

**COMPLIANCE PROGRAMS OF INVESTMENT COMPANIES
AND INVESTMENT ADVISERS**

SUMMARY OF COMMENTS ON PROPOSED NEW RULES 38a-1 UNDER THE
INVESTMENT COMPANY ACT AND 206(4)-7 UNDER THE INVESTMENT ADVISERS
ACT, AND PROPOSED AMENDMENTS TO RULE 204-2 UNDER THE INVESTMENT
ADVISERS ACT

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LIST OF COMMENTERS

Category/Commenter

Short Name

Investment Advisers

Frank Armstrong	Armstrong
Beach Financial Advisory Service	Beach
Capital Research and Management Company	Capital Research
Dare Capital Management & Advisory	Dare Capital
Deloitte & Touche (and Deloitte & Touche Investment Advisors)	Deloitte
Empire Corporate FCU (and MemberTrade Advisory Services)	Empire
Fidelity Management & Research Company	Fidelity
Financial Engines Advisors LLC	Financial Engines
Loring, Wolcott & Coolidge Office	Loring Wolcott
Meyer Advisory Services	Meyer
Prudential Financial, Inc. (and Prudential Investment Management, Inc.)	Prudential
Charles Schwab & Co., Inc. (and Charles Schwab Investment Management, Inc.)	Schwab
Shawbrook	Shawbrook
T. Rowe Price Associates, Inc.	T. Rowe Price
Weil Capital Management, LLC	Weil
Windward Capital Management	Windward

Investment Companies

Vanguard Group	Vanguard
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Independent Directors

Members of Compliance and Shareholder Communications Committee of American Century Funds' Board of Directors	American Century Directors
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Investors

K.C. Gillmo	Gillmo
John U. Kranick	Kranick
Barbara Mortensen	Mortensen

Professional and Trade Associations

American Bar Association, Business Law Section, Committee on Federal Regulation of Securities	ABA
American Federation of Labor and Congress of Industrial Organizations	AFL-CIO
Certified Financial Planner Board of Standards, Inc.	CFP Board
Committee of Annuity Insurers (represented by Sutherland Asbill & Brennan)	CAI

Category/Commenter	Short Name
Council of Institutional Investors	CII
Financial Planning Association	FPA
Investment Company Institute	ICI
Investment Council Association of America, Inc.	ICAA
National Association for Variable Annuities	NAVA
National Association of Insurance and Financial Advisors	NAIFA
National Association of Personal Financial Advisors	NAPFA
National Society of Compliance Professionals	NSCP
North American Securities Administrators Association, Inc.	NASAA
Securities Industry Association – Investment Adviser, Investment Company and Self-Regulation and Supervisory Practices Committees	SIA
<i><u>Compliance Officers</u></i>	
Anonymous compliance officer	Anonymous
Jilaine Hummel Bauer	Bauer
<i><u>Law Firms</u></i>	
Debevoise & Plimpton	Debevoise
Pickard & Djinis LLP	Pickard & Djinis
<i><u>Compliance Consultants</u></i>	
Brown & Associates and Self Audit, Inc.	Brown
Monahan & Roth, LLC	Monahan & Roth
Mulligan Management & Operations, LLC	Mulligan
Sterling Management Solutions Corp.	Sterling
<i><u>Others</u></i>	
Carl H. Buerger, Jr.	Buerger
Theodore E. Angiulo	Angiulo
Us Keatings	Keatings

I. Introduction and Background

On February 5, 2003, the Securities and Exchange Commission (“Commission”) issued a release (“Proposing Release”), in which it proposed new rules and rule amendments to enhance the effectiveness of the compliance programs of investment companies and investment advisers.¹ Specifically, the proposed rules would require each registered investment company (“fund”) and investment adviser to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and appoint a chief compliance officer to be responsible for administering the policies and procedures. In addition, the Commission sought comment on four other ways to involve the private sector in compliance: (i) periodic third-party compliance reviews of funds and advisers, (ii) an expansion of the scope of the fund audits performed by independent public accountants, (iii) the formation of one or more self-regulatory organizations, and (iv) a fidelity bonding requirement for advisers.

The Commission received 46 written comment letters and one telephone comment. The following discussion summarizes these commenters’ general views and specific remarks on matters discussed in the Proposing Release. The Division of Investment Management prepared this summary.

II. General Comments

Commenters generally supported the Commission’s proposal to require funds and advisers to adopt written compliance policies and procedures, but recommended certain

¹ The Commission proposed new rule 38a-1 under the Investment Company Act, new rule 206(4)-7 under the Investment Advisers Act, and amendments to rule 204-2 under the Investment Advisers Act.

refinements. The ICI, which, along with the SIA and ICAA, supported the proposed rules, noted that “to the extent that the Commission determined that additional self-regulation was necessary, a rule mandating that each registered investment company establish and maintain an internal compliance system that meets certain minimum requirements would be the most efficient and expeditious way to ensure future industry compliance with regulatory standards.”²

As described below, however, a number of commenters raised questions about the approach of the proposed rules and some of these recommended against adopting one or both rules. Some of these comments reflect disagreement about whether the proposed rules, as drafted, would sufficiently take into account the fact that large funds and advisers with complex operations often rely on outside entities to perform business functions including compliance. Others questioned whether the rules would be feasible for small advisers, who would have to transition from informal compliance programs to more formal compliance programs with written policies and procedures and a designated chief compliance officer.

With limited exception, commenters generally objected to the four private sector alternatives discussed in the Proposing Release, arguing that direct Commission oversight has been successful and private sector oversight is unnecessary, costly, or unworkable.

III. Specific Comments

A. Requiring Written Compliance Policies and Procedures

The Commission proposed to require each fund and adviser to adopt and implement compliance policies and procedures reasonably designed to prevent violation of the federal

² As the ICI noted in its comment letter, it first took this position when, in 1994, it submitted to the Commission a proposal for a compliance rule for funds.

securities laws (for advisers, the Investment Advisers Act only).³ These proposed rules grew out of the Commission’s experience that written compliance policies are an integral component of a strong and effective internal compliance program.

