Investment Company and Investment Adviser Liability Loss Prevention

From Chubb's Department of Financial Institutions

CHUBB

©2001 Chubb & Son, Inc.

INVESTMENT COMPANY AND INVESTMENT ADVISER LIABILITY LOSS PREVENTION

Prepared by

Thomas R. Smith, Jr.

Brown & Wood LLP

for

Chubb's Department of Financial Institutions

CONTENTS

Foreword 5

Introduction 6

Directors of Investment Companies 8

- Duties and Responsibilities Under the 1940 Act 8
- The 2001 Governance Standards 9
  - Requisite Board Composition 10
  - Selection and Nomination of Independent Directors 12
  - Obtaining Independent Counsel for Independent Directors 14
- Service on Multiple Boards in a Complex 16
- Making the Most of Independent Directors 18
- Importance of the Quality of Directors' Decision-making Process 19
- Importance of Staying Current with Industry and Regulatory Developments 22

Liability Loss Prevention in Portfolio Management and Administration 23

- Importance of Effective Internal Controls and Compliance Programs 23
- Lessons to Be Learned from SEC Enforcement Cases 26
- Areas to Receive Particular Focus in Any Compliance Program 29
  - Compliance with Investment Policies and Restrictions 29
  - Valuation and Pricing of Shares 30
  - Portfolio Transactions, Including Best Execution, Soft Dollars, and Trade Allocations 32

Personal Trading and Codes of Ethics 36

Performance Advertising..38

Affiliated Transactions...39

Privacy of Consumer Financial Information 41

The Need for "Chinese Walls" to Prevent the
Misuse of Inside Information 42

Use of the Internet and Information Technology 44

Improper Use of Fund Assets 45

Special Compliance Situations 46

Multiple Managers and Subadvisers 46

Global Operations 46

Hedge Funds and Private Investment Companies..........47

Lessons to Be Learned from Excessive-fee Cases 49

The Disclosure Cases: The SEC and the Courts..........................52

SEC Disclosure Reforms 52

Lessons to Be Learned from Disclosure Cases 53

Monitoring Sales Practices 56

Considerations Involving Rule 12b-1 Distribution Plans and
Multi-class Arrangements 58

Permissible Indemnification and Insurance
Under the 1940 Act 61

Appendix A: Report of the ICI-appointed Advisory
Group on Best Practices of Fund Directors 64

Appendix B: Certain Representative
Enforcement Proceedings 67

About the Author 71

Acknowledgment 72

FOREWORD

Chubb's Department of Financial Institutions asked Thomas R. Smith, Jr., of Brown & Wood LLP, to prepare this guide to help financial institutions better understand and reduce the risks associated with operating an investment company or acting as an investment adviser. We at Chubb strongly encourage businesses to develop and implement a program to manage these risks. Although this booklet provides general guidance on risk management issues, experienced counsel should be consulted for advice on specific issues and on developing a risk management program.

INTRODUCTION

Investment companies (or funds) are registered under the Investment Company Act of 1940 (the 1940 Act), which contains a pervasive regulatory scheme. The stringent and comprehensive provisions of the 1940 Act require strict adherence to stated investment policies and limitations, prohibit certain types of investments, restrict transactions with affiliates, and regulate management and distribution arrangements. The 1940 Act also regulates the composition and election of directors, custodial arrangements, fidelity bonding, portfolio valuation, liquidity, and best execution.

In addition, the Securities and Exchange Commission (SEC) has adopted numerous rules under the 1940 Act and issued numerous interpretations, often through staff no-action letters, that further define permissible conduct. Investment company (or fund) activities are also subject to other federal securities laws, notably the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) as well as the rules and regulations under those acts. The activities of the investment adviser are regulated under the Investment Advisers Act of 1940 (the Advisers Act). Certain fund and investment adviser activities are also regulated under state securities laws. The sales practices of broker-dealers selling shares of funds are regulated by the National Association of Securities Dealers (NASD), the self-regulatory organization of securities firms. Investment company insiders are subject to certain standards of common law and state statutes that govern all companies. Investment management on a global basis is regulated in other countries under regimes that may differ considerably from the U.S. regulatory scheme.

U.S. regulation subjects the fund, the investment adviser, and others associated with the fund to a wide variety of possible liabilities, which may arise from SEC administrative proceedings or from private litigation. The 1940 Act also contains extensive record-keeping

requirements, and the SEC regularly conducts inspections of funds and fund complexes. The SEC has broad enforcement authority and has a wide range of enforcement remedies under the 1940 Act and the Advisers Act, which allows it to impose significant penalties and sanctions upon the fund directors and officers and, in particular, the fund's investment adviser and distributor. Historically, management has been more likely than the independent directors to be the target of private litigation or SEC proceedings. However, the independent directors are by no means immune from liability.

The purpose of this loss control booklet is to discuss ways in which fund directors and officers and fund investment advisers and distributors can act to limit or contain their potential liabilities. We discuss the role of the independent directors of the fund and the importance of conducting a proper decision-making process. We stress the adequacy of internal control and compliance systems, and internal audit programs. We also highlight certain areas that should receive particular focus in a compliance or audit program.

DIRECTORS OF INVESTMENT COMPANIES

Duties and Responsibilities Under the 1940 Act

Almost all U.S. investment companies are externally managed. Although, as a practical matter, the sponsor of a fund is normally the entity (or an affiliate thereof) that becomes the fund's investment adviser and distributor, it is the statutory responsibility of the directors of the externally managed fund to employ the investment advisers to provide portfolio management and the distributor to distribute the fund's securities. In addition, the directors employ other independent entities to provide various other services required to operate the fund, such as custodians, transfer agents, and accountants. The directors' proper function is to determine the appropriate management and distribution arrangements of the fund, guide and oversee the operation of the fund, and monitor compliance with applicable laws.

