Final Rule:
Compliance Programs of Investment Companies and Investment Advisers

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 270 and 275

[Release Nos. IA-2204; IC-26299; File No. S7-03-03]

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Compliance Programs of Investment Companies and Investment Advisers

Agency: Securities and Exchange Commission.

Action: Final rule; request for comments.

Summary: The Securities and Exchange Commission is adopting new rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that require each investment company and investment adviser registered with the Commission to adopt and implement written 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 designate a chief compliance officer to be responsible for administering the policies and procedures. In the case of an investment company, the chief compliance officer will report directly to the fund board. These rules are designed to protect investors by ensuring that all funds and advisers have internal programs to enhance compliance with the federal securities laws.

Dates: *Effective Date*: February 5, 2004.

Comment Date: Comments requested in section II.F of this release should be received on or before February 5, 2004.

Compliance Date: October 5, 2004. Section III of this release contains more information on the compliance date.

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, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0506.

Supplementary Information: The Securities and Exchange Commission ("SEC" or "Commission") is adopting new rule 38a-1 [17 CFR 270.38a-1] under the Investment Company Act of 1940 [15 U.S.C. 80a] ("Investment Company Act"), new 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 amendments to rule 204-2 [17 CFR 275.204-2] under the Advisers Act, and to Part 1, Schedule A, Item 2(a) of Form ADV [17 CFR 279.1].[2]

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I. Background

Earlier this year the Commission proposed rules that would require investment companies ("funds")[3] and investment advisers to adopt written compliance procedures, review the adequacy of those procedures annually, and designate a chief compliance officer responsible for their administration.[4] We proposed the rules because it is critically important for funds and advisers to have strong systems of controls in place to prevent violations of the federal securities laws and to protect the interests of shareholders and clients. The proposed rules were designed to foster, among other things, improved compliance by clarifying the compliance obligations of fund management and to strengthen the hand of fund boards and compliance personnel when dealing with them.[5]

In recent months, the Commission and state securities authorities have discovered unlawful conduct involving a number of fund advisers, broker-dealers, and other service providers that confirms the need for these rules. Fund advisory or distributor personnel have engaged in, or actively assisted others in engaging in, inappropriate market timing, late trading of fund shares, and the misuse of material, nonpublic information about fund portfolios.[6] These personnel, including in some cases senior executives of fund advisers, have placed their personal interests or the business interests of the fund adviser ahead of the interests of fund shareholders, thus breaching their fiduciary obligations to the funds involved and their shareholders. These individuals have harmed the funds, their management organizations, and the confidence of fund investors.

Our response to these events is twofold. First, we are conducting an intensive investigation of funds, advisers, broker-dealers, and others.[7] We will aggressively pursue and punish those who have violated the federal securities laws and breached their fiduciary obligations to clients. When appropriate, we will actively work with other federal law enforcement authorities and state authorities to see that the full weight of the law is brought to bear against those who have betrayed mutual funds and fund investors. Second, we will review all of our rules to determine what changes may be required to prevent this type of conduct.

We are taking our first regulatory actions designed to curb the abusive practices recently uncovered and to prevent their recurrence. In companion releases, we are proposing to amend our rules regarding mutual fund share pricing and prospectus disclosure.[8] In this release, we are adopting new rules requiring advisers and funds to adopt strong compliance controls administered by a chief compliance officer.

II. Discussion

The Commission is adopting new rule 206(4)-7 under the Advisers Act and new rule 38a-1 under the Investment Company Act.[9] The new rules require each registered investment adviser and each fund to adopt and implement compliance programs that conform to the new rules. Failure of an adviser or fund to have adequate compliance policies and procedures in place will constitute a violation of our rules independent of any other securities law violation. The new rules will thus permit the Commission to address the failure of an adviser or fund to have in place adequate compliance controls, before that failure has a chance to harm clients or investors.

A. Adoption and Implementation of Policies and Procedures

1. Investment Advisers

Under rule 206(4)-7, it is unlawful for an investment adviser registered with the Commission to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.[10] The rule requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.[11]

Commenters generally supported these new requirements, but some expressed concerns for how they would be applied to smaller advisers. The Commission is sensitive to the burdens the rule may impose upon smaller advisory firms.[12] The rule requires only that the policies and procedures be *reasonably* designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser. We would expect smaller advisory firms without conflicting business interests to require much simpler policies and procedures than larger firms that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms.[13] The preparation of these simpler policies and procedures and their administration should be much less burdensome.

Rule 206(4)-7 does not enumerate specific elements that advisers must include in their policies and procedures.[14] Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred,[15] and correct promptly any violations that have occurred.[16]

Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks. We expect that an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;[17]
- 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 aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;[18]
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and 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;[19]
- Marketing advisory services, including the use of solicitors;[20]
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information;[21] and
- Business continuity plans.[22]

Rule 206(4)-7 does not require advisers to consolidate all compliance policies and procedures into a single document. Nor does it require advisers to memorialize every action that must be taken in order to remain in compliance with the Advisers Act. In some cases, it may be enough for the compliance policies and procedures to allocate responsibility within the organization for the timely performance of many obligations, such as the filing or updating of required forms.[23]

2. Investment Companies

Rule 38a-1 requires fund boards to adopt written policies and procedures reasonably designed to prevent the fund from violating the federal securities laws.[24] The procedures must provide for the oversight of compliance by the fund's advisers, principal underwriters,[25] administrators,[26] and transfer agents[27] (collectively, "service providers") through which the fund conducts its activities.[28]

a. Service Providers. Most of the operations of funds are carried out by service providers, which have their own compliance policies and procedures. Commenters pointed out that the proposed rule appeared to require a fund to adopt, as its own, the policies and procedures of its service providers.[29] The final rule requires fund boards to approve the policies and procedures of fund service providers, and requires the fund's policies and procedures to include provisions for the fund to oversee compliance by its service providers.

Rule 38a-1 provides fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization.[30] A fund complex could, for example, adopt compliance policies and procedures that encompass the activities of the funds, the adviser and affiliated underwriters and transfer agents, while approving the policies and procedures of other service providers, such as subadvisers, over which it has oversight responsibility under the rule. Another fund complex could adopt policies and procedures that would cover solely activities of the funds, and could approve the policies and procedures of each of its service providers.

b. Board Approval. Rule 38a-1 requires a fund's board, including a majority of its independent directors, to approve the policies and procedures of the fund and each of its service providers.[31] The approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the federal securities laws by the fund and its service providers.[32]

Some commenters expressed concern that the rule would require directors to review lengthy compliance manuals and devote considerable time at each meeting to approving numerous amendments. Directors may satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by the chief compliance officer, legal counsel or other persons familiar with the compliance programs. The summaries should familiarize directors with the salient features of the programs (including programs of service providers) and provide them with a good understanding of how the compliance programs address particularly significant compliance risks.[33]

In considering whether to approve a fund's or service provider's compliance policies and procedures, boards should consider the nature of the fund's exposure to compliance failures. In the case of a money market fund, for example, the board should consider whether the policies and procedures sufficiently address the fund's compliance with rule 2a-7.[34] Boards should also consider the adequacy of the policies and procedures in light of their recent compliance experiences, which may demonstrate weaknesses in the fund or service provider's compliance programs. We urge boards to also consider best practices used by other fund complexes, and to consult with fund counsel (and independent directors with their counsel), compliance specialists and other experts familiar with compliance practices successfully employed by similar funds or service providers.

The Commission understands that, in some cases, the fund may employ the services of a service provider that is not an affiliated person of the fund, such as a transfer agent or administrator, and that provides similar services to a large number of funds. In such cases, it may be impractical for the fund or its compliance officer to directly review all of the service provider's policies and procedures. In such cases, we will consider a fund's policies and procedures to have satisfied the requirements of this rule if the fund uses a third-party report on the service provider's procedures instead of the procedures themselves when the board is evaluating whether to approve the service provider's compliance program.[35] The third-party report must describe the service provider's compliance program as it relates to the types of services provided to the fund, discuss the types of compliance risks material to the fund, and assess the adequacy of the service provider's compliance controls.[36]

c. Policies and Procedures. Funds' or their advisers' policies and procedures should address the issues we identified for investment advisers above.[37] In addition, we expect policies and procedures of funds (or fund service providers) to cover certain other critical areas. In light of our recent enforcement actions against a number of fund managers and service providers,[38] we are taking this opportunity to review the application of these policies and procedures to several important areas of compliance with the federal securities laws by funds and their service providers.

- **Pricing of portfolio securities and fund shares.** The Investment Company Act requires funds to sell and redeem their shares at prices based on their current net asset value, and to pay redemption proceeds promptly.[39] The Investment Company Act requires funds to calculate their net asset values using the market value of their portfolio securities when market quotations for those securities are "readily available," and, when a market quotation for a portfolio security is not readily available, by using the fair value of that security, as determined in good faith by the fund's board.[40] These pricing requirements are critical to ensuring fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted.

When fund shares are mispriced, short-term traders have an arbitrage opportunity they can use to exploit a fund and disadvantage the fund's long-term investors by extracting value from the fund without assuming any significant investment risk. Mispricing may occur with respect to portfolio securities traded on a foreign market that closes before the time at which the fund prices its shares.[41] If an event affecting the value of the portfolio securities occurs *after* the foreign market closes but *before* the fund prices its shares, the foreign market closing price for the portfolio security will not reflect the correct current value of those securities when the fund prices its shares. In 1984, we stated that, in these circumstances, a fund "*must*, to the best of its ability, determine the fair value of the securities, as of the time" that the fund prices its shares.[42] We believe that funds that fail to fair value their portfolio securities under such circumstances may violate rule 22c-1 under the Investment Company Act.[43] Fund directors who countenance such practices fail to comply with their statutory valuation obligations[44] and fail to fulfill their fiduciary obligation to protect fund shareholders. Accordingly, rule 38a-1 requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;[45] provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security;[46] and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.[47]

- **Processing of Fund Shares.** Our rules require forward pricing of fund shares.[48] An investor submitting a purchase order or redemption request must receive the price next calculated after receipt of the purchase order or redemption request.[49] Accordingly, rule 38a-1 requires that a fund have in place procedures that segregate investor orders received before the fund prices its shares (which will receive that day's price) from those that were received after the fund prices its shares (which will receive the following day's price).[50] Because fund purchase and redemption orders are ultimately transmitted to transfer agents engaged by the fund, we have expanded the service providers covered by the rule to include transfer agents.

