer agents were added to the rule "because fund purchase and redemption orders are ultimately transmitted to transfer agents engaged by the fund." Adopting Release at p. 8. 6 For example, a fund complex could adopt compliance policies and procedures that cover solely the activities of the funds, and approve the policies and procedures of its service providers. 7 According to the Adopting Release, an example of when this situation might arise is when the fund employs the services of a service provider that is not an affiliated person of the fund (e.g., a transfer agent or administrator) and that provides similar services to a large number of funds. 4 whether to approve the service provider's compliance program." Any third-party report must (1) describe the service provider's compliance program as it relates to the types of services provided to the fund; (2) discuss the types of compliance risks material to the fund; and (3) assess the adequacy of the service provider's compliance controls. 2. Contents of the Fund's Policies and Procedures According to the Adopting Release, the policies and procedures of a fund should address the same issues identified for investment advisers. (See the list of bullets in Section IV.A., below.) In addition, however, the Commission "expects" the policies and procedures to cover the following additional "critical" areas: • Pricing of portfolio securities and fund shares – Funds must adopt policies and procedures that: require the fund to monitor the circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities and make any necessary adjustments.8 • Processing fund shares – A fund must have in place procedures that segregate investor orders received before the fund prices its shares from those that were received after the fund prices its shares. The Adopting Release clarifies that a fund may not merely rely on a contractual provision with its transfer agent that requires the transfer agent to segregate the fund's orders. Instead, funds must not only approve and periodically review the segregation policies and procedures of its transfer agent, but "should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered." • Identification of affiliated persons – Funds should have policies and procedures in place to identify affiliated persons and to prevent unlawful transactions with them. • Protection of nonpublic information – Funds should incorporate their Section 204A policies (relating to insider trading) into the policies and procedures required under Rule 38a-1.9 In addition, a fund's Rule 38a-1 policies and procedures should address other potential misuses of nonpublic information, including the disclosure to third 8 The Adopting Release outlines the pricing requirements under the Investment Company Act. It discusses the arbitrage opportunity that arises if fund shares are mispriced, e.g., where fund portfolio securities trade on a foreign market that closes before the time at which the fund prices its shares. According to the Adopting Release, the Commission believes that funds that fail to fair value their portfolio securities in circumstances where an event affecting the value of the portfolio securities occurs after the foreign market closes but before the fund prices its shares may violate Rule 22c-1 under the Investment Company Act, relating to pricing of securities. In addition, "fund directors who countenance such practices fail to comply with their statutory valuation obligations and fail to fulfill their fiduciary obligation to protect

fund shareholders." Adopting Release at pp. 7-8 (footnote omitted). 9 The Adopting Release clarifies that Rule 38a-1 does not supplant any requirements funds have under other provisions of law to maintain written compliance policies and procedures. 5 parties of material information about the fund's portfolio, its trading strategies, pending transactions, and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio.10 The Commission urges funds and advisers to require persons who have access to nonpublic information to trade securities of the fund exclusively through identifiable accounts to enable the fund to monitor for excessive, short-term trading. Alternatively, funds and advisers should consider amending their codes of ethics to cover, and thus require reporting of, trades by persons who have access to nonpublic information about the portfolio, including information about the accuracy of the prices of portfolio securities used to calculate net asset value.11 • Compliance with fund governance requirements – A fund's policies and procedures should be designed to guard against, among other things, an improperly constituted board, the failure of the board to properly consider matters entrusted to it, and the failure of the board to request and consider information required by the Investment Company Act from the fund adviser and service providers.12 • Market timing – Rule 38a-1 requires a fund to have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing and for consistent enforcement of the fund's policies regarding market timing. Also, if the fund permits any waivers of those policies, the procedures should be reasonably designed to prevent waivers that would harm the fund or its shareholders or subordinate the interest of the fund or its shareholders to those of the adviser or any other affiliated person or associated person of the adviser. The Commission strongly urges fund boards to require the fund's adviser, or other persons authorized to waive market timing policies, to report to the board at least quarterly all waivers granted, so that the board can determine whether the waivers were proper. 