Some of these duties and obligations are the responsibility of all the directors of the investment company; others are the specific responsibility of only the independent directors of the investment company, including separate approval of investment advisory and distribution agreements and various day-to-day operational items.[1] Directors have specific responsibilities under the 1940 Act with respect to approval of a number of additional matters, including valuation and pricing of shares, portfolio liquidity, custody arrangements, fidelity bonds and joint insurance policies, transactions involving affiliates, selection of independent accountants, and certain special types of investment practices.

For more detailed information as to the functions, responsibilities, and liabilities of fund directors and information about the structure and operations of the fund board of directors and its relationship to the investment adviser, the distributor, and others important to the fund (including the SEC), see *Fund Director's Guidebook* (1996), published by the Section of Business Law of the American Bar Association. The *Fund*

Director's Guidebook can be obtained by calling the ABA at 1.800.285.2221 or visiting its Web site at www.abanet.org/buslaw/catalog/5070304.html.

The 2001 Governance Standards

On January 2, 2001, the SEC adopted new governance standards (the 2001 Governance Standards) to "enhance the independence and effectiveness of independent directors of investment companies." Basically, the SEC added amendments to 10 rules that exempt funds and their affiliates from certain prohibitions of the 1940 Act.[2] Since most funds fall under one or more of these exemptive rules or may have a need for such an exemption in the future, it is assumed that, with rare exception, funds will comply with the 2001 Governance Standards.

Under the 2001 Governance Standards, commencing July 1, 2002, funds must comply with three new conditions:

- Independent directors must constitute a majority of a fund's board of directors.
- Independent directors must select and nominate other independent directors.
- Any legal counsel for a fund's independent directors must be an "independent" legal counsel.

In June 1999, an advisory group appointed by the Investment Company Institute (ICI) released its ICI Independence Report setting forth best practices for mutual fund directors.[3] The Executive Summary of the ICI Independence Report states:

> This Report recommends a series of policies and practices that go beyond what is required by law and regulation and that are designed to enhance the role of investment company directors. Many of these recommendations are already in use by many

fund boards. The recommendations are designed to ensure that the outside directors are independent from the fund's investment adviser, principal underwriter and their affiliates, and to enhance the effectiveness of all fund directors in fulfilling their oversight responsibilities.

The specific recommendations contained in the ICI Independence Report are set forth in Appendix A (see page 64). The 15 recommendations go beyond the 2001 Governance Standards and include recommendations, among other things, about fund share ownership, directors and officers (D&O) liability and errors and omissions (E&O) liability insurance coverage, retirement policies, and evaluation of board performance. Many fund boards have considered and adopted many of the ICI's best-practices recommendations, and the SEC encourages all fixed boards to review the best-practices recommendations.

Requisite Board Composition

Section 10(a) of the 1940 Act requires that interested persons comprise no more than 40% of the members of a registered investment company's board of directors. Section 10(b) of the 1940 Act imposes a different set of composition requirements: Among other things, it says a fund cannot employ a regular broker or principal underwriter unless a majority of the board is independent of the broker or principal underwriter, and a majority of the board may not be investment bankers or affiliates of investment bankers. Commencing July 1, 2002, the 2001 Governance Standards require that a majority of the board must consist of disinterested independent directors.

The consequences of failing to maintain the requisite number of independent and inside directors can be severe. The 1940 Act requires that certain matters and contractual arrangements—including advisory and distribution arrangements—be approved by a majority of

independent directors. An investment advisory agreement approved by an improperly constituted board may not be valid and, among other things, the adviser may be required to return fees received under the contract or provide its services at cost. Similarly, payments made by a fund to its distributor or underwriter under a distribution plan that has not been approved by a properly constituted board may also be recoverable. To the extent the appropriate balance of directors has not been maintained, other board actions may be subject to challenge as well. Accordingly, it is imperative that the board be properly constituted at all times.

If a board becomes improperly constituted, it may not be easy to correct the imbalance. Strong independent directors are hard to find. Furthermore, Section 16(a) of the 1940 Act limits the authority of the board to fill vacancies on its own initiative to those situations where, upon the filling of the vacancy, at least two-thirds of the directors will have been elected by the shareholders. If that requirement cannot be met, then the vacancy can be filled only by shareholder action. New Rule 10e-1 under the 1940 Act allows funds a grace period of 90 days to fill board vacancies resulting from the death, disqualification, or bona fide resignation of a director that causes the percentage of independent directors to fall below the required threshold. That grace period is 150 days if a shareholder vote is required to fill the vacancy.

The definitions of “affiliated person” and “interested person” are quite technical under the 1940 Act, and it is easy for an independent director to become an interested person. A director becomes an interested person of the fund if any member of his or her immediate family becomes an affiliated person of the fund, an affiliated person of the investment adviser, or a principal underwriter.[4] For example, if the son of a director marries an employee of a principal underwriter, that director suddenly becomes an interested person. It is advisable to have an excess number of independent directors to guard against becoming improperly constituted should an independent director inadvertently

becoming an interested person. A number of funds have only one or two inside directors serving with five or more independent directors.

An investment company should implement compliance procedures to ensure that the board is and remains properly constituted. As part of such a program, detailed directors' questionnaires with specific questions geared to the definitions of "affiliated person" and "interested person" should be administered to board members regularly.

Selection and Nomination of Independent Directors

The 2001 Governance Standards require that independent directors select and nominate new independent directors. Funds that have adopted Rule 12b-1 distribution plans are already subject to this nominating-committee requirement. The Governance Release notes that the investment adviser may suggest independent-director candidates if the independent directors invite such suggestions, but it emphasizes that it is the responsibility of the independent directors to recruit, solicit, and interview independent-director candidates. The adviser has a legitimate interest in ensuring that the independent directors are qualified and are not unduly associated with competitors. On the other hand, the adviser and any interested directors should not be permitted to participate in the process in a manner that limits the independent directors' discretion.

The nominating committee assumes implicit responsibility for evaluating the performance of incumbent directors and for determining whether they should be nominated for reelection at the expiration of their terms. The nominating committee may also be given the responsibility of making a recommendation to remove a director for cause (although such situations are rare).

