**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 270 and 275**

**[Release Nos. IC–25925, IA–2107; File No. S7–03–03]**

**RIN 3235–AI77**

## Compliance Programs of Investment Companies and Investment Advisers

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission is publishing for comment new rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that would require each investment company and investment adviser registered with the Commission to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and appoint a chief compliance officer to be responsible for administering the policies and procedures. The Commission also seeks comment on other ways to involve the private sector in fostering compliance by investment companies and investment advisers with the federal securities laws. The proposed rules are designed to protect investors by being the first step towards enhanced compliance achieved through private initiative.

**DATES:** Comments must be received on or before April 18, 2003.

**ADDRESSES:** To help us process and review your comments more efficiently, comments may be sent to us in either paper or electronic format. Comments should not be sent by both methods.

Comments in paper format should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments in electronic format may be submitted at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–03–03; if e-mail is used, this file number should be included on the subject line. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will also be posted on the Commission's Internet Web site *(http://www.sec.gov).*[1]

**FOR FURTHER INFORMATION CONTACT:** Hester Peirce, Senior Counsel, Office of Regulatory Policy at (202) 942–0690, or Jamey Basham, Special Counsel, Office of Investment Adviser Regulation at (202) 942–0719.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (''SEC'' or ''Commission'') is requesting public comment on proposed rule 38a–1 [17 CFR 270.38a–1] under the Investment Company Act of 1940 [15 U.S.C. 80a] (''Investment Company Act''), proposed rule 206(4)–7 [17 CFR 275.206(4)–7] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (''Investment Advisers Act'' or ''Advisers Act''), and proposed amendments to rule 204–2 under the Advisers Act [17 CFR 275.204–2].

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## I. Background

Mutual funds and other types of investment companies provide access to the capital markets for millions of small and large investors.[2] The tremendous growth of funds reflects the confidence investors have in funds and the regulatory protections provided by the federal securities laws.

The Commission regulates mutual funds and other investment companies under the Investment Company Act, and regulates the investment advisers that provide investment management services to those funds and to other clients under the Advisers Act.[3] The Investment Company Act provides a comprehensive regulatory structure designed to protect largely passive investors in funds, while the Advisers Act, which contains a less detailed regulatory scheme, imposes a broad fiduciary duty on advisers, requiring them to act in the best interest of their clients.[4] These statutes contain common elements: they require registration with us;[5] proscribe certain types of harmful conduct;[6] and give us the authority to require the disclosure of certain information[7] and the maintenance of certain records.[8] They give us authority to examine the records of funds and advisers.[9] During fiscal year 2002, our staff conducted examinations of 278 fund complexes[10] and 1,570 investment advisers.

The Commission's examination of funds and advisers is a key element of our investor protection program. During

[1] We do not edit personal or identifying information, such as names or e-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] In this release, we use the term ''fund'' to mean a registered investment company or a business development company defined in section 2(a)(48) of the Investment Company Act [15 U.S.C. 80a–2(a)(48)], and the term ''mutual fund'' to mean a registered investment company that is an open-end management company defined in section 5(a) of the Investment Company Act [15 U.S.C. 80a–5(a)].

[3] Funds and advisers are also subject to other federal securities laws, including the Securities Act of 1933 [15 U.S.C. 77] and the Securities Exchange Act of 1934 [15 U.S.C 78] (''Exchange Act'').

[4] *Transamerica Mortgage Advisors v. Lewis,* 444 U.S. 11, 17 (1979).

[5] *See* Section 8(a) of the Investment Company Act [15 U.S.C. 80a–8(a)] and section 203 of the Advisers Act [15 U.S.C. 80b–3].

[6] *See, e.g.,* sections 10(f) [15 U.S.C. 80a–10(f)] (prohibiting funds from acquiring securities during the existence of an underwriting syndicate in which an affiliate participates), 12(d) [15 U.S.C. 80a–12(d)] (prohibiting funds from acquiring securities of other funds above certain limits), and 17(a) [15 U.S.C. 80a–17(a)] (prohibiting certain persons from engaging in certain purchase, sale, and loan transactions with an affiliated fund) of the Investment Company Act; and section 206 of the Advisers Act [15 U.S.C. 80b–6] (prohibiting fraud).

[7] *See, e.g.,* section 30(e) of the Investment Company Act [15 U.S.C. 80a–29(e)] (authorizing Commission to require funds to transmit certain information to stockholders) and section 204 of the Advisers Act [15 U.S.C. 80b–4] (authorizing Commission to require advisers to disseminate certain information).

[8] *See* Section 31(a) of the Investment Company Act [15 U.S.C. 80a–30(a)] (authorizing Commission to require funds to maintain records) and section 204 of the Advisers Act (authorizing Commission to require advisers to maintain records).

[9] *See* Section 31(b) of the Investment Company Act [15 U.S.C. 80a–30(b)] (authorizing Commission to examine fund records) and section 204 of the Advisers Act (authorizing Commission to examine adviser records).

[10] In this release, we use the term ''fund complex'' to indicate a group of funds that share a compliance program and often also have a common investment adviser or distributor.

a compliance examination, our staff visits the offices of the fund or adviser, reviews business records and interviews personnel to determine whether the fund or adviser is acting in compliance with the federal securities laws. Our examinations permit us to identify compliance problems at an early stage, identify practices that may be harmful to investors, and provide a deterrent to unlawful conduct. In many respects, our examiners are like ''cops on the beat'' watching for unlawful conduct in a neighborhood.

Like police officers, our examiners cannot be everywhere at all times. Approximately 5,030 funds and 7,790 advisers are currently registered with us.[11] Collectively, these funds and advisers control over $21 trillion of assets, and engage in tens of millions of transactions each year. Our current resources permit us to conduct routine examinations of each of the 966 fund complexes and each adviser only once every five years, and during these examinations we are unable to review every transaction. Instead, our compliance examinations focus on the effectiveness of the internal controls that the fund or adviser has established to prevent and detect violations of the federal securities laws.

Our experience is that funds and advisers with effective internal compliance programs administered by competent compliance personnel are much less likely to violate the federal securities laws. If violations do occur, they are much less likely to result in harm to investors. In contrast, we have learned to regard weak controls as an indicator that undetected (and uncorrected) violations may have occurred, and we have assumed that, until improved controls are implemented, investors are at risk. Accordingly, our staff focuses its examination efforts on testing the effectiveness of controls and related compliance procedures, and requests that management correct any weaknesses that the staff discovers. This focus allows us to leverage our limited examination resources; we are able to direct additional resources to firms with weaker compliance controls, and may examine them more closely and more frequently.[12]

Our ability to protect fund investors and advisory clients has in many respects come to rely upon the effectiveness of these compliance programs. They provide the first line of investor protection. Many funds and advisers have established effective programs staffed with competent and trained professionals.[13] However, neither the federal securities laws nor our rules *require* funds and advisers to adopt and implement comprehensive compliance programs, and not all firms registered with us have adopted and implemented adequate compliance programs. The consequences of inadequate compliance programs are well documented in our releases through which we publicize our enforcement actions.[14]

Because of the importance of these compliance programs to investors and to the administration of our examination authority under the Investment Company Act and Advisers Act, we are proposing two new rules (one for funds and one for advisers) that would require funds and advisers to (i) adopt and implement policies and procedures designed to prevent violations of the securities laws, (ii) review these policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and (iii) designate a chief compliance officer responsible for administering the policies and procedures.[15] We discuss each of the rules in more detail below.

We also are asking for comment on other possible roles for the private sector in overseeing compliance by funds and advisers with the federal securities laws. Specifically, we ask comment on the following possible avenues towards enhanced private sector involvement: (i) Periodic third-party compliance reviews of funds and advisers, (ii) an expansion of the scope of the fund audits performed by independent public accountants, (iii) the formation of one or more self-regulatory organizations, and (iv) a fidelity bonding requirement for advisers.

## II. Discussion

The Commission is proposing new rule 38a–1 under the Investment Company Act and new rule 206(4)–7 under the Advisers Act. In this release, we will refer to the rules collectively as the ''Proposed Rules.''[16] Together the Proposed Rules would require *all* investment companies and advisers registered with us to adopt and

[11] As of November 2002, these registered investment companies were organized into 966 fund complexes and comprised nearly 33,000 fund series and portfolios.

[12] *See* Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations, The Evolution of the SEC's Inspection Program for Advisers and Funds: Keeping Apace of a Changing Industry, Remarks at Conference on Compliance and Inspection Issues for Investment Advisers and Investment Companies (Oct. 30, 2002) (transcript available at: *http://www.sec.gov/news/speech/spch597.htm*) (''[E]xaminers will ask about your compliance and control policies and procedures, and evaluate their implementation and effectiveness. If we can conclude that your controls are working effectively, we will adjust the depth and amount of test-checking we do to reflect that fact. If we find weaknesses in controls, however, our test-checking will be greater, inasmuch as the likelihood of violations will be greater.''). *See also* H.R. Rep. No. 104–622 (1996) (''[T]he goal of examinations effected by the Commission staff should not be simply to duplicate the role played by a fund's internal compliance staff. If a fund has a well-functioning system of internal controls, the Commission's limited resources could be directed to other areas of fund operations, or to other funds.'').