Twenty commenters supported the Commission’s proposal to require funds and advisers to adopt written compliance policies and procedures.⁴ ICI and ICAA both expressed support for the Commission’s efforts to ensure that funds and advisers maintain written compliance programs, and applauded the Commission for allowing flexibility in each firm’s policies and procedures. SIA agreed with the Commission that written policies and procedures that are reviewed periodically and capable compliance personnel are “critical components” of a compliance program. Other commenters favored the proposed rules because, among other things, they would serve as a first line of protection for investors,⁵ reduce violations,⁶ aid the Commission’s examination program,⁷ foster investor confidence in funds and advisers,⁸ and generally encourage all firms to devote adequate attention to compliance.⁹

Eleven commenters objected to requiring funds and/or advisers to adopt written

³ Proposed rules 38a-1(a)(1) and 206(4)-7(a).

⁴ AFL-CIO, Anonymous, Bauer (arguing that the Commission also should require funds and advisers to adopt “good governance principles”), Brown, CII, Deloitte, Empire, Financial Engines, FPA, ICI, ICAA, Monahan & Roth, Mulligan, NAIFA, NAVA, NASAA, Prudential (supporting requirement for *advisers* only), Schwab, SIA, Vanguard.

⁵ Bauer, Deloitte, Financial Engines, Vanguard.

⁶ AFL-CIO, FPA, Monahan & Roth.

⁷ AFL-CIO, CII, Financial Engines.

⁸ Bauer, FPA, Mulligan, Schwab, Vanguard. Brown and Bauer recommended that the Commission consider requiring funds and their advisers to make available to the public a description of their compliance programs.

⁹ Anonymous (also predicting that the proposed rules would promote fair valuation), Brown, Monahan & Roth.

compliance policies and procedures.¹⁰ Two commenters from mutual fund complexes objected to requiring *funds* to adopt and implement written policies and procedures because the compliance policies and procedures of funds' service providers cover all of the fund's activities.¹¹ T. Rowe Price objected that the proposal is impractical because of the number of regulatory requirements the policies and procedures would have to cover. Five commenters from smaller investment advisers objected that the proposed requirements would significantly increase the burden on small investment advisers without improving investor protection.¹² A commenter representing compliance professionals contended that the proposed rules are unnecessary because the Commission's Office of Compliance Inspections and Examinations, through its inspection process, already effectively requires that advisers have procedures in place.¹³ Two other commenters, ABA and Fidelity, recommended further study to identify the critical elements of an effective compliance program.

Objectives of the Proposed Rules

The proposed rules would require funds and advisers to adopt policies and procedures reasonably designed to *prevent* violation of the federal securities laws (for advisers, the Investment Advisers Act only). Five commenters argued that compliance policies and procedures could not *prevent* violations; they recommended instead that the rules require that the

¹⁰ ABA (suggesting further study), American Century Directors, Beach, Dare Capital, Fidelity (suggesting further study), NAPFA, NSCP, Prudential (objecting to proposed rule for funds; supporting proposed rules for advisers), Shawbrook, T. Rowe Price, Weil.

¹¹ American Century Directors, Prudential (supporting proposed rule for investment advisers). These commenters argued, however, that fund boards should exercise appropriate oversight of service providers' compliance activities.

¹² Meyer, Beach, Dare Capital, NAPFA, Weil. Similarly, Shawbrook objected that requiring written policies and procedures would not discourage advisers inclined to violate the securities laws from doing so.

¹³ NSCP.

policies and procedures be reasonably designed to *promote compliance* with the federal securities laws.¹⁴

Reliance on Service Providers' Compliance Programs

The Proposing Release explained that funds and advisers would be permitted to delegate compliance functions to service providers, but would be required to include in their compliance policies and procedures proper oversight of the service providers. Because of funds' extensive reliance on service providers to conduct all operations, commenters representing fund groups generally recommended modifying rule 38a-1 to explicitly permit funds to rely on the compliance policies and procedures of their service providers.¹⁵ A number of these commenters contended that requiring funds to develop compliance policies and procedures to cover areas already covered by the policies and procedures of fund service providers would be inconsistent with mutual funds' heavy reliance on service providers, would be inefficient, and would not enhance compliance.¹⁶ ICI argued that the board should be required only to receive and review, at least annually, reports on fund and service provider compliance policies and procedures.¹⁷

¹⁴ American Century Directors, Capital Research, ICI, Prudential, Vanguard (recommending that, at a minimum, the correction of violations should not be an objective of the policies and procedures). Vanguard also recommended that the Commission require the adoption and implementation of a compliance *program*, rather than compliance policies and procedures, in order to emphasize broad compliance objectives rather than the details of day-to-day compliance.

¹⁵ American Century Directors, Capital Research, Fidelity, ICI, Prudential, Schwab, T. Rowe Price, Vanguard (arguing that fund boards should be permitted to rely on advisers' policies and procedures). ABA also recommended this change. Another commenter, Bauer, recommended requiring investment advisers to certify the adequacy of their compliance policies and procedures to the funds that they advise.

¹⁶ ICI, Prudential (noting that the proposed rule would be particularly unwieldy in the multi-manager context), Schwab.

¹⁷ Other commenters recommended a similar approach. ABA (recommending additionally that service providers provide fund with assurances of the adequacy of their compliance policies and procedures), American Century Directors (recommending additionally that the fund board be

Other commenters recommended even less board involvement.¹⁸ In addition, ICAA, contending that independent subadvisers should not be required to tailor policies and procedures specific to each fund that they advise, recommended that the Commission state that a fund's board does not have to approve the compliance policies and procedures of independent subadvisers to the fund.

