

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

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

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

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

Investment Companies (Oct. 30, 2002) (transcript available at: <http://www.sec.gov/news/speech/spch597.htm>) ("[E]xaminers will ask about your compliance and control policies and procedures, and evaluate their implementation and effectiveness. If we can conclude that your controls are working effectively, we will adjust the depth and amount of test-checking we do to reflect that fact. If we find weaknesses in controls, however, our test-checking will be greater, inasmuch as the likelihood of violations will be greater."). See also H.R. Rep. No. 104-622 (1996) ("[T]he goal of examinations effected by the Commission staff should not be simply to duplicate the role played by a fund's internal compliance staff. If a fund has a well-functioning system of internal controls, the Commission's limited resources could be directed to other areas of fund operations, or to other funds.").

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

¹⁴ See, e.g., Millennium Capital Advisors, Investment Advisers Act Release No. 2092 (Dec. 13, 2002) (unauthorized trading in client account and concealment of this trading were facilitated by adviser's vague and insufficient compliance procedures and absence of independent monitoring of portfolio manager); Gintel Asset Management, Investment Advisers Act Release No. 2079 (Nov. 8, 2002) (repeated improper cross trades, principal transactions, and personal trading resulted in part from inadequate procedures to prevent violation of the adviser's code of ethics); Back Bay Advisors, Investment Advisers Act Release No. 2070 (Oct. 25, 2002) (excessive reliance on self-reporting and self-monitoring by portfolio managers to determine whether the firm was in compliance with the federal securities laws resulted in improper cross-trades); Western Asset Management, Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (subadviser had not established adequate procedures to detect portfolio manager's fraudulent activities with respect to the purchase and pricing of private placement securities); Scudder Kemper

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

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

II. Discussion

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

Investments, Investment Advisers Act Release No. 1848 (Dec. 22, 1999) (adviser did not have in place procedures that could have prevented and detected trader's unauthorized trading for investment company accounts); Rhumblin Advisors, Investment Advisers Act Release No. 1765 (Sept. 29, 1998) (absence of procedures enabled chief investment officer to engage in unauthorized trading and to misrepresent resultant losses); Kemper Financial Services, Investment Advisers Act Release No. 1494 (June 6, 1995) (adviser had no guidelines or procedures in place to address conflicts of interest and funds' portfolio manager misappropriated funds' investment opportunity on behalf of private profit-sharing plan he also managed).

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

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

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

¹² See Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations, The Evolution of the SEC's Inspection Program for Advisers and Funds: Keeping Apace of a Changing Industry, Remarks at Conference on Compliance and Inspection Issues for Investment Advisers and