[13] One reason that funds and advisers may have adopted and implemented comprehensive compliance procedures is to defend themselves against a charge by us that they (or their officers or supervisory personnel) failed to supervise their employees (or other supervised persons). Section 203(e)(6) of the Advisers Act [15 U.S.C. 80b–3(e)(6)] provides that a person shall not be deemed to have failed to supervise any person if: (i) The adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedures; and (iii) the person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.

[14] *See, e.g.,* Millennium Capital Advisors, Investment Advisers Act Release No. 2092 (Dec. 13, 2002) (unauthorized trading in client account and concealment of this trading were facilitated by adviser's vague and insufficient compliance procedures and absence of independent monitoring of portfolio manager); Gintel Asset Management, Investment Advisers Act Release No. 2079 (Nov. 8, 2002) (repeated improper cross trades, principal transactions, and personal trading resulted in part from inadequate procedures to prevent violation of the adviser's code of ethics); Back Bay Advisors, Investment Advisers Act Release No. 2070 (Oct. 25, 2002) (excessive reliance on self-reporting and self-monitoring by portfolio managers to determine whether the firm was in compliance with the federal securities laws resulted in improper cross-trades); Western Asset Management, Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (subadviser had not established adequate procedures to detect portfolio manager's fraudulent activities with respect to the purchase and pricing of private placement securities); Scudder Kemper Investments, Investment Advisers Act Release No. 1848 (Dec. 22, 1999) (adviser did not have in place procedures that could have prevented and detected trader's unauthorized trading for investment company accounts); Rhumbline Advisers, Investment Advisers Act Release No. 1765 (Sept. 29, 1998) (absence of procedures enabled chief investment officer to engage in unauthorized trading and to misrepresent resultant losses); Kemper Financial Services, Investment Advisers Act Release No. 1494 (June 6, 1995) (adviser had no guidelines or procedures in place to address conflicts of interest and funds' portfolio manager misappropriated funds' investment opportunity on behalf of private profit-sharing plan he also managed).

[15] The Investment Company Institute (ICI) submitted a rulemaking proposal to the Commission in November 1994 that recommended we adopt rules similar to the ones that we are proposing today (''ICI Proposal''). A copy of that proposal is available in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549 (File No. S7–03–03).

[16] We also are proposing related amendments to rule 204–2 under the Advisers Act. *See infra* section II.D. These proposed amendments also will be included in the term ''Proposed Rules.''

implement internal compliance programs containing elements described in the rules.[17]

• We request comment on whether we should provide for one or more exceptions. Is there a subset of funds or investment advisers with operations so limited or staffs so small that the adoption of an internal compliance program would not be beneficial? If so, are there alternative measures that these funds and advisers could take to promote their compliance with the federal securities laws?

*A. Adoption and Implementation of Policies and Procedures*

The Proposed Rules would require funds and advisers to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws.[18] They must be written and, in the case of a fund, must be approved by the fund's board of directors, including a majority of the fund's independent directors.[19] A fund's policies and procedures must be designed to prevent violation of the federal securities laws by the fund, its investment adviser, principal underwriter, and administrator in connection with their provision of services to the fund.[20] An adviser's policies and procedures must be designed to prevent violation of the Advisers Act by the adviser and its supervised persons.[21]

The Proposed Rules would require funds and advisers to adopt a system of controls that promotes compliance with the securities laws. Internal control systems have long been used to assure the integrity of financial reporting. Congress recently recognized the importance of internal control systems in the Sarbanes-Oxley Act of 2002, which effectively requires public companies to adopt and periodically review the effectiveness of a system of internal controls.[22] Broker-dealers have long been required to adopt compliance procedures.[23] Banks are required to maintain internal controls that include compliance procedures.[24] Several foreign regulators already require funds or advisers registered with them to adopt compliance policies and procedures.[25] The Proposed Rules do not enumerate specific elements that funds and advisers must include in their required policies and procedures.[26] Funds and advisers are too varied in their operations for the Commission to impose a single list of required elements. The policies and procedures required by the Proposed Rules should take into consideration the nature of each organization's operations.[27] They should be designed to *prevent* violations

[17] The rules also would require business development companies, which are unregistered closed-end investment companies, to adopt and implement such programs.

[18] Proposed rules 38a–1(a)(1) and 206(4)–7(a). Under proposed rule 206(4)–7(a), the policies and procedures would need to address only compliance with the Advisers Act.

[19] Proposed rule 38a–1(a)(2). Fund directors are commonly referred to as ''independent directors'' if they are not ''interested persons'' of the fund. The term ''interested person'' is defined in section 2(a)(19) of the Investment Company Act [15 U.S.C. 80a–2(a)(19)]. If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the policies and procedures. Proposed rule 38a–1(b).

[20] The ICI, in its submission to us suggesting a similar rulemaking, favored requiring the policies and procedures to cover the fund, but not the fund's service providers, such as its adviser. See ICI Proposal, *supra* note 15, at 20. Typically, however, a fund has no employees; personnel of its adviser, principal underwriter and/or administrator conduct all of its activities. It is unclear to us whether the ICI's proposal, limited in this manner, would require a fund to adopt sufficiently comprehensive policies and procedures. Therefore, proposed rule 38a–1 would require a fund's procedures to cover the fund's adviser, principal underwriter and administrator, but only with respect to their activities in connection with the operations of the fund.

[21] A ''supervised person'' is ''any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.'' Section 202(a)(25) of the Advisers Act [15 U.S.C. 80b–2(a)(25)].

[22] *See* Sarbanes-Oxley Act of 2002 [Pub. L. No. 107–204, 116 Stat. 745 (2002)] (''Sarbanes-Oxley Act''). Section 404 of the Sarbanes-Oxley Act requires us to prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78m(a) and 78o(d)] to include internal control reports containing an assessment of the effectiveness of those controls, and further requires that the auditors for an issuer attest to the assessment made by the management of the issuer. In October 2002, we proposed rules to implement the provisions of Section 404. Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Investment Company Act Release No. 25775 (Oct. 22, 2002) [67 FR 66208 (Oct. 30, 2002)]. Section 302 of the Sarbanes-Oxley Act required us to adopt rules under which the principal executives and financial officers of public issuers must certify the information contained in the issuer's quarterly and annual reports. These rules also were to require these officers to certify that: they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. On August 29, 2002, we adopted rules implementing Section 302. Certification of Disclosure in Companies' Quarterly and Annual Reports, Investment Company Act Release No. 25722 (Aug. 29, 2002) [67 FR 57276 (Sept. 9, 2002)].

[23] Broker-dealers are required by the National Association of Securities Dealers (''NASD'') to establish and maintain written procedures ''that are reasonably designed to achieve compliance with applicable securities laws and regulations, and the applicable Rules of [the NASD].'' NASD Conduct Rule 3010(b). *See also* New York Stock Exchange (''NYSE'') Rule 342. Both the NASD and the NYSE recently have proposed to enhance these procedures by, among other things, requiring the annual testing and verification of broker-dealers' internal controls by persons independent of the supervision of the underlying activities. NASD Rulemaking: Supervisory Control Amendments, Exchange Act Release No. 46859 (Nov. 20, 2002) [67 FR 70990 (Nov. 27, 2002)] and NYSE Rulemaking: Amendments to Exchange Rule 342 (''Offices—Approval, Supervision and Control'') and its Interpretation, Rule 401 (''Business Conduct''), Rule 408 (''Discretionary Power in Customers' Accounts''), and Rule 410 (''Records of Orders''), Exchange Act Release No. 46858 (Nov. 20, 2002) [67 FR 70994 (Nov. 27, 2002)].

[24] Under section 39 of the Federal Deposit Insurance Act [12 U.S.C. 1831p-1], banks and thrifts are required by their regulators (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, ''Banking Regulators'')) to adopt internal controls that are ''appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for: (1) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established polices; (2) effective risk assessment; (3) timely and accurate financial, operational and regulatory reports; (4) adequate procedures to safeguard and manage assets; and (5) compliance with applicable laws and regulations.'' Standards for Safety and Soundness, 60 FR 35674 (July 10, 1995) (''Interagency Guidelines''), codified at 12 CFR part 30 (Office of the Comptroller of the Currency), 12 CFR part 208, appendix D–1 and part 263, subpart I (Board of Governors of the Federal Reserve System), 12 CFR part 364 (Federal Deposit Insurance Corporation), and 12 CFR part 570 (Office of Thrift Supervision).

[25] *See, e.g.*, Financial Services Authority (FSA), FSA Handbook of Rules and Guidance, Systems and Controls § 3.2.6 (''Areas covered by systems and controls: Compliance'') (United Kingdom); Commission des Opérations de Bourse, L'Instruction du 15 Decembre 1998 Relative aux [Organisme de Placement Collective en Valeurs Mobilieres] Prise en Application du Reglement, L'Annexe IV No. 89–02, Bulletin Mensuel COB 369 (June 2002) (France); Securities and Futures Commission, Fund Manager Code of Conduct § 1.6.3 (1997) (Hong Kong).

[26] The required polices and procedures should incorporate the policies and procedures funds have adopted pursuant to other requirements in the federal securities laws, a number of which we identify in succeeding notes. These policies and procedures need not be contained in the same document.