  Many funds today have contractual provisions with transfer agents and other intermediaries that obligate those parties to segregate orders received by time of receipt in order to prevent "late trading" based on a previously determined price. Reliance on those contractual provisions alone would be insufficient to meet the requirements of the new rule.[51] Funds should not only approve and periodically review the policies and procedures of transfer agents, as required by the rule, but should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered.[52]

- **Identification of Affiliated Persons.** To prevent self-dealing and overreaching by persons in a position to take advantage of the fund, the Investment Company Act prohibits funds from entering into certain transactions with affiliated persons.[53] Funds should have policies and procedures in place to identify these persons and to prevent unlawful transactions with them.

- **Protection of Nonpublic Information.** The federal securities laws prohibit insider trading, and section 204A of the Advisers Act requires advisers (including advisers to funds) to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the adviser or any of its associated persons from misusing material, nonpublic information. Fund advisers should incorporate their section 204A policies into the policies required by rule 38a-1. These policies typically include prohibitions against trading portfolio securities on the basis of information acquired by analysts or portfolio managers employed by the investment adviser. A fund's compliance policies and procedures should also address other potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio,[54] its trading strategies,[55] or pending transactions, and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio.[56]

- **Compliance with Fund Governance Requirements.** A fund's board plays an important role in overseeing fund activities to ensure that they are being conducted for the benefit of the fund and its shareholders. Fund boards, among other things, are tasked with approving the fund's advisory contracts,[57] underwriting agreements,[58] and distribution plans.[59] The Investment Company Act requires that fund boards of directors be elected by fund shareholders,[60] and that a certain percentage be "independent directors."[61] To rely on many of our exemptive rules, independent directors must constitute a majority of the board, must be selected and nominated by other independent directors, and if they hire legal counsel, that counsel must be an independent legal counsel.[62]

  The consequences of failing to meet the Investment Company Act's governance requirements are severe.[63] Therefore, a fund's policies and procedures should be designed to guard against, among other things, an improperly constituted board,[64] the failure of the board to properly consider matters entrusted to it, and the failure of the board to request and consider information required by the Investment Company Act from the fund adviser and other service providers.[65]

- **Market Timing.** In a companion release today, we are proposing amendments to our mutual fund disclosure rules to require funds to disclose their policies on "market timing," *i.e.*, the excessive short-term trading of mutual fund shares that may be harmful to the fund.[66] Many funds' prospectuses already disclose market timing policies, and failure to adhere to those disclosed policies violates the antifraud provisions of the federal securities laws.[67] Moreover, a fund adviser that waives or disregards those policies for the benefit of itself or a third party has breached its fiduciary responsibilities to the fund.[68] Thus, under rule 38a-1 a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing.[69] If the fund permits any waivers of those policies, the procedures should be reasonably designed to prevent waivers that would harm the fund or its shareholders or subordinate the interests of the fund or its shareholders to those of the adviser or any other affiliated person or associated person of the adviser. In this regard, we strongly urge

fund boards to require fund advisers, or other persons authorized to waive market timing policies, to report to the board at least quarterly all waivers granted, so that the board can determine whether the waivers were proper.

B. Annual Review

1. Investment Advisers

Rule 206(4)-7 requires each registered adviser to review its policies and procedures annually to determine their adequacy and the effectiveness of their implementation.[70] The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures. For example, an adviser that is acquired by a broker-dealer or by the corporate parent of a broker-dealer should assess whether its policies and procedures are adequate to guard against the conflicts that arise when the adviser uses that broker-dealer to execute client transactions, or invests client assets in funds or other securities distributed or underwritten by the broker-dealer.

Although the rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments. For example, we expect all registered advisers will begin reviewing their policies and procedures in light of our adoption of these rules.

2. Investment Companies

Similarly, rule 38a-1 requires a fund to review its policies and procedures, as well as those of its service providers, annually.[71] The rule does not require a fund board to conduct the review; the board would, however, have the benefit of the review in the report submitted by the compliance officer. We expect all funds will begin reviewing their compliance policies and procedures currently, not only in light of the adoption of these rules, but also in light of the recent revelations of unlawful practices involving fund market timing, late trading, and improper disclosures and use of nonpublic portfolio information.

C. Chief Compliance Officer

1. Investment Advisers

Rule 206(4)-7 requires each adviser registered with the Commission to designate a chief compliance officer to administer its compliance policies and procedures.[72] An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.[73] Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.[74]

2. Investment Companies

Rule 38a-1 requires each fund to appoint a chief compliance officer who is responsible for administering the fund's policies and procedures approved by the board under the rule.[75] A fund's chief compliance officer should be

competent and knowledgeable regarding the federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund. The chief compliance officer of a fund, like the chief compliance officer of an investment adviser, should have sufficient seniority and authority to compel others to adhere to the compliance policies and procedures.

The rule contains several provisions, some of which were not included in our proposal, designed to promote the independence of the chief compliance officer from the management of the fund.[76] First, the chief compliance officer will serve in her position at the pleasure of the fund's board of directors, which can remove her if it loses confidence in her effectiveness. The fund board (including a majority of independent directors) must approve the designation of the chief compliance officer, and must approve her compensation (or any changes in her compensation).[77] The board (including a majority of the independent directors) can remove the chief compliance officer from her responsibilities at any time,[78] and can prevent the adviser or another service provider from doing so.[79]

Second, the chief compliance officer will report directly to the board of directors. She must annually furnish the board with a written report on the operation of the fund's policies and procedures and those of its service providers.[80] The report must address, at a minimum: (i) the operation of the policies and procedures of the fund and each service provider since the last report, (ii) any material changes to the policies and procedures since the last report,[81] (iii) any recommendations for material changes to the policies and procedures as a result of the annual review,[82] and (iv) any material compliance matters since the date of the last report.[83] We have added a definition of the term "material compliance matter" to the rule, to clarify that the report should inform the board of those compliance matters about which the fund's board reasonably needs to know in order to oversee fund compliance.[84]

Third, we are requiring that the chief compliance officer meet in executive session with the independent directors at least once each year, without anyone else (such as fund management or interested directors) present.[85] The executive session creates an opportunity for the chief compliance officer and the independent directors to speak freely about any sensitive compliance issues of concern to any of them, including any reservations about the cooperativeness or compliance practices of fund management.

Fourth, we have added a provision to protect the chief compliance officer from undue influence by fund service providers seeking to conceal their or others' non-compliance with the federal securities laws. Rule 38a-1 prohibits the fund's officers, directors, employees or its adviser, principal underwriter, or any person acting under the direction of these persons, from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the fund's chief compliance officer in the performance of her responsibilities under the rule.[86]

The appointment of a chief compliance officer with overall responsibility for management of a fund complex's compliance program is a key element of the investor protections we are today adopting. Some commenters representing fund management companies urged us to permit funds to continue to use multiple compliance managers employed by different service providers, rely on the policies of the fund service providers, and omit the requirement that fund boards approve the compliance officer. These commenters would have us maintain funds' current approach to compliance management. Current practices, however, balkanize responsibility for fund compliance and isolate fund boards from compliance

personnel, thus impeding boards' abilities to exercise their oversight responsibilities effectively. We decline to accept current practices, which we believe have contributed to the serious compliance lapses that are now the subject of our enforcement actions.

We have observed that executives at service providers have overruled their own compliance personnel because of business considerations. For example, some fund advisers have continued to permit investors with whom they had other business relationships to engage in harmful market timing in fund shares after compliance personnel and portfolio managers brought the market timing activity to their attention. These compliance personnel may not have had access to fund directors or, having been overruled by their own management, may have felt they were not in a position to approach the board.

To address these concerns, rule 38a-1 provides fund boards with direct access to a single person with overall compliance responsibility for the fund who answers directly to the board. The rule provides the board with a powerful tool to exercise its oversight responsibilities over fund compliance matters. The new rule also strengthens the hand of compliance personnel by establishing a direct line of reporting to fund boards that is not controlled by management.[87] We have observed that compliance failures have occurred when a fund service provider has denied information to the fund's board, or has been less than forthright, because the service provider viewed full disclosure as detrimental to its own interests. Under the new rule, the chief compliance officer will be responsible for keeping the board apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund's compliance program.

We expect that a fund's chief compliance officer will often be employed by the fund's investment adviser or administrator.[88] We are not adopting a requirement that the chief compliance officer be employed by only the fund because we believe that such a provision would actually weaken her effectiveness. Funds today typically have no employees, and delegate management and administrative functions, including the compliance function, to one or more service providers. If we were to preclude the chief compliance officer from being an employee of an adviser or any other service provider, she would be divorced from all fund operations.[89] The adviser's chief compliance officer would continue to administer the adviser's compliance programs, and the role of the fund's chief compliance officer would be limited to oversight of the service providers' compliance policies and providing advice to the board on their operation. As a result, the fund's chief compliance officer would be almost entirely dependent on information filtered through the senior management of the fund's adviser rather than, for example, information received directly from a trading desk. Moreover, fund management would be unlikely to consult with an "outside" compliance officer on a prospective business decision to ascertain the compliance implications.

We recognize, however, that a chief compliance officer who is an employee of the fund's investment adviser might be conflicted in her duties, and that the investment adviser's business interests might discourage the adviser from making forthright disclosure to fund directors of its compliance failures. The rule, as adopted, is designed to address these concerns by requiring a fund's chief compliance officer to report directly to the board. The board, and the board alone, can discharge the officer if she fails to live up to the position. Thus, a chief compliance officer who fails to fully inform the board of a material compliance failure, or who fails to aggressively pursue non-compliance within the service provider, would risk her position.

She would also risk her career, because it would be unlikely for another board of directors to approve such a person as chief compliance officer.[90]

The chief compliance officer, in exercising her responsibilities under the rule, will oversee the fund's service providers, which will have their own compliance officials. A chief compliance officer should diligently administer this oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The chief compliance officer should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks. She should maintain an active working relationship with each service provider's compliance personnel. Arrangements with the service provider should provide the fund's chief compliance officer with direct access to these personnel, and should provide the compliance officer with periodic reports and special reports in the event of compliance problems. In addition, the fund's contracts with its service providers might also require service providers to certify periodically that they are in compliance with applicable federal securities laws, or could provide for third-party audits arranged by the fund to evaluate the effectiveness of the service provider's compliance controls.[91] The chief compliance officer could conduct (or hire third parties to conduct) statistical analyses of a service provider's performance of its duties to detect potential compliance failures.[92]

D. Recordkeeping

New rule 38a-1 (for funds) and amendments to rule 204-2 (for advisers) require firms to maintain copies of all policies and procedures that are in effect or were in effect at any time during the last five years.[93] In addition, new rule 38a-1 will require funds to maintain materials provided to the board of directors in connection with their approval of the fund's and its service providers' policies and procedures and the annual written reports by the fund's chief compliance officer.[94] New rule 38a-1 and amended rule 204-2 will require funds and advisers to keep any records documenting their annual review.[95] Our rules permit funds and advisers to maintain these records electronically.[96] These new recordkeeping requirements will assist our examination staff in determining whether the adviser or fund is adhering to the new rules and in identifying weaknesses in the compliance program if violations do occur or are uncorrected.

