



INVESTMENT COMPANY INSTITUTE

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APR 17 2003  
OFFICE OF THE SECRETARY

April 17, 2003

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: Compliance Programs of Investment Companies  
(File No. S7-03-03)

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to require each investment company and investment adviser to adopt and implement internal compliance programs.<sup>2</sup> While our comments are limited to proposed Rule 38a-1 under the Investment Company Act, some of our recommendations would be relevant to the compliance rule proposed under the Advisers Act, Rule 206(4)-7. We encourage the Commission to consider similar revisions to that rule as appropriate.

Proposed Rule 38a-1 would require each registered investment company to: adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws; annually review those policies and procedures for their adequacy and the effectiveness of their implementation; designate a chief compliance officer to be responsible for administering them; and maintain specified records demonstrating compliance with these new requirements. In addition, the Proposing Release seeks comment on other ways to involve the private sector in fostering compliance by investment companies and investment advisers with the federal securities laws.

**I. BACKGROUND AND SUMMARY OF COMMENTS**

The Institute supports the Commission's goal of ensuring that each registered investment company has a rigorous internal compliance program. Indeed, as noted in the

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,912 open-end investment companies ("mutual funds"), 554 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.254 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

<sup>2</sup> SEC Release Nos. IC-25925, IA-2107 (February 5, 2003) (the "Proposing Release"). Cites to the Proposing Release in this letter are to the version available from the Commission's website.

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Proposing Release, in 1994 the Institute submitted a rulemaking petition to the Commission recommending the adoption of a rule similar to proposed Rule 38a-1.<sup>3</sup> As with the Commission's current proposal, the Institute's 1994 proposal was intended to respond to concerns the Commission had about its ability to keep pace with industry growth.

In our 1994 submission, we noted that, while the comprehensive system of federal regulation established in 1940 for investment companies remained sound, to the extent that the Commission determined that additional self-regulation was necessary, a rule mandating that each registered investment company establish and maintain an internal compliance system that meets certain minimum requirements would be the most efficient and expeditious way to ensure future industry compliance with regulatory standards. Our submission expressly noted, however, that our support for any Commission rule mandating rigorous internal compliance programs would be contingent upon the reasonableness of the obligations it would impose.

The Commission's proposal differs from the Institute's 1994 proposal in two significant respects. These differences, which are discussed in more detail below, relate to the scope of the rule (*i.e.*, it would cover the fund *and* its service providers rather than just the fund) and the designation of a single chief compliance officer by the fund. The Institute is concerned that, as a result of these differences, the Commission's proposal may impose on fund boards and fund compliance personnel duties and responsibilities that are impractical and overly burdensome. We recommend that proposed Rule 38a-1 be revised in certain respects to address these concerns.

In summary, our comments on the Commission's proposal are as follows:

- We recommend that the rule be revised to clarify that a fund may rely on the compliance policies and procedures of its service providers (*i.e.*, its investment adviser, principal underwriter, and administrator) that govern the services they provide to the fund. This change would better accommodate existing fund compliance structures, which have worked well.
- We recommend that the rule be revised to ensure that, consistent with the Commission's stated intent, the board serves in an oversight role. Rather than requiring the board to approve all compliance policies and procedures governing the fund and its service providers (to the extent of the services they provide to the fund), the rule should require the board to determine that the fund and its service providers have adequate compliance systems in place. To enable the board to make this determination, each fund and service provider should provide a written report to the board, no less frequently than annually, that summarizes the entity's relevant compliance policies and procedures and their implementation.
- Instead of requiring the designation of a single chief compliance officer who must be approved by the fund's board, the rule should require each fund and service provider to identify in its annual report to the board the person(s) within the entity

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<sup>3</sup> See Letter from Matthew P. Fink, President, Investment Company Institute, to the Honorable Arthur J. Levitt, Jr., Chairman, U.S. Securities and Exchange Commission, dated November 23, 1994 (the "Institute's 1994 proposal").

charged with the primary responsibility for implementing the compliance policies and procedures applicable to such entity. The rule should not require the board to approve these persons.

