

parties to segregate orders received by time of receipt in order to prevent "late trading" based on a previously determined price. Reliance on those contractual provisions alone would be insufficient to meet the requirements of the new rule.<sup>51</sup> Funds should not only approve and periodically review the policies and procedures of transfer agents, as required by the rule, but should also take affirmative steps to protect themselves and their shareholders against late trading by obtaining assurances that those policies and procedures are effectively administered.<sup>52</sup>

• *Identification of Affiliated Persons.*

To prevent self-dealing and overreaching by persons in a position to take advantage of the fund, the Investment Company Act prohibits funds from entering into certain transactions with affiliated persons.<sup>53</sup> Funds should have policies and procedures in place to identify these persons and to prevent unlawful transactions with them.

• *Protection of Nonpublic Information.* The federal securities laws

prohibit insider trading, and section 204A of the Advisers Act requires advisers (including advisers to funds) to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the adviser or any of its associated persons from misusing material, nonpublic information. Fund advisers should incorporate their section 204A policies into the policies required by rule 38a-1. These policies typically include prohibitions against trading portfolio securities on the basis of information acquired by analysts or portfolio managers employed by the investment adviser. A fund's compliance policies and procedures should also address other potential misuses of nonpublic information, including the disclosure to third parties of material information about the fund's portfolio,<sup>54</sup> its trading strategies,<sup>55</sup> or pending transactions, and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio.<sup>56</sup>

<sup>54</sup> In a companion release, we are proposing to require funds to disclose their policies and procedures with respect to the disclosure of fund portfolio holdings. See Section II.C of Companion Disclosure Release, *supra* note 8.

<sup>55</sup> Thus, funds' and investment advisers' policies and procedures should preclude fund or advisory personnel from divulging a fund's portfolio schedule that has not been made generally available to the public. Divulging portfolio holdings to selected third parties is permissible only when the fund has legitimate business purposes for doing so and the recipients are subject to a duty of confidentiality. See, e.g., Selective Disclosure and Insider Trading, Securities Act Release No. 7881 at text accompanying n. 29 (Aug. 15, 2000) (65 FR 51716 (Aug. 24, 2000)) (noting that "issuers and their officials may properly share material nonpublic information with outsiders, for legitimate business purposes, when the outsiders are subject to duties of confidentiality"). See also *Dirks v. SEC*, 463 U.S. 646, 655 at n. 14 (1983) ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.") (citations omitted). We understand that many funds provide portfolio information in response to requests by rating agencies and similar organizations only after receiving written assurances that the information will be kept confidential and that persons with access to the information will not use the information to trade securities.

<sup>56</sup> We urge funds and advisers to require persons who have access to nonpublic information to trade securities of the fund exclusively through identifiable accounts to enable the fund to monitor for excessive, short-term trading. Alternatively, although not required by section 17(j) of the Investment Company Act (15 U.S.C. 80a-17(j)) or rule 17j-1 (17 CFR 270.17j-1), funds and advisers should consider amending their codes of ethics to cover, and thus require reporting of, trades by persons who have access to nonpublic information

• *Compliance with Fund Governance Requirements.* A fund's board plays an important role in overseeing fund activities to ensure that they are being conducted for the benefit of the fund and its shareholders. Fund boards, among other things, are tasked with approving the fund's advisory contracts,<sup>57</sup> underwriting agreements,<sup>58</sup> and distribution plans.<sup>59</sup> The Investment Company Act requires that fund boards of directors be elected by fund shareholders,<sup>60</sup> and that a certain percentage be "independent directors."<sup>61</sup> To rely on many of our exemptive rules, independent directors must constitute a majority of the board, must be selected and nominated by other independent directors, and if they hire legal counsel, that counsel must be an independent legal counsel.<sup>62</sup>

The consequences of failing to meet the Investment Company Act's governance requirements are severe.<sup>63</sup> Therefore, a fund's policies and procedures should be designed to guard against, among other things, an

about the portfolio, including information about the accuracy of the prices of portfolio securities used to calculate net asset value.

<sup>57</sup> Sections 15(a) and (c) of the Investment Company Act (15 U.S.C. 80a-15(a) and (c)).

<sup>58</sup> Sections 15(b) and (c) of the Investment Company Act (15 U.S.C. 80a-15(b) and (c)).