E. Private Sector Initiatives

In the Proposing Release, we requested that commenters consider four additional approaches that we might take to require the private sector to assume greater responsibility for compliance with the federal securities laws. These possible approaches included: (i) a requirement that funds and advisers undergo third-party compliance reviews; (ii) an expansion of the role of independent public accountants to include the performance of certain compliance reviews; (iii) the formation of one or more self-regulatory organizations for advisers or funds; and (iv) the requirement that certain advisers obtain fidelity bonds from reputable insurance companies.

We appreciate the many comments we received. Although we are not moving forward with any of these approaches at this time, we continue to regard them as viable options should the measures we are taking today fail to adequately strengthen the compliance programs of funds and advisers. In particular, we may reconsider whether to propose rules requiring funds and advisers to obtain compliance reviews from third-party compliance

experts. Such compliance audits could be a useful supplement to our examination program and would assure the frequent examination of advisers and funds.

F. Additional Request for Comment

Rule 38a-1 includes provisions designed to promote the chief compliance officer's independence from fund management while still maintaining her effectiveness. The fund's board of directors must approve the chief compliance officer's designation and compensation, and has the sole power to remove her from her position.[97] The chief compliance officer reports directly to the board, and must meet with the independent directors in executive session at least annually.[98] The rule also protects the chief compliance officer by prohibiting persons from coercing or fraudulently influencing her in the course of her responsibilities.[99] Today, in addition to adopting rule 38a-1, we request comment on these provisions. Are there other measures (or refinements to these provisions) that would further enhance the independence and effectiveness of chief compliance officers under the rule? We also request comment whether our definition of the "material compliance matters" that must be reported to fund boards by chief compliance officers adequately addresses our concern that fund boards receive compliance information they reasonably need to know in order to oversee fund compliance.[100]

III. Effective Date

New rules 38a-1 and 206(4)-7 and the amendments to rule 204-2 will be effective on February 5, 2004. The compliance date of the new rules and rule amendments is October 5, 2004. On or before the compliance date, all funds and advisers must have designated a chief compliance officer and fund boards must have approved the chief compliance officer. In addition, on or before the compliance date, funds and advisers must adopt compliance policies and procedures that satisfy the requirements in the new rules. In the case of funds, these policies and procedures must have been approved by the board on or before the compliance date. Funds and advisers must complete their first annual review of the compliance policies and procedures no later than eighteen months after the adoption or approval of the compliance policies and procedures. The chief compliance officer of a fund must submit the first annual report to the board within sixty calendar days of the completion of the annual review.

Our allowance for a nine month transition period does not reduce the immediacy of the need for all funds, including those that already have compliance policies in place, to undertake a review of their policies and procedures, in light of recent revelations of unlawful practices involving market timing, late trading, and improper disclosures of nonpublic portfolio information.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The new rules 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. In the Proposing Release, we identified possible costs and benefits of the rules and requested comment on our analysis.

A. Benefits

We expect that fund investors, advisory clients, funds, and advisers will benefit from the new rules. Commenters generally agreed that comprehensive compliance programs are beneficial. Although many funds

and advisers already have such programs in place, the new rules will make this standard practice for all funds and advisers. One commenter, a compliance officer, noted that the benefits of the new measures in the form of increased investor protection would far exceed the costs.

Requiring funds and investment advisers to design and implement a comprehensive internal compliance program will serve to reduce the risk that fund investors and advisory clients (collectively, "investors") will be harmed by violations of the securities laws. With limited exception, commenters agreed that comprehensive written compliance programs are the first line of defense in investor protection. Recent allegations of violations related to market timing and late trading confirm the need for strong compliance programs that do not permit compliance objectives to be subordinated to the business objectives of fund advisers or their affiliated persons.

The appointment of a chief compliance officer for each fund will also provide important investor protection benefits. Funds currently rely on multiple compliance personnel working for different service providers. Fund boards do not receive compliance information directly from these compliance officers; it is filtered through the management of the fund's investment adviser or other service providers. We believe these structures have contributed to serious compliance lapses that are now the subject of our enforcement actions. Rule 38a-1, by requiring each fund to have a compliance officer who serves at the pleasure of the fund's board and who is responsible for oversight of these service providers, and who cannot be unduly influenced will strengthen the hand of compliance personnel by giving them a direct line of reporting to the fund board that is not controlled by management.

The rules will also benefit funds and investment 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. 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. Advisers may be denied eligibility to advise funds.[101] In addition, advisers could be precluded from serving in other capacities.[102]

The designation of a chief compliance officer also should enhance the efficiency of funds' and advisers' operations by centralizing responsibility for the compliance function. While many commenters agreed that fund and investment adviser compliance benefits from clear allocation of compliance responsibilities, they argued that large firms would benefit little from requiring a single person to be designated. We believe that the designation of a single officer will increase the coordination with which distributed compliance functions are executed.

In addition, because the new rules complement our examination program for investment advisers and for fund complexes, they will enhance our ability to protect investors. The existence of a structured compliance program at funds and investment advisers, together with the designation of a chief compliance officer to serve as a point of contact, will 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. Most commenters noted that the proposed rules would enhance the effectiveness of the Commission's examination program and oversight of funds and advisers.

B. Costs

The new rules will result in some additional costs for funds and investment advisers, which, in the case of funds, we expect would be passed on to investors. A number of commenters expressed concern about the costs that the new rules would impose.[103] One commenter, noting that existing compliance mandates place a significant burden on investment advisers, expressed concern that the costs of new compliance obligations might outweigh the benefits. However, because all funds and most investment advisers currently have some written compliance policies and procedures in place, the costs of the new rules in many instances already are reflected in the fees investors currently pay.

We would expect that funds and advisers with substantial commitments to compliance would incur only minimal costs in connection with the adoption of the new rules as they reviewed their internal compliance programs for adequacy. Funds and larger advisory firms typically have adopted and implemented comprehensive, written policies and procedures. Many of these funds and 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.

A number of commenters expressed particular concern about the relative cost of the new rules for small investment advisers.[104] This concern is consistent with our experience that investment advisers (as well as small funds) are less likely than their larger counterparts to have comprehensive, written internal compliance programs in place. 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.

However, we expect a number of factors will enable small investment advisers to control and minimize these costs. Because 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.[105] 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.[106] 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. Estimates of the cost of developing compliance policies and procedures vary greatly depending on the type of help that an investment adviser seeks.[107]

The requirement that each investment adviser designate a chief compliance officer likely will impose only a minimal cost. Many investment advisers already have large compliance staffs headed by an individual who officially or effectively serves as a chief compliance officer.[108] For other investment advisers, costs associated with designating a chief compliance officer also would be minimized by the fact that the new rules would not require firms to hire an individual exclusively charged with serving in this capacity.[109] One commenter characterized the chief compliance officer requirement as unduly burdensome because it would conflict with the complex and varied organizational structures of investment advisers. As noted above, we believe that it is important for each firm to have one person who coordinates compliance efforts on behalf of the firm, even though that individual may rely heavily on others within and outside the firm for assistance. The cost to funds of appointing a chief compliance officer also should not be significant. Like many investment advisers, many fund complexes already have large compliance staffs headed by an individual

who officially or effectively serves as a chief compliance officer. We expect this individual will typically be qualified to serve the fund's board of directors as the fund's chief compliance officer.[110]

We anticipate that costs associated with the annual review requirement also will be limited. Many large funds and investment advisers with comprehensive compliance programs periodically review portions of their compliance programs. These firms may 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 will be less extensive and, therefore, less costly than for their larger counterparts. We have determined that requiring more frequent reviews would impose unnecessary costs on funds and advisers.

Several commenters stated that there would be a substantial cost associated with the requirement that fund boards approve the compliance policies and procedures and review the annual report prepared by the chief compliance officer. We have clarified in this release that the new rules do not require the board of directors to read every policy and procedure. The board may make its decisions about the adequacy of the compliance policies and procedures based on summary reports. Similarly, the board's review of the chief compliance officer's annual report should focus on ensuring that the compliance programs of the fund and its service providers are reasonably designed and functioning effectively. In light of these clarifications, we do not believe that funds will incur excessive costs in connection with board oversight of compliance under the new rules.

One commenter, a large fund complex, suggested that there would be substantial recordkeeping costs associated with the new rules, and suggested that firms be required to maintain for five years copies of only those policies and procedures that form the backbone of the firm's compliance program. Because records may be maintained electronically, the cost of maintaining copies of all compliance policies and procedures in place during the past five years will be contained.

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)] mandate that 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.

As discussed above, the new 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 new rules may indirectly increase efficiency in a number of ways. These compliance programs should increase efficiency by deterring federal 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 will 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 new rules apply equally to all funds and advisers, we do not anticipate that they will introduce any competitive disadvantages. To the contrary, the new 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. Several commenters cautioned, however, that the new rules could have anti-competitive effects on the advisory industry because they would disproportionately burden small advisers and could even force them to merge with their larger, more established counterparts or go out of business. While small advisers will incur the largest relative costs as a result of the new rules, the rule's requirements are essential for the protection of small advisers' clients. Moreover, the existence of a strong compliance program may assist small advisers to attract client assets.

We anticipate that the new rules will indirectly foster capital formation by bolstering investor confidence. It has been our experience that funds and advisers with effective compliance programs are less likely to violate the federal 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.

