

MEMO# 17067

February 5, 2004

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

[17067] February 5, 2004 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 7-04 COMPLIANCE ADVISORY COMMITTEE No. 15-04 SEC RULES MEMBERS No. 18-04 SMALL FUNDS MEMBERS No. 12-04 UNIT INVESTMENT TRUST MEMBERS No. 7-04 RE: 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 comment letter on these two issues, which is summarized below. 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 letter states that requiring the board to approve the CCO's compensation is 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 * See Institute Memorandum to Closed-End Investment Company Members No. 114-03, SEC Rules Members No. 193-03, Small Funds Members No. 89-03, and Unit Investment Trust Members No. 55-03 [16907], and Memorandum to Compliance Advisory Committee No. 112-03 [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 board approve the CCO's compensation, the SEC require that the board receive periodic (e.g., annual) 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

proposed rule vesting in the board the exclusive authority to remove the CCO from his or her position, the letter recommends that the Commission revise this provision to permit the entity that employs the CCO to terminate such person, 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, 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.

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.

REPORTS TO THE BOARD The Institute's letter also recommends that the Commission clarify that the material compliance matters that must be reported to the board are those of which the CCO becomes aware during the reporting period.

Tamara K. Salmon Senior Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 17067, or call the ICI Library at (202) 326-8304 and request the attachment for memo 17067.

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