February 5, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Compliance Programs of Investment Companies and Investment Advisers; File No. S7-03-03

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's additional request for comment on the recently adopted compliance program rule, Rule 38a-1 under the Investment Company Act of 1940.[2] In particular, the Adopting Release seeks comment on provisions added to the rule after it was proposed to: (1) promote the independence of a fund's chief compliance officer ("CCO") from fund management and protect such person from coercion or fraudulent influence in the course of his or her responsibilities and (2) define the term "material compliance matter." In addition to providing comment on these two issues, the Institute recommends that the Commission address an additional issue relating to reports provided to the board as discussed below.

I. PROMOTING THE INDEPENDENCE OF THE CCO

Since Rule 38a-1 was first published for comment, the Commission has added several provisions to it in order to better ensure the CCO's independence from fund management. These additional provisions:

- Require the fund's board to approve the CCO's compensation (in addition to the CCO's designation as was included in the proposed rule);

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,601 open-end investment companies ("mutual funds"), 604 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.240 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

[2] SEC Release Nos. IA-2204 and IC-26299 (Dec. 17, 2003) (the "Adopting Release"). As adopted, Rule 38a-1 requires each investment company registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures.

- Provide the board sole power to remove the CCO from his or her position;
- Require the CCO to meet with the independent directors in executive session at least annually; and
- Prohibit persons from coercing or fraudulently influencing the CCO in the course of performing his or her responsibilities.

The Adopting Release seeks comment on whether these additional provisions would enhance the independence and effectiveness of a CCO under the rule.

The Institute supports the new provisions added to the rule to enhance the CCO's independence from fund management. In particular, we support establishing a direct line through which the CCO reports to the fund's board, requiring that the CCO meet annually with the independent directors, and prohibiting any person from unduly influencing or coercing the CCO.[3] Cumulatively, these provisions should provide the CCO adequate insulation from inappropriate interference with the conduct of his or her responsibilities. Consequently, we question the need to require, as an additional protection, that the board approve the CCO's compensation.[4] We also have concerns with the rule providing that the board, alone, may remove the CCO from his or her position. Each of these is discussed in more detail below.

A. The Board's Approval of the CCO's Compensation

According to the Adopting Release, the Commission has proposed to require the board to approve the CCO's compensation in order to prevent fund management from using the CCO's compensation as a vehicle to influence or coerce the CCO's behavior. We note, however, that, in addition to seeming unnecessary in light of the other provisions added to the rule to enhance the CCO's independence, this provision raises logistical concerns. For example, requiring the board to approve the CCO's compensation would likely result in the board having to become unnecessarily involved in detailed employment matters.[5] There also could be timing issues.[6] In addition, to the extent the process used to determine the CCO's compensation differs, due to the board's input, from that used to determine the compensation paid to other compliance or fund management personnel, this may result in the CCO being viewed by other

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[3] With respect to these new requirements, the Institute requests that the Commission confirm that Section 38a-1(b) of rule, which governs the application of the rule to unit investment trusts (UITs), provides, in total, how a UIT is to comply with the rule. So, for example, provisions in the rule that implicate "independent directors" in the CCO's compliance responsibilities are inapplicable to UITs, which have no boards of directors.

[4] Surely if the CCO felt that fund management was using the CCO's salary to coerce or influence his or her conduct, this would be an issue the CCO could raise with the board directly or in the annual meeting the CCO is required to hold with the fund's independent directors.

[5] For example, against what standard would a board measure the reasonableness of the amount paid to the CCO? Should the standard be what other CCOs of similarly situated fund complexes are paid? Should the standard be what other fund management personnel are paid?

[6] For example, bonuses often are determined within a relatively compressed time period that may not include a regularly scheduled board meeting. To the extent that the rule would require board approval in advance, this could result in the CCO's bonus being delayed.

compliance personnel as an "outsider," contrary to the Commission's intent.[7] Also, for fund complexes with multiple fund boards to which the CCO reports, there would be logistical concerns – *e.g.*, coordinating the approval of the CCO's compensation by all such fund boards.

To address these issues, the Institute recommends that the rule be revised to replace the "approval" requirement with a requirement that the CCO's compensation be *reported* to the board on a periodic basis (*e.g.*, annually). Such regular reports would enable the board to evaluate whether the CCO's compensation is being used by fund management or others to influence the CCO's actions.[8] This alternative would enable the board to monitor the CCO's compensation on an ongoing basis, without becoming bogged down in compensation issues and without the CCO being viewed as an "outsider."