[27] The NASD directs its broker-dealer members to ''implement a supervisory system that is tailored specifically to the member's business.'' *See* NASD Notice to Members 99–45, at 294 (June 1999). The Banking Regulators have taken a similar approach with respect to compliance programs for banks and thrifts. *See* Interagency Guidelines, *supra* note 24, at 35676. *See also* Office of Comptroller of the Currency, *Comptroller's Handbook: Compliance Management System (Consumer Compliance Examination*), at 2 (Aug. 1996); Federal Deposit Insurance Corporation, *Compliance Examination Manual*, at B–2 (July 1999); Board of Governors of the Federal Reserve System, *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations* § 5000.1 (Compliance), at 1 (Sept. 1997); Office of Thrift Supervision, *Compliance Self-Assessment Guide: Components of an Effective Compliance Program*, at 2 (Dec. 2002).

(by, for example, separating operational functions such as trading and reporting), *detect* violations of securities laws (by, for example, requiring a supervisor to review employees' personal securities transactions), and *correct* promptly any material violations.

We would expect that policies and procedures of funds and (to the extent relevant) advisers would, at a minimum, address:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures, and regulatory requirements; [28]
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (''soft dollar arrangements''), and allocates aggregate trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;[29]
- The accuracy of disclosures made to investors, including information in advertisements;
- 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 or use and protects them from untimely destruction;[30]
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the protection of client records and information; [31] and
- Business continuity plans.

Fund procedures would ordinarily cover a number of additional areas, including:

- Pricing of portfolio securities and fund shares; [32]
- Processing of fund shares;
- Identification of affiliated persons with whom the fund cannot enter into certain transactions, and compliance with exemptive rules and orders that permit such transactions;[33]
- Compliance with fund governance requirements; and
- Prevention of money laundering.[34]

While funds and advisers could delegate compliance functions to service providers, their policies and procedures should provide for effective oversight of these service providers. We request comment on our proposed requirement that advisers and funds adopt compliance policies and procedures.

- Should either rule specify certain minimum policies and procedures? If so, what specific required policies and procedures should we include, and in which rule should we include them?
- We anticipate that if we adopt the Proposed Rules, we will provide guidance to funds and advisers in our adopting release similar to what we have provided above (regardless of whether the rules, as adopted, include specific minimum requirements). We request comment on the guidance that we have provided and urge commenters to provide suggestions as to additional areas our guidance should cover.
- Should the policies and procedures of funds or advisers be designed to prevent violations by persons other than those listed in the Proposed Rules?

*B. Annual Review*

Under the Proposed Rules, each fund and adviser must review its policies and procedures at least annually to determine their adequacy and the effectiveness of their implementation.[35] These provisions are designed to require advisers and funds to evaluate periodically whether their policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.

- Should we require more frequent review of the policies and procedures? Our proposed rules implementing Section 404 of the Sarbanes-Oxley Act would require that executives of issuers evaluate the company's internal controls for financial reporting *quarterly*.[36]

*C. Chief Compliance Officer*

The policies and procedures of a firm, no matter how well-crafted, will be ineffective unless well-trained, competent personnel administer them. Therefore, we are proposing to require that each fund and adviser designate an individual responsible for administering the compliance policies and procedures.[37] The chief compliance officer should be competent and knowledgeable regarding the applicable federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the adviser or the fund complex.[38]

[28] Rule 206(4)–6 under the Advisers Act [17 CFR 275.206(4)–6] requires investment advisers to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients. Similarly, funds must disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities. Form N–1A, Item 13(f) [17 CFR 239.15A; 274.11A]; Form N–2, Item 18.16 [17 CFR 239.14; 274.11a–1]; Form N–3, Item 20(o) [17 CFR 239.17a; 17 CFR 274.11b]; and Form N–CSR, Item 7 [17 CFR 249.331; 17 CFR 274.128].

[29] Section 204A of the Advisers Act [15 U.S.C. 80b–4a] requires each adviser registered with us to have written policies and procedures reasonably designed to prevent the misuse of material non-public information by the adviser or persons associated with the adviser. Rule 17j–1(c)(1) under the Investment Company Act [17 CFR 270.17j–1(c)(1)] requires a fund and each investment adviser and principal underwriter of the fund to ''adopt a written code of ethics containing provisions reasonably necessary to prevent'' certain persons affiliated with the fund, its investment adviser or its principal underwriter from engaging in certain fraudulent, manipulative, and deceptive actions with respect to the fund.

[30] Rule 31a–2(f)(3) under the Investment Company Act [17 CFR 270.31a-2(f)(3)] and rule 204–2(g)(3) under the Advisers Act [17 CFR 275.204–2(g)(3)] require funds and advisers that maintain records in electronic formats to establish and maintain procedures to safeguard the records.

[31] Regulation S–P (''Privacy of Consumer Financial Information'') [17 CFR Part 248.30] requires funds and investment advisers to ''adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.''

[32] Rule 2a–7(c)(7) under the Investment Company Act [17 CFR 270.2a–7(c)(7)] requires boards of money market funds to establish written procedures ''reasonably designed * * * to stabilize the money market fund's net asset value per share.''

[33] Rule 10f–3(b)(10) under the Investment Company Act [17 CFR 270.10f–3(b)(10)] requires boards of funds that purchase securities in an underwriting in which certain persons serve as principal underwriters to adopt certain procedures to govern those purchases. Rule 17a–7(e) under the Investment Company Act [17 CFR 270.17a–7(e)] requires boards of funds that engage in purchase or sale transactions with certain affiliated persons to adopt procedures ''reasonably designed'' to achieve compliance with the conditions on such transactions set forth in the rule.

[34] Under 31 CFR 103.130(c), funds must develop an anti-money laundering program, which includes the establishment and implementation of ''policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of the Bank Secrecy Act and the implementing regulations thereunder.''

[35] Proposed rules 38a–1(a)(3) and 206(4)–7(b). The NASD and the NYSE recently have proposed annual reviews of the internal controls, and reports to senior management. *See supra* note 23.

[36] Investment Company Act Release No. 25775, *supra* note 22.

[37] Proposed rules 38a–1(a)(4) and 206(4)–7(c). In the case of an adviser, the individual would have to be a supervised person of the adviser. *See supra* note 21, regarding the definition of ''supervised person.'' Although the NASD does not require its member broker-dealers to appoint a chief compliance officer, NASD Conduct Rule 3010(a)(2) does direct them to designate principals responsible for supervision, which ''ensure[s] that there is an identifiable individual who has ultimate responsibility for implementing the member's supervisory system and written procedures for each type of business the member conducts.'' NASD Notice to Members 99–45, at 295–96 (June 1999).

[38] Designation of a person by an adviser as its chief compliance officer would not, in and of itself, impose upon the person a duty to supervise another person. Thus, a chief compliance officer appointed in compliance with the Proposed Rules would not necessarily be subject to a sanction by us for failure

Continued

We understand that many funds and advisers have designated a person to serve as the chief compliance officer.[39] Not all firms have taken this step, which we believe is critical to an effective compliance program. We expect that the primary effect of the rule on funds and larger advisory firms would be to require the compliance personnel to report to one individual with overall responsibility to coordinate the fund's (or firm's) compliance efforts and to establish procedures for annual review of its compliance programs.[40]

In the case of a fund, the fund's board of directors, including a majority of the independent directors, would have to approve the chief compliance officer, who would have additional duties that reflect the important role of fund boards in overseeing fund compliance with the federal securities laws.[41] Proposed rule 38a-1 would require the chief compliance officer to furnish the fund's board of directors annually with a written report on the operation of the fund's policies and procedures, including (i) any material changes to the policies and procedures since the last report, (ii) any recommendations for material changes to the policies and procedures as a result of the annual review, and (iii) any material compliance matters requiring remedial action that occurred since the date of the last report.[42] The rule would thus require board oversight of the fund's compliance program, but would not require directors to become involved in the day-to-day administration of the program. We designed the proposed rule to reflect the way many fund complexes' compliance personnel currently administer fund codes of ethics under rule 17j–1 of the Investment Company Act.

- Rule 17j–1 requires that funds, their investment advisers, and principal underwriters certify annually that they have adopted procedures reasonably necessary to prevent violations of their codes of ethics adopted under the rule.[43] Should we similarly require each chief compliance officer to certify the fund's compliance policies and procedures?
- The USA PATRIOT Act requires funds to establish anti-money laundering programs that designate an anti-money laundering compliance officer,[44] but the implementing rules permit multiple persons to serve in this role.[45] Should our rule permit multiple compliance officers?
- Should we require that the chief compliance officer be a member of senior management of the fund or the adviser?[46]

*D. Recordkeeping*

We are proposing to require that funds and advisers maintain a copy of their policies and procedures.[47] Funds would have to keep the annual written report by the fund's chief compliance officer.[48] Advisers would have to keep records documenting their annual review.[49] Funds and advisers would have to keep the required documents for five years.[50] These records are designed to provide our examination staff with a basis to determine whether the adviser or fund has complied with the rules.