VI. Paperwork Reduction Act

As we discussed in the Proposing Release, the new rules and amendments would impose "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[111] These collections of information are mandatory. Two of the collections of information are new. The titles of these new collections are "Rule 38a-1" and "Rule 206(4)-7." The Commission 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 other collection of information takes the form of amendments to a currently approved collection titled "Rule 204-2," under OMB control number 3235-0278. The Commission also 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 ensure that investment companies maintain comprehensive internal programs that promote the companies' compliance with the federal securities laws. This collection of information is mandatory. The respondents are investment companies registered with us and business development companies. Our staff, conducting the Commission's examination and oversight program, will 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.[112] Rule 38a-1 requires that certain records be retained for at least five years.[113]

The collection of information under rule 206(4)-7 is necessary to ensure that investment advisers maintain comprehensive internal programs that promote the advisers' compliance with the Advisers Act. This collection of information is mandatory. The respondents are investment advisers registered with us. Our staff, conducting the Commission's examination and oversight program, will 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.[114]

The collection of information under rule 204-2 is necessary for the Commission staff to use in its examination and oversight program. This collection of information is mandatory. 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.[115] The records that an adviser must keep in accordance with the new rules must be retained for at least five years.[116]

A. Rule 38a-1

We estimated in the Proposing Release that there are approximately 5,030 registered investment companies and 53 business development companies (or a total of approximately 5,083 funds) that will be subject to rule 38a-1.[117] We estimated that the average annual hour burden for a fund to document the policies and procedures that make up its compliance program as required by rule 38a-1 would be 60 hours.[118] We further estimated that each fund would spend five hours annually, on average, documenting the conclusions of its annual compliance review for its board of directors as required by rule 38a-1.

We also estimated that each fund would spend 0.5 hours annually, on average, maintaining copies of their compliance policies and procedures and chief compliance officer's annual reports for five years as required by rule 38a-1. In adopting rule 38a-1, we have expanded this recordkeeping requirement to also include copies of briefing materials provided to a fund's board of directors in connection with their approval of the fund and its service providers' compliance programs and board review of the chief compliance officer's annual reports, and to include copies of any records documenting a fund's annual review. Since these changes only require funds to retain copies of a limited number of records they have already created (rather than requiring funds to record any new information), we continue to estimate that the average annual hour burden for each adviser is 0.5 hours.

Most commenters addressing the paperwork burden of rule 38a-1 supported them as reasonable, though one large fund management firm predicted funds would find it burdensome to maintain copies of their compliance policies and procedures for five years as required by the rule. Because of the importance of these copies to our examination and oversight program, we are adopting rule 38a-1 without removing this requirement.

Therefore, our total hour burden estimate for the collections of information under rule 38a-1 remains 332,936.5 burden hours, as we estimated in our proposal.[119]

B. Rule 206(4)-7

In the Proposing Release, we estimated the total annual average burden hours for advisers to document the policies and procedures that make up their compliance programs, as required by rule 206(4)-7, would be 623,200 hours, based on 7,790 investment advisers registered with us spending an annual average of 80 hours on such documentation.[120]

This 80 hour average estimate took into account that many advisers would be the primary drafters of compliance policies and procedures for funds under rule 38a-1, and would be able to draw extensively from their fund compliance programs to supplement, as necessary, compliance policies and procedures for the advisory firm. Our estimate also took into account 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.

Our 80 hour estimate also took into account 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, but can draw on a number of outlines and model programs, and can develop less complex programs because they often do not participate in arranging or effectuating securities transactions that they recommend to their clients. Comments from a trade association representing many smaller advisers generally supported our underlying assessment in this regard. Comments from another investment adviser trade association noted that it would likely be the owner of (or senior person at) a smaller firm who tailors a model compliance program to suit the firm's particular business, and use of this person's time would be more costly to the firm than the compliance personnel used by larger firms.

We are adopting rule 206(4)-7 without change to its paperwork collection requirements. Accordingly, our estimate of the annual aggregate burden of collection for the amended rule remains 623,200 hours.

C. Rule 204-2

In the Proposing Release, we estimated that the amendments to rule 204-2 requiring investment advisers to maintain copies of their compliance policies and procedures and copies of any records documenting the adviser's annual review of those policies, as required by rule 206(4)-2, would increase each registered investment adviser's average annual collection burden under rule 204-2 by 0.5 hours to 211.98 hours. We further estimated the amendments would increase the rule's annual aggregate burden by 3,895 hours.[121] One commenter objected that it would be onerous for advisers to maintain copies of records generated by the adviser's annual compliance review. Because of the importance of these copies to our examination and oversight program, we are adopting the amendments to rule 204-2 without change.[122]

VII. Summary of Final Regulatory Flexibility Analysis

We have prepared a Final Regulatory Flexibility Analysis ("FRFA") in accordance with 5 U.S.C. 604, related to the new rules and rule amendments that we are adopting today. A summary of the Initial Regulatory Flexibility Analysis ("IRFA"), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release. Copies of the FRFA and the IRFA may be obtained by contacting Hester Peirce, Senior Counsel, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549-0506.

The FRFA summarizes the background of the new rules and rule amendments and discusses why these regulatory changes are needed to enhance compliance with the federal securities laws by funds and advisers. These issues are addressed above. The FRFA also discusses comments received in response to the IRFA, the effect of the new rules and rule amendments on small entities, and the Commission's efforts at minimizing the effect on small entities. These issues are summarized below.

The FRFA explains that the new rules and rule amendments will govern all registered investment companies, business development companies, and advisers registered with the Commission, including small entities. For purposes of the Regulatory Flexibility Act,[123] 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.[124]

The staff estimates, based on Commission filings, that there are approximately 186 small open- and closed-end investment companies, 18 small unit investment trusts, and 29 small business development companies.[125]

For purposes of the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more 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 has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[126] The Commission estimates that, as of October 14, 2003, there were approximately 571 small investment advisers registered with us.[127]

The FRFA discusses the comments that we received in response to issues raised in the IRFA.[128] Several commenters, including one trade association for investment advisers, cautioned that the new rules would impose significant costs on small advisers. Another trade association for advisers acknowledged that small advisers would bear a higher relative cost than their larger counterparts, but anticipated that the cost to small advisers would be offset by the fact that compliance policies and procedures would not have to cover as broad a range of activities as the policies and procedures of their larger counterparts.[129] A third commenter, however, noted that even though small firms might have less complex policies and procedures, the cost of drafting the basic policies and procedures would be the same as for larger firms and for some small firms the cost would be prohibitive.

Commenters recommended the following accommodations for small entities: (i) exempt small firms from the requirement to designate a chief compliance officer, (ii) exempt small advisers from all of the new requirements, (iii) identify procedures that are relevant to small firms, (iv) identify issues that do not apply to small advisers or advisers that do not manage assets and therefore would not have to be addressed in their compliance policies and procedures, (v) create a template that firms could adapt to fit their unique characteristics, or (vi) permit small advisers to maintain records outside their office space in an easily accessible location.

The FRFA explains that the rules do not introduce new reporting requirements, but do introduce new compliance requirements, including new recordkeeping obligations. The FRFA sets forth the requirements of the rule (which are described above in detail) and explains that all funds and advisers, regardless of size, are subject to the compliance requirements. The FRFA also explains that while most firms already have instituted a compliance program and have designated someone charged with implementing it, small advisers are disproportionately represented among the firms that have not taken such steps. The FRFA notes that these firms will bear costs in developing and implementing policies and procedures.[130] The FRFA explains that the new rules and rule amendments are designed to achieve their objectives without imposing undue costs on affected firms.

The FRFA discusses the alternatives considered by the Commission in adopting the new rules and rule amendments that might minimize adverse effects on small advisers, including: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (iii) the use of performance rather than design standards;

and (iv) an exemption from coverage of the rules, or any part thereof, for small entities.

We do not presently believe that the establishment of special compliance requirements or timetables for small entities is feasible or necessary.[131] Modifying these requirements for small funds or advisers would place their clients at unnecessary risk. The requirement that each fund or adviser implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, is essential to promote systematic and organized reviews by funds and advisers of their operations and activities. The requirement that funds obtain board approval of their programs and annually report about the programs to their boards is necessary to preserve the crucial oversight role of fund boards of directors.[132] Annual reviews are integral to detecting and correcting any gaps in the program before irrevocable or widespread harm is inflicted upon investors. The required designation of a chief compliance officer is necessary to achieve centralized supervisory authority over all aspects of the compliance program and to reduce the likelihood of gaps in the compliance program. The requirement that funds and advisers keep file copies of their written policies, procedures, reports, and other records for five years, imposes an inconsequential burden on small funds and advisers. The establishment of a special compliance timetable to allow a transition period of more than six months would delay the rules' investor protection benefits without assisting small funds and advisers.

The Commission does not presently believe that clarification, consolidation, or simplification of compliance requirements for small entities is feasible or necessary. The compliance requirements, which are integral to the effectiveness of the rules, are not technical or complex in any sense. The FRFA explains that some commenters requested more specific guidance about the type of compliance policies and procedures that would be required. In the Proposing Release and in this release, we have provided illustration and guidance to firms about the topics that should be addressed by their compliance policies and procedures. Because of the great variety across firms, any template that we could provide would be voluminous and would require extensive tailoring to the unique characteristics of each firm. Thus, it does not appear that Commission templates would effectuate significant burden reduction.

The FRFA explains that the new rules, to the greatest extent possible, embody performance rather than design standards. The rules do not enumerate specific required elements of the policies and procedures, but will allow all firms, including small firms, to tailor their internal compliance programs to the nature and scope of their own business. The FRFA explains that the rules do not set forth a list of attributes that the chief compliance officer must possess and permit firms to designate an existing employee with other responsibilities to fill that role, which the staff anticipates that most small firms will do.

The FRFA explains that we do not believe that the objectives of the rules could be achieved if small entities were exempted from coverage of any part of the proposals. It has been our experience that strong internal compliance programs are essential to investor protection in funds and advisers of all sizes.

VIII. Statutory Authority

We are adopting 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)].[133] We are adopting new rule 206(4)-7 pursuant to the authority set forth in sections 206(4) and 211(a) under the

Advisers Act [15 U.S.C. 80b-6(4) and 80b-11(a)].[134] We are adopting 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].

We are amending rule 279.1, Form ADV, under section 19(a) of the Securities Act of 1933 [15 U.S.C. 77s(a)], sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78w(a) and 78bb(e)(2)], section 319(a) of the Trust Indenture Act of 1939 [15 U.S.C. 77sss(a)], section 38(a) of the Investment Company Act of 1940 [15 U.S.C. 78a-37(a)], and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)].

List of Subjects

17 CFR 270

Investment companies, Reporting and recordkeeping requirements, Securities.