The 1940 Act does not set forth any qualifications for independent directors other than the "interested person" definition and certain disqualifying conduct.

In selecting directors, emphasis should be placed on seeking persons who are knowledgeable about the functions and problems of investment companies and who have special experience (such as compliance experience) to contribute. Potential directors should not have conflicts of interest or business or personal relationships with the fund sponsor and adviser (e.g., a next-door neighbor or former college roommate) that would give the appearance of undermining their independence. In the excessive-fee cases discussed in "Lessons to Be Learned from Excessive-fee Cases" on page, the courts, in upholding the decisions of independent directors, have cited the backgrounds and expertise of the directors and the extent to which they are free from domination or undue influence.

In his book, *Inside the Boardroom, Governance by Directors and Trustees*,[5] William G. Bowen makes some interesting comments on board composition:

> More generally, I believe that every individual on a board should have some special competence or experience to contribute. While it is obviously desirable to have individuals with breadth, it is dangerous in my view, to recruit people who make careers of serving only as outside directors. Having a deep root in another organization or in a particular vocation is at least partial protection against a kind of dilettantism, and against the danger that individuals who spend too much time serving on boards may be tempted simply to "go through the motions."
>
> To end this section on a rather different note, I am persuaded that another qualification, not really "professional," should be taken seriously in composing boards. It is enormously important to include individuals who make it stimulating and enjoyable—fun—for other directors to come to meetings. The pleasure to be derived

from having interesting colleagues is an important reward for service, and the presence of such people encourage fuller attendance and more active participation in the work of the board. This attribute of board membership is a more important determinant of effective governance than most people realize.

Obtaining Independent Counsel for Independent Directors

There is nothing in the 1940 Act or the 2001 Governance Standards that requires the independent directors to retain their own separate legal counsel. However, the fees and expenses of such counsel are a proper expense for the fund to bear. Effective July 1, 2002, any counsel hired to represent the independent directors must be an "independent legal counsel" that is free from significant conflicts that might affect its advice.

Under the 2001 Governance Standards, a person is considered independent legal counsel if:

- The fund's independent directors determine that any representation of the fund's investment adviser, principal underwriter, administrator, or their control persons during the past two fiscal years, is or was "sufficiently limited" so that it is unlikely to adversely affect the professional judgment of the counsel.

- The independent directors obtain an undertaking from the counsel to provide them with sufficient information necessary to make their determination and to promptly update that information if it changes.

The independent directors must make their determination at least annually, and the Governance Release emphasizes that the directors must "consider all relevant factors in evaluating whether conflicting representations are sufficiently limited."

These factors include:

- Whether the representation is current and ongoing.
- Whether the representation involves a minor or substantial matter.
- The nature and extent of the affiliations.
- The importance of the representation to counsel and his or her firm, including economic considerations.
- Whether the work done for affiliates involves mutual funds.
- Whether the individual who represents the directors also personally represents the affiliates.

In addition, the American Bar Association published a report that provides guidance to independent directors in the selection and use of legal counsel, titled "Report of the Task Force on Independent Director Counsel."[6]

In this booklet, we place considerable emphasis on the role of the independent director and the importance of a valid decision-making process. Retaining disinterested legal counsel for the independent directors contributes greatly to the decision-making process. In determining the weight to be given to director approval in Section 36(b) cases, federal courts have consistently and carefully examined the degree of independence of counsel advising the independent directors. In at least one case,[7] the court stated that the decision of the directors might well have been given greater deference had the directors been counseled "by disinterested counsel furnished to the independent directors."

Because the adviser has the largest stake in the independent directors' decision-making process, the adviser has a legitimate interest in the issue of whether counsel for the independent directors is a qualified

independent legal counsel free of significant conflicts that might affect its advice. Advisers have typically been involved in the selection of separate counsel for independent directors and can be expected to become more involved under the 2001 Governance Standards. Unless the SEC clarifies what constitutes "sufficiently limited" representation, some advisers have stated they expect to take a conservative stand with respect to any conflicts involving separate counsel.

Service on Multiple Boards in a Complex

It is industry practice for directors to serve on more than one fund board in a fund complex. For complexes with a large number of funds, this is a practical necessity. Although the funds have areas of common interest, the directors must exercise their board responsibilities on a fund-by-fund basis. Broadened exposure to the operations of a complex can be valuable to a board member and provide a better context for carrying out board functions, such as serving as the independent directors' "watchdog." Service on multiple boards also provides administrative convenience. The ICI's best-practices report recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

The allegation that multiple directorships undermine the independence of the investment adviser is nothing new in the 1940 Act context. This allegation was raised and rejected in the excessive-fee suits of the 1980s, for example, in the *Gartenberg* cases. It was also raised and rejected in several litigations in connection with the Dreyfus-Mellon merger. Among other tactics, the plaintiffs in that matter sought and were denied an SEC hearing on the issue of whether the independent directors were in fact interested persons under the 1940 Act because of their multiple directorships. SEC disclosure regulations and many SEC rules contemplate multiple directorships. Still, this is a subject that has

caused anxiety in the fund industry, particularly as the industry has grown and the aggregate compensation received by directors has grown.

In the past few years, courts in various jurisdictions have examined plaintiffs' claims that serving on multiple boards in a fund complex and receiving significant compensation for that service give rise to the presumption that the directors are "interested persons" under the 1940 Act.[8]

Subsequently, this allegation has been raised in at least five lawsuits in which the plaintiffs in each case argued that since the board was improperly constituted, the contracts were voidable and the fund was entitled to recover all fees paid on the contracts. To date, on motions to dismiss, three courts have dismissed the plaintiff's claim, holding in each case that service on multiple boards alone is insufficient to demonstrate that outside directors were "interested," while two courts have allowed the plaintiff's Section 36(b) claim to proceed for a factual determination of independence. In one case involving the Fidelity funds, the court found that the plaintiff had alleged facts sufficient to support some of the *Gartenberg* factors and thereby permitted a Section 36(b) excessive-fees claim to go forward. In so doing, the court noted that "[w]hile membership on multiple boards does not necessarily establish lack of independence, it may support an inference of a lack of conscientiousness (*Gartenberg* factor 6) by the directors in reviewing fees paid by each of the funds." This case was subsequently settled.[9]

Given the scrutiny on serving on more than one fund board in a complex, the directors and fund management should carefully consider the appropriateness of such service, taking into account the increased responsibility and workload as well as potential conflicts that may arise. If there is concern as to whether the directors can handle the responsibility and workload associated with a number of funds, the board sizes can be expanded or the complex can add an additional cluster in a separate board. Another factor to be considered in an

analysis of the independence of directors is the amount of aggregate compensation they will receive.