<sup>59</sup> Section 12(b) of the Investment Company Act (15 U.S.C. 80a-12(b)) and rule 12b-1(b)(2) (17 CFR 270.12b-1(b)(2)).

<sup>60</sup> Section 16(a) of the Investment Company Act (15 U.S.C. 80a-16(a)).

<sup>61</sup> Section 10(a) of the Investment Company Act (15 U.S.C. 80a-10(a)) (prohibiting more than 60 percent of a fund's directors from being interested persons of the fund); section 10(b)(2) of the Investment Company Act (15 U.S.C. 80a-10(b)(2)) (requiring, in effect, that independent directors comprise a majority of a fund's board if the fund's principal underwriter is an affiliate of the fund's investment adviser); section 15(f)(1) of the Investment Company Act (15 U.S.C. 80a-15(f)(1)) (providing a safe harbor for the sale of an advisory business if directors who are not interested persons of the investment adviser constitute at least 75 percent of a fund's board for at least three years following the assignment of the advisory contract). See also rule 6e-3(T)(b)(15) (17 CFR 270.6e-3(T)(b)(15)) (exempting certain funds underlying insurance products from various Investment Company Act provisions provided that independent directors constitute a majority of the boards of those funds).

<sup>62</sup> See rule 10f-3 (17 CFR 270.10f-3), rule 12b-1 (17 CFR 270.12b-1), rule 15a-4 (17 CFR 270.15a-4), rule 17a-7 (17 CFR 270.17a-7), rule 17d-1(d)(7) (17 CFR 270.17d-1(d)(7)), rule 17e-1 (17 CFR 270.17e-1), rule 17g-1(j) (17 CFR 270.17g-1(j)), rule 18f-3 (17 CFR 270.18f-3), and rule 23c-3 (17 CFR 270.23c-3). See also rule 0-1(a)(6) (17 CFR 270.0-1(a)(6)) (defining "independent legal counsel").

<sup>63</sup> See, e.g., *In re Charles G. Dyer, Investment Company Act Release No. 25107* (Aug. 9, 2001) and *SEC v. Centurion Growth Fund, No. 94-8199-CIV-UNGARO-BENAGES*, (S.D. Fla. Apr. 22, 1994), *Litigation Release No. 14063* (Apr. 28, 1994) (56 SEC Docket 1776).

<sup>51</sup> In a companion release, we are proposing amendments to rule 22c-1 under the Investment Company Act that would eliminate the need for funds and their transfer agents to rely on the segregation of orders by fund intermediaries other than a registered transfer agent or clearing agency. See Companion Late Trading Release, *supra* note 8.

<sup>52</sup> We discuss methods funds can use to oversee such policies and procedures later in this Adopting Release, in connection with the chief compliance officer's oversight of service providers. See *infra* text accompanying footnote 91.

<sup>53</sup> See, e.g., section 17(a) (15 U.S.C. 80a-17(a)) (prohibiting first and second-tier affiliates of a fund from borrowing money or other property from, or selling or buying securities or other property to or from the fund, or any company that the fund controls); section 17(d) (15 U.S.C. 80a-17(d)) (making it unlawful for first- and second-tier affiliates of a fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters, acting as principal, to effect any transaction in which the fund or a company controlled by the fund is a joint or a joint and several participant in contravention of Commission rules); rule 17d-1(a) (270 CFR 270.17d-1(a)) (prohibiting first- and second-tier affiliates of a fund, the fund's principal underwriter, and affiliated persons of the fund's principal underwriter, acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which any such fund or company controlled by a fund is a participant unless an application regarding such enterprise, arrangement or plan has been filed with the Commission and has been granted); section 10(f) (15 U.S.C. 80a-10(f)) (prohibiting a fund from purchasing securities in a primary offering if certain affiliated persons of the fund are members of the underwriting or selling syndicate); section 17(e) (15 U.S.C. 80a-17(e)) (limiting the remuneration that first- and second-tier affiliates of a fund may receive in transactions involving the fund, and companies that the fund controls); and section 12(d)(3) (15 U.S.C. 80a-12(d)(3)) and rule 12d3-1 (270 CFR 270.12d3-1) (together prohibiting a fund from acquiring securities issued by, among others, its own investment adviser).