- The standard by which the compliance policies and procedures required by the rule will be measured should be one of promoting compliance with the federal securities law, not one of preventing violations.
- We support the Commission's approach of not prescribing in the rule the areas that must be included in the policies or procedures of the fund or its service providers. Due to the diversity of the fund industry, we believe it is important for the rule to provide flexibility regarding the appropriate contents of the policies and procedures of the fund and its service providers.
- Proposed Rule 38a-1 should include a safe harbor expressly providing that no person would be liable under the rule solely because a violation of the securities laws occurs if he or she (1) had a reasonable basis to believe that the compliance policies and procedures adopted pursuant to the rule were not deficient and (2) reasonably discharged his or her obligations under the rule.

With respect to the Commission's request for comment on the four initiatives discussed in the Proposing Release to involve the private sector in fostering compliance by investment companies and investment advisers with the federal securities laws, the Institute believes generally that it is premature to consider pursuing any of these concepts at this time. Notwithstanding this, our comments on these initiatives, in summary, are as follows:

*Periodic Compliance Reviews by a Third Party* – The Institute would oppose a requirement that all funds undergo periodic third-party compliance reviews. We believe it would be difficult, if not impossible, for the Commission to define with the necessary specificity requirements relating to the third party's competence and the thoroughness of the compliance review in order to ensure that such reviews are conducted uniformly throughout the industry. Mandating third-party reviews also could impose substantial costs on funds and would eliminate the discretion that funds currently have to determine whether such a review would be cost-effective.

*Expanded Fund Audits* – The Institute believes that expanding a fund's financial audit to include non-financial regulatory issues is inappropriate. The persons conducting an audit of a fund's financial statements may not have the in-depth knowledge of the federal securities laws necessary to audit the fund's compliance policies and procedures. If they did have such knowledge, the costs for expanding the scope of the audit would likely be substantial and exceed any benefit to flow from the expanded audit.

*Creation of One or More Self-Regulatory Organizations* – The Institute strongly opposes the creation of a self-regulatory organization for funds. In addition to the significant costs that would be involved, the creation of a self-regulatory organization would upset the current scheme of regulation and fragment critical and complementary regulatory responsibilities, to the detriment of investors. The current system of direct

Commission oversight of mutual funds has worked exceptionally well for more than sixty years.

*Imposing a Fidelity Bonding Requirement* – The Institute would not oppose the Commission exploring the possibility of imposing a fidelity bonding requirement on investment advisers to registered investment companies, so long as such a requirement would not increase the minimum amount of coverage required by Rule 17g-1 under the Investment Company Act.

Each of these comments is discussed in greater detail below.

## II. SCOPE OF THE PROPOSED RULE

Proposed Rule 38a-1 would require each fund to adopt and implement written policies and procedures reasonably designed to prevent violation of the “federal securities laws” (as this term would be defined in the rule) by the fund or its service providers. In addition, the fund’s board, including a majority of independent directors, would be required to approve those policies and procedures. The scope of the proposal is broader than the Institute’s 1994 proposal, which would have only required the policies and procedures to cover the fund, but not the fund’s service providers. The Commission’s determination to expand the scope of the proposal is based on the fact that “typically . . . a fund has no employees; personnel of its adviser, principal underwriter and/or administrator conduct all of its activities.”<sup>4</sup>

Upon further reflection, the Institute agrees that, instead of limiting the scope of a compliance rule to just the fund (as we proposed in our 1994 submission), it may be appropriate to expand the rule to cover compliance policies and procedures of the fund’s service providers. We believe, however, that expanding the scope of the rule in this manner necessitates two additional revisions.

First, the rule should be revised to clarify that, to the extent a fund’s service providers have compliance policies and procedures that govern the services they provide to the fund, the fund may rely on those policies and procedures and would not be required to adopt its own compliance policies and procedures in those areas. This revision would better reflect current industry practice, which has worked well. It also would avoid forcing funds either to adopt policies and procedures that are duplicative of those adopted by their service providers or to maintain a tome of all the policies and procedures utilized by their service providers. Neither of these results would further the Commission’s goal of ensuring that funds have rigorous internal compliance programs.