We request comment on the recordkeeping requirements. Specifically, as required by section 31(a)(2) of the Investment Company Act [15 U.S.C. 80a-30(a)(2)], we request commenters to address whether there are feasible alternatives to the Proposed Rules that would minimize the recordkeeping burdens, the necessity of these records in facilitating the examinations carried out by our staff, the costs of maintaining the required records, and any effects that the proposed recordkeeping requirements would have on the nature of firms' internal compliance policies and procedures.

*E. Request for Comment on Further Private Sector Involvement*

As we note above, the number of funds and advisers (and the amount of assets they control) has grown significantly.[51] This growth has substantially exceeded the growth in our resources[52] as well as those resources we have been able to allocate to our investment company and investment adviser programs.[53] Although the Commission's resources may increase substantially in the future,[54] other program areas will have competing needs for those resources.[55]

to supervise. A compliance officer that does have supervisory responsibilities will have available the defense discussed above. *See supra* note 13.

[39] Form ADV, the registration form that advisers use to register with us under the Advisers Act, requires each adviser to report the name of its chief compliance officer, but does not require the adviser to *have* a chief compliance officer. Form ADV, Part 1, Schedule A, Item 2(a) [17 CFR 279.1].

[40] The ICI, in its 1994 submission to us, urged that multiple individuals be permitted to perform this role because the knowledge about compliance in specific areas may not be concentrated in any one individual. *See* ICI Proposal, *supra* note 15, at 23. Our proposal, which would require appointment of a single individual, would accommodate a large and diverse compliance organization, but would require the many compliance officers to report ultimately to one individual. The Hong Kong Securities and Futures Commission has taken a similar approach. *See* Fund Manager Code of Conduct at § 1.6.1 (1997) (Hong Kong registered fund managers must have a ''designated compliance officer'').

[41] Proposed rule 38a–1(a)(4)(i). If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the chief compliance officer. Proposed rule 38a–1(b).

[42] Proposed rule 38a–1(a)(4)(ii).

[43] Rule 17j–1(c)(1)(2).

[44] *See* section 352 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107–56, 115 Stat. 272 (''USA PATRIOT Act''), amending 31 U.S.C 5318(h).

[45] 31 CFR 103.130(c)(3).

[46] In the United Kingdom, the FSA requires that firms allocate to a ''director'' or ''senior manager'' responsibility for oversight of the firm's compliance and reporting. FSA Handbook of Rules and Guidance, Systems and Controls § 3.2.8 (''Areas covered by systems and controls: Compliance'') (United Kingdom).

[47] Proposed rules 38a-1(c)(1) and 204–2(a)(17)(i).

[48] Proposed rule 38a-1(c)(2). A fund's board's deliberations in connection with the approval of the compliance policies and procedures and their annual review of the chief compliance officer's report would be documented in the minute books of the fund board, which must be maintained pursuant to rule 31a-1(b)(4) under the Investment Company Act [17 CFR 270.31a-1(b)(4)].

[49] Proposed rule 204–2(a)(17)(ii).

[50] Funds and advisers would be required to maintain copies of all policies and procedures that are in effect or were in effect at any time during the last five years. Proposed rules 38a-1(c)(1) and 204–2(a)(17)(i). Funds would be required to maintain the annual compliance reports to the board for at least five years after the end of the fiscal year in which the report was provided to the board, the first two years in an easily accessible place. Proposed rule 38a-1(c)(2). Advisers would be required to maintain any records documenting their annual review in an easily accessible place for at least five years after the end of the fiscal year in which the review was conducted, the first two years in an appropriate office of the investment adviser. Proposed rule 204–2(e)(1).

[51] The number of registered investment companies has increased approximately 44% in the past 10 years, from approximately 3,500 in 1991 to approximately 5,030 currently. Investment company assets have grown over 400%, from $1.2 trillion to $6.4 trillion over the same period. Although the number of advisers registered with us decreased during the period (as a result of the enactment of the National Securities Markets Improvement Act, Pub. L. No. 104–290, 110 Stat. 3416 (1996) (codified in Section 203A of the Advisers Act [15 U.S.C 80b-3a] and other scattered sections of the United States Code)), which prohibited most smaller state-registered advisers from registering with us, the amount of assets under the management of registered advisers has grown from $10.7 trillion in 1997 to over $21 trillion currently, an increase of nearly 100%.

[52] *See* United States General Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, at 11 (Mar. 2002) (''GAO Study'') (during the past decade, ''the increases in SEC's workload substantially outpaced the increases in SEC's staff'').

[53] *See* GAO Study, *supra* note 52, at 13 (''total assets under management by investment companies (IC) and investment advisers (IA) increased by about 264 percent over 10 years, while the number of IC and IA examination staff increased by 166 percent'').

[54] Section 601 of the Sarbanes-Oxley Act, *supra* note 22, authorized us to spend $776 million in fiscal year 2003, which, if appropriated, would be a substantial increase over our appropriation of $487.2 million in fiscal year 2002.

[55] Section 408 of the Sarbanes-Oxley Act, *supra* note 22, for example, requires us, based upon

Moreover, even if we are able to substantially expand our examinationstaff, it is unlikely that future growth in our resources will ever keep pace with future growth of investment advisers and investment companies. We therefore are exploring ways in which we may make the best use of limited government resources to protect the interests of the millions of investors who invest in funds, participate in pension funds managed by investment advisers, or use the services of a personal financial planner or money manager.

One promising way of leveraging government resources would be for the Commission to rely more heavily on the private sector, *i.e.*, on the advisers and funds that are the indirect beneficiaries of our compliance program and the federal tax dollars that today support our regulatory efforts. The rules we are proposing today are one step in this direction. Others may also be appropriate to consider, including those we describe briefly below. We invite interested persons to submit comments as to the advisability of pursuing any or all of them, as well as other approaches for involving the private sector in enhancing compliance with the federal securities laws. We request that commenters address the Commission's authority to effect through rulemaking each of the approaches.

1. Compliance Reviews

One approach might be to require each fund and adviser to undergo periodic compliance reviews by a third party that would produce a report of its findings and recommendations. Our examination staff could use these reports to identify quickly areas that required attention, permitting us to allocate examination resources better and, as a result, to increase the frequency with which our staff could examine funds and advisers. Funds and advisers with reports indicating that they have effective compliance programs could be examined less frequently, which would reduce the burdens on them of undergoing more frequent examination by our staff.

There are many organizations that provide compliance reviews, including ''mock audits'' for investment advisers and funds, and have personnel that have experience in designing, implementing, and assessing the effectiveness of compliance programs.[56] As a condition to the settlement of an enforcement action, we frequently require an adviser or fund to engage a compliance consultant.[57] The USA PATRIOT Act requires financial institutions (including mutual funds), as part of their anti-money laundering programs, to have an independent audit function to test their programs.[58]

We request comment on the advantages and disadvantages of requiring advisers and funds to undergo compliance reviews. If we adopt such a requirement, should we exclude certain types of funds or advisers? Would the cost of these reviews be prohibitive for smaller advisers? Would some fund groups or advisers hire the least expensive compliance consultant regardless of the quality of the consultant's work? If so, how could we ensure that a high quality compliance review is conducted? If we adopt such a requirement, should we require the third parties who conduct such reviews to satisfy certain minimum standards for education and experience? What criteria should be included in the rule to determine whether a third party compliance expert is independent? How frequently should we require such reviews to be conducted? What is the proper scope for third party reviews? Should we require the third party consultant to file its report with us? If so, what should the scope of the report be?

2. Expanded Audit Requirement

Another approach might be to expand the role of independent public accountants that audit fund financial statements to include an examination of fund compliance controls. Such an approach would involve the performance by fund auditors of certain of the compliance review procedures currently performed by our staff in a compliance examination.[59]

Our rules today require fund auditors to submit internal control reports to fund boards.[60] In these reports, the auditor must identify any material weaknesses in the accounting system, the system of internal accounting controls, and the procedures for safeguarding securities of which they become aware while planning and performing the audit on the fund's financial statements.[61] The auditor's responsibilities could be augmented to require the identification of material weaknesses in the internal controls or a report on other aspects of the internal controls that are not required to be reviewed in planning and performing an audit of the financial statements. Expanding the auditor's responsibilities could, to some extent, serve as a substitute for staff examination or reduce the frequency of staff examination of funds with strong internal compliance programs, which would free Commission resources to focus on other areas of fund operations and permit us to examine funds with weaker internal compliance programs more often.

We request comment on this approach. Should we expand the responsibilities of the fund auditor? If so, what specific areas would it be appropriate for auditors to review? What type of assurance report should be provided?[62]

3. Self-Regulatory Organization

The formation of one or more self-regulatory organizations (SROs) for funds and/or advisers also would be a means to involve the private sector in support of our regulatory program. An SRO would function in a manner analogous to the national securities exchanges and registered securities associations under the Securities Exchange Act of 1934 by (i) establishing business practice rules and ethical standards, (ii) conducting routine examinations, (iii) requiring minimum education or experience standards, and (iv) bringing its own actions to

consideration of certain enumerated criteria, to review the disclosures, including the financial statements made by issuers reporting under the Securities Exchange Act of 1934, at least once every three years.

[56] *See, e.g.*, Jeremy Kahn, *Practice Audits Pay Off*, Fortune, June 24, 2002, at 40 (discussing mock audits of investment advisers); Nancy Opiela, ''*They're Here* * * *,'', 15 Journal of Financial Planning 52 (2002) (discussing use of mock auditors by financial planners preparing for audits by our staff).

