

implement internal compliance programs containing elements described in the rules.<sup>17</sup>

- We request comment on whether we should provide for one or more exceptions. Is there a subset of funds or investment advisers with operations so limited or staffs so small that the adoption of an internal compliance program would not be beneficial? If so, are there alternative measures that these funds and advisers could take to promote their compliance with the federal securities laws?

#### *A. Adoption and Implementation of Policies and Procedures*

The Proposed Rules would require funds and advisers to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws.<sup>18</sup> They must be written and, in the case of a fund, must be approved by the fund's board of directors, including a majority of the fund's independent directors.<sup>19</sup> A fund's policies and procedures must be designed to prevent violation of the federal securities laws by the fund, its investment adviser, principal underwriter, and administrator in connection with their provision of services to the fund.<sup>20</sup> An adviser's policies and procedures must be designed to prevent violation of the Advisers Act by the adviser and its supervised persons.<sup>21</sup>

<sup>17</sup> The rules also would require business development companies, which are unregistered closed-end investment companies, to adopt and implement such programs.

<sup>18</sup> Proposed rules 38a-1(a)(1) and 206(4)-7(a). Under proposed rule 206(4)-7(a), the policies and procedures would need to address only compliance with the Advisers Act.

<sup>19</sup> Proposed rule 38a-1(a)(2). Fund directors are commonly referred to as "independent directors" if they are not "interested persons" of the fund. The term "interested person" is defined in section 2(a)(19) of the Investment Company Act [15 U.S.C. 80a-2(a)(19)]. If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the policies and procedures. Proposed rule 38a-1(b).

<sup>20</sup> The ICI, in its submission to us suggesting a similar rulemaking, favored requiring the policies and procedures to cover the fund, but not the fund's service providers, such as its adviser. See ICI Proposal, *supra* note 15, at 20. Typically, however, a fund has no employees; personnel of its adviser, principal underwriter and/or administrator conduct all of its activities. It is unclear to us whether the ICI's proposal, limited in this manner, would require a fund to adopt sufficiently comprehensive policies and procedures. Therefore, proposed rule 38a-1 would require a fund's procedures to cover the fund's adviser, principal underwriter and administrator, but only with respect to their activities in connection with the operations of the fund.

<sup>21</sup> A "supervised person" is "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment

The Proposed Rules would require funds and advisers to adopt a system of controls that promotes compliance with the securities laws. Internal control systems have long been used to assure the integrity of financial reporting. Congress recently recognized the importance of internal control systems in the Sarbanes-Oxley Act of 2002, which effectively requires public companies to adopt and periodically review the effectiveness of a system of internal controls.<sup>22</sup> Broker-dealers have long been required to adopt compliance procedures.<sup>23</sup> Banks are required to maintain internal controls that include

adviser and is subject to the supervision and control of the investment adviser." Section 202(a)(25) of the Advisers Act [15 U.S.C. 80b-2(a)(25)].

<sup>22</sup> See Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, 116 Stat. 745 (2002)] ("Sarbanes-Oxley Act"). Section 404 of the Sarbanes-Oxley Act requires us to prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78m(a) and 78o(d)] to include internal control reports containing an assessment of the effectiveness of those controls, and further requires that the auditors for an issuer attest to the assessment made by the management of the issuer. In October 2002, we proposed rules to implement the provisions of Section 404. Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Investment Company Act Release No. 25775 (Oct. 22, 2002) [67 FR 66208 (Oct. 30, 2002)]. Section 302 of the Sarbanes-Oxley Act required us to adopt rules under which the principal executives and financial officers of public issuers must certify the information contained in the issuer's quarterly and annual reports. These rules also were to require these officers to certify that: they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. On August 29, 2002, we adopted rules implementing Section 302. Certification of Disclosure in Companies' Quarterly and Annual Reports, Investment Company Act Release No. 25722 (Aug. 29, 2002) [67 FR 57276 (Sept. 9, 2002)].

