

February 5, 2004

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

Re: Final Rule: Compliance Programs of Investment Companies and Investment Advisers; File No. S7-03-03 – Section II.F

Dear Secretary Katz:

The National Society of Compliance Professionals (“NSCP”) appreciates the opportunity to comment on the obligations of the Chief Compliance Officer (“CCO”) included as part of new Rule 38a-1 under the Investment Company Act of 1940, as amended (the “1940 Act”) as set forth in the Final Rule adopted by the Securities and Exchange Commission (the “Commission”) concerning compliance programs of investment companies and investment advisers (the “Rule”).¹ The Rule requires each registered investment company (a “fund”) to designate one individual as CCO who is responsible for administering the fund’s policies and procedures adopted under new Rule 38a-1(a) (1). The Rule requires that the CCO may be removed from his/her responsibilities by action of (and only with the approval of) the fund’s board of directors, including a majority of the directors who are not interested persons of the fund and requires the CCO to report at least annually to just the fund’s independent directors. The Rule also requires the CCO to report “Material Compliance Matters.”

The Rule is of considerable interest to the NSCP and its members. NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, effective supervision, and oversight. The principal purpose of NSCP is to enhance compliance in the securities industry, including firms’ compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. An important mission of the NSCP is to instill in its members the importance of developing and implementing sound compliance programs across-the-board.

Since its founding in 1987, NSCP has grown to over 1,250 members, and the constituency from which its membership is drawn is unique. NSCP’s membership is drawn principally from traditional broker-dealers, investment advisers, bank and insurance affiliated firms, as well as the law firms, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel, and the asset management members of NSCP span a wide spectrum of firms, including employees from the largest brokerage and investment management firms to those

¹ See Proposed Rule 38a-1 (a) (4) of the 1940 Act contained in the “Final Rule: Compliance Programs of Investment Companies and Investment Advisers”, Release Nos. IA – 2204; IC – 26299; File No. S7-03-03, Dec. 17, 2003.

operations with only a handful of employees. The diversity of our membership allows the NSCP to represent a large variety of perspectives in the asset management industry.

The NSCP strongly supports the Commission's efforts to enhance and strengthen compliance programs at investment advisers and investment companies, but nonetheless is concerned with the nature, scope and lack of specificity in the Rule. Our views, as well as our concerns over the broad definition of "Material Compliance Matter," are discussed below.

A. Duties of the Fund's CCO

Key among NSCP's concerns is the requirement that a CCO must provide a report, no less frequently than annually, to the board of directors that, at a minimum, addresses the following items:

- the adequacy of the policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent and the effectiveness of their implementation;

- changes made to said policies and procedures since the date of the last report and any material changes to the policies and procedures recommended as a result of the annual review conducted pursuant to paragraph (a) (3) of new Rule 38a-1; and

- each "Material Compliance Matter" that occurred since the date of the last report.

NSCP submits there is a vast difference between those fund groups that provide advisory, principal underwriting, administration and transfer agency services either in-house or through affiliates, and those fund groups that rely on outside third party service providers to provide some or all of those services. The Rule provides little guidance on how far a CCO must go in terms of reviewing an outside entity's policies and procedures and compliance therewith. Indeed, there is contradictory guidance. Early in the adopting release, the Commission acknowledges that when a fund uses a third party service provider that provides such services to many funds, "it may be impractical for the fund or its compliance officer to directly review all of the service provider's policies and procedures." The release goes on to state that in such situations, the Commission will consider "a fund's policies and procedures to have satisfied the requirements of this rule if the fund uses a third-party report on the service provider's procedures instead of the procedures themselves when the board is evaluating whether to approve the service provider's compliance program." However, later in the release, in speaking of the CCO's duties and required report, the Commission states that the CCO will have responsibility for overseeing all the fund's service providers and contemplates that the service providers' compliance officers will "report" to the fund CCO. The release states: "A chief compliance officer should diligently administer this oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The chief compliance officer should be familiar with each service provider's operations and

understand those aspects of their operations that expose the fund to compliance risks. She should maintain an active working relationship with each service provider's compliance personnel." This is significantly more proactive than relying on third party audits and reports. A number of questions are raised by these requirements. For example, does the Commission expect that, in addition to fluency in the federal securities laws (see section (e)(1)), the CCO will be expert in all operational aspects of transfer agency, accounting, anti-money laundering, sales practices, etc., sufficient to review and opine to the directors on the outside providers' policies and procedures? Is the CCO expected to recommend changes to the service provider? Is the CCO to determine who at the service provider is "competent" and who is not and, if so, on what basis or standard? What if a fund board asks a CCO whether a change made by an outside service provider is sufficient to address a particular issue? To what extent can a CCO and fund board rely upon SAS 70s and other reports of reviews prepared by independent parties to fulfill this responsibility under the Rule? Finally, to what extent would the CCO have liability for the non-disclosure of a compliance failure by an unaffiliated service provider? How much due diligence must the CCO undertake? As described in the release, it appears that the only way a CCO can adequately oversee third party providers is to hire outside consultants to "audit" the service providers. This creates a new and expensive burden on the fund.

In addition, among the requirements to be imposed on the CCO is the requirement to report to the board each "Material Compliance Matter" that occurred since the date of the last report to the board. However, missing from this requirement is any provision that the CCO need only inform the board of those "Material Compliance Matters" of which the CCO has actual knowledge or of which the CCO "knew or should have known." Without such a knowledge proviso, the CCO is left open for being on the hook for a "Material Compliance Matter" of which s/he was not aware. This fact, coupled with the over broad way in which "Material Compliance Matter" is currently defined (see below) is of grave concern.

B. "Material Compliance Matter"

The Commission wisely asked for comment on the definition of "Material Compliance Matter" currently in the Rule which includes any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance and involves the following matters, without limitation:

- a violation of Federal Securities Laws by the fund, its investment adviser, principal underwriter, administrator or transfer agent (or officers, directors, employees or agents thereof);

- a violation of the policies/procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent; or

- a weakness in the design or implementation of the policies/procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent.

We submit that what is currently covered by Material Compliance Matter is overly broad and would lead to the Board being overwhelmed by minutiae as even the most minor books and records mistake can, arguably, be deemed a violation of the federal securities laws. In this environment, it is more likely that providers will “over-report” rather than risk underreporting to the CCO. The CCO, in turn, would be left with no guidance but much discretion as to what to report. Finally, the defined term “Material Compliance Matter” does not contain in the definition the concept of “materiality” or indeed is there any reference to the word “material” in the definition as currently proposed. Thus the name of the defined term and the ensuing definition do not comport and will more than likely lead to confusion and mislead an unsuspecting CCO trying to comply with its terms.

We recommend that the definition of Material Compliance Matter be clarified to consist of those compliance matters which are expected to adversely affect shareholders based upon some evidence of fraud or a systemic weakness that may result in shareholder loss. Otherwise, the definition of “Material Compliance Matter” is too broad and places on the CCO much too high of a burden in trying to cover all Federal Securities Laws at each of the investment adviser, principal underwriter, administrator and transfer agent including each of those entities’ officers, directors, employees and agents.

Without some more realistic limits placed on the matters falling within the ambit of “Material Compliance Matter,” we submit that the CCO will be unable to meet the requirements set forth in the Proposed Rule particularly with respect to third party service providers.

Conclusion

We appreciate your consideration of our comments and recommendations. While we strongly support the Commission’s efforts to enhance and strengthen compliance programs at investment advisers and investment companies, we believe that much of what the rules contemplate would place an undue and arguably “insurmountable” burden on the CCO.

Sincerely,

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