The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**COMMENT LETTER**

August 16, 2002

# Comment Letter on CEO Certification Proposal, August 2002

August 16, 2002

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549-0609

Re: Certification of Disclosure in Companies' Quarterly and Annual Reports (File No. S7-21-02)

Dear Mr. Katz:

The Investment Company Institute 1 appreciates the opportunity to comment on the Securities and Exchange Commission's release relating to the certification requirements contained in Section 302 of the Sarbanes-Oxley Act of 2002 (the "Act"). 2 The certification requirements in Section 302, like the certification requirements recently proposed by the Commission, 3 would require a public company's principal executive officer and principal financial officer, or persons performing similar functions, to certify information contained in annual and quarterly reports filed by that company under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934. The Supplemental Release requests comment on the manner in which the certification requirements should apply to registered investment companies, including the appropriate location for the certification, the appropriate individuals to provide the certification, how the rule should apply to different types of investment companies, and any other matters that are specific to registered investment companies. 4

While it is not entirely clear that investment companies are covered, or were intended to be covered, by Section 302, we are submitting this letter in response to the Commission's request for comment on the manner in which Section 302 should be applied to investment companies, if it is in fact determined that they are subject to Section 302.

As a preliminary matter, we note that, as a result of its outstanding rulemaking proposal to require certifications of public company reports, the Commission has had time to consider many of the issues relating to the application of this requirement to those companies, and the public has had an appropriate time within which to comment. In the case of investment companies, however, the entire process has been condensed into a 30-day time period. 5

Our comment letter addresses several points regarding the application of Section 302 to management investment companies. These are: (1) the scope of the certification requirement, (2) the officers who should be responsible for the certification, (3) the scope of the internal control evaluation under Section 302, and (4) the need for a transition period before compliance with Section 302 is required. Our letter also discusses the applicability of Section 302 to unit investment trusts and recommends that the Commission exclude certain UITs from the certification requirement.

## Scope of Certification

We believe that any certification requirement for officers of investment companies should apply exclusively to the financial statements and other financial information included in the reports provided to shareholders pursuant to Section 30(e) of the Investment Company Act of 1940, which are filed with the Commission under Section 30(b)(2) of the Investment Company Act. Specifically, we believe the "financial statements and other financial information" referenced in Section 302(a)(3) of the Act should, in the case of registered management investment companies, be defined as the fund's financial statements for the period as required under Regulation S-X, along with the condensed financial information for the same period. 6 We further recommend that the certification required under Section 302(a)(2) of the Act be limited to this information. Shareholders of funds who wish to evaluate a fund's results of operations and financial position would rely upon the financial statements and other financial information in fund shareholder reports. And, although this information is not completely analogous to the financial information included in annual and quarterly reports of operating companies, it represents the only meaningful periodic financial information prepared by investment companies that is sent to shareholders (and made available to other investors).

In contrast, we do not believe that officers of investment companies should be required to certify information contained in Form N-SAR filings, even though, as a technical matter, these filings are currently used by investment companies to satisfy their obligations to file periodic reports under Sections 13(a) and 15(d) of the 1934 Act. 7 Form N-SAR does not contain financial statements; it only contains limited financial information derived from the fund's financial statements, along with a significant amount of other information that is not financial in nature. 8 Such information, thus, does not "fairly present in all material respects the financial condition and results of operations of the issuer." 9 Moreover, the information contained in Form N-SAR is not intended to assist investors in evaluating a fund's results or financial position. The Form N-SAR is not provided to shareholders and, even if they obtain it, the information it contains would be of little value in assessing a fund. The format of Form N-SAR also is not one that is designed to facilitate investor use or comprehension. This is not surprising, as Form N-SAR is a technical document designed solely to furnish certain statistical and compliance-related information to the Commission staff. For these reasons, we believe it would serve no purpose and would be inconsistent with Congressional intent to apply the certification requirement to information included in Form N-SAR. 10

We likewise recommend that investment company officers should not be required to certify information contained in fund shareholder reports other than the financial information described above. Shareholder reports often include additional voluntary information, such as "President's letters", interviews with portfolio managers, and the like. These disclosures do not relate to a fund's financial statements and, therefore, do not appear to represent the type of disclosures that the Section 302 certification requirement was intended to cover. 11

Many open-end investment company shareholder reports also include the information otherwise required in mutual fund prospectuses under Item 5 of Form N-1A, the "Management's Discussion of Fund Performance" (or "MDFP"). 12 We believe investment company officers should not be required to certify the MDFP. The MDFP is designed to provide investors with disclosures regarding a fund's past performance and describes the factors that affected that performance. It consists of a discussion of the factors that materially affected fund performance during the most recently completed fiscal year, including relevant market conditions and the investment strategies and techniques used by the fund's investment adviser, as well as a line graph comparing the fund's total return to a broad-based securities index, and average annual total return information covering prescribed periods.