Minimum Elements of Compliance Policies and Procedures

The proposed rules did not specify the elements that would have to be included in the compliance policies and procedures, but the Proposing Release set forth a number of issues that the Commission expected, at a minimum, would be included to the extent they are relevant for a particular firm. ICAA and two other trade associations, arguing that even the items in the minimum list were not relevant for all advisory firms, objected to the specification of minimum elements in the Proposing Release.¹⁹ FPA, by contrast, asked the Commission to provide in the adopting release more specific guidance about particular policies and procedures and their applicability to firms of different sizes. Vanguard recommended that the adopting release set forth seven broad guidelines for compliance programs, while leaving the specification of

required to make an annual determination that the compliance programs of the fund and its service providers are reasonably designed), Fidelity (recommending additionally that funds be required to obtain, as a prerequisite for entering into or renewing a contract with an independent service provider, a report on the service provider's compliance program), Prudential (recommending additionally that the fund board be required to determine periodically that the compliance systems of the fund and its service providers are reasonably designed to ensure that fund activities comply with law and regulations), Schwab (recommending additionally that the fund board be required to determine periodically that the compliance systems of the fund and its service providers are adequate).

¹⁸ Capital Research (allowing funds to cross-reference to the policies and procedures of service providers), T. Rowe Price (recommending requiring board to review only adviser's *major* compliance policies and perhaps a compliance report from the adviser).

¹⁹ ICAA, NAPFA, NSCP. It should be noted that, in the Proposing Release, we prefaced the list of compliance issues with the statement that these issues should be addressed in "the policies and procedures of funds and (*to the extent relevant*) advisers." (Emphasis added.)

particular elements of the program to individual firms. Monahan & Roth went further and urged the Commission to publish a template, which could then be modified by firms as needed.²⁰

The Proposing Release also asked comment on whether the *rules* should specify certain minimum policies and procedures. Eleven commenters, emphasizing the need for firms to have the latitude to tailor their policies to their own businesses, recommended against enumerating specific policies and procedures in the rule.²¹ In addition, CAI recommended specifically against requiring insurance company separate accounts to adopt specific minimum policies.

Accommodations for Specific Types of Entities

Six commenters recommended that the proposed rules be revised for certain types of entities. Three commenters recommended that proposed rule 38a-1 make allowance for the business structure of insurance company separate accounts.²² In addition, three commenters requested special accommodations for entities that are registered as both investment advisers and broker-dealers.²³ SIA and Pickard & Djinis recommended that the Commission clarify that dually registered advisers would be permitted to have a single compliance program as long as the program has as one of its objectives the prevention of violations of the Advisers Act. Schwab recommended that, in order to accommodate dual registrants, compliance with SRO rules should

²⁰ NASAA recommended supplementing the guidance provided in the release by explaining that: (i) the procedures should be designed to prevent violations of state law as well as federal law, (ii) the procedures should cover the timely filing of required state and federal forms, (iii) the policies regarding safeguarding of client assets should apply to all of an adviser's employees (iv) the procedures should extend to compliance with the solicitation rule, and (v) there will be serious consequences for a failure to have to have adequate compliance policies in place.

²¹ ABA, Capital Research, Deloitte, Financial Engines, ICAA, ICI, NAVA, NASAA, Prudential, Schwab, Vanguard.

²² CAI, NAVA, Prudential. These commenters discussed the passive unit investment trust structure of variable insurance products and their reliance on compliance policies and procedures of multiple business units of their sponsoring insurance company.

²³ Pickard & Djinis, Schwab, SIA.

be deemed to be compliance with proposed rule 206(4)-7. NAPFA urged the Commission, in determining the appropriate level of regulation, to consider whether an adviser takes custody of client assets, effects trades on behalf of clients, or earns commissions on discretionary trades.

B. Chief Compliance Officer

The Commission proposed to require each fund and adviser to designate a chief compliance officer who is competent and knowledgeable regarding the applicable federal securities laws and empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the adviser or the fund complex.²⁴ Seven commenters supported the requirement.²⁵ Thirteen others, including ICI and ICAA, supported the rule, but requested modifications to certain elements of the requirement as discussed in the sections below.²⁶

Four commenters opposed the proposed chief compliance officer requirement.²⁷ Brown objected on the grounds that it would encourage top management to avoid responsibility for compliance and liability concerns would discourage people from accepting the chief compliance officer position. Another two commenters (Financial Engines and Weil) expressed concern that the requirement would be too costly, particularly for small advisers.²⁸ Four commenters,

²⁴ Proposed rules 38a-1(a)(4) and 206(4)-7(c).

²⁵ AFL-CIO, Anonymous, Bauer, CII, Deloitte, Empire (favoring the requirement as long as the chief compliance officer can delegate duties and small firms can rely on their parent companies for assistance), Mortensen.

²⁶ ABA (suggesting modifications to requirement and requesting clarification of the role of the compliance officer), American Century Directors, CAI, Capital Research, Fidelity, ICAA, ICI, NASAA, NSCP, Prudential, Schwab, T. Rowe Price, Vanguard.

²⁷ Brown, Financial Engines, Shawbrook, Weil.

²⁸ In addition, while ICAA supported the chief compliance officer requirement, it cautioned that the cost of designating a chief compliance officer for a small adviser could be higher, and the benefits lower, than anticipated. NSCP contended that small investment advisers should be permitted to

contending that responsibility for compliance lies with funds' service providers, objected to requiring *funds* to appoint a chief compliance officer.²⁹

Commenters also requested clarification on the following points: (i) that an adviser's chief compliance officer may oversee both broker-dealer and adviser compliance,³⁰ (ii) that a fund and its adviser may share a chief compliance officer,³¹ and (iii) that a principal of the firm may serve as chief compliance officer.³²

Requiring Chief Compliance Officer to be a Member of Senior Management

In response to a question in the Proposing Release whether the rules should require the chief compliance officer to be a member of senior management, five commenters answered that the rules should so require.³³ One of these commenters, Bauer, recommended that the chief compliance officer should be required to be an executive officer with no other executive functions, supervisory duties, or duties related to portfolio management, trading, or marketing.³⁴

continue to rely on outside consultants or counsel, rather than being required to appoint a chief compliance officer.