<sup>23</sup> Broker-dealers are required by the National Association of Securities Dealers ("NASD") to establish and maintain written procedures "that are reasonably designed to achieve compliance with applicable securities laws and regulations, and the applicable Rules of [the NASD]." NASD Conduct Rule 3010(b). See also New York Stock Exchange ("NYSE") Rule 342. Both the NASD and the NYSE recently have proposed to enhance these procedures by, among other things, requiring the annual testing and verification of broker-dealers' internal controls by persons independent of the supervision of the underlying activities. NASD Rulemaking: Supervisory Control Amendments, Exchange Act Release No. 46859 (Nov. 20, 2002) [67 FR 70990 (Nov. 27, 2002)] and NYSE Rulemaking: Amendments to Exchange Rule 342 ("Offices—Approval, Supervision and Control") and its Interpretation, Rule 401 ("Business Conduct"), Rule 408 ("Discretionary Power in Customers' Accounts"), and Rule 410 ("Records of Orders"), Exchange Act Release No. 46858 (Nov. 20, 2002) [67 FR 70994 (Nov. 27, 2002)].

compliance procedures.<sup>24</sup> Several foreign regulators already require funds or advisers registered with them to adopt compliance policies and procedures.<sup>25</sup> The Proposed Rules do not enumerate specific elements that funds and advisers must include in their required policies and procedures.<sup>26</sup> Funds and advisers are too varied in their operations for the Commission to impose a single list of required elements. The policies and procedures required by the Proposed Rules should take into consideration the nature of each organization's operations.<sup>27</sup> They should be designed to *prevent* violations

<sup>24</sup> Under section 39 of the Federal Deposit Insurance Act [12 U.S.C. 1831p-1], banks and thrifts are required by their regulators (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, "Banking Regulators")) to adopt internal controls that are "appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for: (1) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies; (2) effective risk assessment; (3) timely and accurate financial, operational and regulatory reports; (4) adequate procedures to safeguard and manage assets; and (5) compliance with applicable laws and regulations." Standards for Safety and Soundness, 60 FR 35674 (July 10, 1995) ("Interagency Guidelines"), codified at 12 CFR part 30 (Office of the Comptroller of the Currency), 12 CFR part 208, appendix D-1 and part 263, subpart I (Board of Governors of the Federal Reserve System), 12 CFR part 364 (Federal Deposit Insurance Corporation), and 12 CFR part 570 (Office of Thrift Supervision).

<sup>25</sup> See, e.g., Financial Services Authority (FSA), FSA Handbook of Rules and Guidance, Systems and Controls § 3.2.6 ("Areas covered by systems and controls: Compliance") (United Kingdom); Commission des Opérations de Bourse, L'Instruction du 15 Decembre 1998 Relative aux [Organisme de Placement Collective en Valeurs Mobilières] Prise en Application du Reglement, L'Annexe IV No. 89-02, Bulletin Mensuel COB 369 (June 2002) (France); Securities and Futures Commission, Fund Manager Code of Conduct § 1.6.3 (1997) (Hong Kong).

<sup>26</sup> The required policies and procedures should incorporate the policies and procedures funds have adopted pursuant to other requirements in the federal securities laws, a number of which we identify in succeeding notes. These policies and procedures need not be contained in the same document.

<sup>27</sup> The NASD directs its broker-dealer members to "implement a supervisory system that is tailored specifically to the member's business." See NASD Notice to Members 99-45, at 294 (June 1999). The Banking Regulators have taken a similar approach with respect to compliance programs for banks and thrifts. See Interagency Guidelines, *supra* note 24, at 35676. See also Office of Comptroller of the Currency, *Comptroller's Handbook: Compliance Management System (Consumer Compliance Examination)*, at 2 (Aug. 1996); Federal Deposit Insurance Corporation, *Compliance Examination Manual*, at B-2 (July 1999); Board of Governors of the Federal Reserve System, *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations* § 5000.1 (Compliance), at 1 (Sept. 1997); Office of Thrift Supervision, *Compliance Self-Assessment Guide: Components of an Effective Compliance Program*, at 2 (Dec. 2002).