

2. Investment Companies

Rule 38a-1 requires each fund to appoint a chief compliance officer who is responsible for administering the fund's policies and procedures approved by the board under the rule.⁷⁵ A fund's chief compliance officer should be competent and knowledgeable regarding the Federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the fund. The chief compliance officer of a fund, like the chief compliance officer of an investment adviser, should have sufficient seniority and authority to compel others to adhere to the compliance policies and procedures.

The rule contains several provisions, some of which were not included in our proposal, designed to promote the independence of the chief compliance officer from the management of the fund.⁷⁶ First, the chief compliance officer will serve in her position at the pleasure of the fund's board of directors, which can remove her if it loses confidence in her effectiveness. The fund board (including a majority of independent directors) must approve the designation of the chief compliance officer, and must approve her compensation (or any changes in her compensation).⁷⁷ The board (including a majority of the independent directors) can remove the chief compliance officer from her responsibilities at any time,⁷⁸

appeared to have assumed that they would be required to hire an additional person to fill the position of chief compliance officer.

⁷⁵ Rule 38a-1(a)(4).

⁷⁶ In the Proposing Release we requested comment on whether the chief compliance officer should be a senior manager of the fund because such a person would be in a better position to compel compliance with the fund's policies and procedures, and would less likely be intimidated in the performance of her duties. We are not adopting such a requirement because, as several commenters pointed out to us, it is very difficult to ascertain who is a "senior manager" in some organizations. Instead, we have described the authority we believe an individual must possess to be designated as a chief compliance officer, and have added a provision to the rule making it unlawful to exert undue influence on the chief compliance officer in the performance of her duties (*see infra* text accompanying note 86).

⁷⁷ Rule 38a-1(a)(4)(i). These requirements were not included in proposed rule 38a-1. Compensation would include any bonus. In approving a change in compensation, the board should assure itself that the chief compliance officer is not denied any customary cost of living increase or any full customary bonus and that fund managers are not otherwise retaliating against the chief compliance officer for having informed the board of a compliance failure or for having taken aggressive actions to ensure compliance with the federal securities laws by the fund or service provider.

⁷⁸ Rule 38a-1(a)(4)(ii).

and can prevent the adviser or another service provider from doing so.⁷⁹

Second, the chief compliance officer will report directly to the board of directors. She must annually furnish the board with a written report on the operation of the fund's policies and procedures and those of its service providers.⁸⁰ The report must address, at a minimum: (i) The operation of the policies and procedures of the fund and each service provider since the last report, (ii) any material changes to the policies and procedures since the last report,⁸¹ (iii) any recommendations for material changes to the policies and procedures as a result of the annual review,⁸² and (iv) any material compliance matters since the date of the last report.⁸³ We have added a definition of the term "material compliance matter" to the rule, to clarify that the report should inform the board of those compliance matters about which the fund's board reasonably needs to know in order to oversee fund compliance.⁸⁴

Third, we are requiring that the chief compliance officer meet in executive session with the independent directors at least once each year, without anyone else (such as fund management or interested directors) present.⁸⁵ The executive session creates an opportunity for the chief compliance officer and the

⁷⁹ In a change from the proposed rule, the chief compliance officer can only be discharged from her responsibilities with the approval of the board. Rule 38a-1(a)(4)(ii).

⁸⁰ If the fund is a unit investment trust, the fund's principal underwriter or depositor must approve the chief compliance officer, must receive all annual reports, and must approve the removal of the chief compliance officer from his or her responsibilities. Rule 38a-1(b).

⁸¹ A change would be "material" in this context if it is a change that a fund director would reasonably need to know in order to oversee fund compliance.

⁸² *Id.* The report should also discuss the fund's particular compliance risks and any changes that were made to the policies and procedures to address newly identified risks.

⁸³ Rule 38a-1(a)(4)(iii). Our proposal would have required the report to include only compliance matters that resulted in remedial action; our final rule contains no such limitation because we are concerned that a fund or its service providers might abuse the limitation and fail to impose remedial actions in order to avoid having to report a compliance failure to the board.

⁸⁴ Rule 38a-1(e)(2). Serious compliance issues must, of course, always be brought to the board's attention promptly, and cannot be delayed until an annual report. In addition, individual compliance matters that, taken in isolation, may not be material may collectively suggest a material compliance matter, such as a material weakness in the compliance programs of the fund or its service providers. *See, e.g.,* Personal Investment Activities of Investment Company Personnel, Investment Company Act Release No. 23958, at n. 25 (Aug. 20, 1999) (64 FR 46821 (Aug. 27, 1999)).

⁸⁵ Rule 38a-1(a)(4)(iv). Independent counsel to the independent directors may be present.

independent directors to speak freely about any sensitive compliance issues of concern to any of them, including any reservations about the cooperativeness or compliance practices of fund management.

Fourth, we have added a provision to protect the chief compliance officer from undue influence by fund service providers seeking to conceal their or others' non-compliance with the federal securities laws. Rule 38a-1 prohibits the fund's officers, directors, employees or its adviser, principal underwriter, or any person acting under the direction of these persons, from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the fund's chief compliance officer in the performance of her responsibilities under the rule.⁸⁶

The appointment of a chief compliance officer with overall responsibility for management of a fund complex's compliance program is a key element of the investor protections we are today adopting. Some commenters representing fund management companies urged us to permit funds to continue to use multiple compliance managers employed by different service providers, rely on the policies of the fund service providers, and omit the requirement that fund boards approve the compliance officer. These commenters would have us maintain funds' current approach to compliance management. Current practices, however, balkanize responsibility for fund compliance and isolate fund boards from compliance personnel, thus impeding boards' abilities to exercise their oversight responsibilities effectively. We decline to accept current practices, which we believe have contributed to the serious compliance lapses that are now the subject of our enforcement actions.

We have observed that executives at service providers have overruled their own compliance personnel because of business considerations. For example, some fund advisers have continued to permit investors with whom they had other business relationships to engage in harmful market timing in fund shares after compliance personnel and portfolio managers brought the market timing activity to their attention. These compliance personnel may not have had access to fund directors or, having been overruled by their own management,

⁸⁶ Rule 38a-1(c). This prohibition is similar to the prohibition on unduly influencing auditors found in section 303(a) of the Sarbanes-Oxley Act (Pub. L. 107-204, 116 Stat. 745 (2002)) and rule 13b2-2(b)(1) (17 CFR 240.13b2-2(b)(1)) under the Securities Exchange Act.