In order to take advantage of the great value that flows from having independent directors making sound and reasonable determinations in a valid decision-making process, fund management should be careful not to overburden the independent directors with too many funds or too much detail.

Like corporate directors, the directors of a fund are responsible for setting their own compensation and are subject to a fiduciary duty arising under state law, which generally limits directors to "reasonable" compensation. Directors have an inherent conflict of interest in setting their own compensation, and that conflict is not reduced if the recommendation is made by the investment adviser. Therefore, directors should seek the data necessary to determine a reasonable amount of compensation, including data on comparable funds, together with analysis of any special factors that may relate to the fund or fund group. Directors should also be mindful that compensation paid to each director by the fund and by the fund complex as a whole must be publicly disclosed.

Making the Most of Independent Directors

The courts have placed great emphasis on the extent to which independent directors are informed about the issues being considered. In each of the excessive-fee cases tried on the merits discussed in "Lessons to Be Learned from Excessive-fee Cases" on page 49, the independent directors received voluminous materials outlining their duties and setting forth information relevant to the factors that must be considered in determining reasonable management compensation.

The adviser should provide the independent directors with written materials describing their duties and responsibilities and information about the relevant factors. The adviser should also keep directors

informed of recent investment-company regulation and industry developments. Independent directors' decisions will be undermined if they are somehow misled or not fully informed. Therefore, the adviser should never withhold information from independent directors or provide misleading information, but should instead always err on the side of full disclosure.

Independent directors should periodically meet separately to review the appropriate corporate governance policies and standards relating to the manner in which the board conducts its operations. Topics to be considered include the:

- Size of the board and its overall composition.
- Frequency of meetings.
- Adequacy of the agendas.
- Quality of the information being received.
- Adequacy of access to the personnel of the adviser and others.
- Access to qualified legal counsel that is sufficiently independent from the adviser and its affiliates.
- Adequacy of continuing education regarding their duties and responsibilities.
- Retirement policies.
- Peer reviews.

Importance of the Quality of Directors' Decision-making Process

A number of court decisions have examined the actions of independent directors to determine whether their approvals should be upheld in situations involving a conflict of interest between the investment

company and the investment adviser and its affiliates. Much of the discussion in this area has focused on two issues: whether proper procedures were followed and whether there was a valid decision-making process. The courts have carefully scrutinized the qualifications of the directors, their independence, and the nature and quality of information provided to them. Emphasis has been placed on whether the directors were adequately informed, whether they were free of domination or undue influence, whether they gave careful consideration to relevant factors, and whether such deliberations were substantive, not a mere formality. For example, in *Tannenbaum v. Zeller*,[10] the court of appeals held that approval by the independent directors of an adviser's compensation arrangements would be controlling under Section 36(b) (and its previous version) if those directors:

- Were not unduly influenced by the adviser.
- Were fully informed by the adviser about the issue in question.
- Made a reasonable business decision after a thorough review of all relevant factors.[11]

If proper procedures are not followed and the decision-making process is found to be inadequate or invalid, the courts will never reach the question of the fairness of the transaction.

Factors cited by the courts in assessing the quality of the deliberative process (and, therefore, the weight to be given to director determinations and approvals) have included:

- The relative number of independent directors.
- The backgrounds and expertise of the directors and the extent to which they are free of domination or undue influence.
- The methods used in selecting and nominating directors.

- The extent and quality of the information supplied to the directors by the adviser, particularly with respect to areas in which the adviser's interests and those of the fund may conflict, and the manner in which the information is presented.

- The extent to which directors understand the nature of their statutory duties and responsibilities.

- The nature of the directors' deliberations and whether those deliberations are substantive in nature and evidence real scrutiny on the part of directors or are a formality.

- The initiative of the independent directors in seeking additional information that they believe is necessary for their deliberations and reviewing alternatives to management proposals.

- The responsiveness of the adviser to directors' initiatives.

- Whether the independent directors have their own independent counsel and have used that person or other qualified experts to review information or consider matters that require special expertise.

- The degree to which the conduct of the directors evidences "arm's-length bargaining" by the directors on behalf of the fund and its shareholders.

This is not to say that every factor need be present or has been present in the favorable court decisions. It should be noted, however, that regardless of the weight a court ultimately accords to director approval of advisory compensation, the courts have independently scrutinized the reasonableness of advisory-fee arrangements and have not applied a strict business-judgment rule.

The SEC, through its fund-inspection program, increasingly scrutinizes the quality of the information furnished to the independent directors

and reviews the deliberative process to determine whether the directors are performing their duties. In this regard, the SEC reviews fund-board meeting minutes. In the absence of standard practice, however, questions remain about how detailed board minutes should be.

Importance of Staying Current with Industry and Regulatory Developments

The manner and the environment in which funds operate are constantly evolving, as are the regulations governing fund and investment management activities. For example, in addition to the 2001 Governance Standards, the SEC recently enacted new consumer privacy regulations, fund name requirements, and disclosure requirements for after-tax returns that demand considerable study on the part of fund complexes. It is essential that fund management and directors (not to mention applicable compliance programs) stay abreast of new industry and regulatory developments affecting how business is conducted.