The MDFP stands on its own, and does not analyze or provide context for the fund's financial statements. This is in contrast to the "Management's Discussion and Analysis of Financial Condition and Results of Operations" (or "MD&A"), 13 which is required to be included in the periodic reports filed by public companies under Sections 13(a) and 15(d) of the 1934 Act and, therefore, would be required to be certified under Section 302. The MD&A is intended to provide a narrative explanation of an operating company's financial statements and to provide the context within which the financial statements should be analyzed. Accordingly, the MD&A is an integral part of the financial information included in quarterly or annual reports of operating companies. Consequently, despite its superficial resemblance to the MD&A of operating companies, we do not believe that the MDFP should be within the scope of the certification requirement for investment companies.

In conclusion, we recommend that the Commission's rules to implement the certification requirement for registered management investment companies provide that the financial information included in these companies' annual and semi-annual reports to shareholders would constitute the "report" contemplated under Section 302. We believe that the Commission can adopt such a standard pursuant to its authority under Section 3(a) of the Act to promulgate rules and regulations as may be necessary in furtherance of the Act.

## Certifying Officers

As noted above, the Supplemental Release seeks comment on who should be the appropriate individuals to provide certification in the case of investment company issuers. We believe the appropriate individuals would be those designated as the fund's principal executive officer and principal financial officer (or their equivalent).

We believe it is more appropriate to designate an officer or officers of the fund itself for this purpose, rather than officers of any particular third party. While it is true that the vast majority of funds are externally managed, it is also true that funds, as corporate entities, have their own officers (who generally will also be officers or employees of the fund's adviser, administrator, or other entity). Indeed, fund registration statements are required to be signed by, among others, the fund's principal executive officer and principal financial officer.

In addition, the wide variety of relationships between funds and their affiliates and other service providers would seem to preclude the possibility of crafting a standard that could specify which third party personnel should be responsible for certification. For example, for some funds, the persons who fill the roles of principal executive officer and principal financial officer will be employees of the fund's adviser. In other cases, they will be

employees of the fund's administrator. In others, one may be employed by the adviser and the other by the administrator. In still others, one or both may only be employed by the fund, and not by any other entity.

For the reasons stated above, it is important that funds have the flexibility to designate the appropriate persons to provide the certification. We believe that applying the certification requirement to an officer or officers of the fund would give funds (and their boards) the necessary flexibility. Accordingly, we recommend that the Commission take this approach.

# Internal Controls

Sections 302(a)(4) through 302(a)(6) of the Act require the certification to include statements regarding the issuer's internal controls. Among other things, the certification must indicate that the signing officers are responsible for establishing and maintaining internal controls that are designed to ensure that material information relating to the public company and its consolidated subsidiaries is made known to such officers by others within those entities. 14

In adopting rules to implement Section 302, we urge the Commission to make clear that internal controls in this context are limited to those procedures designed to collect, process and make known to certifying officers the material information that forms the basis of the information that is being certified under Sections 302(a)(2) and (3). Investment companies have a variety of other internal controls relating to numerous other compliance-related functions. While these controls are important, we do not believe that Section 302 was intended to apply to them, and request that the Commission confirm this. We note that this interpretation would be consistent with the Commission's proposed Rules 13a-15 and 15d-15, as described in the Proposing Release. There, the Commission stated that the proposed internal controls were designed to "ensure that a company maintains . . . procedures for gathering, analyzing and disclosing all information that is required to be included in its periodic and current reports." 15

The Commission also should clarify that, in the case of investment companies, the internal controls that must be evaluated are those of the fund itself. Investment companies engage a variety of entities, including unaffiliated third parties, to perform various functions for them. For example, fund transfer agents are typically responsible for controls over the issuance and redemption of fund shares, while fund custodians are typically responsible for controls over settlement of the fund's transactions in portfolio securities. As a practical matter, a fund's officers would not have the ability to "establish and maintain" control procedures at these service providers to the extent contemplated in Section 302. Consequently, we recommend that the Commission clarify that the scope of the internal controls review requirement extends only to those internal controls necessary to ensure that the certifying officers receive the appropriate information.

