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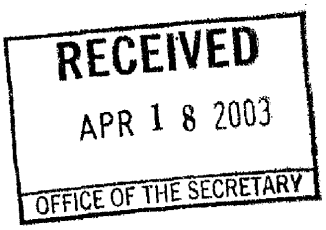
NSCP

NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS INC



April 17, 2003

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

Re: File **No.** S7-03-03 – Proposed **Rules:** Compliance Programs of Investment Companies and Investment Advisers

Dear Secretary Katz:

The National Society *of* Compliance Professionals (NSCP) appreciates the opportunity to comment on the rule proposed by the Securities and Exchange Commission (Commission) that would require SEC-registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Investment Advisers Act of 1940, as amended (Advisers Act). The proposal also would require advisers to conduct an annual review of these policies and procedures and to designate a chief compliance officer responsible for administering them.[1] The Proposed Rules also would impose similar requirements on investment companies, requiring fund boards of directors to approve the compliance program and require the compliance officer to provide no less frequently than annually, a written report to the board.

The Proposed Rules are of considerable interest to the NSCP and its members. NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, **effective** supervision, and oversight. The principal purpose of NSCP is to enhance compliance in the securities industry, including firms' compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. **An** important mission of the NSCP is to instill in its members the importance of developing and implementing sound compliance programs across-the-board.

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1 Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2107 (Feb. 5, 2003) (Proposed Rules).

Since its founding in 1987, NSCP has grown to over 1,250 members, and the constituency from which its membership is drawn is unique. NSCP's membership is drawn principally from traditional broker-dealers, investment advisers, bank and insurance affiliated firms, as well as the law firms, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel, and the asset management members of NSCP span a wide spectrum of firms, including employees from the largest brokerage and investment management firms to those operations with only a handful of employees. The diversity of our membership allows the NSCP to represent a large variety of perspectives in the asset management industry.

The NSCP strongly supports the Commission's efforts to enhance and strengthen compliance programs at investment advisers and investment companies, but nevertheless is concerned about the nature and scope of the Proposed Rules. In particular, the NSCP is concerned that the Proposed Rules would be interpreted to require the same compliance program of all advisers, without consideration of the diversity of the investment advisory industry and the fact that investment advisers range from firms which employ a small number of personnel to firms with offices in several countries and thousands of employees. We do not believe that a single set of compliance policies and procedures is appropriate to such a diverse group or would achieve our shared goal of enhancing compliance within the asset management industry.

We also believe that the use of the Commission's antifraud authority is an inappropriate means to promulgate a rule to mandate an effective compliance program under the Advisers Act. Moreover, the imposition of antifraud liability is unlikely to further the underlying goal of the Proposed Rules, which we understand to be strengthening and fostering ethical behavior in the advisory industry. As discussed below, the NSCP believes that a compliance culture and practice is more effectively advanced through the Commission and its Staff articulating principles and standards through the dissemination of interpretive guidance and direction.[2]

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[2] We note that regulators in other countries also advocate this approach. See, e.g., UK Financial Services Authority, Discussion Paper: An Ethical Framework for Financial Services (Oct. 18, 2002) ("We have constructed a framework of principles, supported by more detailed rules and guidance, and developed a risk-based approach to regulation. We do not seek compliance for its own sake. In any case, mechanical compliance has done little to prevent problems in the past, often with serious repercussions for those affected."); and David Knott, Chairman, Australian Securities and investments Commission, Corporate Governance – Principles, Promotion and Practice, Monash Governance Research Unit Inaugural Lecture (July 16, 2002) ("Corporations should strive to achieve a culture of governance; and resist the temptation to give formal, rather than substantive, compliance to the principles of good governance.").

Adoption and Implementation of Policies and Procedures

The NSCP strongly supports sound, fundamental policies and procedures for each and every investment adviser, and further supports the regular review of such policies and procedures and revisions as necessary. This is true regardless of whether the adviser is regulated by the Commission or the state securities authorities, and whether the adviser is domiciled in the US or abroad. However, given the varying compositions of advisory firms, we would suggest that mandating the adoption of specific policies and procedures is unnecessarily restrictive. The requirement for policies and procedures governing investment advisory firms can be better addressed, in our view, by the setting forth of standards such as the Commission has done on prior occasions.

