



SEC RULE 38a-1 FOR MUTUAL FUNDS

SEC Rule 38a-1 requires mutual fund boards to adopt written policies and procedures reasonably designed to prevent the fund from violating the federal securities laws. These procedures must provide that supervision of compliance matters is the joint responsibility of the fund's advisers, principal underwriters, custodians, auditors, administrators and transfer agents.

These rules are designed to protect investors by ensuring that all funds and advisers have internal programs to enhance compliance with the federal securities laws. A critical element of both new rules is the designation of a chief compliance officer (CCO) who is charged with the administration of the written compliance policies and procedures.

WHO IS AFFECTED BY SEC RULE 38a-1?

Directors/trustees of registered mutual funds will be most affected. A fund's board members will, however, be allowed to satisfy their oversight obligation by reviewing summaries of compliance programs that are prepared by the chief compliance officer (CCO), the fund's legal counsel, or other persons familiar with the compliance programs.

Rule 38a-1 calls on the board to consider the adequacy of the policies and procedures in light of other recent compliance experiences and additional factors. Board members of registered funds are urged to consider "best practices" used by other funds and to consult with fund counsel (independent directors/trustees have to consult with their "special" counsel), compliance specialists as well as other experts who are familiar with successful compliance practices used by similar funds or service providers.

WHAT ARE THE REQUIREMENTS OF SEC RULE 38a-1?

Funds will be maintaining copies of their compliance policies and procedures and chief compliance officer's annual reports for five years as required by rule 38a-1. In adopting rule 38a-1, this recordkeeping requirement has been expanded to also include copies of briefing materials provided to a fund's board of directors in connection with their approval of the fund and its service providers' compliance programs and board review of the CCO's annual reports, and to include copies of any records documenting a fund's annual review.

Rule 38a-1 provides fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization. A fund complex could, for example, adopt compliance policies and procedures that encompass the activities of the funds, the adviser and affiliated underwriters and transfer agents, while approving the policies and procedures of other service providers, such as sub-advisers, over which it has oversight responsibility under the rule.

Rule 38a-1 requires a fund's board, including a majority of its independent directors, to approve the policies and procedures of the fund and each of its service providers. The approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the federal securities laws by the fund and its service providers.

Directors may satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by the CCO, legal counsel or other persons familiar with the compliance programs. The summaries should familiarize directors with the salient features of the programs (including programs of service providers) and provide them with a good understanding of how the compliance programs address particularly significant compliance risks.

WHEN IS SEC RULE 38a-1 EFFECTIVE?

Effective Date: February 5, 2004. *Compliance Date:* October 5, 2004.

WHAT ARE THE PENALTIES FOR SEC RULE 38a-1?

The consequences of failing to meet governance requirements are severe. The SEC fined five of the largest investment banks in the world over USD \$8 million dollars for having inadequate procedures and systems in place for the retrieval of email as defined by SEC 17a-4. Goldman, Sachs & Co., Citigroup Inc.'s Salomon Smith Barney, Morgan Stanley & Co., Deutsche Bank Securities Inc., and U.S. Bancorp Piper Jaffray Inc. all agreed to pay, and to review and report on procedures for email retention. These penalties foreshadow potential industry penalties of more than USD \$1 billion, and individual fines up to USD \$500 million for some brokerages. The penalties for non-compliance include not only fines, but also license suspensions or revocations.

HOW DO FIRMS COMPLY WITH SEC RULE 38a-1?

Rule 38a-1 requires fund boards to adopt written policies and procedures reasonably designed to prevent the fund from violating the federal securities laws. The procedures must provide for the oversight of compliance by the fund's advisers, principal underwriters, administrators, and transfer agents (collectively, "service providers") through which the fund conducts its activities.

Thus, under rule 38a-1 a fund must have procedures reasonably designed to ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity, and for consistent enforcement of the fund's policies regarding market timing.