17 CFR 275

Reporting and recordkeeping requirements, Securities.

Text of Rules

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is 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, and 80a-39, unless otherwise noted.

* * * * *

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

§ 270.38a-1 Compliance procedures and practices of certain 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, including policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund;

(2) Board approval. Obtain the approval of the fund's board of directors, including a majority of directors who are not interested persons of the fund, of the fund's policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund, which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund;

(3) Annual review. Review, no less frequently than annually, the adequacy of the policies and procedures of the fund and of each investment adviser,

principal underwriter, administrator, and transfer agent and the effectiveness of their implementation;

(4) Chief compliance officer. Designate one individual responsible for administering the fund's policies and procedures adopted under paragraph (a)(1):

(i) Whose designation and compensation must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund;

(ii) Who may be removed from his or her responsibilities by action of (and only with the approval of) the fund's board of directors, including a majority of the directors who are not interested persons of the fund;

(iii) Who must, no less frequently than annually, provide a written report to the board that, at a minimum, addresses:

(A) The operation of the policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent of the fund, any material changes made to those 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) Each Material Compliance Matter that occurred since the date of the last report; and

(iv) Who must, no less frequently than annually, meet separately with the fund's independent directors.

(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, must receive all annual reports, and must approve the removal of the chief compliance officer from his or her responsibilities.

(c) Undue influence prohibited. No officer, director, or employee of the fund, its investment adviser, or principal underwriter, or any person acting under such person's direction may directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence the fund's chief compliance officer in the performance of his or her duties under this section.

(d) Recordkeeping. The fund must maintain:

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

(2) Copies of materials provided to the board of directors in connection with their approval under paragraph (a)(2) of this section, and written reports provided to the board of directors pursuant to paragraph (a)(4)(iii) of this section (or, if the fund is a unit investment trust, to the fund's principal underwriter or depositor, pursuant to paragraph (b) of this section) for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and

(3) Any records documenting the fund's annual review pursuant to paragraph (a)(3) of this section for at least five years after the end of the fiscal year in which the annual review was conducted, the first two years in an easily accessible place.

(e) Definitions. For purposes of this section:

(1) Federal Securities Laws means the Securities Act of 1933 (15 U.S.C. 77a-aa), the Securities Exchange Act of 1934 (15 U.S.C. 78a-mm), 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 (Pub. L. No. 106-102, 113 Stat. 1338 (1999), any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act (31 U.S.C. 5311-5314; 5316-5332) as it applies to funds, and any rules adopted thereunder by the Commission or the Department of the Treasury.

(2) A Material Compliance Matter means any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance, and that involves, without limitation:

(i) A violation of the Federal Securities Laws by the fund, its investment adviser, principal underwriter, administrator or transfer agent (or officers, directors, employees or agents thereof),

(ii) A violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent, or

(iii) A weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent.

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)(i), inclusive, and (c)(2) 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 shall be unlawful within the meaning of section 206 of the Act (15 U.S.C. 80b-6) 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.

PART 279 - FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

6. The authority citation for Part 279 continues to read as follows:

AUTHORITY: The Investment Advisers Act of 1940, 15 U.S.C. 80b-1, et seq.

7. Form ADV (referenced in 279.1) is amended by:

In Part 1, Schedule A, revising Item 2(a), to read "each Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Legal Officer, Chief Compliance Officer (Chief Compliance Officer is required and cannot be more than one individual), director and any other individuals with similar status or functions;"

By the Commission.

Margaret H. McFarland
Deputy Secretary

Dated: December 17, 2003

Footnotes

[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] Unless otherwise noted, when we refer to rule 38a-1 or any paragraph of the rule, we are referring to 17 CFR 270.38a-1 of the Code of Federal Regulations in which the rule is published, as amended by this release; when we refer to rule 206(4)-7 or any paragraph of the rule, we are referring to 17 CFR 275.206(4)-7 of the Code of Federal Regulations in which the rule is published, as amended by this release; and when we refer to rule 204-2 or any paragraph of the rule, we are referring to 17 CFR

275.204-2 of the Code of Federal Regulations in which the rule is published, as amended by this release.

[3] In this release, we use the term "fund" to mean a registered investment company or a business development company, which is an unregistered closed-end investment company. *See* section 2(a)(48) of the Investment Company Act [15 U.S.C. 80a-2(a)(48)]. We use 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)].

[4] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925 (Feb. 5, 2003) [68 FR 7038 (Feb. 11, 2003)] ("Proposing Release").

[5] Forty-eight commenters, most of which were investment advisers, fund management companies, and organizations representing those groups, submitted comments in response to the Proposing Release. Commenters generally supported the proposal to require funds and advisers to adopt and implement compliance programs, but many sought changes. The comment letters and a summary of comments prepared by our staff are available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC (File No. S7-03-03). The comment summary is also available on the Commission's Internet web site (http://www.sec.gov/rules/extra/s70303summary.pdf).

[6] The Commission has already obtained settlements in a number of actions arising from such violations. *See, e.g.,* In re Putnam Investment Management, Investment Advisers Act Release No. 2192 (Nov. 13, 2003) (finding that an investment adviser failed to disclose potentially self-dealing securities trading by several of its employees, failed to have reasonable procedures to prevent misuse of material nonpublic information, and failed to reasonably supervise the employees who committed violations); In re Connelly, Securities Act Release No. 8304 (Oct. 16, 2003) (finding that a former executive of an investment adviser to a fund complex, in contravention of fund disclosures, approved agreements that permitted select investors to time certain funds in the complex); In re Markovitz, Securities Act Release No. 8298 (Oct. 2, 2003) (finding that a former hedge fund trader violated the federal securities laws and defrauded investors by engaging in late trading of mutual fund shares).

[7] To date, we have brought 10 enforcement actions. *See* SEC v. Mutuals.com, Inc., Civil Action No. 303 CV 2912D (N.D. Tex. Dec. 4, 2003) (alleging that dually registered broker-dealer and investment adviser, three of its executives, and two affiliated broker-dealers assisted institutional brokerage customers and advisory clients in carrying out and concealing thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds); SEC v. Invesco Funds Group, Civil Action No. 03-N-2421 (PAC) (D. Colo. Dec. 2, 2003) (alleging that investment adviser, with approval of its president and chief executive officer, entered into market timing arrangements with more than sixty broker dealers, hedge funds, and advisers without disclosing these arrangements to the affected mutual funds' independent directors or shareholders); SEC v. Security Trust Company, Civil Action No. 03-2323 (D. Ariz. Nov. 24, 2003) (alleging that unregistered financial intermediary and three of its senior executives facilitated and participated in late trading and market timing schemes by a group of related hedge funds); SEC v. Pilgrim, Civil Action No. 03-CV-6341 (E.D. Penn. filed Nov. 20, 2003) (alleging that investment adviser and two senior executives permitted a hedge fund, in which one of the executives had a substantial financial interest, to engage in repeated short-term trading of several mutual funds and that one of the executives provided

nonpublic portfolio information to a broker-dealer, which passed it on to its customers); SEC v. Druffner, Civil Action No. 03-12154-RCL (D. Mass. Nov. 4, 2003) (alleging that five brokers, with the assistance of their branch office manager, evaded attempts to restrict their trading and conducted thousands of market timing trades in numerous mutual funds); SEC v. Scott, Civil Action No. 03-12082-EFH (D. Mass. filed Oct. 28, 2003) (alleging that two senior investment executives of an investment adviser engaged in repeated short-term trading in their personal accounts of funds over which they had investment decision-making responsibility and about which they had access to nonpublic information); In re Sihpol, Administrative Proceeding No. 3-11261 (Sept. 16, 2003) (charging former broker with playing a key role in enabling certain hedge fund customers to engage in late trading in shares of funds). *See also supra* note 6. A number of state actions are also pending.

[8] Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) [68 FR 70388 (Dec. 17, 2003)] ("Companion Late Trading Release"); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26287 (Dec. 11, 2003) [68 FR 70402 (Dec. 17, 2003)] ("Companion Disclosure Release").

[9] We also are adopting related amendments to rule 204-2 under the Advisers Act and a technical amendment to Form ADV.

[10] Rule 206(4)-7(a). *See also* section 202(a)(25) of the Advisers Act [15 U.S.C. 80b-2(a)(25)] (defining "supervised person" as "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").

[11] In response to several comments, we revised the text of the rule so that a violation of the rule would be deemed to be "unlawful" rather than "a fraudulent, deceptive, or manipulative act, practice or course of business." This change, which responds to commenters' concerns regarding the optics of the rule, does not change its substance; failure to comply with its terms will result in a violation of section 206(4) of the Act.

[12] In the Proposing Release, we requested comment on whether we should except a subset of investment advisers or funds from the requirements of the rules. Some commenters suggested that we except small advisers, but we believe that the flexibility of the rules obviates the need for this exception.

[13] Even small advisers may have arrangements, such as soft dollar agreements, that create conflicts. Advisers of all sizes, in designing and updating their compliance programs, must identify these arrangements and provide for the effective control of the resulting conflicts.

[14] Advisers already are subject to requirements to maintain written compliance policies and procedures in certain areas. The new rules do not alter those requirements. *See, e.g.*, Investment Company Act rule 17j-1(c)(1) [17 CFR 270.17j-1(c)(1)] (requiring each investment adviser and principal underwriter of a 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); Advisers Act rule 206(4)-6 [17 CFR 275.206(4)-6] (requiring investment advisers to adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes securities

in the best interest of clients); Advisers Act section 204A [15 U.S.C. 80b-4a] (requiring each adviser registered with us to have written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the adviser or persons associated with the adviser); Regulation S-P ("Privacy of Consumer Financial Information") [17 CFR Part 248.30] (requiring investment advisers to "adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information").

15 Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the adviser's fulfillment of its duty of best execution), or an analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities).

16 In the Proposing Release, we noted that the compliance policies and procedures should be designed to prevent, detect, and correct promptly any material violation of the federal securities laws (or in the case of advisers, the Advisers Act). A number of commenters suggested that these objectives were unrealistic and recommended that the rules be designed instead to promote compliance with the securities laws. While we understand that compliance policies and procedures will not prevent every violation of the securities laws, we believe that prevention should be a key objective of all firms' compliance policies and procedures.

17 Rule 206(4)-6 under the Advisers Act [17 CFR 275.206(4)-6] requires registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes securities 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].