[57] *See, e.g.*, Gintel Asset Management, Investment Advisers Act Release No. 2079 (Nov. 8, 2002); Performance Analytics, Investment Advisers Act Release No. 2036 (June 17, 2002); ND Money Management, Investment Advisers Act Release No. 2027 (Apr. 12, 2002); Stan D. Kiefer & Associates, Investment Advisers Act Release No. 2023 (Mar. 22, 2002).

[58] Section 352 of the USA PATRIOT Act, *supra* note 44. *See also* 31 CFR 103.130(c)(2) (requiring mutual funds, as a part of their written anti-money laundering programs, to provide for ''independent testing for compliance to be conducted by the mutual fund's personnel or by a qualified outside party'').

[59] We first raised this idea in a concept release we issued in 1983. Concept of Utilizing Private Entities in Investment Company Examinations and Imposing Examination Fees, Investment Company Act Release No. 13044 (Feb. 23, 1983) [48 FR 8485 (Mar. 1, 1983)].

[60] Rule 30a-1 [17 CFR 270.30a-1]; Item 77B of Form N-SAR [17 CFR 249.330; 17 CFR 274.101].

[61] Item 77B, *supra,* note 60.

[62] *See, e.g.,* American Institute of Certified Public Accountants (AICPA), Statement on Auditing Standards No. 70 Service Auditor's Report; AICPA, Statement on Standards for Attestation Engagements, AT §§ 500.54–61 (''Compliance Attestation Reporting'')).

discipline members for violating its rules and the federal securities laws.

SROs play an increasingly important role in the regulation of financial services in the United States. SROs participate with us in overseeing the public securities markets, including broker-dealers.[63] They also oversee the municipal bond market,[64] and the system of clearance and settlement of securities trades.[65] An SRO also plays an important part in the oversight of the futures markets, including futures commissions merchants, commodity pool operators, and commodity trading advisers.[66] In the Sarbanes-Oxley Act, Congress affirmed the role of private sector regulatory organizations by establishing the Public Company Accounting Oversight Board, which is charged with overseeing the audit of public companies.[67]

United States Supreme Court Justice Stewart stated that the purpose of the provisions of the Exchange Act creating SROs was ''to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry.''[68] Our experience with SROs suggests that this delegation of authority can have many advantages: SROs can marshal resources not available to the Commission and can have greater access to industry expertise. They can act more nimbly than a government agency, which is subject to significant personnel, contracting, and procedural requirements. An SRO can require its members to adhere to higher standards of ethical behavior than we can require under the securities laws. Moreover, industry leaders who participate in the regulatory process acquire a greater sense of their stake in the process.[69]

Proposals to create SROs for funds or investment advisers have been considered by Congress, the Commission, and members of the investment management industry in past years. In 1983, we requested comment on the concept of designating an ''inspection-only'' SRO for funds.[70] And in 1989, we submitted legislation to Congress requesting authority to designate one or more SROs for investment advisers.[71] Both initiatives reflected the concern of the Commission that our resources were inadequate to address the growth of investment advisers and funds.[72] Any SRO would be subject to the pervasive oversight of the Commission. We would examine its activities, require it to keep records, and approve its rules only if we conclude that they further the goals of the federal securities laws. Disciplinary actions could be appealed to the Commission. We would expect to be vigilant in preventing SRO rules that impose a burden on competition not necessary to further a regulatory purpose. Our staff would continue to examine the activities of funds and advisers, both to ensure adequate examination coverage and to provide oversight of the SRO examination program.

We request comment on whether one or more SROs should be established for funds and/or investment advisers. Should the SROs be limited in their authority? For example, should they be limited to conducting examinations? How should the activities of an SRO be financed? [73]

### 4. Fidelity Bonding Requirement for Advisers

Another means to privatize some of the compliance function would be to require investment advisers to obtain fidelity bonds from insurance companies. Fidelity bonds provide a source of compensation for advisory clients who are victims of fraud or embezzlement by advisory personnel. They result in additional oversight of advisers by insurance companies, which are unwilling to issue bonds to advisers that place their assets at risk by having poor controls or that hire employees with criminal or poor disciplinary records. The cost of that oversight is reflected in the premiums charged for the bond. High-risk advisers would be denied bonds or would be charged

[63] National Securities Exchanges register with us as SROs pursuant to Section 6 of the Exchange Act [15 U.S.C. 78f]. Currently, there are nine active securities exchanges. Section 15A of the Exchange Act [15 U.S.C. 78*o*-3] authorizes us to register one or more national securities associations to regulate the activities of member broker-dealers. NASD is the only national securities association currently registered under this section. Section 15A was added in 1938 to regulate the activities of brokers who traded securities of issuers that were not listed on the exchanges. Maloney Act, Pub. L. No. 75–719, 52 Stat. 1070 (1938).

[64] The Securities Amendments Act of 1975 [Pub. L. No. 94–29, 87 Stat. 97 (1975)] added section 15B to the Exchange Act [15 U.S.C. 78*o*-4], which directed the Commission to establish the Municipal Securities Rulemaking Board (''MSRB''). Unlike the other SROs, the MSRB was created by Congress solely to write rules governing the municipal securities market; it is not a membership organization and does not have authority to discipline its members.

[65] Clearing agencies register with us pursuant to Section 17A(b) of the Exchange Act [15 U.S.C. 78q-1(b)]. Currently, there are 13 clearing agencies registered with us.

[66] *See* Commodity Futures Trading Commission (''CFTC'') Rule 170.15 [17 CFR 170.15] (membership in a registered futures association mandatory) and National Futures Association (''NFA'') Bylaw 1101 (membership in the NFA mandatory for any registered party that transacts futures business with the public). The NFA performs various functions for the CFTC, including processing of applications for registration and conducting proceedings to deny, condition, suspend, restrict or revoke the registration of persons registered with the CFTC.

[67] Section 101 of the Sarbanes-Oxley Act, *supra* note 22.

[68] *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 371 (1963) (Stewart, J., dissenting).

[69] *See* Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88–95, pt. 4, at 722 (1963) (''Special Study'').

[70] Investment Company Act Release No. 13044, *supra* note 59.

[71] The legislation was introduced as S. 1410 and H.R. 3054, 101st Cong. (1989). Consideration by the Commission of an SRO for investment advisers appears to have first begun in 1963 when our Special Study of the Securities Markets recommended that membership in an SRO should be required of all registered investment advisers. Special Study, *supra* note 69, pt. 1, at 158–59. In 1976, the Commission asked Congress for the authority to conduct a formal study of the feasibility of establishing one or more SROs for investment advisers. S. Rep. No. 94–910, at 10 (1976).

In 1986, the NASD conducted a pilot program to determine the feasibility of examining the investment advisory activities of its members who were also registered as investment advisers. *See* Staff of the Securities and Exchange Commission, *Report on Financial Planners to House Comm. on Energy and Commerce, Subcomm. on Telecommunications and Finance,* at 118–23 (Feb. 1988). In 1993, the House of Representatives passed a bill that, among other things, would have amended the Advisers Act to authorize the creation of an ''inspection-only'' SRO for investment advisers. H.R. 578, 103rd Cong. (1993).

Industry organizations and their members and commenters have, from time-to-time, also called for the creation of an SRO for investment advisers. *See* Note, *Financial Planning: Is It Time for a Self-Regulatory Organization?,* 53 Brook. L. Rev. 143 (1987); Charles Lefkowitz, *The World of Financial Planning: Why an SRO Makes Sense,* 87 Best's Review, Dec. 1986, at 32. In 1985, the International Association of Financial Planners proposed the creation of an SRO for financial planners based on the NASD model. *See* Letter from Hubert L. Harris, Executive Director of the International Association for Financial Planning, to Kathryn B. McGrath, Director of the Commission's Division of Investment Management (June 19, 1985) (transmitting summary of proposal for financial planner SRO adopted by the Association's board of directors) (available in File No. S7–03–03). Not all industry participants have supported the creation of an SRO. *See* David Tittsworth, Executive Director, Investment Counsel Association of America, Statement for our Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) (''We continue to oppose the creation of a self-regulatory organization for the advisory profession * * * [which] is unwarranted and would impose a new layer of cost and bureaucracy on the profession.'') (available at: *http://www.sec.gov/rules/other/f4–433/tittswo1.htm).* Others object to being regulated by a particular SRO. *See* Aaron Luccetti, *NASD's Push to Extend Its Reach Spurs Anger of Investment Advisers,* Wall St. J., Nov. 12, 1998, at C1.

[72] We issued the 1983 concept release out of a concern, in part, that the growth in money market funds (which were then a novel type of fund) would outstrip our examination resources. In 1983, money market funds had $179 million of assets under management. Today, they have nearly $2.3 trillion of assets. Investment Company Institute, *2002 Mutual Fund Fact Book* 86.

[73] Other financial SROs, for example, are financed by fees imposed on members and users of their services rather than by public funds.

higher amounts to compensate the insurance company for assuming greater risk.