The Cornmission Staff has repeatedly acknowledged the diversity of the investment advisory profession. In the Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds,[3] for example, the Commission Staff stated in part that "[e]ach broker-dealer and investment adviser has a unique organizational structure and operating environment, such that all of the internal control procedures described below may not be appropriate for each broker-dealer or adviser. Moreover, other procedures may be just as effective." In addition, the Commission recently stated that "[i]nvestment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable. . . ."[4] (Emphasis added.)

NSCP submits that it is appropriate for the Commission to encourage investment advisory firms to adopt and maintain effective compliance policies and procedures directed toward such firm's specific business and clients. The Commission's Office of Compliance, Inspections, and Examinations (OCIE) has effectively required advisers *to* maintain such policies and procedures for several years, and regularly cites firms in deficiency letters if they have failed *to* do so. However, we believe that mandating such a requirement with a new rule under Section 206 of the Advisers Act is not the best approach.

We are unaware of any systemic breakdown in the compliance systems of the advisory industry that would necessitate the adoption of a rule under the antifraud provisions requiring all advisers to adopt written procedures covering all aspects of their business. By contrast, the advisory industry is one of the few segments of the financial services industry that has not been tainted by financial scandal. The Commission has mandated various procedures that must be adopted to address specific issues and concerns raised by enforcement actions or a trend in

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[3] Commission, Office of Compliance, Inspections, and Examinations, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998).

[4] See Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003), Section II.A.2 (Proxy Voting Adopting Release).

examination findings. Where there have been actual violations, firms and individuals that have not been the primary violators have been cited for failure to supervise. Indeed, Section 203(e)(6) inferentially imposes a supervisory system on advisers and provides an affirmative defense if an adviser had policies and procedures in place that are reasonably designed to prevent and detect violative conduct. If the Commission has concluded that it is necessary to adopt a rule specifically providing for compliance procedures, it should consider adopting a rule under Section 203. Moreover, the Commission also could adopt a rule under Section 204 that would achieve the same goal of requiring advisers to develop and implement supervisory procedures that would be enforceable by the panoply of monetary and other remedies available to the Commission in enforcement actions under the Advisers Act.

Under other circumstances, the Commission has recognized the great diversity among the types, size and businesses of investment advisory firms. This suggests that the better approach would be to set forth the list of areas that should be "reviewed and considered" by all investment advisers in putting together and maintaining their compliance policies and system of internal controls.[5] Consistent with our view that ethical practices are best enhanced through a reliance on principles, standards, and past Commission practices, we believe that many of the Commission's proposals would be better crafted as a menu of standards and practices that advisers consider in designing policies and procedures "suitable to their businesses and the nature of the conflicts they face."[6]

Adoption of a New Rule under Rule 206 *of* the Advisers Act

The fact that the advisory industry is not "one size fits all" heightens our concern that the Proposed Rules would be tinder the antifraud provisions of the Advisers Act. Section 206 and the rules promulgated under Section 206 relate practices that the Commission has determined to be fraudulent, deceptive, or manipulative. The Commission, and in particular the OCIE Staff, has repeatedly taken the position that good compliance is good for business. We agree, and the NSCP supports the continued efforts of the Commission and its Staff to reinforce the importance of each adviser maintaining strong internal controls and a healthy compliance culture.[7]

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[5] A necessary component of strong internal controls would, for many advisers, include developing, implementing, and maintaining procedures for personal trading, portfolio management (including soft dollars), client disclosures, recordkeeping, privacy, contingency planning, and others, depending on the business conducted by the adviser. ***See*** Proposed Rules, supra, Section II.A.

[6] See Proxy Voting Adopting Release, supra, at Section II.A.2.

[7] See Paul Roye, Director, Division of Investment Management, "Priorities in Investment Adviser Regulation," Remarks before the IA Compliance Summit and Best Practices

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An antifraud rule, however, could produce consequences that would be harmful to the advisory industry. For example, the **NSCP** is very concerned that, should an adviser adopt what the Staff subjectively deems to be an "inadequate" policy, the adviser would be subject to enforcement action under the antifraud rules *of* the Advisers Act. This would remain the case, even if the policy that the Commission determined was inadequate was unrelated to any fraudulent activity.