²⁹ American Century Directors, Capital Research, Fidelity, Prudential.

³⁰ SIA.

³¹ T. Rowe Price. Bauer recommended that rule 38a-1 include safeguards, such as board review of the chief compliance officer's salary and performance, to ensure that a chief compliance officer for a fund who has a relationship with the adviser does not compromise the interests of the fund.

³² NAPFA.

³³ AFL-CIO (arguing also that the chief compliance officer should report directly to the board), Bauer (recommending also that the chief compliance officer be required to report to the chief legal officer or chief executive officer), Empire, ICAA (recommending that, at a minimum, the chief compliance officer should report directly to a member of senior management), NASAA (generally favoring requirement that chief compliance officer have "substantial managerial powers," but expressing concern that requirement would not be effective in certain business organizations, and requesting clarification of the term "senior management").

³⁴ Bauer also recommended that the chief compliance officer should be subject to continuing education requirements. Mortensen recommended that the chief compliance officer be covered by a fidelity bond and have credentials comparable to those of a top fund manager.

Three commenters recommended that the chief compliance officer should *not* be required to be a member of senior management.³⁵ These commenters maintained that such a requirement could prevent firms from designating the most qualified candidate.

Allowing Firms to Designate Multiple Compliance Officers

The proposed rules would require each fund and adviser to designate an individual to be responsible for administering the firm's compliance policies and procedures, but the Proposing Release asked whether the rules should permit the designation of multiple compliance officers. AFL-CIO and Mortensen supported requiring the designation of *one* chief compliance officer.

Thirteen commenters, including ICI and ICAA, recommended permitting multiple individuals or a committee to share compliance responsibilities.³⁶ Five of these commenters argued that doing so would afford firms the flexibility to assign responsibility for compliance in a specific area to individuals who have expertise in that area.³⁷ NSCP argued that the designation of only one chief compliance officer would be inconsistent with the organizational and management structures employed by many advisers. Four commenters stated that a requirement that one person be designated as chief compliance officer would be inconsistent with the organizational structure pursuant to which many funds operate.³⁸ Responsibility for different aspects of compliance may be spread across individuals employed by different service providers

³⁵ Capital Research, Financial Engines, Schwab (noting that the term "senior manager" can have different meanings in different entities).

³⁶ ABA, CAI, Capital Research, Fidelity, Financial Engines, ICI, ICAA, NAVA, NSCP, NASAA, Schwab, T. Rowe Price, Vanguard.

³⁷ ABA, ICAA, Schwab, T. Rowe Price, Vanguard.

³⁸ ABA (noting also that firms would have difficulty finding a single person with knowledge of all the securities laws), Fidelity, Financial Engines, ICI. In addition, American Century Directors, Capital Research, Fidelity, and Prudential argued that funds should not be required to designate a chief compliance officer because many funds are entirely reliant on service providers.

(or different fund groups for multi-managers). Commenters thus contend that it would be impractical to require all of these individuals to report to one chief compliance officer, outside the established lines of authority in their business units.

ICI recommended that the Commission modify proposed rule 38a-1 to permit funds and their service providers to designate initially and annually thereafter one or more persons with primary responsibility for compliance, *without* board approval for each of the designated persons.

Chief Compliance Officer's Liability for Violations of the Policies and Procedures

Because a chief compliance officer may not have supervisory responsibilities over anyone else, the Proposing Release stated that a person who has been designated as a chief compliance officer would not necessarily be subject to a sanction by the Commission for failure to supervise.³⁹ Schwab recommended that the Commission reiterate this statement in its adopting release and clarify that it applies to chief compliance officers not only of investment advisers, but also of funds. Three other commenters, including ICI and SIA, requested that the Commission include in the rules a safe harbor to protect a chief compliance officer in the event of a violation if he or she reasonably believed the policies and procedures were adequate and reasonably discharged the obligations of the rule.⁴⁰

Certification by the Chief Compliance Officer

The Proposing Release asked comment on whether the chief compliance officer should be required to certify the compliance policies and procedures. Three commenters objected to

³⁹ Proposing Release, at n. 38.

⁴⁰ Bauer, ICI, SIA.

such a requirement.⁴¹ One of these commenters, ICAA, argued that including such a requirement would unfairly burden a single individual and could weaken compliance programs because compliance officers would have an incentive not to implement comprehensive, strict procedures. Schwab, another of the objecting commenters, argued that compliance officers do not supervise employees and therefore are not the proper parties to certify compliance policies and procedures.

C. Annual Review and Reporting Requirements

Under the proposed rules, funds and advisers would have to review their compliance policies and procedures annually.⁴² Twelve commenters supported the annual review requirement.⁴³ Two commenters (ABA and Pickard & Djinis) opposed the requirement as unduly burdensome and an unnecessary supplement to periodic reviews already conducted by the compliance staff.⁴⁴ Capital Research objected to mandating review according to any fixed schedule and recommended instead that policies and procedures be reviewed as needed.

The Proposing Release requested comment on whether reviews should take place more often than annually. Bauer recommended requiring supplemental quarterly reports if there have been any material changes in the compliance program or any material compliance issues. Two commenters (Financial Engines and ICAA) opposed requiring more frequent review.⁴⁵

⁴¹ ICAA, Schwab, Vanguard. NASAA, which did not take a position with respect to the requirement, recommended that the Commission clarify certain aspects of the requirement, including what the officer would have to certify.

⁴² Proposed rules 38a-1(a)(3) and 206(4)-7(b).

