The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**MEMO# 15911**

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# ICI COMMENT LETTER ON SEC COMPLIANCE RULE PROPOSAL AND REQUEST FOR COMMENT ON OTHER INITIATIVES TO ENHANCE COMPLIANCE

[15911] April 17, 2003 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 36-03 COMPLIANCE ADVISORY COMMITTEE No. 30-03 INVESTMENT ADVISER MEMBERS No. 14-03 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 7-03 SEC RULES MEMBERS No. 49-03 SMALL FUNDS MEMBERS No. 19-03 UNIT INVESTMENT TRUST MEMBERS No. 14-03 RE: ICI COMMENT LETTER ON SEC COMPLIANCE RULE PROPOSAL AND REQUEST FOR COMMENT ON OTHER INITIATIVES TO ENHANCE COMPLIANCE As we previously informed you, in February, the Securities and Exchange Commission proposed for comment new Rule 38a-1 under the Investment Company Act of 1940 to require each registered investment company to (1) adopt and implement policies and procedures 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, and (3) designate a chief compliance officer responsible for administering them.1 The Commission's proposing release also sought comment on other ways to involve the private sector in fostering compliance by investment companies and investment advisers with the federal securities laws.2 The Institute's comment letter is attached and briefly summarized below.3 I. COMMENTS ON PROPOSED RULE 38a-1 The Institute's letter expresses support for the Commission's goal of ensuring that each registered investment company has a rigorous internal compliance program, noting that in 1994 1 See Institute Memoranda Nos. 14926 and 15651, dated February 6, 2003 and February 12, 2003, respectively. 2 The four initiatives on which the Commission sought comment were: (1) periodic third-party compliance reviews of funds and advisers; (2) an expansion of the scope of fund audits performed by independent public accountants to include a review of the fund's compliance policies and procedures and their implementation; (3) the formation of one or more self-regulatory organizations; and (4) a fidelity bonding requirement for advisers. 3 As discussed in the first paragraph of our letter, the Institute's comments were limited to the compliance rule proposed under the Investment Company Act, Rule 38a-1. However, to the extent our recommendations would be relevant to the compliance rule proposed under the Advisers Act, our letter encourages the Commission to make similar revisions to that rule as appropriate. 2 the Institute submitted a proposed internal compliance rule to the Commission that was similar to proposed Rule 38a-1. The letter identifies two significant ways in which the Commission's proposed rule differs from the Institute's proposal. First, it would, in effect, require the fund's board to approve all of the compliance policies and

procedures of a fund and its service providers. Second, the Commission's rule would require the appointment of a single compliance officer with ultimate responsibility for the fund's compliance program and would require that such person be approved by the board. The Institute's letter discusses why these aspects of the Commission's proposal would be problematic. The Institute's letter includes the following recommendations: • We recommend that the rule be revised to clarify that a fund may rely on the compliance policies and procedures of its service providers (i.e., its investment adviser, principal underwriter, and administrator) that govern the services they provide to the fund. This change would better accommodate existing fund compliance structures, which have worked well. • We recommend that the rule be revised to ensure that, consistent with the Commission's stated intent, the board serves in an oversight role. Rather than requiring the board to approve all compliance policies and procedures governing the fund and its service providers (to the extent of the services they provide to the fund), the rule should require the board to determine that the fund and its service providers have adequate compliance systems in place. To enable the board to make this determination, each fund and service provider should provide a written report to the board, no less frequently than annually, that summarizes the entity's relevant compliance policies and procedures and their implementation. • Instead of requiring the designation of a single chief compliance officer who must be approved by the fund's board, the rule should require each fund and service provider to identify in its annual report to the board the person(s) within the entity charged with the primary responsibility for implementing the compliance policies and procedures applicable to such entity. The rule should not require the board to approve these persons. • The standard by which the compliance policies and procedures required by the rule will be measured should be one of promoting compliance with the federal securities law, not one of preventing violations. • We support the Commission's approach of not prescribing in the rule the areas that must be included in the policies or procedures of the fund or its service providers. Due to the diversity of the fund industry, we believe it is important for the rule to provide flexibility regarding the appropriate contents of the policies and procedures of the fund and its service providers. • Proposed Rule 38a-1 should include a safe harbor expressly providing that no person would be liable under the rule solely because a violation of the securities laws occurs if he or she (1) had a reasonable basis to believe that the compliance policies and 3 procedures adopted pursuant to the rule were not deficient and (2) reasonably discharged his or her obligations under the rule. II. COMMENTS ON OTHER MEASURES TO PROMOTE COMPLIANCE In response to the Commission's request for comment on the four initiatives identified to involve the private sector in fostering compliance by investment companies and investment advisers with the federal securities laws, the Institute's letter discusses why we believe it is premature to consider pursuing any of these concepts at this time. The letter states that notwithstanding this, our comments on the four initiatives are as follows: Periodic Compliance Reviews by a Third Party – The Institute would oppose a requirement that all funds undergo periodic third-party compliance reviews. We believe it would be difficult, if not impossible, for the Commission to define with the necessary specificity requirements relating to the third party's competence and the thoroughness of the compliance review in order to ensure that such reviews are conducted uniformly throughout the industry. Mandating third-party reviews would impose substantial direct and indirect costs on funds and would eliminate the discretion that funds currently have to determine whether such a review would be cost-effective. Expanded Fund Audits – The Institute believes that expanding a fund's financial audit to include non-financial regulatory issues is inappropriate. The letter notes that the persons conducting an audit of a fund's financial statements may not have the in-depth knowledge of the federal securities laws necessary to audit the fund's compliance policies and procedures. If they did have such knowledge, the costs for expanding the scope of the

audit would likely be substantial and exceed any benefit to flow from the expanded audit. Creation of One or More Self-Regulatory Organizations – The Institute strongly opposes the creation of a self-regulatory organization for funds. In addition to the significant costs that would be involved, the creation of a self-regulatory organization would upset the current scheme of regulation and fragment critical and complementary regulatory responsibilities, to the detriment of investors. The current system of direct Commission oversight of mutual funds has worked exceptionally well for more than sixty years. Imposing a Fidelity Bonding Requirement – The Institute would not oppose the Commission exploring the possibility of imposing a fidelity bonding requirement on investment advisers to registered investment companies, so long as such a requirement would not increase the minimum amount of coverage required by Rule 17g-1 under the Investment Company Act. 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 15911, or call the ICI Library at (202) 326-8304 and request the attachment for memo 15911.

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