Investment advisers are among the only financial service providers handling client assets that are not required to obtain fidelity bonds.[74] The Advisers Act does not require advisory firms to have a minimum amount of capital invested, and many have few assets.[75] When we discover a serious fraud by an adviser, often the assets of the adviser are insufficient to compensate clients. The losses are borne by clients who may lose their life's savings, or be unable to afford a college education for their children or a comfortable retirement.

Should advisers be required to obtain a fidelity bond from a reputable insurance company? If so, should some advisers be excluded?[76] Alternatively, should advisers be required to maintain a certain amount of capital that could be the source of compensation for clients?[77] What amount of capital would be adequate?[78]

## III. General Request for Comment

The Commission requests comment on the Proposed Rules, suggestions for additions to the Proposed Rules, and comment on other matters that might have an effect on the proposals contained in this release. We note that the comments that are of greatest assistance are those that are accompanied by supporting data and analysis of the issues addressed in those comments.

## IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The Proposed Rules would require each fund and adviser to adopt and implement policies and procedures reasonably designed to prevent violations of the securities laws, to review these annually, and to designate an individual as chief compliance officer. We have identified certain costs and benefits, which are discussed below, that may result from the proposals. We request comment on the costs and benefits of the Proposed Rules. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

### *A. Benefits*

We anticipate that fund investors, advisory clients, funds, and advisers will benefit from the Proposed Rules. The Proposed Rules would benefit fund investors and advisory clients (collectively, ''investors'') by requiring funds and advisers to design and implement a comprehensive internal compliance program. Although many funds and advisers already have such programs in place, the Proposed Rules would make this standard practice for all firms. Investors would be less likely to be harmed by violations of the securities laws because experience has shown that strong internal compliance programs lower the likelihood of securities laws violations occurring and enhance the likelihood that any violations that do occur will be detected and corrected. In addition, because the Proposed Rules are designed to complement the Commission's examination program, the Commission's ability to protect investors would be enhanced. The existence of a structured compliance program, together with the designation of a chief compliance officer to serve as a point of contact, would facilitate the examination staff's efforts to conduct each examination in an organized and efficient manner and thus to allocate resources to maximize investor protection.

Although the Proposed Rules would impose additional compliance costs on many funds and advisers, they would benefit funds and advisers by diminishing the likelihood of securities violations, Commission enforcement actions, and private litigation. For a fund or adviser, the potential costs associated with a securities law violation may consist of much more than merely the fines or other penalties levied by the Commission or civil liability. Advisers may be denied eligibility to advise funds.[79] In addition, advisers could be precluded from serving in other capacities.[80] The reputation of a fund or adviser may be significantly tarnished, resulting in redemptions (in the case of an open-end fund) or lost clients.

### *B. Costs*

The Proposed Rules would result in some additional costs for funds and advisers, which, in the case of funds, we expect would be passed on to investors. However, since all funds and most advisers currently have some written compliance policies and procedures in place, the costs in many instances already are reflected in the fees investors currently pay. Funds and larger advisory firms typically have adopted and implemented comprehensive, written policies and

[74] Fidelity bonds are required to be obtained by: broker-dealers (NASD Conduct Rule 3020; NYSE Rule 319; American Stock Exchange Rule 330); transfer agents (NYSE Listed Company Manual § 906.01); investment companies (17 CFR 270.17g–1); national banks (12 CFR 7.2013); and federal savings associations (12 CFR 563.190). Section 412 of the Employee Retirement Income Security Act (ERISA) [29 U.S.C. 1112] requires investment advisers to obtain a fidelity bond with respect to any employee benefit plan assets the adviser manages, and many state laws require state-registered advisers to obtain fidelity bonds. *See, e.g.*, Ala. Admin. Code r. 830-x-3-.06(4) (2002) (requiring $50,000 bond for advisers that have custody of or discretionary authority over customer assets); Mass. Regs. Code tit. 950, § 12.205(5)(b) (2002) (requiring $10,000 bond for advisers that have custody of or discretionary authority over client assets or receive prepayments); Minn. R. 2875.1930, Subpart 1 (2002) (requiring $25,000 bond for advisers that have custody of or discretionary authority over client assets); N.J. Admin. Code tit. 13, § 47.A–2.2 (2002) (requiring $25,000 bond or $25,000 minimum capital for advisers that have custody of client assets); 21 Va. Admin. Code 5–80–180(B) (requiring $25,000 bond or $25,000 minimum capital for advisers). Similarly, independent financial advisers registered with the FSA in the United Kingdom must maintain professional indemnity insurance. Prudential Rules for Independent Financial Advisers § 13.13R (Nov. 2001).

[75] In 1992, both the Senate and House of Representatives passed bills that would have given us authority to require advisers to obtain fidelity bonds. S. 2266, § 5, 102nd Cong. (1992), and H.R. 5726, § 107, 102nd Cong. (1992). Because differences in the two bills were never reconciled, neither became law.

[76] The 1992 legislation would have given us authority to require bonding of advisers that have custody of client assets or that have discretionary authority over client assets. Section 412 of ERISA requires plan fiduciaries to obtain a bond with respect to plan assets ''handled'' by the plan fiduciary. Department of Labor rules clarify that handling plan assets includes having discretionary authority over them. 29 CFR 2580.412–6.

[77] In 1973, a Commission advisory committee recommended that Congress authorize us to adopt minimum financial responsibility requirements for investment advisers, including minimum capital requirements. Advisory Committee on Investment Management Services for Individual Investors, *Small Account Investment Management Services: Recommendations for Clearer Guidelines and Policies* 64–66 (Jan. 1973). Three years later, in 1976, the Senate Committee on Banking, Housing, and Urban Affairs reported a bill that, among other things, authorized the Commission to adopt rules requiring advisers (i) with discretionary authority over client assets, (ii) with access to client funds or securities, or (iii) that advise registered investment companies, to meet financial responsibility standards. S. Rep. No. 94–910, at 14–15 (1976) (reporting favorably S. 2849). S. 2849 was never enacted.

[78] Section 412 of ERISA requires that the bond required under that section be no less than 10% of the amount of funds handled.

[79] Section 9(a) of the Investment Company Act [15 U.S.C. 80a–9(a)] prohibits a person from serving as an adviser to a fund if, within the past 10 years, the person has been convicted of certain crimes or is subject to an order, judgment, or decree of a court prohibiting the person from serving in certain capacities with a fund, or prohibiting the person from engaging in certain conduct or practice.

[80] *See, e.g.*, 29 U.S.C. 1111(a) (prohibiting a person from acting in various capacities for an employee benefit plan, if within the past 13 years, the person has been convicted of, or has been imprisoned as a result of, any crime described in section 9(a)(1) of the Investment Company Act [15 U.S.C. 80a–9(a)(1)].

procedures. Many of these advisers also have well-staffed compliance departments. Many conduct periodic reviews of their compliance programs and some hire independent compliance experts to review the adequacy of their compliance programs and the effectiveness of their implementation. We would expect that funds and advisers with substantial commitments to compliance would incur only minimal costs in connection with the adoption of the Proposed Rules as they reviewed their internal compliance programs for adequacy.

It is our experience that small funds and advisers are less likely than their larger counterparts to have comprehensive, written internal compliance programs in place. The Proposed Rules would impose larger relative costs on these firms. Based on our examination experience, we estimate that as many as one half of SEC-registered investment advisers do not have comprehensive, written internal compliance programs in place. These firms would incur costs in order to develop a compliance program or to convert their current compliance activities into a systematic program. However, we expect a number of factors will enable these firms to control and minimize these costs. Because these small firms typically engage in a limited number and range of transactions and have one or two employees, their internal compliance programs would be markedly less complex than those of their large firm counterparts. In addition, we anticipate that these firms will turn to a variety of industry representatives, commentators, and organizations that have developed outlines and model programs that these firms can tailor to fit their own situations. If these firms need individualized outside assistance, we expect that the number of independent compliance experts will grow to fill this demand at competitive prices, as has been the case in comparable situations.

The requirement that each firm designate a chief compliance officer likely would impose only a minimal cost. Many firms already have large compliance staffs headed by an individual who effectively serves as a chief compliance officer. For other firms, costs associated with designating a chief compliance officer also would be minimized by the fact that the Proposed Rules would not require firms to hire an individual exclusively charged with serving in this capacity.

We anticipate that costs associated with the annual review requirement also would be limited. Many large firms with comprehensive compliance programs periodically review portions of their compliance programs. These firms would incur a cost associated with transforming their periodic reviews into a more systematic annual review, but this cost is difficult to quantify. Most of the firms without any review mechanism in place are small. For these firms, the annual review requirement likely would be less extensive and, therefore, less costly than for their larger counterparts.

*C. Request for Comment*

We request comment on the potential costs and benefits identified in the proposal and any other costs or benefits that may result from the Proposed Rules. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[81] the Commission also requests information regarding the impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide data to support their views.