⁴³ AFL-CIO, American Century Directors, CII, Deloitte, Empire, Financial Engines, FPA, ICAA, Monahan & Roth, Prudential, NSCP, Vanguard.

⁴⁴ Pickard & Djinis recommended that if the Commission were to adopt a review requirement, it should extend only to affected areas when there has been a material change in the adviser's business, the adviser's compliance program, the applicable legal requirements, or a material violation.

⁴⁵ In addition, NASAA and Prudential supported annual review as the appropriate standard, but

Proposed rule 38a-1 would require a fund's chief compliance officer to furnish the fund's board of directors a written report on the operation of the fund's policies and procedures annually.⁴⁶ Vanguard supported the requirement, but recommended against specifying the contents of, or persons responsible for preparing, the report.⁴⁷ Other commenters recommended: (i) permitting funds to incorporate the compliance report with other reports into a single report to the board,⁴⁸ (ii) requiring the inclusion of a discussion of the adviser's compliance program with respect to services provided to the fund,⁴⁹ (iii) requiring funds to submit the annual report to the Commission,⁵⁰ and (iv) requiring advisers to prepare a similar report for submission to the Commission.⁵¹

D. Role of Fund Board

Proposed rule 38a-1 would require a fund's board to: (i) approve the fund's compliance policies and procedures,⁵² (ii) approve the chief compliance officer,⁵³ and (iii) review the report provided to the board annually by the chief compliance officer.⁵⁴ Seven commenters objected to

noted that some firms would need to conduct more frequent reviews in response, for example, to the discovery of inadequacies in their compliance policies and procedures.

⁴⁶ Proposed rule 38a-1(a)(4)(ii).

⁴⁷ Vanguard also sought clarification that the annual report would not displace periodic compliance reporting throughout the year.

⁴⁸ NAVA.

⁴⁹ Bauer.

⁵⁰ CII.

⁵¹ CII.

⁵² Proposed rule 38a-1(a)(2).

⁵³ Proposed rule 38a-1(a)(4)(i).

⁵⁴ Proposed rule 38a-1(a)(4)(ii).

the role for the fund board under proposed rule 38a-1.⁵⁵ They characterized proposed rule 38a-1 as a departure from the Commission's position that fund directors should not be involved in routine fund administration. Five of these commenters argued that a fund's board should assess the adequacy of compliance policies and procedures generally, but not approve specific compliance policies and procedures.⁵⁶

E. Recordkeeping

The proposed rules would require funds and advisers to maintain a copy of their policies and procedures and certain records related to the annual review of the compliance policies and procedures.⁵⁷ Empire and NASAA expressed support for the recordkeeping requirements.⁵⁸ NAIFA commented that the recordkeeping burden of the proposed rules could be reduced by permitting advisers to retain only the final report generated during annual reviews and clarifying that documents could be maintained electronically.

F. Anti-Fraud Status of Proposed Rule 206(4)-7

Eight commenters objected to the adoption of the adviser's compliance rule under the Commission's anti-fraud authority in section 206(4) of the Investment Advisers Act.⁵⁹ FPA and ICAA contended that adopting the rule as an anti-fraud rule would mislead investors and others by causing even minor compliance infractions to look like serious violations.⁶⁰ Another of the

⁵⁵ ABA, American Century Directors, Capital Research (objecting specifically to the requirement that the board approve the chief compliance officer), Debevoise, ICI, Schwab, T. Rowe Price.

⁵⁶ ABA, American Century Directors, Debevoise, ICI, Schwab.

⁵⁷ Proposed rules 38a-1(c) and 204-2.

⁵⁸ Empire cautioned, however, that any additional requirements would be unduly burdensome.

⁵⁹ Brown, Financial Engines, ICAA, NSCP, Pickard & Djinis, Schwab, T. Rowe Price, Vanguard.

⁶⁰ ICAA pointed out that adopting the rule as an anti-fraud rule could have implications for

objecting commenters, Financial Engines, contended that the Commission, by relying on its anti-fraud authority to adopt the rule, could place firms attempting to comply with the rule at risk for heavier sanctions than their counterparts who deliberately choose not to implement comprehensive compliance programs. Three of the objecting commenters recommended that, instead of adopting a rule, the Commission issue interpretive guidance.⁶¹ ICAA explained that the Commission could issue an interpretive release describing a compliance program, implementation of which would serve as an affirmative defense to a failure to supervise charge in the event of a compliance violation. Four commenters suggested that a rule could be adopted instead under other sections of the Investment Advisers Act.⁶²

G. Cost

The Commission requested comment on the costs and benefits of the proposed rules, including the effects on small entities.⁶³ ICAA and FPA supplied cost estimates for developing compliance programs.⁶⁴ Five commenters expressed general concern that the costs of the compliance rules could outweigh their benefits.⁶⁵ Another commenter, Debevoise suggested that

insurance coverage and for the Commission's implementation of the rule.

⁶¹ ICAA, NSCP, Pickard & Djinis.

⁶² ICAA (suggesting, as an alternative to its primary recommendation that the Commission issue an interpretive release under section 203(e)(6), adopting the rule under section 211(a)), NSCP (section 203 or 204), Schwab (sections 203(e)(6) and 211), Vanguard (section 204 or 211(a)).

⁶³ Proposing Release, Sections IV (Cost-Benefit Analysis), V (Consideration of Promotion of Efficiency, Competition, and Capital Formation), VI (Paperwork Reduction Act), and VII (Summary of the Initial Regulatory Flexibility Analysis).

⁶⁴ FPA estimated that a small advisory firm with discretionary authority over client funds would spend between \$675 and \$3,900 to initiate a compliance program. ICAA estimated that developing policies and procedures for an adviser would cost between \$10,000 and \$200,000 depending on the size of the adviser. ICAA estimated that investment advisers could get assistance in drafting their policies and procedures for between \$2,500 and \$3,500, and that off-the-shelf policies and procedures are available for less than \$1,000.