For exampte, **suppose the** policy in question concerned the maintenance of an advertising file. Suppose further that the file in fact contained all materials required under the recordkeeping rules and that the advertising **materials** themselves were not fraudulent, deceptive or misleading. However, the firm's written policies and procedures did not adequately describe the firm's recordkeeping practices. While there is no disagreement that the maintenance of such files **is** an important element of supervision, and is required under the recordkeeping rules, the inadequacy of the policies and procedures should not, in our view, give rise to a violation of an antifraud rule in the absence of any activity that has misled or deceived **a** client.

It is anomalous that the failure to maintain adequate insider trading policies, an area of significant importance to the Cornmission and advisers alike, **would** violate Section **204A** of the Advisers Act, but the failure to maintain adequate policies relating to a comparatively ministerial function such **as** the maintenance of an advertising file would violate Section 206. The severity of this approach, we would suggest, undermines the effectiveness of the Advisers **Act,** which **has** proven an effective system of regulation of an industry as varied as the investment advisory profession for more than sixty years. **A** better approach would be to sanction the adviser if the underlying conduct *is* fraudulent, otherwise violates the Advisers Act, or if the adviser has failed to supervise its employees.[8] The absence of appropriate policies and procedures may be evidence of those failures, but should not be a deemed a fraud, in and *of* itself. The Advisers Act already affords **the** Commission these tools, making it unnecessary to escalate a failure or defect in **a** policy or procedure to fraudulent, manipulative and deceptive conduct.

As noted above, the Commission has defined specific instances that constitute a fraudulent, deceptive or manipulative act. Further, the Commission has the broad anti-fraud provisions set

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Update (Apr. 8, 2002); Lori Richards, Director, Office of Compliance, Inspections, and Examinations (OCIE), Remarks at the 2002 Internal Auditors Division Annual Conference, Securities Industry Association (Oct. 15, 2002); John H. Walsh "What Makes Compliance a Profession," Remarks before NRS Symposium on the Compliance Profession (Apr. 11, 2002).

[8] It is not unusual for the Commission in such situations, to impose a fine on the investment adviser and on specific individuals involved and, depending upon the facts and circumstances, either to bar a person or persons from being associated with an investment adviser and/or to require the adviser to retain an outside consultant.

forth under Sections 206 (1), (2) and (4) to address fraudulent or deceptive acts by investment advisers. We are skeptical that mandating written policies and procedures under Section 206 would lead to the desired goal of the Commission in having all advisers adopt adequate and comprehensive policies and procedures.

A. Chief Compliance Officer

The NSCP supports the notion that compliance with policies and procedures should be the responsibility of specifically designated staff. The NSCP also supports the notion that management of an adviser is responsible for compliance. The designation of a chief compliance officer is one way to foster strong compliance in the investment advisory profession. However, we are concerned that the Commission's proposal to designate a single individual as a firm's chief compliance officer will be incompatible with both the collegial management structures employed by smaller advisers and the complex organizational structures employed by larger advisers. It therefore is necessary for the Commission to strike a reasonable balance between protecting the public and enabling advisers to conduct an economically viable business.

We also are concerned that centralizing compliance responsibility in larger firms may be incompatible with the complex organizational structures utilized in many of these firms. In larger firms, management may be embedded in a divisional or multi-layered system. Management controls may also include so-called direct and dotted line relationships. In addition, many larger firms utilize management structures (such as committees and boards) that emphasize collective responsibility for management.[9]

Due to the wide array in size and sophistication of the investment advisory firms falling under the Commission's jurisdiction and the fact that "one size does not fit all," mandating all investment advisory firms designate and maintain a separate chief compliance officer is unduly burdensome."[10]

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[9] John H. Walsh, Chief Counsel, OCIE, recently highlighted the complexity of larger organizations, noting that "[c]omplex organizations often have complex organizational structures.... This complexity poses a significant issue for compliance. In an environment of multiplying layers, spreading dotted lines, and collective activity, who is a supervisor?" John H. Walsh, Managing Compliance in a Complex Organization, An Occasional Series, Part 4: Who is a Supervisor? NSCP Currents (Jan.-Feb. 2003).

[10] There is no suggestion being made that compliance by small investment advisory firms is deemed any "less important" than compliance by larger investment advisory firms. The Advisers Act and its rules apply with equal force to both. That said, it is up to the smaller firms to ensure they are in compliance with the Advisers Act and this is more typically done through the use of outside consultants and counsel on presumptively a cost-effective basis.