## V. Consideration of Promotion of Efficiency, Competition and Capital Formation

Section 2(c) of the Investment Company Act [15 U.S.C. 80a–2(c)] and section 202(c) of the Advisers Act [15 U.S.C. 80b–2(c)] require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[82]

As discussed above, the Proposed Rules would require funds and investment advisers to adopt and implement written policies and procedures designed to prevent violations of the federal securities laws, and review those policies and procedures at least annually. Although we recognize that a compliance program may divert resources from funds' and advisers' primary businesses, we expect that the Proposed Rules may indirectly increase efficiency in a number of ways. These compliance programs would increase efficiency by deterring securities law violations, or by facilitating the fund's or adviser's early intervention to decrease the severity of any violations that do occur. In addition, funds and advisers would be required to carry out their internal compliance functions in an organized and systematic manner, which may be more efficient than their current approach to these functions. The existence of an industry-wide compliance program requirement may enhance efficiency further by encouraging third parties to create new informational resources and guidance to which industry participants can refer in establishing and improving their compliance programs.

Since the Proposed Rules would apply equally to all funds and advisers, we do not anticipate that any competitive disadvantages would be created. To the contrary, the Proposed Rules may encourage competition on a more level basis than exists in the current environment, in which compliance-oriented industry participants incur greater costs to maintain compliance programs than other firms.

We anticipate the Proposed Rules would indirectly foster capital formation. It has been our experience that funds and advisers with effective compliance programs are less likely to violate the securities laws and harm to investors is less likely to result. To the extent such an environment enhances investor confidence in funds and client confidence in investment advisers, investors and clients are more likely to make assets available through these intermediaries for investment in the capital markets.

We request comment on whether the Proposed Rules, if adopted, would impose a burden on competition. We also request comment on whether the Proposed Rules, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views, if possible.

## VI. Paperwork Reduction Act

The Proposed Rules would impose ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[83] If adopted, these collections of information would be mandatory. Two of the collections of information are new. The Commission has submitted these new collections to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles of these new collections are ''Rule 38a–1'' and ''Rule 206(4)–7.'' The OMB has not yet assigned these collections control numbers. The other collection of information takes the form of

[81] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996).

[82] Although proposed rule 206(4)–7 is not based on a statutorily-mandated public interest determination, in the interest of comprehensiveness, we include it in this analysis.

[83] 44 U.S.C. 3501 to 3520.

amendments to a currently approved collection titled ''Rule 204–2,'' under OMB control number 3235–0278. The Commission also has submitted the amendments to this collection to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The collection of information under rule 38a–1 is necessary to assure that investment companies maintain comprehensive internal programs that promote the companies' compliance with the federal securities laws. The respondents are investment companies registered with us and business development companies. Our staff, conducting the Commission's examination and oversight program, would use the information collected to assess funds' compliance programs. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[84] Rule 38a–1 requires that certain records be retained for at least five years.[85]

The collection of information under rule 206(4)–7 is necessary to assure that investment advisers maintain comprehensive internal programs that promote the advisers' compliance with the Advisers Act. The respondents are investment advisers registered with us. Our staff, conducting the Commission's examination and oversight program, would use the information collected to assess investment advisers' compliance programs. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[86]

The collection of information under rule 204–2 is necessary for the Commission staff to use in its examination and oversight program. The respondents are investment advisers registered with us. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[87] The records that an adviser must keep in accordance with the Proposed Rules must be retained for at least five years.[88]

[84] See section 31(c) of the Investment Company Act [15 U.S.C. 80a–30(c)].

[85] *See* Proposed rule 38a–1(c).

[86] *See* section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

[87] *Id.*

[88] *See* proposed rule 204–2(a)(17)(i) and rule 204–2(e)(1) [17 CFR 275.204–2(e)(1)].

*A. Rule 38a–1*

There are currently approximately 5,030 registered investment companies and 53 business development companies.[89] Thus, approximately 5,083 funds would be subject to proposed rule 38a–1. We estimate that the average annual hour burden for a fund to document the policies and procedures that make up its compliance program would be 60 hours. While each fund would be required to maintain written policies and procedures under rule 38a–1, this average estimate takes into account that most funds are located within a fund complex. Based on our staff's experience in connection with our examination and oversight program, we expect that each fund in a complex would be able to draw extensively from the fund complex's ''master'' compliance program to assemble appropriate compliance policies and procedures. It also has been our experience that many fund complexes already have written policies and procedures documenting their compliance programs. Further, a fund needing to develop policies and procedures on one or more topics in order to achieve a comprehensive compliance program can draw on a number of outlines and model programs available from a variety of industry representatives, commentators, and organizations.

We also estimate that each fund would spend five hours annually, on average, documenting the conclusions of its annual compliance review for its board of directors. Finally, we estimate that each fund would spend 0.5 hours annually, on average, maintaining the records required by proposed rule 38a-1. In total, the collections of information under rule 38a–1 would entail 332,936.5 burden hours.[90]

*B. Rule 206(4)–7*

There are currently approximately 7,790 investment advisers registered with us.[91] We estimate that the average annual hour burden for each adviser to document the policies and procedures that make up its compliance program would be 80 hours, for a total burden of 623,200 hours.[92] While each adviser registered with us would be subject to the requirement to maintain written policies and procedures under proposed rule 206(4)–7, this average estimate takes into account that many advisers would be the primary drafters of compliance policies and procedures for funds under proposed rule 38a–1. We expect that these advisers would be able to draw extensively from their fund compliance programs to supplement, as necessary, compliance policies and procedures for the advisory firm.

It also has been our staff's experience in connection with our examination and oversight program that approximately half of the investment advisers registered with us already have drafted procedures addressing many aspects of their compliance programs, and many investment advisers in this group have drafted comprehensive procedures. Further, while it has been our experience that a significant number of smaller registered investment advisers—who typically employ one or a few persons and have complete oversight of their business operations—have not adopted written policies and procedures, these advisers can draw on a number of outlines and model programs available from a variety of industry representatives, commentators, and organizations. Based on our experience, these smaller advisers are less likely to participate in arranging or effectuating securities transactions that they recommend to their clients, thereby greatly simplifying the scope of the policies and procedures they would be required to document under the proposed rule.

*C. Rule 204–2*

The currently-approved annual aggregate information collection burden under rule 204–2 is 1,625,638.5 hours. This approved annual aggregate burden was based on estimates that 7,687 advisers were subject to the rule, and each of these advisers spends an average of 211.48 hours preparing and preserving records in accordance with the rule. Based upon the most recently available data, there are 7,790 registered investment advisers. The increase in the number of registered investment advisers increases the total burden hours of current rule 204–2 from 1,625,638.5 to 1,647,429.2,[93] an increase of 21,790.7 hours.[94]

[89] These numbers are based on Commission filings and are current as of January 2003.

[90] (5,083 funds (5,030 registered investment companies + 53 business development companies)) × (60 hours for documenting compliance policies and procedures + 5 hours for documenting conclusions of annual compliance review + 0.5 hours for maintaining records) = 332,936.5 burden hours.

[91] This is the number of investment advisers registered with us on our Investment Adviser Registration Depository System as of January 14, 2003.

[92] 7,790 registered investment advisers × 80 annual average burden hours = 623,200 hours.

[93] 7,790 registered investment advisers × 211.48 hours = 1,647,429,2 hours.

[94] 1,647,429.2 hours—1,625,638.5 hours = 21,790.7 hours.

The proposed amendments to rule 204–2 would require a registered investment adviser to maintain copies of the written policies and procedures drafted under proposed rule 206(4)–7. In addition, the proposed amendments would require a registered investment adviser to retain copies of any records documenting the adviser's annual review of its policies and procedures under proposed rule 206(4)–7. The collection of information under rule 204–2 is necessary for the Commission staff to carry out its examination and oversight program. The adviser would be required to maintain these records for five years.[95]

We estimate that these proposed amendments would increase each registered investment adviser's average annual collection burden under rule 204–2 by 0.5 hours to 211.98 hours,[96] and would increase the rule's annual aggregate burden by 3,895 hours.[97] If the proposed amendments to rule 204–2 are adopted, the rule's aggregate annual burden would be 1,651,324.2 hours.[98]

*D. Request for Comment*

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, New Executive Office Building, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609 with reference to File No. S7–03–03.

OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–03–03, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW, Washington, DC 20549.

## VII. Summary of Initial Regulatory Flexibility Analysis

We have prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding the proposed rule 38a–1 under the Investment Company Act, and proposed rule 206(4)–7 and proposed amendments to rule 204–2 under the Advisers Act. The following summarizes the IRFA.

The IRFA summarizes the background of the proposals. The IRFA also discusses the reasons for the proposals and the objectives of, and legal basis for, the proposals. Those items are discussed above.

The IRFA discusses the effect of the Proposed Rules on small entities. For purposes of the Regulatory Flexibility Act, a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of $50 million or less as of the end of its most recent fiscal year.[99] An investment adviser is a small entity if it (i) manages less than $25 million in assets, (ii) has total assets of less than $5 million on the last day of its most recent fiscal year, and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that manages $25 million or more in assets, or any person (other than a natural person) that had total assets of $5 million or more on the last day of the most recent fiscal year.[100] The staff estimates, based on Commission filings, that there are 200 small open- and closed-end investment companies and 29 small business development companies.[101] The staff further estimates that there are approximately 7,790 registered investment advisers, of which approximately 172 are small entities.[102]

The IRFA explains that the Proposed Rules would impose no new reporting requirements, but would impose compliance requirements on funds and advisers, including small funds and advisers. A fund would be required to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, obtain approval of the policies and procedures from its board of directors, review the policies and procedures at least annually, and provide a written report on the review to its board of directors. A fund also would be required to designate a chief compliance officer, and to maintain copies of the policies and procedures and reports to the board for at least five years. An adviser would be required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and review the policies and procedures at least annually. An adviser would be required to designate a chief compliance officer, and to maintain copies of the policies and procedures and any records documenting the annual review for at least five years.