We further recommend that the Commission clarify that investment companies within a single complex that share a common internal control system can rely on an evaluation of that system for purposes of the certification requirement. It is common practice for investment companies within the same complex to rely on the same control systems. Section 302(a)(4)(C) requires the signing officers to certify that they have evaluated the effectiveness of the issuer's internal controls within 90 days prior to the report. If a separate evaluation were to be required for every fund within a complex, this could prove to be extremely burdensome, especially in the case of complexes consisting of large

numbers of funds. Moreover, there would be no benefit in requiring separate evaluations. Therefore, it would be more logical for the certifying officers to evaluate the controls of the complex as a whole. 16

## Transition Period

As stated in the Supplemental Release, Section 302 of the Act requires the Commission to adopt rules implementing the certification requirements by August 29, 2002. We recommend, however, that the final rules not require investment companies to comply with the new requirements until after a reasonable transition period. For these purposes, we would recommend a transition period of 120 days following adoption of the rules.

We note that there have been other recent instances where rules have been adopted and become effective on or shortly before a statutory deadline, but where a later compliance date has been specified in order to provide parties with adequate time to implement new requirements. 17 A similar transition period is needed in this case. Such matters as the form of the certification, scope of the certification, and persons responsible for the certification will not be known to funds until the Commission's rules are adopted. Even more problematic is the fact that it will take time to perform an evaluation of the effectiveness of internal controls (as required by Section 302(a)(4)(C)) and make the required disclosures to auditors and the audit committee (as required by Section 302(a)(5)). Fund officers will be required to complete the required evaluations and notification before any filing is made that is subject to the new certification requirements, including any filings that are made shortly after August 29, 2002. 18 Immediate compliance is not reasonably practicable.

We believe that a compliance date 120 days after the effective date of the final rules would be a reasonable and appropriate transition period. In addition, it would accommodate those funds that require or desire board action in connection with the new requirements (e.g., to designate the certifying officers), as fund boards frequently meet on a quarterly basis.

## Unit Investment Trusts

For a variety of reasons, we recommend that the Commission exclude unit investment trusts from the requirements of Section 302. 19 First, unit investment trusts are fixed investment pools. Investors in UITs receive a prospectus containing financial information about the trust, but there is little additional material information contained in subsequent financial disclosures. Thus, there would not seem to be any policy basis for subjecting UITs to a certification requirement. Second, and probably in recognition of the fact that any such subsequent financial disclosures would be of little value to investors, the Commission does not require UITs to send periodic reports to unitholders or to file such reports with the Commission (unlike the case of mutual funds and closed-end funds). Thus, there would be no financial statements contained in periodic filings of UITs that could be certified. 20 (UIT trustees typically send unitholders an annual report, in the form specified by the trust indenture, that discloses receipts, expenses, distributions to unitholders, dispositions of securities, and the cash and securities on hand and unit value at the end of the year. This information is reported on a cash basis and is unaudited. It would not appear to be the sort of disclosure that Congress could have intended the certification requirements to apply to.)

Third, it is not clear who could certify UIT information. UITs do not have officers. While the

sponsor of a UIT is technically considered to be the issuer of the UIT's securities under the securities laws, the sponsor will typically have no role in preparing information that is periodically disseminated to unitholders (such as the annual reports referred to above). Instead, the trustee usually prepares that information. Thus, it would be wholly inappropriate to require officers of the sponsor to certify that information. And, while UIT trustees are more directly involved in the operations of UITs on an ongoing basis, it is not clear that the Commission would have the authority to require their officers to be responsible for the certifications required under Section 302.

The Institute believes that the foregoing reasons justify the Commission exempting UITs from the requirements of Section 302, pursuant to its rulemaking authority under Section 3(a) of the Act.