Second, the rule should be revised to ensure that, consistent with the Commission’s intent, the board’s role is one of oversight, rather than detailed administration of the compliance programs of the fund and its service providers. We are concerned that, as currently drafted, the rule would require a fund’s board, in effect, to review and approve each of the compliance policies and procedures of the fund and its service providers. Such a requirement would

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<sup>4</sup> See Proposing Release at n.20.

impose on the board a duty that is both unworkable (due to the breadth and depth of all of the policies and procedures that would have to be reviewed) and inappropriate, inasmuch as it would require the board to involve itself in the minutia of the day-to-day operations of the fund and its service providers.

For example, as part of its anti-money laundering compliance program, a fund might adopt policies that restrict the acceptable forms of payment for fund shares (*e.g.*, prohibitions against cash and traveller's checks) and implement monitoring procedures to ensure compliance. As another example, the investment managers of a multi-manager fund might each have separate trade allocation policies that would be subject to board approval. These policies, and the procedures designed to implement them, could differ in significant ways. The Institute agrees that it is appropriate for fund boards to be fully informed about these types of policies and procedures. To go beyond that, however, and require board approval of these policies and procedures would only serve to distract the board from areas where its oversight and judgment can be far more valuable.<sup>5</sup> It would also invite a level of micromanagement that would appear to be inconsistent with the Commission's stated intent to adopt a rule that would "require board *oversight* of the fund's compliance program, but would not require directors to become involved in the day-to-day operations of the program."<sup>6</sup>

For these reasons, we recommend that the rule be revised to require each fund and its service providers (to the extent of the services they provide to the fund) to adopt and implement relevant compliance policies and procedures. We further recommend that the rule require fund boards to determine that the fund and its service providers have adequate compliance processes in place. To make this determination, the board should be required to receive and review written reports provided to it no less frequently than annually by the fund and its service providers.<sup>7</sup> These reports should be required to include: (1) a summary of the entity's relevant compliance policies and procedures; (2) the names of the persons at the entity responsible for implementing the policies and procedures;<sup>8</sup> and (3) a summary of the adequacy and effectiveness of the policies and procedures, including a discussion of any material changes made or proposed to be made to the policies and procedures since the date of the last report and any material compliance matters requiring remedial action that occurred since the date of the last report.<sup>9</sup> Consistent with the Commission's proposal, funds and their service providers should also be required to maintain records evidencing their compliance with the rule.

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<sup>5</sup> Several rules under the Investment Company Act already reflect a specific determination by the Commission that board adoption of compliance procedures is necessary and/or appropriate in particular areas. *See, e.g.*, Rules 10f-3, 17a-7, 17e-1. Imposing a blanket requirement for fund boards to approve *all* compliance policies and procedures ignores this more considered and deliberate approach to fund board involvement and could result in diluting the board's ability to focus on those areas that the Commission has specifically determined require its special attention (*e.g.*, areas involving potential conflicts of interest).

<sup>6</sup> *See* Proposing Release at p. 8. (Emphasis added.)

<sup>7</sup> In the case of a unit investment trust, the principal underwriter or depositor should perform the functions assigned to fund boards. This is consistent with the approach in the Commission's proposal and Rule 17j-1 under the Investment Company Act.

<sup>8</sup> The designation of compliance personnel is discussed in more detail in Section III below.

<sup>9</sup> These requirements are consistent with those in proposed Rule 38a-1(a)(4)(ii).

Our recommended approach would ensure that the role of the fund's board under the rule would be one of exercising meaningful oversight with respect to the fund's overall compliance program. In addition, our approach would accommodate the compliance structures in place at most funds and their service providers, which have worked well, thereby lessening the burdens that would flow from adoption of the compliance rule.

### III. THE APPOINTMENT OF A SINGLE COMPLIANCE OFFICER

The Commission's proposal would require each fund to designate, and have its board approve, a single chief compliance officer. While the Commission's rule would permit a fund to have many compliance officers, they would all be required to report to the designated chief compliance officer.<sup>10</sup>

