

rule 204-2 will require funds and advisers to keep any records documenting their annual review.<sup>95</sup> Our rules permit funds and advisers to maintain these records electronically.<sup>96</sup> These new recordkeeping requirements will assist our examination staff in determining whether the adviser or fund is adhering to the new rules and in identifying weaknesses in the compliance program if violations do occur or are uncorrected.

#### E. Private Sector Initiatives

In the Proposing Release, we requested that commenters consider four additional approaches that we might take to require the private sector to assume greater responsibility for compliance with the Federal securities laws. These possible approaches included: (i) A requirement that funds and advisers undergo third-party compliance reviews; (ii) an expansion of the role of independent public accountants to include the performance of certain compliance reviews; (iii) the formation of one or more self-regulatory organizations for advisers or funds; and (iv) the requirement that certain advisers obtain fidelity bonds from reputable insurance companies.

We appreciate the many comments we received. Although we are not moving forward with any of these approaches at this time, we continue to regard them as viable options should the measures we are taking today fail to adequately strengthen the compliance

provided to the board, the first two years in an easily accessible place. Funds already are required to document in the fund board's minute books the board's deliberations in connection with the approval of the compliance policies and procedures and their annual review of the chief compliance officer's report. Board minute books must be maintained pursuant to rule 31a-1(b)(4) under the Investment Company Act (17 CFR 270.31a-1(b)(4)). All reports required by our rules are meant to be made available to the Commission and the Commission staff and, thus, they are not subject to the attorney-client privilege, the work-product doctrine, or other similar protections.

<sup>95</sup> Rules 38a-1(d)(3) and 204-2(a)(17)(ii). In a change from proposed rule 38a-1, funds will have to maintain any records documenting their annual review for at least five years after the end of the fiscal year in which the annual review was conducted, the first two years in an easily accessible place. Advisers will have to maintain any records documenting their annual review in an easily accessible place for at least five years after the end of the fiscal year in which the review was conducted, the first two years in an appropriate office of the investment adviser. Rule 204-2(e)(1).

<sup>96</sup> See rules 31a-2(f) (17 CFR 270.31a-2(f)) and 204-2 (17 CFR 275.204-2(g)). Funds and advisers that maintain records electronically must provide those records to our staff in electronic format upon request. Rule 31a-2(f)(2)(ii)(A) under the Investment Company Act (17 CFR 270.31a-2(f)(2)(ii)(A)) and rule 204-2(g)(2)(ii)(A) under the Investment Advisers Act (17 CFR 275.204-2(g)(2)(ii)(A)).

programs of funds and advisers. In particular, we may reconsider whether to propose rules requiring funds and advisers to obtain compliance reviews from third-party compliance experts. Such compliance audits could be a useful supplement to our examination program and would assure the frequent examination of advisers and funds.

#### F. Additional Request for Comment

Rule 38a-1 includes provisions designed to promote the chief compliance officer's independence from fund management while still maintaining her effectiveness. The fund's board of directors must approve the chief compliance officer's designation and compensation, and has the sole power to remove her from her position.<sup>97</sup> The chief compliance officer reports directly to the board, and must meet with the independent directors in executive session at least annually.<sup>98</sup> The rule also protects the chief compliance officer by prohibiting persons from coercing or fraudulently influencing her in the course of her responsibilities.<sup>99</sup> Today, in addition to adopting rule 38a-1, we request comment on these provisions. Are there other measures (or refinements to these provisions) that would further enhance the independence and effectiveness of chief compliance officers under the rule? We also request comment whether our definition of the "material compliance matters" that must be reported to fund boards by chief compliance officers adequately addresses our concern that fund boards receive compliance information they reasonably need to know in order to oversee fund compliance.<sup>100</sup>

#### III. Effective Date

New rules 38a-1 and 206(4)-7 and the amendments to rule 204-2 will be effective on February 5, 2004. The

<sup>97</sup> Rule 38a-1(a)(4)(i)-(ii). See *supra* notes 76-79 and accompanying text.

<sup>98</sup> Rule 38a-1(a)(4)(iii)-(iv). See *supra* notes 80-85 and accompanying text.

<sup>99</sup> Rule 38a-1(c) prohibits the fund's officers, directors, employees, or its adviser or 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 compliance responsibilities under the rule. See *supra* note 86 and accompanying text, and note 76.

<sup>100</sup> Rule 38a-1(e)(2) defines the term "material compliance matter" to mean those compliance matters—including violations of the federal securities laws or compliance policies and procedures by the fund or its service providers, as well as weaknesses in the design or implementation of those policies and procedures—about which the fund's board reasonably needs to know in order to oversee fund compliance. See *supra* note 84 and accompanying text.

compliance date of the new rules and rule amendments is October 5, 2004. On or before the compliance date, all funds and advisers must have designated a chief compliance officer and fund boards must have approved the chief compliance officer. In addition, on or before the compliance date, funds and advisers must adopt compliance policies and procedures that satisfy the requirements in the new rules. In the case of funds, these policies and procedures must have been approved by the board on or before the compliance date. Funds and advisers must complete their first annual review of the compliance policies and procedures no later than 18 months after the adoption or approval of the compliance policies and procedures. The chief compliance officer of a fund must submit the first annual report to the board within 60 calendar days of the completion of the annual review.

Our allowance for a nine month transition period does not reduce the immediacy of the need for all funds, including those that already have compliance policies in place, to undertake a review of their policies and procedures, in light of recent revelations of unlawful practices involving market timing, late trading, and improper disclosures of nonpublic portfolio information.

#### IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. The new rules 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. In the Proposing Release, we identified possible costs and benefits of the rules and requested comment on our analysis.

##### A. Benefits

We expect that fund investors, advisory clients, funds, and advisers will benefit from the new rules. Commenters generally agreed that comprehensive compliance programs are beneficial. Although many funds and advisers already have such programs in place, the new rules will make this standard practice for all funds and advisers. One commenter, a compliance officer, noted that the benefits of the new measures in the form of increased investor protection would far exceed the costs.

Requiring funds and investment advisers to design and implement a comprehensive internal compliance program will serve to reduce the risk