

higher amounts to compensate the insurance company for assuming greater risk.

Investment advisers are among the only financial service providers handling client assets that are not required to obtain fidelity bonds.⁷⁴ The Advisers Act does not require advisory firms to have a minimum amount of capital invested, and many have few assets.⁷⁵ When we discover a serious fraud by an adviser, often the assets of the adviser are insufficient to compensate clients. The losses are borne by clients who may lose their life's savings, or be unable to afford a college education for their children or a comfortable retirement.

Should advisers be required to obtain a fidelity bond from a reputable insurance company? If so, should some advisers be excluded?⁷⁶ Alternatively, should advisers be required to maintain a certain amount of capital that could be the source of compensation for

clients?⁷⁷ What amount of capital would be adequate?⁷⁸

III. General Request for Comment

The Commission requests comment on the Proposed Rules, suggestions for additions to the Proposed Rules, and comment on other matters that might have an effect on the proposals contained in this release. We note that the comments that are of greatest assistance are those that are accompanied by supporting data and analysis of the issues addressed in those comments.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The Proposed Rules would require each fund and adviser to adopt and implement policies and procedures reasonably designed to prevent violations of the securities laws, to review these annually, and to designate an individual as chief compliance officer. We have identified certain costs and benefits, which are discussed below, that may result from the proposals. We request comment on the costs and benefits of the Proposed Rules. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

A. Benefits

We anticipate that fund investors, advisory clients, funds, and advisers will benefit from the Proposed Rules. The Proposed Rules would benefit fund investors and advisory clients (collectively, "investors") by requiring funds and advisers to design and implement a comprehensive internal compliance program. Although many funds and advisers already have such programs in place, the Proposed Rules would make this standard practice for all firms. Investors would be less likely

to be harmed by violations of the securities laws because experience has shown that strong internal compliance programs lower the likelihood of securities laws violations occurring and enhance the likelihood that any violations that do occur will be detected and corrected. In addition, because the Proposed Rules are designed to complement the Commission's examination program, the Commission's ability to protect investors would be enhanced. The existence of a structured compliance program, together with the designation of a chief compliance officer to serve as a point of contact, would facilitate the examination staff's efforts to conduct each examination in an organized and efficient manner and thus to allocate resources to maximize investor protection.

Although the Proposed Rules would impose additional compliance costs on many funds and advisers, they would benefit funds and advisers by diminishing the likelihood of securities violations, Commission enforcement actions, and private litigation. For a fund or adviser, the potential costs associated with a securities law violation may consist of much more than merely the fines or other penalties levied by the Commission or civil liability. Advisers may be denied eligibility to advise funds.⁷⁹ In addition, advisers could be precluded from serving in other capacities.⁸⁰ The reputation of a fund or adviser may be significantly tarnished, resulting in redemptions (in the case of an open-end fund) or lost clients.

B. Costs

The Proposed Rules would result in some additional costs for funds and advisers, which, in the case of funds, we expect would be passed on to investors. However, since all funds and most advisers currently have some written compliance policies and procedures in place, the costs in many instances already are reflected in the fees investors currently pay. Funds and larger advisory firms typically have adopted and implemented comprehensive, written policies and

⁷⁴ Fidelity bonds are required to be obtained by: broker-dealers (NASD Conduct Rule 3020; NYSE Rule 319; American Stock Exchange Rule 330); transfer agents (NYSE Listed Company Manual § 906.01); investment companies (17 CFR 270.17g-1); national banks (12 CFR 7.2013); and federal savings associations (12 CFR 563.190). Section 412 of the Employee Retirement Income Security Act (ERISA) [29 U.S.C. 1112] requires investment advisers to obtain a fidelity bond with respect to any employee benefit plan assets the adviser manages, and many state laws require state-registered advisers to obtain fidelity bonds. *See, e.g.,* Ala. Admin. Code r. 830-x-3-.06(4) (2002) (requiring \$50,000 bond for advisers that have custody of or discretionary authority over customer assets); Mass. Regs. Code tit. 950, § 12.205(5)(b) (2002) (requiring \$10,000 bond for advisers that have custody of or discretionary authority over client assets or receive prepayments); Minn. R. 2875.1930, Subpart 1 (2002) (requiring \$25,000 bond for advisers that have custody of or discretionary authority over client assets); N.J. Admin. Code tit. 13, § 47.A-2.2 (2002) (requiring \$25,000 bond or \$25,000 minimum capital for advisers that have custody of client assets); 21 Va. Admin. Code 5-80-180(B) (requiring \$25,000 bond or \$25,000 minimum capital for advisers). Similarly, independent financial advisers registered with the FSA in the United Kingdom must maintain professional indemnity insurance. Prudential Rules for Independent Financial Advisers § 13.13R (Nov. 2001).

⁷⁵ In 1992, both the Senate and House of Representatives passed bills that would have given us authority to require advisers to obtain fidelity bonds. S. 2266, § 5, 102nd Cong. (1992), and H.R. 5726, § 107, 102nd Cong. (1992). Because differences in the two bills were never reconciled, neither became law.

⁷⁶ The 1992 legislation would have given us authority to require bonding of advisers that have custody of client assets or that have discretionary authority over client assets. Section 412 of ERISA requires plan fiduciaries to obtain a bond with respect to plan assets "handled" by the plan fiduciary. Department of Labor rules clarify that handling plan assets includes having discretionary authority over them. 29 CFR 2580.412-6.

⁷⁷ In 1973, a Commission advisory committee recommended that Congress authorize us to adopt minimum financial responsibility requirements for investment advisers, including minimum capital requirements. Advisory Committee on Investment Management Services for Individual Investors, *Small Account Investment Management Services: Recommendations for Clearer Guidelines and Policies* 64-66 (Jan. 1973). Three years later, in 1976, the Senate Committee on Banking, Housing, and Urban Affairs reported a bill that, among other things, authorized the Commission to adopt rules requiring advisers (i) with discretionary authority over client assets, (ii) with access to client funds or securities, or (iii) that advise registered investment companies, to meet financial responsibility standards. S. Rep. No. 94-910, at 14-15 (1976) (reporting favorably S. 2849). S. 2849 was never enacted.

⁷⁸ Section 412 of ERISA requires that the bond required under that section be no less than 10% of the amount of funds handled.

⁷⁹ Section 9(a) of the Investment Company Act [15 U.S.C. 80a-9(a)] prohibits a person from serving as an adviser to a fund if, within the past 10 years, the person has been convicted of certain crimes or is subject to an order, judgment, or decree of a court prohibiting the person from serving in certain capacities with a fund, or prohibiting the person from engaging in certain conduct or practice.

⁸⁰ *See, e.g.,* 29 U.S.C. 1111(a) (prohibiting a person from acting in various capacities for an employee benefit plan, if within the past 13 years, the person has been convicted of, or has been imprisoned as a result of, any crime described in section 9(a)(1) of the Investment Company Act [15 U.S.C. 80a-9(a)(1)]).