⁶⁵ Beach, Capital Research, Dare Capital, Pickard & Djinis, Weil.

the Commission should have taken into account the cost of board time. Two other commenters (Schwab and AFL-CIO) expressed skepticism that costs should be an obstacle to the rule.⁶⁶

Eight commenters, including ICAA, expressed concerns about the effect of the proposed rules on small firms, which would be less equipped than their larger counterparts to absorb the cost.⁶⁷ One of these commenters, Meyer, argued that ultimately investors would be harmed if the rule were to put small advisers out of business.⁶⁸ ABA stated that small entities that outsource their compliance functions would have to hire new personnel. Monahan & Roth contended that although small firms could have simpler compliance programs than larger firms, the cost of drafting basic policies would be the same regardless of the size of the firm.

H. Exceptions

The Proposing Release asked whether there should be any exceptions from the proposed requirements. Four commenters stated that exceptions are not necessary.⁶⁹ NAPFA suggested less stringent rules for advisers without custody of, or discretion over, client assets and fee-only advisers. NAIFA recommended that the Commission create a full or partial exception for small advisers. Bauer opposed an exception for small advisers. More generally, ABA and Fidelity recommended that the Commission, rather than proceeding with its plan to mandate compliance programs, should convene a panel to consider ways to improve compliance.

⁶⁶ Schwab argued that the flexibility of the rules should attenuate concerns about cost. AFL-CIO suggested that the Commission should view the industry's cost estimates with skepticism.

⁶⁷ ABA, Empire, ICAA, Meyer, Monahan & Roth, NAIFA, NAPFA, Weil.

⁶⁸ ICAA and Meyer noted that even state advisers could be affected because states tend to incorporate Commission rules. NASAA anticipated that, if adopted, the proposed rules would assist state regulators in achieving regulatory uniformity. FPA recommended that the Commission staff consult with states that have implemented NASAA's model compliance rules.

⁶⁹ AFL-CIO, Deloitte, NASAA, Schwab.

I. Effective Date

Three commenters recommended delaying the effective date of the proposed rules for at least one year following their adoption.⁷⁰ Two of these commenters (ICI and Prudential) explained that firms, in the process of implementing recent regulatory changes, would need time to review their compliance programs and make any necessary systematic changes. Another commenter, Deloitte, recommended delaying the initial recordkeeping compliance date for one year after the effective date of the rules.

J. Request for Comment on Further Private Sector Involvement

Along with proposing the rule changes described above, the Commission solicited comment about additional possible ways of involving the private sector in enhancing compliance with the federal securities laws. The Proposing Release briefly described four possible approaches, which are discussed below, and encouraged commenters to address these and any approaches. With limited exception, commenters opposed the private sector approaches.

Commenters cited a number of reasons for their opposition to the private sector initiatives, including: (i) the Commission's successful history of directly regulating and inspecting funds and advisers,⁷¹ (ii) the absence of any evidence of widespread compliance problems in the investment management industry to justify such changes,⁷² (iii) the decrease in the number of federally registered advisers brought about by the National Securities Markets

⁷⁰ Fidelity, ICI, Prudential.

⁷¹ Fidelity, NAPFA, Schwab, T. Rowe Price, Vanguard, Weil. CII also argued that the Commission, not the private sector, is charged with protecting investors.

⁷² American Century Directors, Fidelity, FPA, ICI, NSCP, Pickard & Djinis (noting that investment advisers are already under legal and regulatory constraints to act on behalf of their clients), Schwab, Vanguard.

Improvement Act of 1996,⁷³ (iv) the expected enhancements to disclosure and transparency once anticipated amendments to Form ADV are adopted,⁷⁴ (v) the expected costs to funds and advisers of the private sector initiatives,⁷⁵ and (vi) the lack of qualified compliance experts to put the private sector initiatives into practice.⁷⁶

Commenters urged the Commission, at a minimum, to suspend further consideration of any of the private sector initiatives until it had an opportunity to assess the effect on fund and adviser compliance of the recent infusion of funding to the Commission,⁷⁷ the recent changes to the Commission's examination program,⁷⁸ and the proposed compliance rules after adoption.⁷⁹ In addition, ICAA urged the Commission to remove the SRO option from consideration and, questioning whether the benefits of any of the other three private sector initiatives would outweigh their costs, recommended further study before proceeding with any of these initiatives.

There was, however, qualified support for a fidelity bond requirement. Additionally, several commenters suggested alternate approaches to achieving enhanced private sector participation in compliance.⁸⁰ Among these commenters was the CFP Board, which suggested

⁷³ NSCP, Pickard & Djinis.

⁷⁴ FPA.

⁷⁵ ICI, NSCP, Pickard & Djinis.

⁷⁶ Vanguard.

⁷⁷ American Century Directors, CII, ICI, Pickard & Djinis, Prudential, Schwab, Vanguard. In addition, seven commenters recommended, in lieu of the private sector initiatives, full funding to enable the Commission to continue its historically effective oversight role. AFL-CIO, American Century Directors, CII, Capital Research, Mortensen, NAPFA (also recommending enhanced disclosure about conflicts of interest), Schwab.

⁷⁸ American Century Directors, ICI, NSCP, Vanguard.

⁷⁹ American Century Directors, CII, ICI, Prudential, Schwab, T. Rowe Price, Vanguard.

⁸⁰ Bauer suggested that the Commission could (i) require fund advisers to be audited, (ii) prohibit loans to executive officers and directors of advisers, and (iii) create a forum to facilitate communication between the Commission and firms, especially smaller firms. Mulligan and Sterling observed that the Commission could enhance compliance by expanding the safe harbor

that its certification and disciplinary process could serve as tools in the Commission's enforcement program.