3. Board Approval of the Policies and Procedures A fund's board, including a majority of its independent directors, must approve the policies and procedures of the fund and each of its service providers. Such approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the federal securities laws by the fund and its service providers. If the 10 According to the Adopting Release, the policies and procedures of a fund or investment adviser should preclude fund or advisory personnel from divulging a fund's portfolio schedule that has not been made generally available to the public. Moreover, in the view of the Commission, divulging portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality. Adopting Release at n.55. 11 The Adopting Release acknowledges that Rule 17j-1, which governs personal trading activities of investment company personnel, does not require codes of ethics to cover such persons or their trading activity. Adopting Release at n.56. 12 The Adopting Release notes that, because reliance on many of the Investment Company Act's exemptive rules is conditioned on compliance with various of the Act's governance requires, the consequence of failing to meeting these requirements is "severe." 6 policies and procedures of a service provider are included within the policies and procedures adopted by the fund, separate approval of the service provider's policies and procedures by the board is not required. Also, a fund that is approving the policies and procedures of service providers is required to make its findings only with respect to activities of the service provider that could affect the fund. Directors are not required to approve amendments to the policies and procedures of the fund or its service providers.13 According to the Adopting Release, directors may satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by the CCO, legal counsel, or other

persons familiar with the compliance programs. Such summaries should familiarize directors with the salient features of the programs (including the programs of service providers) and provide them “with a good understanding” of how the compliance programs address “particularly significant compliance risks.” In considering whether to approve compliance policies and procedures, boards should consider the nature of the fund’s exposure to compliance failures, as well as the adequacy of the policies and procedures in light of the fund’s recent compliance experiences. The Commission urges boards to consider best practices used by other fund complexes and to consult with fund counsel (and independent directors with their counsel), compliance specialists, and other experts familiar with compliance practices successfully employed by similar funds or service providers. B. Annual Review of and Report on a Fund’s Policies and Procedures Rule 38a-1 requires a fund to review its policies and procedures, as well as those of its service providers, annually. The rule does not require the fund’s board to conduct this review. Instead, the board would have the benefit of the review in the required written report on the operation of the fund’s policies and procedures and those of its service providers that the CCO must annually provide to the board.14 This report must address, at a minimum: (i) The operation of the policies and procedures of the fund and each service provider since the last report; (ii) Any material changes to the policies and procedures since the last report;15 (iii) Any recommendations for material changes to the policies and procedures as a result of the annual review;16 and 13 Instead, the fund’s CCO is required to discuss material changes to such policies and procedures in the CCO’s annual report to the fund’s board. 14 In limited circumstances, a fund may use third-party reports for its annual review of an unaffiliated service provider. However, the fund must also gather and take into account other relevant information, such as its experience with the service provider. See fn.7, above, and accompanying textual material and the Adopting Release at n.35. 15 A change would be “material” if it is a change that a fund director would reasonably need to know in order to oversee fund compliance. 16 The report should also discuss the fund’s particular compliance risks and any changes that were made to the policies and procedures to address newly identified risks. 7 (iv) Any material compliance matters since the date of the last report.17 With respect to compliance matters that must be reported to the board, the Adopting Release notes that individual compliance matters that, taken in isolation, may not be material may collectively suggest a material compliance matter that must be reported. Also, notwithstanding the required annual review and report, serious compliance issues “must, of course, always be brought to the board’s attention promptly, and cannot be delayed until an annual report.”18 C. Designation of a CCO 1. The CCO’s Qualifications and Oversight Responsibilities Rule 38a-1 requires each fund to appoint a CCO who is responsible for administering the fund’s policies and procedures approved by the board under the rule.19 According to the Adopting Release, the CCO should be competent and knowledgeable regarding the federal securities laws and empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund.20 In addition, the CCO is expected to oversee the fund’s service providers that have their own compliance officials. Accordingly, she should also have sufficient seniority and authority to compel others to adhere to the compliance policies and procedures. Under the rule, the CCO is responsible for keeping the board apprised of significant compliance events at the fund or its service providers and advising the board of needed changes in the fund’s compliance program.21 17 See fn.2, above, for the rule’s definition of “material compliance matter.” As noted above, the Commission is seeking comment on whether this proposed definition would adequately ensure that fund boards receive compliance information they reasonably need to know in order to oversee the fund. 18 Adopting Release at n.84. 19 While commenters, including the Institute, had urged the Commission to permit multiple compliance officers, the Commission rejected this approach because it “balkanizes