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We appreciate the Commission's consideration of our comments. Any questions regarding our letter may be directed to the undersigned at 202/326-5815.

Sincerely,

Craig S. Tyle
General Counsel

cc: Paul F. Roye, Director
Cynthia M. Fornelli, Deputy Director
Division of Investment Management

Alan L. Beller, Director
Division of Corporation Finance

Giovanni Prezioso, General Counsel
Office of General Counsel

**ENDNOTES**

1The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,990 open-end investment companies ("mutual funds"), 504 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.615 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

2 SEC Release No. 34-46300 (August 2, 2002); 67 Fed. Reg. 51508 (August 8, 2002) (the "Supplemental Release").

3 SEC Release No. 34-46079 (June 14, 2002); 67 Fed. Reg. 41877 (June 20, 2002) (the "Proposing Release").

4 Supplemental Release at pp. 4-5.

5 Given this, the Commission may wish to consider whether it should extend the comment period for Section 302 rules for investment companies and temporarily suspend the application of Section 302 to investment companies, pursuant to its rulemaking authority

under Section 3(a) of the Act, until it adopts such rules. This would allow the Commission to consider such rules through a more deliberative process, and provide more meaningful opportunity for public comment.

6 See Items 22(b)(1) and (2) and (c)(1) and (2) of Form N-1A and Instructions 4.a. and b. and 5.a. and b. of Form N-2.

7 See Rule 30a-1 under the Investment Company Act. In any event, the certification should be required with respect to one set of reports, and not to both the financial statements and Form N-SAR. It would be anomalous if the Commission placed a heavier burden on investment companies than the Congress has placed on 1934 Act reporting issuers.

8 See, e.g., Item 61 (minimum initial investment), Item 39 (account maintenance fees) and Item 15 (custodial arrangements).

9 Section 302(a)(3) of the Act.

10 By the same token, we do not believe that it would be appropriate to require certification of information included in Form N-SAR, even if limited to the financial information contained therein. To the extent that such information is not duplicative of the information in annual and semi-annual reports to shareholders, much of it is at a level of detail that is of no use to investors. See, e.g., Item 72K (amount fund spent on postage). This is clearly not the type of information Congress believed should be certified.

11 It should be noted that this information is generally considered to be supplemental sales literature and, as a result, is generally filed with the NASD. Moreover, if this information were required to be certified, funds might be discouraged from continuing to provide it, which would be a disservice to investors.

12 Item 5 of Form N-1A provides that this information is not required to be included in a fund's prospectus if it is included in the fund's annual report.

13 Item 303 of Regulation S-K.

14We do not read the use of the word "ensure" in Section 302(a)(4)(B) of the Act as imposing strict liability on the certifying officers for any failures of the internal controls. We believe it would be helpful if the Commission confirmed our reading of that section of the Act.

15 Proposing Release at 8.

16 As a practical matter, this would mean that, while a fund-by-fund review could require evaluations as frequently as monthly in the case of a large fund complex consisting of funds with staggered fiscal years, an evaluation of controls at the fund complex level could be done on a quarterly basis, which would be consistent with the requirements for operating companies. We suggest, however, that the Commission consider the possibility of requiring fund officers to conduct an internal controls evaluation on a semi-annual basis, rather than within 90 days of each report. The 90 day period clearly was designed with quarterly reports (Form 10-Q) in mind, not semi-annual certifications.

17 See, e.g., Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Mutual Funds, 67 Fed. Reg. 21117 (April 29, 2002).

18 In the case of larger fund complexes that consist of numerous funds with staggered fiscal years, filings containing information that will have to be certified may occur as frequently as monthly. This will make it very difficult for those complexes to accelerate or delay certain filings in order to minimize compliance burdens.

19 Our comments in this section of our letter are limited to unit investment trusts other than those that invest substantially all of their assets in securities issued by a single management investment company (i.e., those trusts that are not required to deliver shareholder reports under Investment Company Act Rule 30e-2). We do not have a position on whether other types of UITs should likewise be exempt from the Section 302 requirements.

20 UITs are required to file N-SARs, although they only file them on an annual basis. For the reasons set forth above, we do not believe the information contained in that form should be the subject of a certification requirement. This is especially so in the case of UITs, which are required only to furnish limited information in their Form N-SAR filings.

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