The Institute is concerned that requiring the designation of a single chief compliance officer would dictate a structure that, in many instances, is inconsistent with current practice, would be difficult to implement, and would not enhance the effectiveness of compliance programs that are currently structured in other ways. Because of the breadth and complexity of the regulatory requirements imposed on funds,<sup>11</sup> many funds and their service providers have implemented effective compliance programs that assign responsibility for ensuring the fund's compliance with applicable laws in different substantive areas, such as investment management, advertising rules, anti-money laundering requirements, trading practices, etc., to different professionals within each firm who have expertise in these areas.<sup>12</sup> The proposed requirement to designate a single individual as the chief compliance officer thus could be very disruptive to the current operations of mutual fund complexes, even though, as the Commission noted in the Proposing Release, many of these programs have been "effective" and are "staffed with competent and trained professionals."<sup>13</sup>

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<sup>10</sup> As contemplated by the Commission, this one person would be "responsible for administering the compliance policies and procedures" and, consequently, "should be competent and knowledgeable regarding the applicable federal securities laws" and "empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the adviser or the fund complex." Designation of a person as a compliance officer would not, however, in and of itself, impose upon such person a duty to supervise another person. See Proposing Release at p. 7 and nn.13 and 38. The Institute recommends that the Commission reiterate in the adopting release that the rule does not impose upon designated compliance personnel a duty to supervise other persons.

<sup>11</sup> Not only are registered investment companies subject to each of the four major federal securities acts, they are also subject to Regulation M under the Internal Revenue Code, Title V of the Gramm-Leach-Bliley Act, and various provisions of the USA PATRIOT Act, to name but a few. Indeed, the list of topics that, according to the Proposing Release should, at a minimum, be included in a fund's compliance policies and procedures runs the gamut from portfolio pricing to corporate governance and from processing fund shares to preventing money laundering.

<sup>12</sup> For example, since the adoption of Regulation S-P in 2000, many fund groups have appointed a chief privacy officer who is specifically charged with ensuring the fund's compliance with the regulation. This person may not have expertise in areas outside of what he or she needs to know for the fund to be compliant with Regulation S-P. In addition, under Section 352 of the USA PATRIOT Act, funds are required to designate a compliance officer for anti-money laundering compliance. As noted in the Proposing Release, more than one person can serve in this role. See Proposing Release at p. 8.

<sup>13</sup> See Proposing Release at p. 4.

This prescriptive approach is also inconsistent with the Commission's recognition in the Proposing Release that the rule needs to be sufficiently flexible in its application to accommodate the diversity of mutual fund structures. For example, some funds use one or more affiliated entities to carry out their operations; other funds delegate various functions to unaffiliated service providers. Some funds are served by multiple advisers and sub-advisers. In light of this diversity, funds must have flexibility to address important compliance requirements with the personnel, processes, and systems that they have determined, based upon their unique structure, are best suited to ensuring these responsibilities are met. In many cases, the designation of a *single* chief compliance officer would be inefficient and even unworkable. It would not make sense, for example, for a compliance professional at a third-party fund administrator to be required to report to a chief compliance officer employed by the fund's adviser.

The Institute also questions the appropriateness of requiring a fund's board to pass on the qualifications of the compliance personnel of the fund's service providers, some of whom may be third parties with a vendor relationship to the fund. While the board can, and should, receive information on the personnel with compliance responsibilities, requiring the board to approve such persons would be inconsistent with the Commission's objective of having fund directors play an *oversight* role.<sup>14</sup>

In light of the foregoing, the Institute recommends two revisions to proposed Rule 38a-1. First, rather than requiring the designation of a single chief compliance officer, we recommend that the rule permit a fund and its service providers to designate, initially and in the annual report provided to the fund's board, the person or persons who are primarily responsible for compliance in specified areas. Under such an approach, fund boards would be fully informed of how relevant compliance responsibilities are assigned. Second, we recommend that the rule not require the board to *approve* the compliance officers that have been designated by the fund and its service providers.

#### IV. ADDITIONAL COMMENTS ON PROPOSED RULE 38a-1

The Institute has the following additional comments on the proposed rule.

##### A. The Appropriate Compliance Standard

Proposed Rule 38a-1 would require a fund to adopt policies and procedures that are reasonably designed to "prevent violation of" the federal securities laws. We recommend that the standard to govern the adequacy of the policies and procedures instead be to "promote compliance with" the federal securities laws. This is the standard we recommended in our 1994 submission. As we stated then, "[t]his [standard] would require funds to develop a system that addresses the entire federal system of securities regulation, but at the same time, would not mandate that the system address every possible securities law issue, or provide absolute assurance that violations will not occur."<sup>15</sup> Because even the best compliance procedures will be

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<sup>14</sup> It should be noted that, while fund boards generally play an active role in overseeing the performance of portfolio managers, there is no requirement for boards to specifically approve individual portfolio managers.