responsibility for fund compliance and isolates fund boards from compliance personnel." 20 According to the Adopting Release, having the title of CCO does not, in and of itself, carry supervisory responsibility. "Thus, a [CCO] appointed in accordance with the [compliance rules] would not necessarily be subject to a sanction by [the Commission] for failure to supervise other . . . personnel." Adopting Release at n.73. 21 According to the Adopting Release at p. 13: A [CCO] should diligently administer this oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The [CCO] should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks. She should maintain an active working relationship with each service provider's compliance personnel. Arrangements with the service provider should provide the fund's [CCO] with direct access to these personnel, and should provide the [CCO] with periodic reports and special reports in the event of compliance problems. In addition, the fund's contracts with its service providers might also require service providers to certify periodically that they are in compliance with applicable federal securities laws, or could provide for third-party audits arranged by the fund to evaluate the effectiveness of the service provider's compliance controls. The [CCO] could conduct (or hire third parties to conduct) statistical analyses of a service provider's performance of its duties to detect potential compliance failures. 8 2. Ensuring the CCO's Independence from Fund Management According to the Adopting Release, the Commission expects that the fund's CCO often will be employed by the fund's investment adviser or administrator. Indeed, the Adopting Release confirms that the rule does not require that the CCO be employed by only the fund.22 This being the case, the adopted rule includes several provisions to promote the independence of the CCO from the management of the fund. These provisions, which were not in the proposed version of the rule, are as follows: • The CCO serves at the pleasure of the fund's board – The fund's board (including a majority of independent directors) must approve the designation of the CCO and must approve her compensation and any changes in her compensation. The board can remove the CCO from her responsibilities at any time and can prevent the adviser or another person from doing so; • The CCO reports directly to the fund's board – The CCO must annually furnish the board with a written report on the operations of the fund's policies and procedures and those of its service providers;23 • The CCO must meet in executive session with the independent directors at least once a year – Such meeting must occur without "anyone else (such as fund management or interested directors)" present, though independent counsel to the independent directors may be present;24 and • The CCO should be free of undue influence by fund service providers – The rule prohibits the fund's officers, directors, and employees, its adviser, principal, underwriter, or any person acting under the direction of these persons, from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the fund's CCO in the performance of her responsibilities under the rule. D. Recordkeeping Requirements Rule 38a-1 requires all funds to: (1) maintain copies of all policies and procedures that are in effect or were in effect at any time during the last five years; (2) keep any records documenting their annual review; and (3) maintain materials provided to the board of directors in connection with their approval of the policies and procedures of the fund and its service providers and the annual written reports by the fund's CCO. The Adopting Release confirms that these records may be maintained electronically. 22 The Adopting Release explains that, if the rule precluded the CCO from being employed by the adviser, she "would be almost entirely dependent on information filtered through the senior management of the fund's adviser rather than, for example, information received directly from a trading desk." Adopting Release at pp. 12-13. 23 The rule's requirement that the CCO report directly to the fund's board is intended to address the fact that a CCO who is an employee of the fund's investment adviser might be

conflicted in her duties. 24 Adopting Release at n.85. 9 E. Unit Investment Trusts The rule includes a provision clarifying the rule's application to unit investment trusts. This provision, Rule 38a-1(b), provides that, if a fund is a unit investment trust, the fund's principal underwriter or depositor must approve the fund's policies and procedures and CCO, must receive all annual reports, and must approve the removal of the CCO from his or her responsibilities. IV. SUMMARY OF RULE 206(4)-7, INVESTMENT ADVISER COMPLIANCE POLICIES AND PROCEDURES A. Contents of the Policies and Procedures Rule 206(4)-7 makes it unlawful25 for a registered investment adviser to provide investment advice unless it has adopted and implemented policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or its supervised persons. According to the Adopting Release, by using the phrase "reasonably designed," the rule requires that the adviser's policies and procedures only encompass considerations relevant to the operations of that the adviser. As such, small firms without conflicting business interests may have simpler procedures