

Moreover, even if we are able to substantially expand our examination staff, it is unlikely that future growth in our resources will ever keep pace with future growth of investment advisers and investment companies. We therefore are exploring ways in which we may make the best use of limited government resources to protect the interests of the millions of investors who invest in funds, participate in pension funds managed by investment advisers, or use the services of a personal financial planner or money manager.

One promising way of leveraging government resources would be for the Commission to rely more heavily on the private sector, *i.e.*, on the advisers and funds that are the indirect beneficiaries of our compliance program and the federal tax dollars that today support our regulatory efforts. The rules we are proposing today are one step in this direction. Others may also be appropriate to consider, including those we describe briefly below. We invite interested persons to submit comments as to the advisability of pursuing any or all of them, as well as other approaches for involving the private sector in enhancing compliance with the federal securities laws. We request that commenters address the Commission's authority to effect through rulemaking each of the approaches.

### 1. Compliance Reviews

One approach might be to require each fund and adviser to undergo periodic compliance reviews by a third party that would produce a report of its findings and recommendations. Our examination staff could use these reports to identify quickly areas that required attention, permitting us to allocate examination resources better and, as a result, to increase the frequency with which our staff could examine funds and advisers. Funds and advisers with reports indicating that they have effective compliance programs could be examined less frequently, which would reduce the burdens on them of undergoing more frequent examination by our staff.

There are many organizations that provide compliance reviews, including "mock audits" for investment advisers and funds, and have personnel that have experience in designing, implementing, and assessing the effectiveness of

compliance programs.<sup>56</sup> As a condition to the settlement of an enforcement action, we frequently require an adviser or fund to engage a compliance consultant.<sup>57</sup> The USA PATRIOT Act requires financial institutions (including mutual funds), as part of their anti-money laundering programs, to have an independent audit function to test their programs.<sup>58</sup>

We request comment on the advantages and disadvantages of requiring advisers and funds to undergo compliance reviews. If we adopt such a requirement, should we exclude certain types of funds or advisers? Would the cost of these reviews be prohibitive for smaller advisers? Would some fund groups or advisers hire the least expensive compliance consultant regardless of the quality of the consultant's work? If so, how could we ensure that a high quality compliance review is conducted? If we adopt such a requirement, should we require the third parties who conduct such reviews to satisfy certain minimum standards for education and experience? What criteria should be included in the rule to determine whether a third party compliance expert is independent? How frequently should we require such reviews to be conducted? What is the proper scope for third party reviews? Should we require the third party consultant to file its report with us? If so, what should the scope of the report be?

### 2. Expanded Audit Requirement

Another approach might be to expand the role of independent public accountants that audit fund financial statements to include an examination of fund compliance controls. Such an approach would involve the performance by fund auditors of certain of the compliance review procedures

<sup>56</sup> See, e.g., Jeremy Kahn, *Practice Audits Pay Off*, *Fortune*, June 24, 2002, at 40 (discussing mock audits of investment advisers); Nancy Opiela, "They're Here \* \* \*," 15 *Journal of Financial Planning* 52 (2002) (discussing use of mock auditors by financial planners preparing for audits by our staff).

<sup>57</sup> See, e.g., Gintel Asset Management, Investment Advisers Act Release No. 2079 (Nov. 8, 2002); Performance Analytics, Investment Advisers Act Release No. 2036 (June 17, 2002); ND Money Management, Investment Advisers Act Release No. 2027 (Apr. 12, 2002); Stan D. Kiefer & Associates, Investment Advisers Act Release No. 2023 (Mar. 22, 2002).

<sup>58</sup> Section 352 of the USA PATRIOT Act, *supra* note 44. See also 31 CFR 103.130(c)(2) (requiring mutual funds, as a part of their written anti-money laundering programs, to provide for "independent testing for compliance to be conducted by the mutual fund's personnel or by a qualified outside party").

currently performed by our staff in a compliance examination.<sup>59</sup>

Our rules today require fund auditors to submit internal control reports to fund boards.<sup>60</sup> In these reports, the auditor must identify any material weaknesses in the accounting system, the system of internal accounting controls, and the procedures for safeguarding securities of which they become aware while planning and performing the audit on the fund's financial statements.<sup>61</sup> The auditor's responsibilities could be augmented to require the identification of material weaknesses in the internal controls or a report on other aspects of the internal controls that are not required to be reviewed in planning and performing an audit of the financial statements. Expanding the auditor's responsibilities could, to some extent, serve as a substitute for staff examination or reduce the frequency of staff examination of funds with strong internal compliance programs, which would free Commission resources to focus on other areas of fund operations and permit us to examine funds with weaker internal compliance programs more often.

We request comment on this approach. Should we expand the responsibilities of the fund auditor? If so, what specific areas would it be appropriate for auditors to review? What type of assurance report should be provided?<sup>62</sup>

### 3. Self-Regulatory Organization

The formation of one or more self-regulatory organizations (SROs) for funds and/or advisers also would be a means to involve the private sector in support of our regulatory program. An SRO would function in a manner analogous to the national securities exchanges and registered securities associations under the Securities Exchange Act of 1934 by (i) establishing business practice rules and ethical standards, (ii) conducting routine examinations, (iii) requiring minimum education or experience standards, and (iv) bringing its own actions to

<sup>59</sup> We first raised this idea in a concept release we issued in 1983. Concept of Utilizing Private Entities in Investment Company Examinations and Imposing Examination Fees, Investment Company Act Release No. 13044 (Feb. 23, 1983) [48 FR 8485 (Mar. 1, 1983)].

<sup>60</sup> Rule 30a-1 [17 CFR 270.30a-1]; Item 77B of Form N-SAR [17 CFR 249.330; 17 CFR 274.101].

<sup>61</sup> Item 77B, *supra*, note 60.

<sup>62</sup> See, e.g., American Institute of Certified Public Accountants (AICPA), Statement on Auditing Standards No. 70 Service Auditor's Report; AICPA, Statement on Standards for Attestation Engagements, AT § 500.54-61 ("Compliance Attestation Reporting").

consideration of certain enumerated criteria, to review the disclosures, including the financial statements made by issuers reporting under the Securities Exchange Act of 1934, at least once every three years.