The IRFA states that we have not identified any federal rules that conflict with the Proposed Rules. The IRFA explains that the written policies and procedures that would be required by the Proposed Rules would include some policies and procedures required by other rules under the federal securities laws, but the Proposed Rules would not require them to be duplicated.[103] The IRFA further explains that some of the records a fund would be required to maintain under the Proposed Rules also may be required records under the general recordkeeping provisions of rule 31a-1 of the Investment Company Act, but that the overlap would be limited

[95] Proposed rule 204–2(a)(17)(i) would require advisers to maintain a copy of any policies and procedures in effect during the past five years. Pursuant to proposed rule 204–2(e)(1), the records documenting the adviser's annual review of those policies and procedures would have to be maintained and preserved in an easily accessible place for five years, the first two in an office of the investment adviser.

[96] 211.48 hours + 0.5 hours = 211.98 hours.

[97] 7,790 registered investment advisers × 0.5 hours = 3,895 hours.

[98] 1,625,638.5 (currently-approved burden) + 21,790.7 (adjustment attributable to increase in number of investment advisers registered with us) + 3,895 (additional burden hours associated with the proposed amendments to rule 204–2) = 1,651,324.2 hours.

[99] 17 CFR 270.0–10.

[100] 17 CFR 275.0–7.

[101] These numbers, which are current as of June 2002, are derived from analyzing information from databases such as Morningstar and Lipper. Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

[102] The number of small investment advisers is derived from information submitted by investment advisers registered with us on Form ADV, or amendments thereto, through January 14, 2003.

[103] *See supra* notes 26, and 29 through 34.

and the Commission would not require the fund to maintain duplicate copies.

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant economic impact on small entities. The IRFA explains that we currently believe that different compliance requirements for small entities could not be established, because the compliance requirements are integral to achieving the objectives of the Proposed Rules. The IRFA also states that we currently believe it would not be necessary to establish different recordkeeping requirements, because the recordkeeping requirements of the Proposed Rules impose an inconsequential burden on small entities. The IRFA also describes our current view that these compliance and recordkeeping provisions could not be consolidated, and that there would be no reason to simplify or clarify them because they are not technical or complex.

As the IRFA explains, the Proposed Rules would rely on performance standards rather than design standards. Each small entity would be afforded the flexibility to implement policies and procedures, and to determine qualifications for its chief compliance officer that are appropriate in light of its business operations.

The IRFA also explains our present view that the objectives of the Proposed Rules could not be achieved if small entities were exempted from coverage of any part of the Proposed Rules, because it has been our experience that small funds and advisers are less likely to have comprehensive, written compliance programs and are more likely to have the kinds of compliance deficiencies that could be remedied by such programs.

We encourage comment with respect to any aspect of the IRFA. We specifically request comment on the number of small entities that would be affected by the Proposed Rules, and the likely impact of the Proposed Rules on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of the Proposed Rules, and will be placed in the same public file as comments on the Proposed Rules themselves. A copy of the IRFA may be obtained by contacting Hester Peirce, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

## VIII. Statutory Authority

The Commission is proposing new rule 38a-1 under the Investment Company Act pursuant to the authority set forth in sections 31(a) and 38(a) of the Act [15 U.S.C. 80–30(a) and 80a–37(a)].[104] The Commission is proposing new rule 206(4)–7 pursuant to the authority set forth in sections 206 and 211(a) under the Advisers Act [15 U.S.C. 80b–6 and 80b–11(a)].[105] The Commission is proposing amendments to rule 204–2 pursuant to the authority set forth in sections 204 and 211 of the Advisers Act [15 U.S.C. 80b–4 and 80b–11].

## List of Subjects

*17 CFR 270*

Investment companies, Reporting and recordkeeping requirements, Securities.

*17 CFR 275*

Reporting and recordkeeping requirements, Securities.

## Text of Proposed Rules

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

## PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a–1 *et seq.,* 80a–34(d), 80a–37, 80a–39, unless otherwise noted;

* * * * *

2. Section 270.38a–1 is added to read as follows:

### § 270.38a–1 Compliance procedures and practices of registered investment companies.

(a) Each registered investment company and business development company (''fund'') must:

(1) *Policies and procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund, or by its investment adviser, principal underwriter or administrator in connection with their provision of services to the fund;

(2) *Board approval.* Obtain the approval of the policies and procedures of the fund by the board of directors of the fund, including a majority of directors who are not interested persons of the fund;

(3) *Annual review.* Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation;

(4) *Chief compliance officer.* Designate an individual responsible for administering the policies and procedures adopted under paragraph (a)(1) of this section who must:

(i) Be approved by the board of directors of the fund, including a majority of directors who are not interested persons of the fund; and

(ii) No less frequently than annually, provide a written report to the board on:

(A) Existing policies and procedures, any material changes made to the policies and procedures since the date of the last report, and any material changes to the policies and procedures recommended as a result of the annual review conducted pursuant to paragraph (a)(3) of this section; and

(B) Any material compliance matters requiring remedial action that occurred since the date of the last report.

(b) *Unit investment trusts.* If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the fund's policies and procedures and chief compliance officer, and receive all annual reports.

(c) *Recordkeeping.* The fund must maintain:

(1) A copy of the fund's policies and procedures that are in effect, or at any time within the past five years were in effect, in an easily accessible place; and

(2) Written reports provided to the board of directors pursuant to paragraph

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[104] Section 38(a) authorizes the Commission to ''make * * * such rules and regulations * * * as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in [the Investment Company Act].'' We are proposing rule 38a–1 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including section 31(b) of the Investment Company Act [15 U.S.C. 80a–30(b)] (authority to examine funds) and section 42 of the Investment Company Act [15 U.S.C. 80a–41] (authority to enforce the provisions of the Investment Company Act). Further, requiring the maintenance of internal compliance policies and procedures and an annual compliance report would fall under the authority granted to us under section 31(a), which authorizes us to require funds to maintain and preserve records, including memoranda, books, and other documents.

[105] Section 206(4) permits the Commission to define conduct as fraudulent under the Advisers Act, and to adopt rules reasonably designed to prevent fraud. We are proposing rule 206(4)–7 as a means reasonably necessary to prevent fraud by investment advisers. Further, section 211(a) of the Advisers Act authorizes the Commission to ''make * * * such rules and regulations * * * as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in [the Act].'' We are proposing rule 206(4)–7 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including section 204 of the Advisers Act (authority to examine advisers) and section 209 of the Advisers Act [15 U.S.C. 80b–9] (authority to enforce the provisions of the Advisers Act).

(a)(4)(ii) of this section for at least five years after the end of the fiscal year in which the report is provided to the board, the first two years in an easily accessible place.

(d) For purposes of this section, *Federal Securities Laws* means the Securities Act of 1933 (15 U.S.C. 77a), the Securities Exchange Act of 1934 (15 U.S.C. 78a), the Sarbanes-Oxley Act of 2002 (Pub. L. 107–204, 116 Stat. 745 (2002)), the Investment Company Act of 1940 (15 U.S.C. 80a), the Investment Advisers Act of 1940 (15 U.S.C. 80b), Title V of the Gramm-Leach-Bliley Act (15 U.S.C. 6801), any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act (31 U.S.C. 5311) as it applies to funds, and any rules adopted thereunder by the Commission or the Department of the Treasury.

## PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

3. The authority citation for Part 275 continues to read in part as follows:

**Authority:** 15 U.S.C. 80b–2(a)(11)(F), 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6a, 80b–11, unless otherwise noted.

* * * * *

4. Section 275.204–2 is amended by adding new paragraph (a)(17) and by revising paragraph (e)(1). The additions and revisions read as follows:

### § 275.204–2 Books and records to be maintained by investment advisers.

(a) * * *

(17)(i) A copy of the investment adviser's policies and procedures formulated pursuant to § 275.206(4)–7(a) of this chapter that are in effect, or at any time within the past five years were in effect, and

(ii) Any records documenting the investment adviser's annual review of those policies and procedures conducted pursuant to § 275.206(4)–7(b) of this chapter.

* * * * *

(e)(1) All books and records required to be made under the provisions of paragraphs (a) to (c)(1), inclusive, of this section (except for books and records required to be made under the provisions of paragraphs (a)(11), (a)(16), and (a)(17)(i) of this section), shall be maintained and preserved in an easily accessible place for a period of not less than five years, from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

* * * * *

5. Section 275.206(4)–7 is added to read as follows:

### § 275.206(4)–7 Compliance procedures and practices.

If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3), it is a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b–6(4)) for you to provide investment advice to clients unless you:

(a) *Policies and procedures.* Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act;

(b) *Annual review.* Review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and

(c) *Chief compliance officer.* Designate an individual (who is a supervised person) responsible for administering the policies and procedures that you adopt under paragraph (a) of this section.

By the Commission.

Dated: February 5, 2003.

**Jill M. Peterson,**

*Assistant Secretary.*

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