than larger firms with greater potential conflicts of interest. The Adopting Release additionally clarifies that advisers are not required to consolidate all of their compliance policies and procedures into a single document; nor must advisers memorialize every action that must be taken to remain in compliance with the Advisers Act. According to the Adopting Release, advisers should adopt policies and procedures that (1) take into consideration the nature of the adviser's business, and (2) are designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.26 In compiling its procedures, the Adopting Release suggests that advisers first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks. While the adopted rule does not enumerate specific elements that advisers must include in their policies and procedures, the Release notes that, "at a minimum," the adviser's policies and procedures should address the following issues "to the extent they are relevant to the adviser:" • Portfolio management processes; • Trading practices; • Proprietary trading of the adviser and personal trading by its supervised persons; • The accuracy of disclosures to investors, clients, and regulators, including in account statements and advertising; 25 As proposed, violation of the rule would have been deemed to be a fraudulent, deceptive, or manipulative act, practice, or course of business. Based upon the concerns of commenters, this provision was revised in the final rule to make violation of the rule "unlawful." 26 The Adopting Release clarifies that the rule does not alter requirements advisers have under other provisions of law to maintain written policies and procedures in certain areas (e.g., the code of ethics requirement under Rule 17j-1 of the Investment Company Act). 10 • Safeguarding of client assets from conversion or inappropriate use by advisory personnel; • The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration, use, or destruction; • Marketing advisory services, including the use of solicitors; • Processes to value client holdings and assess fees; • Safeguards for the privacy protection of client records and information; and • Business continuity plans.27 The Adopting Release notes that, "where appropriate," an adviser's policies and procedures should employ, among other methods to detect violations, compliance tests that analyze information over time in order to identify unusual patterns. These compliance tests might include an analysis of: the quality of brokerage executions; the portfolio turnover rate; or the comparative performance of similarly managed accounts. B. Designation of a CCO Rule 206(4)-7 requires each federally-registered investment adviser to designate a CCO to administer its compliance policies and procedures, who would be listed as the adviser's compliance officer on Schedule A of Form ADV. As in the case of a fund's CCO, the adviser's CCO should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop

and enforce appropriate policies and procedures for the adviser. As such, the CCO should have a position “of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.”28 C. Annual Review Rule 206(4)-7 requires each registered adviser to review its policies and procedures annually to determine their adequacy and the effectiveness of their implementation. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to review the policies and procedures. D. Recordkeeping Rule 204-2 under the Advisers Act, which governs an adviser’s recordkeeping requirements, has been revised to require an adviser to maintain copies of all policies and procedures that are in effect or were in effect at any time during the past five year as well as any 27 In connection with this item, the Adopting Release notes the Commission’s belief that “an adviser’s fiduciary obligation to its clients includes the obligation to take steps to protect the clients’ interests from being placed at risk as a result of the adviser’s inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel.” Adopting Release at n.22. 28 Adopting Release at p. 10 and n.73. See also fn.20, above. According to the Adopting Release, “A compliance officer who does have supervisory responsibilities can continue to rely on the defense provided for in Section 203(e)(6) of the Advisers Act,” which provides that a person shall not be deemed to have failed to supervise provided certain conditions are satisfied. 11 records documenting the adviser’s annual review. These records may be maintained electronically. V. PRIVATE SECTOR INITIATIVES When Rules 38a-1 and 206(4)-7 were published for comment, the Proposing Release also requested comment on four additional approaches that the Commission might take to require the private sector to assume greater responsibility for compliance with the federal securities laws.29 The Adopting Release notes that, while the Commission is not moving forward with any of these approaches at this time, they “continue to regard them as viable options should the [new compliance rules] fail to adequately strengthen the compliance programs of funds and advisers.” In particular, the Commission may reconsider whether third-party compliance audits “could be a useful supplement” to the Commission’s examination program and assure the frequent examination of advisers and funds. Tamara K. Salmon Senior Associate Counsel 29 These four approaches were: (1) a requirement that funds and advisers undergo third-party compliance reviews; (2) an expansion of the role of a fund’s independent public accountant to include the performance of a compliance review; (3) the formation of one or more self-regulatory organizations for advisers and funds; and (4) a requirement that certain advisers obtain fidelity bonds from a reputable insurance company.