1. Third Party Compliance Reviews

The Proposing Release asked whether all funds and advisers should undergo mandatory, periodic compliance reviews by a third party. Fifteen commenters opposed making third-party reviews mandatory for all funds and advisers.⁸¹ Ten of these commenters objected to the expense of such a requirement.⁸² American Century Directors and Schwab stated that hiring a third party to conduct a compliance review should be at the discretion of the fund's board of directors. Six commenters questioned how the Commission would ensure that the third party reviews were consistent in quality and scope.⁸³ Three commenters suggested that some firms should be exempted from a third party review requirement.⁸⁴

in section 28(e) to encompass the use of soft dollars for compliance expenditures.

⁸¹ Brown (recommending instead that the Commission scale back its examinations of firms that voluntarily undergo such reviews), Capital Research, Deloitte, Empire, Financial Engines, FPA, ICI, ICAA (recommending that before considering this option, the Commission should study the effectiveness of third party reviews that it has required as part of the settlement of enforcement actions), Meyer, NAIFA, NAVA (expressing particular concern about the potentially broad scope of third party reviews of insurance separate account), NSCP, Pickard & Djinis, SIA, T. Rowe Price.

⁸² Deloitte, Empire, Financial Engines (arguing that requiring third party audits would raise the price of an already expensive service), ICAA (estimating that a third party review would cost between \$5,000 and \$100,000 and arguing that a firm's internal staff may be better suited than a third party to carry out a compliance review), NAIFA, NAVA, Pickard & Djinis (arguing that the requirement would be prohibitively costly for small advisers), NSCP, SIA, T. Rowe Price.

⁸³ FPA (also underscoring the need for third party experts to be independent), ICI, Pickard & Djinis, SIA, Schwab, Vanguard.

⁸⁴ Deloitte and Empire recommended an exemption for advisers without discretionary authority over or custody of fund assets. FPA recommended limiting mandatory compliance reviews to advisers determined to be high risk. In addition, NASAA recommended that any third party review requirement should take into account the special circumstances of small advisers.

Four commenters favored such reviews.⁸⁵ Commenters explained that third party compliance reviews could provide much needed compliance guidance to firms lacking adequate internal compliance expertise.⁸⁶ NASAA recommended that, if the requirement were adopted, the third party compliance reviewer should provide a summary of the results of its review to the Commission.⁸⁷ T. Rowe Price argued against requiring information from third-party reviews to be provided to the Commission.

2. Expanded Audit Requirement

The Proposing Release asked for comment on whether the Commission should require independent public accountants who audit fund financial statements to also examine fund compliance controls. Nine commenters opposed expanding the role of fund accountants in this manner.⁸⁸ These commenters argued that auditors would be hampered by lack of qualifications,⁸⁹ and that such an approach would expand auditors' involvement in non-audit services⁹⁰ and create conflicts of interest.⁹¹ Three of these commenters, including ICI, also argued that this approach

⁸⁵ Anonymous, Bauer, Buerger, NASAA (supporting requirement as *supplement* to Commission reviews, but expressing concerns about the costs of such a requirement).

⁸⁶ Anonymous (positing that such reviews would be particularly beneficial for small firms without large internal compliance staffs); Bauer (favoring a requirement that each fund and adviser submit to a third party review prior to start-up and then periodically thereafter with waivers for new funds that are part of a fund complex and for existing firms that conduct an annual, comprehensive internal control review).

⁸⁷ NASAA urged the Commission to consider, however, whether the information submitted would be available to the public through the Freedom of Information Act.

⁸⁸ Anonymous (favoring, however, inclusion in annual audit of review of controls to derive NAV and balance sheet), CII, Financial Engines, ICI, NSCP, Schwab, T. Rowe Price, Vanguard, Windward.

⁸⁹ CII, ICI, Schwab, Vanguard.

⁹⁰ NSCP, Schwab, T. Rowe Price, Vanguard.

⁹¹ NSCP, Windward.

would be too expensive.⁹² ICAA suggested deferring consideration of expanded audits until the completion of the Commission's accounting reforms. One commenter, Buerger, supported this proposal as a supplement to Commission oversight.

3. Self-Regulatory Organization

The third possible private sector approach discussed in the Proposing Release was the formation of one or more self-regulatory organizations (SROs) for funds and/or advisers. All but four commenters who addressed this proposed approach strongly opposed it.⁹³ These commenters questioned the Commission's authority to establish an SRO,⁹⁴ contended that forming an SRO would add an unnecessary and potentially incompatible regulatory layer,⁹⁵ and anticipated that forming and operating an SRO would be extremely costly (and that firms, and ultimately investors, would have to bear the cost).⁹⁶ They also predicted that any SRO would be characterized by problematic conflicts of interest,⁹⁷ and argued that wide variations across funds

⁹² Financial Engines, ICI, Windward.

⁹³ Armstrong, Beach, CII, Capital Research, Dare Capital, Deloitte (arguing that the formation of an SRO could undermine investor confidence), FPA (opposing SRO, but supporting consideration of formation of professional regulatory organization for financial planners), Gillmo, ICI, ICAA, Kranick, Meyer (arguing that an SRO would act as a barrier to entry for advisers and would stifle innovation without an offsetting effect on investor protection), Mortensen, NAPFA, NSCP, NASAA, Pickard & Djinis, Schwab, Shawbrook, SIA, T. Rowe Price, Vanguard, Weil. Two commenters (FPA and Pickard & Djinis) noted that even organizations that had once favored the formation of an SRO have since withdrawn their support for the idea. In addition, NAVA opposed the formation of an SRO that would govern insurance separate accounts, which already are subject to oversight by the NASD.

⁹⁴ ICAA, Pickard & Djinis, T. Rowe Price.

⁹⁵ Capital Research, Deloitte, ICI, NAPFA, NSCP, NASAA, Pickard & Djinis, Schwab, SIA (noting that existing SROs already regulate funds indirectly), Vanguard. Three of these commenters argued that the Commission has demonstrated that it does not need to rely on an SRO to carry out its oversight of funds and advisers. ICI, NAPFA, SIA. In addition, Mortensen and Kranick favored strengthening Commission oversight rather than creating an SRO.