18 Section 204A of the Advisers Act [15 U.S.C. 80b-4a] requires registered investment advisers to have written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the advisers or persons associated with the advisers. Rule 17j-1(c)(1) under the Investment Company Act [17 CFR 270.17j-1(c)(1)] requires funds and each investment adviser and principal underwriter of a 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.

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

20 Rule 206(4)-3 under the Advisers Act [17 CFR 275.206(4)-3] requires written agreements setting forth procedures to govern solicitation activities conducted by certain third parties on behalf of an adviser.

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

[22] We believe that an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations.

[23] Advisers who are also registered as broker-dealers are not required to segregate their investment adviser compliance policies and procedures from their broker-dealer compliance policies and procedures.

[24] Rule 38a-1(a)(1). For purposes of rule 38a-1, "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, the Advisers Act, Title V of the Gramm-Leach-Bliley Act (15 U.S.C. 6801) (governing disclosure of nonpublic personal information), any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act (31 U.S.C. 5311-5314; 5316-5332) (imposing restrictions designed to prevent financial intermediaries from being used in money laundering activities) as it applies to funds, and any rules adopted thereunder by the Commission or the Department of the Treasury. Rule 38a-1(e)(1).

[25] A "principal underwriter" of a fund (other than a closed-end fund) is "any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company." Section 2(a)(29) of the Investment Company Act [15 U.S.C. 80a-2(a)(29)].

[26] An "administrator" is "any person who provides significant administrative or business management services to an investment company." Investment Company Act rule 0-1(a)(5) [17 CFR 270.0-1(a)(5)].

[27] Section 3(a)(25) of the Securities Exchange Act of 1934 [15 U.S.C. 78c-(3)(a)(25)] defines a "transfer agent" as "any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates."

[28] In this release, we use the term "service provider" to refer only to a fund's advisers, principal underwriters, administrators, and transfer agents. By limiting the term in this manner, we are not lessening a fund's obligation to consider compliance as part of its decision to employ other entities, such as pricing services, auditors, and custodians.

[29] Some commenters urged us to permit funds to simply rely on their service providers' policies and procedures. We have not adopted this suggestion because it would permit funds and their boards to absolve themselves of responsibility for compliance activities of the service providers through which funds conduct most of their activities.

[30] In this release, we use the term "fund complex" to mean a group of funds that share a compliance program and a common investment adviser and/or distributor.

[31] In this release, we refer to directors who are not "interested persons" of the fund as "independent directors." Section 2(a)(19) identifies persons who are "interested persons" of a fund. 15 U.S.C. 80a-2(a)(19).

[32] Rule 38a-1(a)(2). In response to comments seeking clarification of the board's responsibilities, we have added language to the rule text explicitly stating the basis for approval. If the policies and procedures of a service provider are included within the policies and procedures adopted by the fund, separate approval by the board is not required. A fund that is approving policies and procedures of service providers is required to make findings only with respect to activities of the service provider that could affect the fund.

[33] Rule 38a-1 does not require fund boards to approve amendments to policies and procedures of the fund or its service providers. Such a requirement would, as commenters pointed out, inundate fund boards with review of minor changes and detract from their ability to address significant responsibilities committed to them by the Act and our rules. Moreover, such a requirement could delay funds and their service providers from making needed changes. Instead, the rule requires the fund's chief compliance officer to discuss material changes to the compliance policies and procedures in his or her annual report to the fund board. Rule 38(a)-1(a)(4)(iii)(A). As we note below, however, serious compliance issues must be raised with the board immediately. *See infra* note 83.

[34] 17 CFR 270.2a-7.

[35] In these limited circumstances, we would also consider the fund to have satisfied the rule's requirement with regard to annual review of service providers, as discussed in section II.B.2. of this release, *supra*, and with respect to the chief compliance officer's annual report with regard to service providers, as discussed in section II.C.2. of this release, *supra*, if such reviews and reports use such third-party reports provided to the fund no less than annually. If the fund uses such reports for its approval of a service provider's compliance program or the annual review or reporting on the program, the fund must also gather and take into account other relevant information, such as its experience with the service provider.

[36] *See, e.g.*, Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 70, Reports on Processing of Transactions by Service Organizations (American Inst. of Certified Public Accountants).

[37] *See supra* text accompanying notes 17 through 22. Funds are also subject to requirements to maintain written compliance policies and procedures in certain of our rules. The new rules do not supplant these requirements. *See, e.g.*, Investment Company Act rules 2a-7(c)(7) [17 CFR 270.2a-7(c)(7)] (requiring boards of money market funds to establish written procedures "reasonably designed . . . to stabilize the money market fund's net asset value per share") and 17j-1(c)(1) [17 CFR

270.17j-1(c)(1)] (requiring funds 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); Form N-1A, Item 13(f) [17 CFR 239.15A; 274.11A] (requiring funds to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities); 31 CFR 103.130(c) (requiring funds to 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"); Regulation S-P ("Privacy of Consumer Financial Information") [17 CFR Part 248.30] (requiring funds to "adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information").

[38] *See supra* notes 6 and 7 and accompanying text.

[39] Section 22(e) of the Investment Company Act generally prohibits mutual funds from suspending the right of redemption and prohibits funds from postponing the payment of redemption proceeds for more than seven days. 15 U.S.C. 80a-22(e). Rule 22c-1(b) under the Act generally requires that a fund's net asset value be computed at least once daily, Monday through Friday, at a time or times specified by the fund's board of directors. 17 CFR 270.22c-1(b).

[40] Section 2(a)(41) of the Investment Company Act and rule 2a41-1 [17 CFR 270.2a41-1].

[41] Mispricing may also occur when a domestic trading market in a security closes before the time the fund prices its shares, or when market quotations for a security are not reliable because, *e.g.*, sales have been infrequent or there is a thin market in the security. *See* Accounting Series Release No. 118 (Dec. 23, 1970) [35 FR 19986 (Dec. 31, 1970)]. Thus, in addition to monitoring for events that may necessitate fair value pricing, funds must pay attention to circumstances that would suggest the need for using fair value pricing.

[42] Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase, Investment Company Act Release No. 14244 (Nov. 21, 1984) [49 FR 46558 (Nov. 21, 1984)], at n. 7 (emphasis added) (proposing amendments to rule 22c-1). Subsequent to the issuance of this release, our staff has reminded funds of their fair valuation obligations. In 1999 and 2001, the Division of Investment Management issued interpretive letters elaborating on funds' obligations under sections 2(a)(41) of the Investment Company Act and rule 22c-1 [17 CFR 270.22c-1] thereunder. Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 8, 1999) (http://www.sec.gov/divisions/investment/ guidance/tyle120899.htm); Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Apr. 30, 2001) (http://www.sec.gov/divisions/investment/guidance/tyle043001.htm).

[43] 17 CFR 270.22c-1.

[44] Section 2(a)(41) [15 USC 80a-2(a)(41)] of the Investment Company Act.

45 In some cases, funds have adopted policies and procedures requiring the use of fair value pricing in circumstances when prices may be affected by events subsequent to the close of trading, but have established criteria that result in infrequent use of fair value pricing, which provides an opportunity for price arbitrage. *See, e.g.,* Susan Lee, *The Dismal Science: The Feeling's Not Mutual*, Wall St. J., Nov. 24, 2003, at A15. As we have stated previously, funds must fair value their portfolio securities whenever market quotations become unreliable. *See supra* note 42. The failure of a fund to establish sufficiently sensitive criteria for using fair value pricing should be recognizable in subsequent reviews of the accuracy of the prices used to compute the net asset value of the fund.

46 In determining fair value, some funds use correlations between the exchange prices of foreign securities and other appropriate instruments or indicators, such as relevant indices, American Depository Receipts, and futures contracts. Software developed by vendors is today available to assist funds to determine the fair value of portfolio securities.

47 In a companion release, we are proposing to amend funds' disclosure requirements with respect to the use and the effects of fair value pricing. *See* Section II.B of Companion Disclosure Release, *supra* note 8.

48 Rule 22c-1(a) [17 CFR 270.22c-1(a)].

49 *Id*. We adopted the forward pricing requirement in 1968 to eliminate so-called "backward pricing" that permitted sales and purchases of fund shares at a stated price. We concluded that backward pricing resulted in dilution of the value of fund shares, and that it disrupted fund management by encouraging short-term trading in funds by speculators seeking to take advantage of fund prices that did not reflect the current value of the fund portfolio. Adoption of Rule 22c-1 under the Investment Company Act of 1940 Prescribing the Time Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase, and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (Nov. 7, 1968)].

50 Rule 38a-1(a)(1). In most cases, we expect these matters will be addressed by the policies and procedures of fund transfer agents. *See* Companion Late Trading Release, *supra* note 8, for a detailed discussion of how fund share transactions are processed by intermediaries.

51 In a companion release, we are proposing amendments to rule 22c-1 under the Investment Company Act that would eliminate the need for funds and their transfer agents to rely on the segregation of orders by fund intermediaries other than a registered transfer agent or clearing agency. *See* Companion Late Trading Release*, supra* note 8.

52 We discuss methods funds can use to oversee such policies and procedures later in this Adopting Release, in connection with the chief compliance officer's oversight of service providers. *See infra* text accompanying footnote 91.

53 *See, e.g.*, section 17(a) [15 U.S.C. 80a-17(a)] (prohibiting first and second-tier affiliates of a fund from borrowing money or other property from, or selling or buying securities or other property to or from the fund, or any company that the fund controls); section 17(d) [15 U.S.C. 80a-17(d)] (making it unlawful for first- and second-tier affiliates of a fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters, acting as principal, to effect any transaction in which the fund

or a company controlled by the fund is a joint or a joint and several participant in contravention of Commission rules); rule 17d-1(a) [270 CFR 270.17d-1(a)] (prohibiting first- and second-tier affiliates of a fund, the fund's principal underwriter, and affiliated persons of the fund's principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which any such fund or company controlled by a fund is a participant unless an application regarding such enterprise, arrangement or plan has been filed with the Commission and has been granted); section 10(f) [15 U.S.C. 80a-10(f)] (prohibiting a fund from purchasing securities in a primary offering if certain affiliated persons of the fund are members of the underwriting or selling syndicate); section 17(e) [15 U.S.C. 80a-17(e)] (limiting the remuneration that first- and second-tier affiliates of a fund may receive in transactions involving the fund, and companies that the fund controls); and section 12(d)(3) [15 U.S.C. 80a-12(d)(3)] and rule 12d3-1 [270 CFR 270.12d3-1] (together prohibiting a fund from acquiring securities issued by, among others, its own investment adviser).

