

that fund investors and advisory clients (collectively, "investors") will be harmed by violations of the securities laws. With limited exception, commenters agreed that comprehensive written compliance programs are the first line of defense in investor protection. Recent allegations of violations related to market timing and late trading confirm the need for strong compliance programs that do not permit compliance objectives to be subordinated to the business objectives of fund advisers or their affiliated persons.

The appointment of a chief compliance officer for each fund will also provide important investor protection benefits. Funds currently rely on multiple compliance personnel working for different service providers. Fund boards do not receive compliance information directly from these compliance officers; it is filtered through the management of the fund's investment adviser or other service providers. We believe these structures have contributed to serious compliance lapses that are now the subject of our enforcement actions. Rule 38a-1, by requiring each fund to have a compliance officer who serves at the pleasure of the fund's board and who is responsible for oversight of these service providers, and who cannot be unduly influenced will strengthen the hand of compliance personnel by giving them a direct line of reporting to the fund board that is not controlled by management.

The rules will also benefit funds and investment 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. 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. Advisers may be denied eligibility to advise funds.¹⁰¹ In addition, advisers could be precluded from serving in other capacities.¹⁰²

¹⁰¹ 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.

¹⁰² 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)).

The designation of a chief compliance officer also should enhance the efficiency of funds' and advisers' operations by centralizing responsibility for the compliance function. While many commenters agreed that fund and investment adviser compliance benefits from clear allocation of compliance responsibilities, they argued that large firms would benefit little from requiring a single person to be designated. We believe that the designation of a single officer will increase the coordination with which distributed compliance functions are executed.

In addition, because the new rules complement our examination program for investment advisers and for fund complexes, they will enhance our ability to protect investors. The existence of a structured compliance program at funds and investment advisers, together with the designation of a chief compliance officer to serve as a point of contact, will 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. Most commenters noted that the proposed rules would enhance the effectiveness of the Commission's examination program and oversight of funds and advisers.

B. Costs

The new rules will result in some additional costs for funds and investment advisers, which, in the case of funds, we expect would be passed on to investors. A number of commenters expressed concern about the costs that the new rules would impose.¹⁰³ One commenter, noting that existing compliance mandates place a significant burden on investment advisers, expressed concern that the costs of new compliance obligations might outweigh the benefits. However, because all funds and most investment advisers currently have some written compliance policies and procedures in place, the costs of the new rules in many instances already are reflected in the fees investors currently pay.

We would expect that funds and advisers with substantial commitments to compliance would incur only minimal costs in connection with the adoption of the new rules as they

¹⁰³ We believe that many of these concerns stemmed from the incorrect perception that the new rules would require the adoption and implementation of one-size-fits-all compliance programs. As discussed above, the new rules require each firm to adopt a compliance program that conforms with the scope and nature of its operations, thus eliminating concerns that the new rules will require duplicative or excessively detailed compliance programs.

reviewed their internal compliance programs for adequacy. Funds and larger advisory firms typically have adopted and implemented comprehensive, written policies and procedures. Many of these funds and advisers also have well-staffed compliance departments. Many conduct periodic reviews of their compliance programs and some hire independent compliance experts to review the adequacy of their compliance programs and the effectiveness of their implementation.

A number of commenters expressed particular concern about the relative cost of the new rules for small investment advisers.¹⁰⁴ This concern is consistent with our experience that investment advisers (as well as small funds) are less likely than their larger counterparts to have comprehensive, written internal compliance programs in place. Based on our examination experience, we estimate that as many as one half of SEC-registered investment advisers do not have comprehensive, written internal compliance programs in place.

However, we expect a number of factors will enable small investment advisers to control and minimize these costs. Because small firms typically engage in a limited number and range of transactions and have one or two employees, their internal compliance programs would be markedly less complex than those of their large firm counterparts.¹⁰⁵ In addition, we anticipate that these firms will turn to a variety of industry representatives, commentators, and organizations that have developed outlines and model programs that these firms can tailor to fit their own situations.¹⁰⁶ If these firms need individualized outside assistance, we expect that the number of independent compliance experts will grow to fill this demand at competitive

¹⁰⁴ The Investment Counsel Association of American ("ICAA"), for example, noted that in small firms with few employees, the responsibility for developing a compliance program, if done in-house, would likely be borne by a highly-paid employee.

¹⁰⁵ The ICAA estimated that, depending on an adviser's size and complexity, the adviser could purchase an off-the-shelf compliance manual for under \$1,000, but would have to spend time adjusting the manual to correspond to its organizational structure. Alternatively, the ICAA also estimated that the adviser could enlist the assistance of a third-party compliance firm to draft a firm-specific manual for a small to mid-size firm for between \$2,500 and \$3,500. The ICAA also estimated that a law firm would charge between \$10,000 and \$120,000 to draft procedures (and an accounting firm would charge between \$50,000 and \$200,000), depending on the size and complexity of the adviser's operations.

¹⁰⁶ Firms will incur a cost in tailoring these programs to their specific needs.