B. Compliance Reviews

While the NSCP supports the notion of enhancing investors' confidence in compliance systems, the NSCP believes mandatory periodic third-party compliance reviews are unnecessary. Moreover, for some advisers, these reviews could instill a false sense of confidence in both the adviser and its clients. The hiring and retention of third-party firms to perform compliance reviews is costly and potentially unduly burdensome, depending upon the size and type of business of the firm.

Historically, and as noted by the Commission in the Proposed Rules," a myriad of outside third-party firms perform compliance or "mock audit" exams. These firms include accounting firms, law firms, and consulting firms. Depending upon the scope and size of the proposed Compliance review and the size, sophistication and location or locations of the investment advisory firm, the cost of the compliance review can easily reach six figures. As this observation suggests, the industry already utilizes such services as part of an active effort to establish and maintain effective compliance systems, Moreover, many clients expect advisers to include such third-party reviews as part of regular compliance programs. Although third-party reviews may be part of a good compliance program, we nevertheless do not believe that all advisers should be required to utilize third-party reviews. Third-party reviews may be especially inappropriate for smaller advisers because their organizational structures frequently emphasize mutual accountability for compliance. The cost of a third-party review is not one that can easily be borne by these advisers. Further, we submit that the end product may not be as useful as the Commission in its Proposed Rules may suggest.

In addition, many larger firms employ internal audit departments to achieve the same objectives. Requiring the use of a third party would not add a significant amount of confidence in these firms' compliance processes, but would increase their costs of doing business. Because of the differences in organizational structure, resources and complexity among investment advisers, we do not believe that the Commission should require that all advisers use a single tool to ensure that they have adopted adequate compliance policies and procedures. Rather, the Commission should support the industry's use of a large tool set and should then assess whether the tools chosen by individual advisers are appropriate to those advisers' businesses.

If an adviser were required to undergo periodic compliance reviews by a third party, one natural candidate to consider is the investment adviser's auditor. The firm's auditor is already familiar with the adviser and could likely perform a thorough audit more efficiently than a firm that was unfamiliar with the adviser's business. However, given the recent passage of the Sarbanes-Oxley Act of 2002[12] and rules promutgated thereunder by the Commission,[13] there are potential

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[11] See Proposed Rules, supra, Section II.E.l and n.56.

[12] Pub. L. 107-204, 116 Stat. 745 (2002).

conflicts of interests that would prohibit the adviser from using its regular auditor to perform the third-party review. Thus, to engage another third-party to perform the audit would necessarily lead to higher costs **as** a result of less familiarity with the investment adviser and its business, and increase the likelihood that the review will be ineffective. For these reasons, we view the mandatory compliance review **as** unnecessary and unduly burdensome for advisers.

C. Annual Review

NSCP supports the concept of an annual review as set forth under the Rules Proposal. Such a review is arguably already provided for and mandated of each investment adviser under the explicit provisions of Rule 204-1(a) of the Advisers Act. That rule provides that investment advisers must at least annually, if not more often, update disclosures provided in their Form ADVs. Among the salutary effects of updating the Form ADV on an annual basis (or more often as may **be** required) **is** the benefit of taking into account changes in the investment adviser's business **as** well as changes in the regulatory environment in which investment advisers operate. Thus, an annual review **as** set forth under the Proposed Rules **is** consistent with the annual updating requirements set forth under Rule 204-1(a) with respect to Form ADV and has our support.[14]

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[13] See Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185 (Jan. 29, 2003); Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 47265 (Jan. 28, 2003); Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Exchange Act Release No. 47264 (Jan. 28, 2003); Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 47262 (Jan. 27, 2003); Retention of Records Relevant to Audits and Reviews, Exchange Act Release No. 47241 (Jan. 24, 2003); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 47235 (Jan. 23, 2003); Insider Trades During Pension Fund Blackout Periods, Exchange Act Release No. 47225 (Jan. 22, 2003); Conditions for Use of Non-GAAP Financial Measures, Exchange Act Release No. 47226 (Jan. 22, 2003); Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46427 (Aug. 28,2002); Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 46421 (Aug. 27, 2002).