54 In a companion release, we are proposing to require funds to disclose their policies and procedures with respect to the disclosure of fund portfolio holdings. *See* Section II.C of Companion Disclosure Release, *supra* note 8.

55 Thus, funds' and investment advisers' policies and procedures should preclude fund or advisory personnel from divulging a fund's portfolio schedule that has not been made generally available to the public. Divulging portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality. *See, e.g.*, Selective Disclosure and Insider Trading, Securities Act Release No. 7881 at text accompanying n. 29 (Aug. 15, 2000) [65 FR 51716 (Aug. 24, 2000)] (noting that "issuers and their officials may properly share material nonpublic information with outsiders, for legitimate business purposes, when the outsiders are subject to duties of confidentiality"). *See also* Dirks v. SEC, 463 U.S. 646, 655 at n. 14 (1983) ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.") (citations omitted). We understand that many funds provide portfolio information in response to requests by rating agencies and similar organizations only after receiving written assurances that the information will be kept confidential and that persons with access to the information will not use the information to trade securities.

56 We urge funds and advisers to require persons who have access to nonpublic information to trade securities of the fund exclusively through identifiable accounts to enable the fund to monitor for excessive, short-term trading. Alternatively, although not required by section 17(j) of the Investment Company Act [15 U.S.C. 80a-17(j)] or rule 17j-1 [17 CFR 270.17j-1], funds and advisers should consider amending their codes of ethics to cover, and thus require reporting of, trades by persons who have access to nonpublic information about the portfolio, including information about the accuracy of the prices of portfolio securities used to calculate net asset value.

57 Sections 15(a) and (c) of the Investment Company Act [15 U.S.C. 80a-15(a) and (c)].

[58] Sections 15(b) and (c) of the Investment Company Act [15 U.S.C. 80a-15(b) and (c)].

[59] Section 12(b) of the Investment Company Act [15 U.S.C. 80a-12(b)] and rule 12b-1(b)(2) [17 CFR 270.12b-1(b)(2)].

[60] Section 16(a) of the Investment Company Act [15 U.S.C. 80a-16(a)].

[61] Section 10(a) of the Investment Company Act [15 U.S.C. 80a-10(a)] (prohibiting more than 60 percent of a fund's directors from being interested persons of the fund); section 10(b)(2) of the Investment Company Act [15 U.S.C. 80a-10(b)(2)] (requiring, in effect, that independent directors comprise a majority of a fund's board if the fund's principal underwriter is an affiliate of the fund's investment adviser); section 15(f)(1) of the Investment Company Act [15 U.S.C. 80a-15(f)(1)] (providing a safe harbor for the sale of an advisory business if directors who are not interested persons of the investment adviser constitute at least 75 percent of a fund's board for at least three years following the assignment of the advisory contract). *See also* rule 6e-3(T)(b)(15) [17 CFR 270.6e-3(T)(b)(15)] (exempting certain funds underlying insurance products from various Investment Company Act provisions provided that independent directors constitute a majority of the boards of those funds).

[62] *See* rule 10f-3 [17 CFR 270.10f-3], rule 12b-1 [17 CFR 270.12b-1], rule 15a-4 [17 CFR 270.15a-4], rule 17a-7 [17 CFR 270.17a-7], rule 17d-1(d)(7) [17 CFR 270.17d-1(d)(7)], rule 17e-1 [17 CFR 270.17e-1], rule 17g-1(j) [17 CFR 270.17g-1(j)], rule 18f-3 [17 CFR 270.18f-3], and rule 23c-3 [17 CFR 270.23c-3]. *See also* rule 0-1(a)(6) [17 CFR 270.0-1(a)(6) (defining "independent legal counsel").

[63] *See, e.g.*, In re Charles G. Dyer, Investment Company Act Release No. 25107 (Aug. 9, 2001) and SEC v. Centurion Growth Fund, No. 94-8199-CIV-UNGARO-BENAGES, (S.D. Fla. Apr. 22, 1994), Litigation Release No. 14063 (Apr. 28, 1994) (56 SEC Docket 1776).

[64] A board lacking a sufficient number of disinterested directors, for example, would be improperly constituted. To avoid this, fund procedures should provide for a process of determining that independent director candidates are not "interested persons" and, after their election, for a periodic reassessment that they continue not to be interested persons. See rule 31a-2 [17 CFR 270.31a-2(a)(4)] under the Investment Company Act (requiring the maintenance of "any record of the initial determination that a director is not an interested person of the investment company and each subsequent determination that the director is not an interested person . . . includ[ing] any questionnaire and any other document used to determine that a director is not an interested person of the company").

[65] Section 15(c) requires fund directors "to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company." A board that fails to acquire sufficient information about the advisory fee and other fund expenses will be unable to negotiate effectively on behalf of the fund. As a result, the fund may pay a higher than necessary advisory fee, fail to benefit from economies of scale as a result of insufficient breakpoints in the advisory fee, or bear too many operating expenses.

[66] *See* Section II.A. of the Companion Disclosure Release, *supra* note 8.

67 Failure to adhere to statements made in the prospectus may render the prospectus disclosure materially misleading and thus violate provisions of the federal securities laws that prohibit fraud. *See, e.g.,* section 17(a) of the Securities Act [15 U.S.C. 77q], section 10(b) of the Securities Exchange Act [15 U.S.C. 78j] and rule 10b-5 [17 CFR 240.10b-5] thereunder, and section 34(b) of the Investment Company Act [15 U.S.C. 80a-33(b)].

68 An investment adviser has a fiduciary duty to act in the best interests of a fund it advises. Section 206 under the Advisers Act [15 U.S.C. 80b-6] and section 36(a) under the Investment Company Act [15 U.S.C. 80a-35(a)]. *See also* Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971); Brown v. Bullock, 194 F. Supp. 207, 229, 234 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961); In re Provident Management Corp., Securities Act Release No. 5115 (Dec. 1, 1970) at text accompanying note 12.

69 *See, e.g.,* C. Meyrick Payne, *Strengthening the Role of Mutual Fund Directors after the Canary Scandal*, Management Practice Bulletin (Oct. 2003) (http://www.mfgovern.com/reports/ 2_canaryscandal.html) (explaining that "periodic sales and redemption data" are useful for detecting practices such as late trading and market timing).

70 Rule 206(4)-7(b).

71 Rule 38a-1(a)(3).

72 Rule 206(4)-7(c). We are also making a technical amendment to the item related to chief compliance officers on Form ADV, the registration form that advisers use to register with us under the Advisers Act. Form ADV, Part 1, Schedule A, Item 2(a) [17 CFR 279.1]. The revision requires each registered adviser and each applicant for registration as an adviser to identify a *single* compliance officer.

73 Having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. Thus, a chief compliance officer appointed in accordance with rule 206(4)-7 (or rule 38a-1) would not necessarily be subject to a sanction by us for failure to supervise other advisory personnel. A compliance officer who does have supervisory responsibilities can continue to rely on the defense provided for in section 203(e)(6) of the Advisers Act [15 USC 80b-3(e)(6)]. Section 203(e)(6) provides that a person shall not be deemed to have failed to reasonably supervise another 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 supervising 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.

74 The rule does not require advisers to hire an additional executive to serve as compliance officer, but rather to designate an individual as the adviser's chief compliance officer. Several commenters who complained of the burdens this proposed requirement would impose on them appeared to have assumed that they would be required to hire an additional person to fill the position of chief compliance officer.

75 Rule 38a-1(a)(4).

76 In the Proposing Release we requested comment on whether the chief compliance officer should be a senior manager of the fund because such a person would be in a better position to compel compliance with the fund's policies and procedures, and would less likely be intimidated in the

performance of her duties. We are not adopting such a requirement because, as several commenters pointed out to us, it is very difficult to ascertain who is a "senior manager" in some organizations. Instead, we have described the authority we believe an individual must possess to be designated as a chief compliance officer, and have added a provision to the rule making it unlawful to exert undue influence on the chief compliance officer in the performance of her duties (*see infra* text accompanying note 86).

77 Rule 38a-1(a)(4)(i). These requirements were not included in proposed rule 38a-1. Compensation would include any bonus. In approving a change in compensation, the board should assure itself that the chief compliance officer is not denied any customary cost of living increase or any full customary bonus and that fund managers are not otherwise retaliating against the chief compliance officer for having informed the board of a compliance failure or for having taken aggressive actions to ensure compliance with the federal securities laws by the fund or service provider.

78 Rule 38a-1(a)(4)(ii).

79 In a change from the proposed rule, the chief compliance officer can only be discharged from her responsibilities with the approval of the board. Rule 38a-1(a)(4)(ii).

80 If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the chief compliance officer, must receive all annual reports, and must approve the removal of the chief compliance officer from his of her responsibilities. Rule 38a-1(b).

81 A change would be "material" in this context if it is a change that a fund director would reasonably need to know in order to oversee fund compliance.

82 *Id*. The report should also discuss the fund's particular compliance risks and any changes that were made to the policies and procedures to address newly identified risks.

83 Rule 38a-1(a)(4)(iii). Our proposal would have required the report to include only compliance matters that resulted in remedial action; our final rule contains no such limitation because we are concerned that a fund or its service providers might abuse the limitation and fail to impose remedial actions in order to avoid having to report a compliance failure to the board.

84 Rule 38a-1(e)(2). Serious compliance issues must, of course, always be brought to the board's attention promptly, and cannot be delayed until an annual report. In addition, individual compliance matters that, taken in isolation, may not be material may collectively suggest a material compliance matter, such as a material weakness in the compliance programs of the fund or its service providers. *See, e.g.*, Personal Investment Activities of Investment Company Personnel, Investment Company Act Release No. 23958, at n. 25 (Aug. 20, 1999) [64 FR 46821 (Aug. 27, 1999)].

85 Rule 38a-1(a)(4)(iv). Independent counsel to the independent directors may be present.

86 Rule 38a-1(c). This prohibition is similar to the prohibition on unduly influencing auditors found in section 303(a) of the Sarbanes-Oxley Act [Pub. L. 107-204, 116 Stat. 745 (2002)] and rule 13b2-2(b)(1) [17 CFR 240.13b2-2(b)(1)] under the Securities Exchange Act.

87 Rules 38a-1(a)(4)(ii) (providing that the board's approval is required to remove the chief compliance officer) and 38a-1(a)(4)(iii) (requiring the chief compliance officer to provide a written compliance report to the board).