<sup>15</sup> See the Institute's 1994 proposal at p. 19.

unable to prevent all violations, the rule should not suggest that funds and their service providers are subject to an unattainable or unrealistic standard.

## **B. Contents of the Required Policies and Procedures**

We are pleased that the proposal does not prescribe the items a fund and its service providers must include in the required policies and procedures. The Commission has, however, sought comment on whether the rule should specify certain minimum policies and procedures. The Institute strongly recommends that it not. Given the diversity of the fund industry, it is not desirable, and probably not even feasible, to require a uniform set of compliance policies and procedures.<sup>16</sup> As recognized by the Commission in the Proposing Release, a fund's policies and procedures should take into consideration the scope and nature of each organization's operations.<sup>17</sup>

While the proposed rule does not prescribe specific elements to be addressed in a fund's compliance policies and procedures, the Proposing Release provides guidance to funds regarding those elements by including a list of the areas that, "at a minimum," the Commission would expect to be included. The Proposing Release notes that the Commission expects to provide similar guidance in any adopting release and it seeks comment on such guidance. The Institute believes it is helpful for the Commission to provide guidance regarding areas that may need to be covered in compliance programs, to the extent applicable to a particular fund. We recommend, however, that in providing such guidance, the Commission make clear that a fund and its service providers are not required to include in their compliance programs policies and procedures in areas that are inapplicable to the fund's operations. This clarification would affirm the Commission's intent to provide the flexibility necessary for funds to tailor their compliance programs to their specific operations.

## **C. Liability**

The Institute's 1994 proposal included a provision that was intended to provide a safe harbor from liability for persons who reasonably discharge their responsibilities under the rule. The Commission's current proposal contains no such provision.<sup>18</sup> We are concerned that the absence of a safe harbor provision in the rule may result in any violation of law by a fund or its service providers being deemed either a *de facto* violation of the compliance rule or a failure to supervise. To avoid this result, we recommend that Rule 38a-1 expressly provide that no person would be liable under the rule solely because a violation of the securities laws occurs if he or she (1) had a reasonable basis to believe that the compliance policies and procedures adopted pursuant to the rule were not deficient and (2) reasonably discharged his or her obligations under the rule. Such a safe harbor provision is consistent with the Commission's

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<sup>16</sup> For example, as noted in our 1994 submission, "a short-term government securities fund faces considerably less risk of insider trading violations than a fund devoted exclusively to investments in the equity markets." See the Institute's 1994 proposal at p. 10.

<sup>17</sup> See Proposing Release at p. 5 and n.27.

<sup>18</sup> The Proposing Release does, however, note that designation of a person as a chief compliance officer would not, in and of itself, impose supervisory duties upon such person. See Proposing Release at nn.13 and 38.

historical approach regarding internal controls<sup>19</sup> and would explicitly recognize that a securities law violation, without more, does not demonstrate a flaw in a compliance system. Moreover, including such a provision in the rule would recognize that persons should not be held liable for violating the rule merely because a compliance failure occurs if they have no reasonable basis to question the established compliance procedures and they have reasonably discharged the duties imposed on them pursuant to the rule.

#### V. THE NEED FOR A TRANSITION PERIOD

Notwithstanding the fact that many fund groups currently have rigorous compliance programs in place, any compliance rule adopted by the Commission will necessitate a comprehensive review by all funds and their service providers of their existing policies and procedures and, in all likelihood, will require changes to adapt existing programs to the specific requirements of the final rule. This process will likely take a considerable period of time. In addition, to the extent the rule requires the involvement of a fund's board of directors in this process, a fund's ability to achieve full compliance with the rule may take even longer as a result of the board's meeting schedule.<sup>20</sup> In view of this, the Institute recommends that any compliance rule adopted by the Commission provide funds and their service providers sufficient time to comply with the requirements of the new rule. In particular, we recommend that compliance with any new compliance rule not be required for a period of one year from its adoption.<sup>21</sup>

#### VI. OTHER MEASURES TO PROMOTE COMPLIANCE

The Proposing Release seeks comment on the advisability of pursuing any or all of the following four initiatives involving increased reliance on the private sector: (1) requiring each fund and adviser to undergo periodic compliance reviews by a third party; (2) expanding the role of independent public accountants that audit fund financial statements to include an examination of fund compliance controls; (3) forming one or more self-regulatory organizations; and (4) requiring investment advisers to have fidelity bonds.