LIABILITY LOSS PREVENTION IN PORTFOLIO MANAGEMENT AND ADMINISTRATION

Importance of Effective Internal Controls and Compliance Programs

Investment companies are subject to numerous federal and state statutes, rules and regulations, court and regulatory decisions, and rules of self-regulatory organizations. Funds also have detailed investment policies and limitations set forth in various constituent documents, including the fund's prospectus, charter, and by-laws. To qualify for the tax treatment afforded "regulated investment companies" under Subchapter M of the Internal Revenue Code, funds must also comply with a number of highly technical tax requirements. Funds investing on a global basis or selling their shares abroad must consider foreign legal and regulatory requirements, which can be quite different from the U.S. regulatory scheme.

The directors contract with third parties to perform the ongoing operations of the fund. Obviously, it is important that the investment adviser, as well as others to whom responsibilities are delegated, maintain effective internal control and compliance programs. The independent directors, in acting as "watchdogs" for the shareholders of the fund, obviously are not expected to discover compliance failures on their own. The independent directors should monitor the adequacy of internal controls and compliance programs and establish procedures—e.g., quarterly reports—to ensure that they are kept informed of any compliance or control deficiencies. This topic should be discussed each year with the independent auditors. If the directors or management have concerns about the internal control environment, they should consider retaining a consultant to complete a full review of the compliance system.

Compliance experts will tell you that there is no uniform off-the-shelf compliance manual from which a compliance program can be derived.

It has been said that an effective compliance program is based 20% on what the law requires and 80% on the manner in which the entity does business.

Elements of an effective compliance program include:

- Comprehensive written procedures covering all policies, restrictions, and functions that present compliance concerns.
- Procedures tailored to the needs of each particular fund, reasonably designed to both prevent and detect violations as the activities of the fund evolve.
- Procedures designed to ensure that the fund activities conform not only to regulatory requirements, but also to the disclosures set forth in the fund's prospectus, shareholder reports, and related documents and in the adviser's Form ADV (a filing made by the adviser pursuant to the Investment Advisers Act of 1940).
- "User-friendly" procedures that are not overly complex (too much detail can be a trap when it is impossible to comply); written checklists can be useful in this regard.
- A system for monitoring activities and procedures for investigating violations and imposing sanctions on employees.
- Mandatory training programs and continuing education for portfolio managers, traders, and other operational personnel. (The adviser should take care to document employees' participation in the programs to limit the exposure of management if an employee violates policies.)
- Knowledgeable compliance personnel who operate along clearly established lines of authority and have the responsibility and accountability for enforcing procedures.

A very important component of any compliance program is the support of senior management and their ability to foster firm-wide commitment to observing sound practices. Lax attitudes at the senior-management level may allow an environment to develop that can make it difficult for compliance personnel to enforce their authority and result in a breeding ground for poor standards throughout an organization. Regulators are more likely to bring action against a fund or adviser if they believe senior management is not fully committed to compliance. Support from senior management is also required to provide the investment with adequate resources to maintain an effective compliance program.

If the adviser has affiliates that potentially can do business with the fund, the compliance program should ensure that any fund transaction involving affiliates complies with the 1940 Act restrictions on affiliated transactions.

The internal controls should include an effective internal-audit process to detect and correct problems as they arise. The adviser should adopt procedures to ensure that problems that are detected do not arise again. The internal audit function should be adequately staffed, and internal audits should be routinely conducted. The results of each internal audit should appear in a written report, which should identify all recipients of the report and any responses to it. The written report should be carefully prepared in view of potential access by litigants or regulators. The independent directors should schedule periodic meetings with senior compliance personnel to review compliance procedures and deficiencies that have been discovered.

Compliance personnel will tell you that no matter how comprehensive the formal structure of the compliance program, there is no substitute for walking around and maintaining a physical presence with the operational personnel. Often it is the offhand "by the way" comment of the official on the line that uncovers a compliance deficiency. An effective compliance program also needs compliance personnel who can

smoothly relate to operational personnel; a compliance program is undermined by compliance personnel who cannot by dint of personality gain the respect and attention of those they oversee.

Lessons to Be Learned from SEC Enforcement Cases

In recent years, there has been a marked increase in enforcement activity involving investment companies and investment advisers under both the 1940 Act and the Advisers Act.

SEC enforcement officers have stated that the increase in enforcement actions is not “scandal-driven;” rather, it is the result of the tremendous growth in the fund industry, which creates more opportunities for problems to develop, and the fact that the SEC has become more investor-protection oriented, paying particular attention to the fund area. Appendix B contains brief descriptions and citations of recent representative enforcement cases.

The criteria the SEC applies when deciding whether to bring an enforcement proceeding for alleged violations include:

- The overall magnitude of the violation and the impact the conduct had on investors.
- How long the problem persisted.
- Whether prompt remedial action was taken to correct the problem once it was discovered.
- The nature of the violation:
    - Was it fraud or a technical violation?
    - Was the conduct intentional or inadvertent?
    - Was the violation an isolated incident or part of a pattern of conduct?

- The involvement of senior management in the violation; and, if not involved, how senior management reacted when they learned of the problem.
- The clarity of the law and whether there is a reasonable basis for a different interpretation.
- Whether prior examination-deficiency letters have been issued with respect to the violation and whether steps were taken to correct those deficiencies as soon as possible.

One decision that the SEC must make in proceedings involving misconduct on the part of an individual employee is whether to bring a "failure to supervise" action against the investment adviser. In such instances, the staff looks to whether adequate internal controls, compliance procedures, and training programs were in place; whether the breakdown was of a sporadic nature; and how management responded to the problem when it was identified. The fact that the procedures break down and a violation occurs does not necessarily result in a failure-to-supervise action. The SEC has stated that although no set of procedures is foolproof, the adviser is much better off with a set of procedures that are taken seriously than with no procedures in place.

Effective internal controls and compliance procedures may help simplify the inspection process, especially when funds can demonstrate that their compliance function has detected and rectified control deficiencies. The SEC's Office of Compliance Inspections and Examinations (OCIE) inspects violations and bases the scope of its examination on whether the fund has a strong internal control environment. Typically, upon the conclusion of an inspection, the SEC writes a deficiency letter to the adviser setting forth any problems it has found. This letter is frequently the starting point for the inspection staff on the subsequent visit, and it is very important that problems cited in the deficiency letter be corrected prior to the follow-up examination.