88 Indeed, she is likely to be the chief compliance officer of that organization inasmuch as the duties of the positions will have significant overlap. Alternatively, the chief compliance officer of the fund may be another member of the adviser or administrator's legal or compliance departments.

89 Internalizing the compliance function while retaining an externalized management function would also raise a number of practical issues, such as whether the chief compliance officer could use the adviser's office space and other resources, including support staff. In addition, it would be costly for funds, particularly small funds, to hire a chief compliance officer and pay her benefits. Those costs would be borne by investors.

90 If such a person were approved by another fund, our staff would enhance its scrutiny of the fund accordingly.

91 Mutual funds already rely on these types of measures in connection with their responsibility to ensure that their service providers carry out anti-money laundering compliance programs. Rules under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L No. 107-56 (USA PATRIOT Act) require funds to maintain procedures reasonably designed to prevent them from being used for money laundering or the financing of terrorist activities. *See, e.g.,* Anti-Money Laundering Programs for Mutual Funds*,* 67 FR 21117, 21119 (Apr. 29, 2002) (mutual fund may contractually delegate functions under 31 CFR 103.130 to a service provider, but must take steps to ensure that the service provider's compliance program is reasonably designed, and to monitor its implementation and ensure its effectiveness).

92 In the case of an insurance company separate account, the principal service provider typically will be the sponsoring insurance company. Therefore, the chief compliance officer must oversee the insurance company's compliance program with respect to the separate accounts, including the processing of new account applications, premium payments, and exchanges.

93 Rules 38a-1(d)(1) and 204-2(a)(17)(i). As discussed above, the required polices and procedures do not all need to be contained in a single document. *See supra* text following note 22. We understand many firms issue policies and procedures in loose-leaf form, distributing revised sections periodically within their firms. These firms may comply with the recordkeeping requirements by keeping the current policies and procedures and retaining the superseded section(s) for the requisite period of time, so long as the firm can indicate to our examination staff the version of compliance policies and procedures that were in effect as of a given date.

94 Rule 38a-1(d)(2). In a change from proposed rule 38a-1, funds will have to maintain materials provided to the board of directors in connection with their approval of service providers' policies and procedures in addition to the annual compliance report. These records must be maintained for at least five years after the end of the fiscal year in which the documents were provided to the board, the first two years in an easily accessible place. Funds already are required to document in the fund board's minute books the 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. Board minute books must be maintained pursuant to rule 31a-1(b)(4) under the Investment Company Act [17 CFR 270.31a-1(b)(4)]. All reports required by our rules are meant to be made available to the Commission and the Commission staff and, thus, they are not subject to the attorney-client privilege, the work-product doctrine, or other similar protections.

95 Rules 38a-1(d)(3) and 204-2(a)(17)(ii). In a change from proposed rule 38a-1, funds will have to maintain any records documenting their annual review for at least five years after the end of the fiscal year in which the annual review was conducted, the first two years in an easily accessible place. Advisers will have 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. Rule 204-2(e)(1).

96 *See* rules 31a-2(f) [17 CFR 270.31a-2(f)] and 204-2 [17 CFR 275.204-2(g)]. Funds and advisers that maintain records electronically must provide those records to our staff in electronic format upon request. Rule 31a-2(f)(2)(ii)(A) under the Investment Company Act [17 CFR 270.31a-2(f)(2)((ii)(A) and rule 204-2(g)(2)(ii)(A) under the Investment Advisers Act [17 CFR 275.204-2(g)(2)(ii)(A).

97 Rule 38a-1(a)(4)(i)-(ii). *See supra* notes 76-79 and accompanying text.

98 Rule 38a-1(a)(4)(iii)-(iv). *See supra* notes 80-85 and accompanying text.

99 Rule 38a-1(c) prohibits the fund's officers, directors, employees, or its adviser or principal underwriter or any person acting under the direction of these persons, from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence the fund's chief compliance officer in the performance of compliance responsibilities under the rule. *See supra* note 86 and accompanying text, and note 76.

100 Rule 38a-1(e)(2) defines the term "material compliance matter" to mean those compliance matters - including violations of the federal securities laws or compliance policies and procedures by the fund or its service providers, as well as weaknesses in the design or implementation of those policies and procedures - about which the fund's board reasonably needs to know in order to oversee fund compliance. *See supra* note 84 and accompanying text.

101 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.

102 *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)].

103 We believe that many of these concerns stemmed from the incorrect perception that the new rules would require the adoption and implementation of one-size-fits-all compliance programs. As discussed above, the new rules require each firm to adopt a compliance program that conforms with the scope and nature of its operations, thus eliminating

concerns that the new rules will require duplicative or excessively detailed compliance programs.

[104] The Investment Counsel Association of American ("ICAA"), for example, noted that in small firms with few employees, the responsibility for developing a compliance program, if done in-house, would likely be borne by a highly-paid employee.

[105] The ICAA estimated that, depending on an adviser's size and complexity, the adviser could purchase an off-the-shelf compliance manual for under $1,000, but would have to spend time adjusting the manual to correspond to its organizational structure. Alternatively, the ICAA also estimated that the adviser could enlist the assistance of a third-party compliance firm to draft a firm-specific manual for a small to mid-size firm for between $2,500 and $3,500. The ICAA also estimated that a law firm would charge between $10,000 and $120,000 to draft procedures (and an accounting firm would charge between $50,000 and $200,000), depending on the size and complexity of the adviser's operations.

[106] Firms will incur a cost in tailoring these programs to their specific needs.

[107] One commenter stated that prohibitive costs may be the reason that some firms, particularly small firms, do not have compliance programs. The Financial Planning Association, however, estimated, based on discussions with a number of compliance vendors, a small adviser (with five employees) would spend $675 to purchase compliance software and customize it in-house. Alternatively, the FPA estimated that such an adviser could purchase a turn-key manual customized for the adviser for $1,500. Finally, the FPA estimated that the adviser could retain an outside consultant to develop a written compliance manual for $3,900.

[108] The ICAA noted that most of its members have employees responsible for compliance and many of these have designated a chief compliance officer.

[109] Several commenters expressed concern about the cost to small firms of hiring a chief compliance officer. The rules that we are adopting do not require funds or investment advisers to hire a separate chief compliance officer, and we expect that many small investment advisers will designate a principal or employee of the firm to serve as chief compliance officer. However, a firm that does not currently have a person qualified to serve as chief compliance officer will incur costs associated with training someone in the firm.

[110] The requirement that fund boards approve the designation and compensation of the chief compliance officer, or take action to remove a chief compliance officer, will impose minimal costs, if any, beyond the current costs incurred to prepare briefing materials for directors and convene board meetings. With rare exception, fund boards should be able to take up these issues during their existing schedule of meetings.

[111] 44 U.S.C. 3501 to 3520.

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

[113] *See* rule 38a-1(c).

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

115 *Id.*

116 *See* rules 204-2(a)(17)(i) and (ii) and rule 204-2(e)(1) [17 CFR 275.204-2(e)(1)].

117 These numbers are based on Commission filings as of January 2003.

118 While each fund would be required to maintain written policies and procedures under rule 38a-1, this average estimate took into account that many fund complexes already have written policies and procedures documenting their compliance programs and can draw on a number of outlines and model programs available from a variety of industry representatives, commentators, and organizations to supplement these programs, if necessary. The estimate also took into account that most funds are located within a fund complex, and would be able to draw extensively from the fund complex's "master" compliance program.

119 5,083 funds (5,030 registered investment companies + 53 business development companies) x (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.

120 7,790 was the number of number of investment advisers registered with us on our Investment Adviser Registration Depository System as of January 14, 2003. 7,790 registered investment advisers x 80 annual average burden hours = 623,200 hours.

121 7,790 registered investment advisers x 0.5 hours = 3,895 hours.

122 Accordingly, our estimate in the Proposing Release of the annual aggregate burden of collection for the amended rule remains 1,651,324.2 hours. This estimate was based on the OMB's approved burden of 1,625,638.5 hours before the amendments (shared by 7,687 investment advisers at an annual average of 211.48 hours per adviser), plus an increase of 21,790.7 hours attributable to an increase in the number of investment advisers registered with us to 7,790 as of January 2003, (each incurring an average annual burden of 211.48 hours) and an increase of 3,895 additional burden hours associated with the amendments to rule 204-2 (7,790 registered investment advisers x 0.5 hours).

123 5 U.S.C. 601-612.

124 17 CFR 270.0-10.

125 The number of small entities, which is current as of June 2003, is derived from analyzing information from Form N-SAR and various databases including 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.

126 17 CFR 275.0-7(a).

127 The number of small investment advisers is derived from the Commission's Investment Adviser Registration Depository.

128 The comment letters and a summary of comments prepared by our staff are available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC (File No. S7-03-03).

The comment summary is also available on the Commission's Internet web site (http://www.sec.gov/rules/extra/s70303summary.pdf).

129 The Financial Planning Association estimated that it would cost a small firm with five employees between $675 and $3,900 to develop a compliance program.

130 The staff estimates that approximately half of these firms will develop these policies internally, while the remaining firms will seek outside assistance from compliance consultants, the number of which is expected to rise after the new rules are adopted.

131 As stated above, the rules impose no reporting requirements.

132 In the case of investment advisers, for which such governance issues are not present, we have not included comparable requirements.

133 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 adopting rule 38a-1 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including sections 9(b) (authority to prohibit certain persons from serving in certain capacities with respect to investment companies), 31(b) (authority to examine funds), 36(a) (authority to bring actions for the breach of fiduciary duty); and 42 (authority to enforce the provisions of the Investment Company Act) of the Investment Company Act [15 U.S.C. 80a-9(b), 80a-30(b), and 80a-41]. Further, requiring the maintenance of internal compliance policies and procedures and an annual compliance report falls 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.

134 Section 206(4) permits the Commission to define and prescribe rules to prevent conduct that is unlawful under section 206. Rule 206(4)-7 defines an activity that is unlawful under section 206. 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 adopting rule 206(4)-7 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including sections 203(e) (authority to censure, place limitations on, suspend, or revoke the registration of certain investment advisers), 204 (authority to examine advisers), and 209 (authority to enforce the provisions of the Advisers Act) of the Advisers Act [15 U.S.C. 80b-3(e), 80b-4, and 80b-9].

http://www.sec.gov/rules/final/ia-2204.htm