

MEMO# 15196

September 23, 2002

INSTITUTE LETTER TO THE SEC WITH RESPECT TO CODES OF ETHICS AND FINANCIAL EXPERTS

[15196] September 23, 2002 TO: ACCOUNTING/TREASURERS COMMITTEE No. 45-02 SEC RULES COMMITTEE No. 78-02 RE: INSTITUTE LETTER TO THE SEC WITH RESPECT TO CODES OF ETHICS AND FINANCIAL EXPERTS The recently-enacted Sarbanes-Oxley Act of 2002 contains several provisions that must be implemented through SEC rulemaking. Some provisions require the SEC to propose rules within 90 days of the legislation's enactment (i.e., by October 28th). Included among these are: (1) Section 406, which directs the Commission to issue rules to require each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers and if not, why not, and (2) Section 407, which requires each issuer to disclose whether or not its audit committee includes at least one member who is a "financial expert," as that term is defined by the SEC. In anticipation of the publication of proposed rules, the Institute sent a letter to the SEC that makes recommendations regarding the application of these provisions to investment companies. A copy of the letter is attached. The letter is similar to the draft letter previously sent to you.¹ The letter urges the SEC, in developing rules to implement Sections 406 and 407, to take into account existing requirements applicable to investment companies and the unique nature of investment company financial statements. In particular, with respect to Section 406, the letter describes existing code of ethics requirements for investment companies under the Investment Company Act of 1940 and notes several other relevant provisions of the Investment Company Act, as well as the recently adopted certification requirements under Section 302 of the Sarbanes-Oxley Act. The letter recommends that the SEC deem compliance with Rule 17j-1 under the Investment Company Act and other relevant requirements to satisfy any new Commission requirement applicable to investment companies under Section 406. With respect to Section 407, the letter recommends that the SEC define "financial expert" for investment companies in a way that recognizes the inherent differences between investment companies and operating companies. The letter notes that due to the straightforward nature of fund financial statements and accounting policies, investment company audit committees ¹ Memorandum to SEC Rules Committee No. 77-02, Accounting/Treasurers Committee No. 44-02, dated September 17, 2002. ² typically do not include directors with accounting or auditing experience. Rather, audit committees for investment companies typically have members with relevant investment company experience or other appropriate business experience. The letter then notes that these persons have provided effective oversight of investment company accounting and auditing processes, as evidenced by the absence of reported abuses involving investment company financial statements. The letter notes that Section 407(b) requires the

Commission to consider as a factor in defining “financial expert” whether that person has through education and experience as a public accountant, principal financial officer of an issuer, or from a position involving the performance of similar functions an understanding of, among other things, generally accepted accounting principles. The letter asserts that there are numerous positions, aside from those specifically identified, that would provide relevant knowledge and experience to an investment company “financial expert,” such as the chief operating officer of a public company, a business school professor, or a person with experience in managing investments or in investment company operations. The letter notes that such persons could be expected to have an understanding of generally accepted accounting principles, internal controls, and audit committee functions that would enable them to provide meaningful oversight of fund accounting and auditing processes. Finally, the letter notes that some of the other factors that the SEC is directed to consider in developing a definition of “financial expert” (e.g., whether the person has experience in “accounting for estimates, accruals, and reserves”) are not relevant to investment companies and therefore should not be prerequisites for an investment company director to be considered a financial expert. Dorothy M. Donohue Associate Counsel Attachment (in .pdf format)

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