B. The Board's Exclusive Authority to Fire the CCO

To the extent the CCO is employed by an entity other than the fund (as the rule expressly contemplates), the Institute is concerned with the potential employment law implications of the rule providing that the CCO's employment may be terminated only with approval of the fund's board. In essence, the Commission's rule would establish a joint employment relationship between the fund's board and the employer of the CCO. However, of these two entities, only the board would have authority to remove the CCO from his or her responsibilities. Under the rule, the CCO's joint employer would be divested of its right to determine whether to continue to employ the CCO. This could create substantial liability for such joint employer.

For example, if the CCO is employed by the investment adviser and the investment adviser decided to terminate the employment of the CCO for sexual harassment or some other violation of the Equal Employment Opportunity laws, the investment adviser would be precluded from doing so unless and until the board concurred. At the same time, confidentiality concerns might preclude the investment adviser from sharing information concerning its investigation of the sexual harassment or other misconduct with the fund's board. If the board did not concur with the adviser's recommendation that the CCO be fired, the adviser would be put in a position of having to retain a person that it does not believe should continue to be an employee of the adviser. Not only would this result in a terribly awkward situation, it could result in additional liability for the adviser under federal or state employment laws. To avoid this problem, and to preserve the traditional employment relationship between the CCO and the investment adviser, the Commission should permit the entity that employs the CCO to terminate the employment of the CCO without approval of the

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[7] We note that the Commission deliberately did not require the CCO to be a fund employee out of concerns that this would distance the CCO from fund management and lead to the CCO being perceived as an "outsider." According to the Adopting Release, having the CCO viewed as an outsider from fund management "would actually weaken [the CCO's] effectiveness" because "fund management would be unlikely to consult with an 'outside' compliance officer on a prospective business decision to ascertain the compliance implications." Adopting Release at pp. 12-13.

[8] These periodic reports would enable the board to monitor the CCO's compensation over time and thereby to assess whether changes in salary and/or bonuses (or a lack thereof) might indicate an attempt to exert undue influence that may warrant further investigation by the board.

fund's board, so long as such termination would not violate the rule's prohibition against coercing or fraudulently influencing the CCO in the performance of his or her responsibilities.

II. PROPOSED DEFINITION OF "MATERIAL COMPLIANCE MATTER"

Under Rule 38a-1, the CCO must annually provide a written report to the fund's board that, in part, addresses, "each material compliance matter that occurred since the date of the last report." To assist funds in complying with this requirement, the Commission has proposed to add a definition of "material compliance matter" to the rule. While the Institute generally supports adoption of the proposed definition, we note that the qualifier "material" does not appear within this definition. To remedy this, we recommend that this new term be defined, in relevant part, as "any *material* compliance matter" including a *material* violation of the federal securities laws, a *material* violation of the policies and procedures of the fund or its service providers, or a *material* weakness in the design or implementation of the policies and procedures of the fund or its service providers.[9]

III. ADDITIONAL IMPLEMENTING ISSUE: REPORTS TO THE BOARD

As noted above, Rule 38a-1 requires a CCO annually to report to the board "each material compliance matter that occurred since the date of the last report." As originally proposed, this provision would have instead required the CCO to report only those material compliance matters "requiring remedial action" that occurred since the last report.[10] Thus, it was clear under the proposal that only those material compliance matters of which the CCO became aware since the last report were required to be included. As a result of the change to this provision, however, it could now be interpreted to require reporting of *all* violations that have occurred since the last report, regardless of whether the CCO was aware of them. This does not appear to be what the Commission intended. Therefore, the Institute recommends that the Commission clarify that the material compliance matters that must be reported to the board are those of which the CCO becomes aware during the reporting period.[11]

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[9] This change would be consistent with the manner in which the term "material violation" is defined in the Commission's Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer ("Standards of Professional Conduct"). *See* 17 CFR 205.2(i).

[10] According to the Adopting Release, this provision was revised out of the Commission's concern that, as proposed, the requirement may have resulted in a fund or its service providers failing to impose remedial actions in order to avoid having to report a compliance failure to the board. Adopting Release at n.83.

[11] This clarification would be consistent the reporting required of attorneys under the Standards of Professional Conduct. *See* 17 CFR 205.3(b). Additionally, this recommended clarification would ensure the duty of the CCO to report all material compliance matters that have come to the CCO's attention during the reporting year, even if such matters occurred prior to the current reporting year but were not known until the current reporting year.

The Institute appreciates the opportunity to provide these comments in response to the Commission's Adopting Release. If you have any questions concerning these comments or would like additional information, please contact me at (202) 326-5815 or Tamara Salmon at (202) 326-5825.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
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