It is important for the adviser to be ready for an inspection before the SEC examiners arrive. The adviser that waits until it receives a notice of an inspection to try to decide how to prepare for the examination and assemble written documentation has waited too long. Of course, the adviser may be subjected to an unannounced inspection for cause or as part of an industry-wide sweep program. Hallmarks of effective internal controls are written policies and orderly books and records evidencing that the adviser has followed sound business practices and compliance procedures. In this regard, it is essential that the adviser comply with the 1940 Act books and records requirements to the extent they apply. The adviser should also conduct regular inventories of its books and records as part of its compliance program, since the OCIE has stated that sloppiness in maintaining books and records and making SEC filings often indicates a lax compliance and control environment.

A compliance program should particularly focus on matters receiving special attention in the SEC's enforcement program and in recent SEC pronouncements (the so-called "hot topics"). For example, in March 2001, the OCIE stated that the hot topics at the top of its inspection examination list are best execution and compliance with the newly enacted privacy rule (Regulation S-P), which is discussed in detail in "Privacy of Consumer Financial Information" on page 41.

Other matters the OCIE has emphasized in recent years include:

- Personal trading by advisory personnel.
- Soft dollars.
- Use of derivatives.
- Fair-value pricing of securities.
- Portfolio trade allocations, particularly IPO allocations.

- Performance advertising.
- Portfolio management "sleight of hand."

The SEC expects that with effective internal controls, violations will be regularly detected and corrected. Questions arise as to how a compliance department should resolve internally detected violations in order to best insulate the fund and the adviser from subsequent actions by the SEC. Tougher questions arise regarding under what circumstances a violation should be reported to the independent directors, or even to the SEC, and under what circumstances the independent directors should be involved in correcting the violation. The adviser generally should involve the independent directors and their counsel in problems involving intentional or fraudulent conduct or conflict-of-interest situations. If there is doubt, the adviser should err on the side of going to the independent directors. Additional considerations that may be relevant in the decision to go to the SEC are the amount involved and whether the conduct involves areas of particular concern to the SEC.

Areas to Receive Particular Focus in Any Compliance Program

Compliance with Investment Policies and Restrictions

The investment policies and restrictions of a fund and the risks associated with such investments are set forth in the fund prospectus, shareholder reports, marketing materials, and other communications. It is important that the investment adviser not deviate from the fund's stated policies in managing the fund's portfolio. Such deviations can be the subject of private disclosure suits and SEC enforcement actions, particularly when losses have occurred. For example, advisers have been forced into costly settlements when funds make portfolio investments that their disclosure documents declare will not be made, or when investments do not fit the risk profile set forth in the disclosure documents. Compliance and internal audit programs should be

structured to monitor the portfolio investments of a fund to ensure that they comply with stated policies and restrictions. Increasingly, the OCIE focuses on whether the portfolio management drifted from the stated objectives and policies. The independent directors should regularly review portfolio management to ascertain whether it complies with the fund's stated objectives and policies.

The SEC has recently been concerned with what it describes as portfolio management "sleight of hand," and it has expressed concern with both "portfolio pumping" and "window dressing."

Portfolio pumping allegedly occurs when an adviser increases the fund's stake in portfolio securities at the end of a financial period solely for the purpose of driving up the value of the existing holdings and thereby increasing net asset value. While there have not been any demonstrated abuses in this area or enforcement actions brought, the SEC is sufficiently concerned such that it has formed a task force to address the issue. Thus, SEC examiners can be expected to evaluate trading data that could be construed to constitute portfolio pumping.

Window dressing occurs when a fund's adviser buys and sells portfolio securities at the end of a reporting period for the purpose of altering investor perceptions of the securities held by the fund, the strategies used by the adviser, or the source of the fund's performance. The SEC considers window dressing to be a fraudulent practice, and examiners can be expected to evaluate trade dates of portfolio securities that indicate some type of window-dressing activity.

Valuation and Pricing of Shares

Because the price at which a mutual fund's shares are sold and redeemed on any given day is based on the next determined net asset value (NAV), and because asset-based payments such as Rule 12b-1 fees and most advisory fees are accrued based on NAV, it is critical that fund assets be valued on a fair and accurate basis at least once each business day.

Because errors in pricing can result in losses irrespective of whether the error is on the high or low side, there is no such thing as a "conservative" pricing policy. Errors in valuation can lead to costly adjustments and, to the extent that shareholders suffer any material loss in the purchase or redemption of shares due to an inaccurate NAV, fund management responsible for the error may be required to reimburse shareholders. Accordingly, pricing and valuation must receive special focus in the compliance program and should be subject to periodic internal audits.

Although directors are not directly responsible for the daily determination of the fund's net asset value, the board should approve the valuation methodologies that set forth the means by which management does this calculation. Portfolio securities, for which market quotations are readily available, must be valued at market price. When the market price of securities cannot be readily determined, such as when trading is suspended or when securities are restricted or illiquid, the securities must be valued at fair value determined in good faith by or under the direction of the directors. (A security is considered illiquid if it cannot be disposed of in the ordinary course of business within seven days at approximately the value at which it appears on the fund's books.) If detailed written procedures have been developed, the directors can delegate this responsibility to the adviser. In its inspection program, the OCIE focuses on the efficacy of control procedures used to monitor fair-value pricing.

Mutual funds must comply with SEC regulations regarding portfolio liquidity. The percentage of a fund's assets that can be held in illiquid securities is limited, depending on the type of fund. Generally speaking, illiquid securities cannot exceed 15% of the portfolio. Directors should establish guidelines and standards for determining portfolio liquidity.