The Institute generally believes that it is premature to consider pursuing any of these concepts at this time for the following reasons. First, the Commission has just proposed a compliance rule that, according to the Proposing Release, is intended to ensure that fund complexes establish, implement, and annually review and report on comprehensive compliance programs. Because these rules have not yet even been adopted, it is too soon to tell whether

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<sup>19</sup> Our proposed safe harbor is consistent with that currently provided to broker-dealers under Section 15(b)(4)(E) of the Securities Exchange Act of 1934 and to investment advisers under Section 203(e)(6) of the Investment Advisers Act. These provisions provide that "no person shall be deemed to have failed reasonably to supervise any other person" if, generally speaking, there are established procedures and a system for applying such procedures that would reasonably be expected to prevent and detect, insofar as practicable, any such violation and such person reasonably discharged her or his duties or obligations under the procedures.

<sup>20</sup> We understand that the vast majority of fund boards meet on a quarterly basis.

<sup>21</sup> We further believe that a one-year period is warranted in view of the various other new and anticipated regulatory initiatives that funds will have to implement over the course of the next year. These initiatives include the proxy voting rules, shareholder report reform, anti-money laundering rules, and rules under the Sarbanes-Oxley Act.

additional private sector measures would meaningfully enhance fund compliance. Second, the Commission has recently announced a "risk-based" approach to determining the frequency and scope of inspections of investment companies and investment advisers.<sup>22</sup> The Commission should determine whether this new approach increases the efficiency of its inspection process before considering whether additional oversight of funds and their service providers is warranted. Third, while the Proposing Release cites the number of examinations conducted by the Commission's staff in fiscal year 2002,<sup>23</sup> there is no mention in the Proposing Release of findings by the Commission's staff of widespread abuses or compliance problems in the industry that indicate a need for additional oversight of funds or their advisers. Fourth, under the spending bill passed by Congress for fiscal year 2003, the Commission will receive an increase in funding of 47% above the amount of money used by the Commission in 2002. These additional resources should enable the Commission to increase its staff significantly.<sup>24</sup>

Finally, we note that, with one exception, each of the concepts proposed by the Commission would result in a substantial increase in costs for funds, which likely would be passed through to fund shareholders. We question whether these initiatives would, in fact, benefit fund shareholders and, if so, whether such benefits would outweigh their costs. With these overarching concerns as a backdrop, our specific views on each of the concepts raised in the Proposing Release are set forth briefly below.

#### A. Periodic Compliance Reviews by a Third Party

The Institute would oppose a requirement that all funds undergo periodic third-party compliance reviews. The value of such a review would, in large part, depend upon (1) the competence and qualifications of the person conducting the review and (2) the thoroughness with which it is conducted. We believe it would be difficult, if not impossible, for the Commission to define, with the necessary specificity, requirements in these two areas that would ensure that third-party reviews are conducted uniformly. And yet, to achieve any benefit of requiring a third-party compliance review across-the-board, we believe such specificity would be essential.

In addition, a third-party compliance review would impose additional significant costs on funds and, ultimately, their shareholders.<sup>25</sup> It is far from clear that the benefits of mandating

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<sup>22</sup> Under this risk-based approach, the frequency with which the Commission inspects a firm and the scope of each inspection will depend on the firm's risk profile, which, in large part, will be determined based upon the firm's risk management and internal control processes. See *"The Evolution of the SEC's Inspection Program for Advisers and Funds: Keeping Apace of a Changing Industry,"* Lori Richards, Director, SEC Office of Compliance Inspections and Examinations (October 30, 2002). According to the Proposing Release, the proposed compliance rules "are designed to complement the Commission's [risk-based] examination program." See Proposing Release at p. 12.