⁹⁶ ICAA, NAPFA, Pickard & Djinis, Schwab, T. Rowe Price, Vanguard.

⁹⁷ AFL-CIO, CII, Gillmo, Kranick, T. Rowe Price.

and advisers precludes the formation of an SRO.⁹⁸

Commenters recommended that, if the Commission establishes an SRO, it should make accommodations for small firms,⁹⁹ advisers without discretionary authority over, or custody of, client assets,¹⁰⁰ and financial planners.¹⁰¹

Four commenters supported the formation of one or more SROs.¹⁰² Windward and an anonymous commenter favored shifting the routine examination burden from the Commission to an SRO so that the Commission could focus on more important matters.¹⁰³ Empire supported the formation of an SRO, but recommended that an SRO's role should be limited initially to offering guidance to firms, and the SRO should not yet be charged with conducting examinations. FPA opposed the creation of an SRO for investment advisers generally, but supported studying the costs and benefits of a voluntary professional regulatory organization to develop ethical and practice guidelines for financial planners.

The Proposing Release did not suggest giving regulatory authority over funds or advisers to an *existing* SRO, but a number of commenters addressed this possibility. Three commenters

⁹⁸ ICAA, Schwab.

⁹⁹ Bauer.

¹⁰⁰ Deloitte.

¹⁰¹ Beach, Dare Capital.

¹⁰² Anonymous, Buerger, Empire, Windward (recommending the formation of an adviser-funded SRO to review advisers). A fifth commenter, Financial Engines, stated that an SRO may merit further study.

¹⁰³ Specifically, Windward recommended the creation of an SRO, funded by a fee levied on all advisers, to conduct routine examinations of advisers. The anonymous commenter, pointing to the fact that all other financial services firms are regulated by SROs, noted that an SRO for funds and advisers could conduct routine examinations, which would enable the Commission to focus on more complex issues. Buerger likewise advocated the formation of an SRO for funds as a way to spread the Commission's examination burden.

identified the CFP Board of Standards as a possible SRO.¹⁰⁴ Six commenters recommended against engaging the NASD to serve as an SRO for advisers.¹⁰⁵ Two commenters, including ICAA, recommended more generally against relying on *any* existing SRO.¹⁰⁶

4. Fidelity Bonding Requirement for Advisers

Finally, the Proposing Release asked for comment on whether to require investment advisers to obtain a fidelity bond. Six commenters supported such a requirement.¹⁰⁷ Two additional commenters, Capital Research and ICI, explained that a fidelity bond requirement would serve largely to codify existing practice.¹⁰⁸ Nine questioned whether the requirement would serve any real need.¹⁰⁹ Six commenters urged the Commission to apply the requirement

¹⁰⁴ Beach, Dare Capital, Weil. As noted above, CFP Board also pointed to the assistance that it could offer to the Commission through its certification of personal financial planners.

¹⁰⁵ Armstrong, Beach, Buerger, Dare Capital, ICAA, NAPFA.

¹⁰⁶ ICAA, Windward.

¹⁰⁷ Anonymous, Deloitte, Empire, NAPFA (supporting fidelity bonding requirement with exemption for advisers without custody of client assets), NASAA (recommending adoption of rule, similar to NASAA's model rule, requiring minimum capital and bonding for advisers with custody of or discretionary authority over client assets), SIA (noting that advisers that are dual registrants or affiliates of broker-dealers are already covered by bonds), Vanguard (supporting fidelity bond to protect investors from fraudulent and criminal acts).

¹⁰⁸ Four commenters addressed the interaction between a fidelity bond requirement and existing requirements under ERISA, the Internal Revenue Code, and rule 17g-1 under the Investment Company Act. ICAA (noting that advisers would have to purchase a bond in addition to the ERISA bonds they already have), ICI (noting that many advisory personnel already are covered by bonds under section 17(g) of the Investment Company Act and recommending that any fidelity bond requirement not increase the minimum coverage required by rule 17g-1), Loring Wolcott (recommending against patterning a fidelity bond requirement on ERISA or Internal Revenue Code bonding rules and favoring instead the state model), Schwab (favoring consistency with ERISA and rule 17g-1 requirements).

¹⁰⁹ Bauer, Beach, Dare Capital, ICAA, NAIFA, NSCP, Pickard & Djinis (arguing that bonding companies do not provide a level of oversight that would justify the cost to advisers), Schwab, Weil. Bauer recommended, as an alternative to a fidelity bond requirement, minimum net capital requirements for investment advisers along with certain insurance requirements. FPA and Loring Wolcott, however, contended that a minimum net capital requirement would be prohibitively costly without a commensurate benefit to investors.

only to advisers that have custody of client assets.¹¹⁰ Six commenters expressed concern about the costs of fidelity bonds.¹¹¹ NAPFA estimated an annual cost of only \$500 to \$800 for small advisers. Two commenters (NAIFA and Financial Engines) expressed concern about potential anti-competitive effects of a fidelity bond requirement.¹¹²

¹¹⁰ Deloitte, FPA (also supporting requirement for advisers with an enforcement history), Shawbrook, NAPFA (suggesting modified version of the requirement for advisers with discretionary authority), NASAA (noting that state requirements generally apply only to advisers with custody or discretionary authority over client assets), T. Rowe Price.

¹¹¹ Beach, Dare Capital, Financial Engines (arguing that a fidelity bond requirement would increase the price of an already scarce service), FPA, T. Rowe Price, Weil (estimating its own annual cost would be \$20,000 to \$25,000).

¹¹² Financial Engines objected that the issuers of fidelity bonds are competitors of investment advisers. NAIFA contended that the requirement could serve as a barrier to entry in the advisory field without affording investors any additional protection.