Asset valuation and portfolio liquidity determinations are becoming increasingly complex issues for management due to the rapid

development of new types of investment instructions and market structure and the increased globalization of fund operations. The availability of market prices before and after normal trading hours complicates this issue. Questions arise concerning the valuation and liquidity of restricted securities and other illiquid securities, Rule 144A securities (previously issued securities that may be sold in secondary-market transactions to qualified institutional buyers), and foreign securities. In the case of funds investing in foreign securities, the OCIE looks to see whether there are procedures for handling material intervening events between the close of the foreign market and the calculation of the NAV. Questions also arise because of the increasingly complex investment products available in the marketplace such as those involving derivative structures. Such products are often thinly traded and can be difficult to value.

Recent issues involved the valuation of interest-only (IO) and principal-only (PO) derivative instruments, high-yield municipal bonds, bank loans (whether they are valued at face amount or marked to market) and the valuation and liquidity of Malaysian securities that are subject to exchange controls.

Portfolio Transactions, Including Best Execution, Soft Dollars, and Trade Allocations

The manner in which a fund conducts its portfolio transactions has always been important and is becoming an increasingly sensitive area due to developments in the securities markets and globalization. Portfolio transactions require special attention in any compliance program. Compliance concerns include:

- The process for obtaining best execution.
- Trade errors.
- Trade allocations.

- Soft dollars.
- Trades with affiliates.
- Personal trading.
- Insider trading.

Let's take a closer look at the most sensitive of the areas: best execution, trade allocations, and soft dollars.

Best Execution. A fund's prospectus discloses its policies for obtaining best price and execution, and it addresses issues such as the adviser's receipt of research services from brokers and directing brokerage to dealers to sell fund shares or to reduce fund costs. The SEC recognizes that best execution does not require the lowest possible transaction cost in every instance. SEC inspections focus on the procedures in place for achieving best execution. The SEC expects advisers to make reasonable efforts to evaluate trading alternatives and continuously evaluate new options in the markets. In this regard, the OCIE looks to see whether the adviser periodically and systematically evaluates and measures the quality and cost of services obtained from the securities firms with whom it has brokerage arrangements, as well as the quality and costs of alternative market venues. The OCIE prefers advisers to conduct this analysis in a formal, well-documented, structured manner. The burden of proof with respect to best execution is much higher when conflicts (e.g., the broker is the brother-in-law), soft dollars, affiliated relationships, or fund share sales are involved. The fund's board of directors should be informed of its best-execution process and provide oversight. It is important that best-execution procedures be conducted and monitored not just by traders, but also by compliance personnel, and all actions should be documented. Special rules apply when the transactions involve affiliates.

The compliance controls should also be designed to detect and correct trade errors.

Trade Allocations. Another sensitive area involving portfolio transactions is the manner in which advisers allocate trades among accounts under their management. Enforcement actions have been brought when there has not been timely and equitable allocation of block purchases and sales of securities to various funds, and amounts under common management, particularly when allocations have resulted in favoritism to in-house or personal accounts. Particular attention needs to be paid to the allocation of so-called "hot IPOs," which offer the opportunity for instant profits. One case brought by the SEC in 2000 involved providing preferential access to IPOs to independent directors of a fund. The action alleged that the IPO allocations were improper because they gave the directors potentially profitable opportunities that rightfully belonged to the funds. The SEC, which brought its action as a disclosure violation rather than a violation of the underlying activity, found that the representation in the fund's prospectus that the allocation of IPOs would be made in a fair manner was deficient.

Soft Dollars. High on the SEC's list of things to examine are its policies regarding "soft dollars," which is the use of fund commission dollars to obtain research or other services from a broker-dealer, either directly (e.g., in-house research) or indirectly through third parties. A fund's brokerage commissions are considered to be an asset of the fund, and the fund must receive the benefits of any soft dollars flowing from these commissions. The SEC examines soft-dollar practices to determine what services are being purchased with soft dollars, what commissions are being paid, the nature of the disclosure to the public, and whether the adviser is getting best price and execution—all with a view to determining that the brokerage commissions that belong to the fund are used to benefit the fund and not others. A variety of services purchased with soft dollars fall into gray areas and require careful attention in any compliance program. The independent directors should be kept apprised of the use of soft dollars generated by the fund.

In Part II of Form ADV, advisers must disclose their policies and procedures for selecting brokers and paying commissions for effecting securities transactions. Disclosure of soft-dollar arrangements is also required in various other documents and filings under the 1940 Act.

In a March 1998 report titled "Brokerage Allocation Practices," the ICI reviewed the legal framework applicable to soft-dollar practices and the special constraints imposed on advisers to funds, including the 1940 Act, the Advisers Act, and other relevant regulatory provisions. The ICI report also discussed systems employed by advisers in their brokerage allocation processes that are designed to ensure compliance with regulatory requirements.

In September 1998, the OCIE issued "The SEC Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds," based on a major inspection sweep of broker-dealers, investment advisers, and investment companies. The report provides soft-dollar guidance and suggests a series of internal controls that broker-dealers and investment advisers should consider implementing with respect to their soft-dollar arrangements. The report also recommends that the SEC require advisers to provide better disclosure of their soft-dollar relationships and to maintain better records about them. The report is available on the SEC's Web site at http://www.sec.gov/news/studies/softdolr.htm.

The compliance program of the adviser should document the policies and procedures for each of its brokerage allocation arrangements. Advisers that participate in soft-dollar arrangements need systems to ensure that they are obtaining only products and services that meet all necessary regulatory requirements, including the requirement that the funds receive the benefits of their brokerage commissions. The procedures should also ensure that all proper disclosures are made to clients.

Personal Trading and Codes of Ethics

Rule 17j-1 under the 1940 Act requires that a fund, its investment adviser and sub-adviser, an investment company, and the investment company's investment adviser(s) and principal underwriter adopt a written code of ethics to prevent directors, officers, and other personnel with access to inside information from engaging in fraudulent conduct. The fund must also institute reasonable procedures necessary for preventing violations of the code of ethics. The rule is intended essentially to prevent purchases and sales of securities by insiders that conflict with the fund's investment program. Generally, access persons (officers or employees of a fund with access to securities) must report all transactions in securities of which they are beneficial owners.