[14] See Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers 2-33 (2002) ("...the discipline of reducing its policies and practices to writing provides an adviser with an opportunity to double check these policies and procedures and to ensure that it has adequate compliance and regulatory procedures. Finally, the process of updating the brochure

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D. Self-Regulatory Organization

NSCP does not support the formation of one or more self-regulatory organizations (SROs) for funds and/or advisers. While there have been changes in the overall financial industry affecting financial services firms, notably investment advisers as well as regulated investment companies, those changes also have limited the regulatory oversight and burden on the Commission and OCIE. With the passage of the National Securities Market Improvement Act of 1996, as amended (NSMIA)," the oversight responsibility of the Commission for all registered investment advisers decreased significantly.[16]

The Commission's move towards conducting risk-based examinations also will further decrease the regulatory burden on the Staff.[17] With this approach, the Staff expressed its intention to select advisers for inspection that will result in different inspection schedules for firms with different risk profiles. As noted by the Staff, the assets managed by advisory firms are highly concentrated with the twenty largest advisers having approximately a quarter of all assets under management.[18]

Thus, with the passage of NSMIA and the evolution of the Commission inspection process, the arguments in favor of the inter-positioning of a self-regulatory organization in the investment advisory and investment company areas are, in our view, weakened.

In addition to the above, our concerns vary with respect to which entity would serve as the SRO and exactly what its role would be with respect to investment advisers and investment companies, both now and in the future. We would oppose an SRO that is established to set

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provides an adviser with a mechanism to review the above matters and modify them in light of its changing circumstances, business needs and regulatory developments.").

[15] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 USC).

[16] It is estimated that at the time Congress amended the Advisers Act through NSMIA, the Commission had oversight responsibility for approximately 22,500 investment advisers. The Commission has stated that this number now stands at approximately 7,790.

[17] See Lori A. Richards, Director, OCIE, "The Evolution of the Commission's Inspection Program for Advisers and Funds: Keeping Apace of a Changing Industry," Speech before Glasser Legal Works – Compliance and Inspection Issues for Investment Advisers and Investment Companies (Oct. 30, 2002).

[18] See id.

standards and rules for investment advisers and investment companies. The present system of federal and state regulation of investment advisors, in our opinion, is appropriate given the diversity of the industry and has worked exceedingly well. An additional layer of substantive regulation, particularly given the recent proliferation of new regulation with respect to both investment advisers and investment companies, is inappropriate. For example, Congress and/or the Commission have mandated requirements relating to proxy voting, anti-money laundering, independent directors of investment companies, after tax returns disclosure rules, custody, investment company names, and privacy of consumer financial information. The imposition of regulatory burdens is accelerating and, at least with respect to investment advisers, does not appear justified by any widespread scandal or failing of the industry. We see little reason to add yet another layer of regulation, absent a very demonstrative justification that this layer is necessary to protect advisory clients.

E. Fidelity Bonding Requirement for Advisers

Although the NSCP can appreciate the potential investor protection goals associated with requiring advisers to obtain fidelity bonds, it is the experience of NSCP members that the reality falls far short of these goals. It is our experience that very few bonds ever pay any funds to investors, and therefore we do not believe that this new requirement will significantly enhance the security of investors. On the contrary, a mandatory fidelity bond could create a false sense of security among less sophisticated clients. Moreover, most advisers, and generally all advisers with custody of client assets, already maintain fidelity bonds. However, fewer than ten percent of the advisers registered with the Commission have custody of client assets. We also note that fidelity bonding is required under both the Investment Company Act of 1940, as amended, and the Employee Retirement Income Security Act of 1974, as amended.

NSCP also would not support a minimum capital requirement for investment advisers. Like the Contemplated fidelity bond requirement, a minimum amount of capital is unlikely to provide any measurable relief to clients in the event of an adviser's misconduct. Moreover, the imposition of significant capital requirements would be anti-competitive, as it would create a significant barrier to entry for new advisers. The effect is that a minimum capital requirement would reduce competition without affording any meaningful protection to investors.

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The Commission's proposals on investment adviser compliance programs contain many positive elements, and we support them. We believe that the Commission's overall objectives could be fully achieved by providing standards and guidance for advisers to consider when adopting their policies and procedures without adopting an antifraud rule. Moreover, although we appreciate the goals of increasing private sector involvement in the oversight of investment advisers, the concepts put forth in the Proposed Rules, in our view, would do little to better regulate advisers and protect investors, but would unnecessarily increase advisers' compliance costs. As we discuss above, there are more cost-effective measures that would provide real benefits to advisers and their clients.

Questions regarding our comments or requests for additional information should be directed to the undersigned at 860.672.0843.

Sincerely yours,

Joan Hinchman
Executive Director

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul **S. Atkins**
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
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