<sup>23</sup> See Proposing Release at p. 3.

<sup>24</sup> At the time of the Proposing Release, the Commission anticipated that it might receive a significant increase in funding. See Proposing Release at n.54. According to one article quoting the Commission's Executive Director, the amount appropriated to the Commission will enable it "to support an increase in staff of 710 - a 26 percent [increase] over [its] current operating levels." See *Securities Regulation and Law Report*, BNA (February 24, 2003) at p. 307.

<sup>25</sup> These costs could be particularly burdensome for small funds.

periodic third-party compliance reviews for all funds would justify these costs.<sup>26</sup> Mandating such reviews would inappropriately take away funds' discretion to determine whether a third-party review would, in fact, be cost-effective in their particular circumstances. Absent any finding of a serious compliance deficiency, we believe funds should maintain this discretion.<sup>27</sup>

## **B. Expanded Fund Audits**

We do not believe that expanding the role of a fund's independent auditor to include an examination of the fund's compliance controls would be appropriate. While the auditor of a fund's financial statements undoubtedly has the necessary competence to conduct that audit, the person or persons who audit the fund's financial statements might not have similar in-depth knowledge of the federal securities laws, which would be necessary to conduct an audit of the fund's compliance policies and procedures. Even if the auditor did have the requisite expertise, the costs associated with expanding the scope of the audit<sup>28</sup> would likely exceed any benefit expected to flow from the expanded audit, especially given the annual review and report requirements under proposed Rule 38a-1. For these reasons, the Institute opposes the expansion of the role of the auditor of a fund's financial statements.

## **C. Creation of One or More Self-Regulatory Organizations**

The Institute strongly opposes the creation of one or more self-regulatory organizations for funds or fund advisers. The existing system of oversight, which entrusts the Commission with the responsibility for all aspects of mutual fund regulation, including inspections, rulemaking, and enforcement, has proven to be effective and efficient. The creation of a self-regulatory organization for funds or their advisers, by imposing a duplicative and/or inconsistent layer of regulation on mutual funds, would upset the current scheme of regulation and fragment critical and complementary regulatory responsibilities, to the detriment of investors. Moreover, the creation of a self-regulatory organization – even one with limited authority – would likely be a very expensive undertaking.

It bears emphasizing that the current system of direct Commission oversight of mutual funds has worked exceptionally well for more than sixty years. Indeed, nothing in the Proposing Release indicates otherwise. Nor does anything in the Proposing Release even suggest that there is a need for a self-regulatory organization (or any of the other concepts to enhance compliance by funds and advisers) to address actual or perceived abuses in the industry. The mutual fund industry is proud of its record of compliance with both the letter and spirit of the securities laws. This record makes us question why, in the view of the

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<sup>26</sup> Moreover, in addition to direct costs, such a requirement would entail indirect costs and burdens. For example, funds and their service providers likely would have to devote substantial internal resources to facilitating any third-party review, *e.g.*, through educating the third party about the funds, producing documents, participating in interviews, responding to questions, etc.

<sup>27</sup> As discussed in the Proposing Release, the Commission may currently impose a mandatory compliance review as a condition of the settlement of an enforcement action where the Commission believes such condition is warranted based upon the facts and circumstances presented.

<sup>28</sup> As with the third-party reviews discussed above, these costs would include both direct and indirect costs. *See supra* n.26.

Commission, it is even necessary to contemplate creation of a self-regulatory organization for mutual funds. Thus, we were pleased to see Chairman Donaldson also question the need for the mutual fund industry to be policed by a self-regulatory body in light of the fact that he's "not convinced that [the Commission isn't] doing a really good job of regulating the industry now."<sup>29</sup>

The Institute strongly encourages the Commission to consider the concerns expressed by Professor Tamar Frankel when the issue of a self-regulatory organization for mutual funds was last raised by the Commission in 1993:

. . . [A] fundamental change in the regulatory system of Funds should be approached with the utmost caution; such a change should be introduced if, and only if, after serious study, less drastic alternatives are not feasible. The idea of an SRO for Funds and their advisers is innovative; in theory it may work even better than the SEC's inspection program. But innovations can become the bane of financial institutions. Such regulatory changes are risky because we cannot predict all their direct or side effects. If an SRO of Funds were to prove ineffective or deleterious, a successful segment of the financial system that provides satisfactory services to millions of Americans may be adversely affected.<sup>30</sup>

#### **D. Imposing a Fidelity Bonding Requirement**

The fourth concept on which the Commission seeks comment is requiring investment advisers to obtain fidelity bonds from insurance companies. As a preliminary matter, we note that most funds already include advisory personnel who provide services to the fund on their fidelity bonds, which are required under Section 17(g) of the Investment Company Act and Rule 17g-1 thereunder.<sup>31</sup> As such, imposing a fidelity bonding requirement on advisers to investment companies would largely result in codifying current industry practice. Accordingly, the Institute would not oppose the Commission exploring the possibility of imposing a fidelity bonding requirement on advisers to registered investment companies, so long as such a

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<sup>29</sup> See "SEC Chief Isn't Sure Funds Need Overseer," Wall Street Journal (March 14, 2003). Similarly, Commissioner Atkins has "questioned whether such an organization would simply 'impose another layer of regulation'" on the industry. Moreover, he questions whether the Commission would have the legal authority to create a self-regulatory organization for mutual funds. See "Chief Compliance Officers, Self-Regulation Among New SEC Cries," Mutual Fund Market News (February 10, 2003). The Institute shares the concerns expressed by Commissioner Atkins and we, too, question whether the Commission would have the legal authority to create a self-regulatory organization for mutual funds.

<sup>30</sup> See Tamar Frankel, "The Pros and Cons of a Self-Regulatory Organization for Advisers and Mutual Funds," The Investment Lawyer (September 1994) at p. 6. See also Letter from Tamar Frankel, Professor of Law, Boston University School of Law, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, dated November 3, 1993, expressing similar concerns.

<sup>31</sup> Section 17(g) of the Investment Company Act authorizes the Commission to require certain officers or employees of registered management investment companies to be bonded by a reputable fidelity insurance company against larceny and embezzlement. Rule 17g-1 implements this requirement.

requirement did not increase the minimum amount of the bond required under Rule 17g-1.<sup>32</sup> We recommend, however, that before considering such an expansion of the fidelity bonding requirement, the Commission update Rule 17g-1, as previously recommended by the Institute.<sup>33</sup>

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The Institute appreciates the opportunity to provide these comments in response to the Commission's Proposing Release. If you have any questions concerning these comments or would like additional information, please contact me at (202) 326-5815 or Amy Lancellotta at (202) 326-5824.

Sincerely,



Craig S. Tyle  
General Counsel

cc: The Honorable William H. Donaldson  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos  
The Honorable Cynthia A. Glassman  
The Honorable Harvey J. Goldschmid

Paul F. Roye, Director  
Susan Nash, Associate Director  
Division of Investment Management

Lori A. Richards, Director  
Office of Compliance Inspections and Examinations

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<sup>32</sup> Inasmuch as the minimum bond amounts set forth in the rule are based on the fund's assets under management, adding additional persons to the bond's coverage should not impact this minimum amount.

<sup>33</sup> In 1996, the Institute recommended that the Commission revise Rule 17g-1 to update and modernize its provisions. These recommendations were also included in a submission the Institute filed with the Commission in 2002. See Letter from Paul Schott Stevens, Senior Vice President and General Counsel of the Institute to Barry P. Barbash, Director, SEC Division of Investment Management, dated March 13, 1996 and Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission, dated May 1, 2002, transmitting *Investment Company Institute Proposals to Improve Investment Company Regulation* (May 1, 2002) at p. 41. We also note that the bonding requirements established by Section 17(g) of the Investment Company Act and Rule 17g-1 thereunder differ from those imposed under Section 412 of ERISA, even though investment advisers and certain other persons may effectively be subject to both sets of requirements in many instances. As a result, in many cases, investment advisers are purchasing duplicative coverage for the same underlying events. The Institute strongly encourages the staff of the Commission to work with the staff of the U.S. Department of Labor to reconcile, to the extent practicable, these bonding requirements to promote efficiencies and avoid unnecessary overlap of coverages.

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