Procedures that are designed to prevent violations should be reviewed regularly to ensure that they adequately enforce the standards of conduct contained in the code of ethics. Each person must strictly comply with those provisions of the fund's code of ethics that apply to their personal investment activities. Fund directors should be familiar with each of their fund's code of ethics and monitor its effectiveness. In doing so, the boards should receive regular reports of any significant ethics-code violations and of the sanctions, if any, that are imposed.

In 1994, the ICI responded to several highly publicized cases and intense SEC interest in the area by issuing the "Report of the Advisory Group on Personal Investing," which recommended that all participants in the fund industry adopt certain policies and procedures governing personal investment activities of fund personnel. The report, designed to address "recognized potential for abuse," is available on the ICI's Web site at http://www.ici.org/pdf/personal_investing.pdf. In the report, the ICI recommended that:

- Investment personnel should be prohibited from acquiring any securities in an IPO and should be strictly limited in their ability to participate in private placements of securities.

- Fund managers should be subject to seven-day “blackout periods” during which they would be prohibited from buying or selling securities after the fund they manage purchases or sells the same securities.

- Investment personnel should be prohibited from profiting from the purchase and sale, or the sale and purchase, of the same securities within 60 days, and any profits realized on such short-term trades should be disgorged.

- Investment personnel should be prohibited from serving on boards of directors of publicly traded companies, absent prior authorization based on a determination that such board service would be consistent with the interests of the fund and its shareholders.

- Investment personnel should be prohibited from receiving any gift of more than *de minimis* value from any person or entity that does business with, or on behalf of, the fund.

- Investment personnel should be required to pre-clear all personal securities transactions.

- Investment personnel should be required to disclose to the fund all personal securities holdings at the commencement of employment and annually thereafter.

- Investment personnel should be required to instruct their brokers to send copies of trade confirmations and account statements directly to their employers.

- Appropriate procedures should be implemented by the fund to monitor personal investment activity by access persons after pre-clearance has been granted.

- Access persons should be required to certify annually that they have read and understood the fund's code of ethics and acknowledge that they are subject to it.

- Fund management should submit to the fund's board of directors or trustees an annual report (1) summarizing, among other things, any changes made during the past year to the fund's procedures governing personal investing by access persons and (2) identifying any violations of the procedures by an access person requiring significant remedial action during the past year.

The SEC issued its own report in 1994 generally endorsing the ICI recommendations. Many, if not most, codes of ethics were amended to respond to the ICI recommendations. The SEC amended Rule 17j-1 in 2000 to require greater board involvement, increased reporting, and enhanced disclosure with respect to personal trading and codes of ethics.

In connection with these amendments, the SEC emphasized the need to tailor a fund's code of ethics to the facts and circumstances, stating that a "one-size-fits-all" approach to codes of ethics would not effectively prevent fraudulent personal-trading practices. A number of enforcement proceedings have been brought against advisory personnel for personal-investment activities considered to conflict with the interests of the firm.

The OCIE's inspection program presently concentrates on reviewing compliance with the new Rule 17j-1 provisions and the overall effectiveness of the procedures and controls used to monitor and control trading by access persons.

Performance Advertising

The SEC has been concerned about the presentation of fund-performance advertising, particularly during 1998 and 1999 when some

funds had triple-digit returns. The SEC's concern has been over whether full disclosure is made of special factors that materially contributed to a fund's performance and to assess whether these special circumstances make it unlikely that the performance can be sustained. Thus, funds and their distributors should establish internal procedures for evaluating whether special disclosure should accompany performance data. The SEC recently brought two high-profile enforcement proceedings regarding performance advertising involving Van Kampen and Dreyfus, which are cited in Appendix B.

In performance advertising, care must also be taken to ensure that the performance returns are calculated correctly and that the information is not stale (particularly on a Web site). The performance data must be current to the end of the most recent calendar quarter. The OCIE states that performance advertising is one of the most troublesome areas it confronts in its examination of advisers, stating that it finds misleading computations of composites and other areas of malfeasance. Accordingly, advisers can expect special scrutiny of their performance advertising.

In April 2000, the NASD issued Notice to Members 00-21 reminding members "of their responsibilities to present fund-performance information in a fair and balanced manner and not to create unrealistic investor expectations with regard to future fund performance." Specifically, the NASD noted that if a fund's recent performance was the result of factors that may not continue (such as investing primarily in IPOs or in an unusually "hot" industry), prominent, cautionary language should be added to the advertisement to balance the extraordinary performance data.

Affiliated Transactions

The 1940 Act contains a number of restrictions with respect to fund securities transactions involving affiliates, which are becoming increasingly difficult to monitor and analyze given the consolidation in

the financial services industry and the increased complexity of investment instruments. The four principal provisions are:

- Section 17(a)—Prohibits a fund from conducting principal transactions with affiliated persons.

- Section 10(f)—Prohibits a fund from acquiring a security if an underwriting syndicate, related to the security, exists where an affiliated person is a member of such syndicate.

- Section 17(e)—Regulates brokerage or agency transactions by a fund with affiliated persons.

- Section 17(d) and Rule 17d-1—Prohibit a fund from engaging in "joint transactions" with affiliated persons.

The SEC has adopted exemptive rules with respect to these provisions that set forth specific responsibilities for independent directors. Each is premised on the duty of the independent director to implement and monitor certain prescribed procedures to mitigate the effects of the inherent conflicts of interest in transactions involving affiliates. The exemptive orders permit certain types of affiliated transactions, subject to specific conditions.

Difficult questions arise with respect to the Section 17(d) joint-transactions provisions. Joint transactions can occur in a variety of situations, some of which may not involve the fund. A fund may have an investment in an issuer, and an affiliate may conduct a transaction with the issuer that could have some effect on the fund's existing investment and be deemed a joint transaction. For example, a reorganization of an insolvent issuer in which a fund has a debt interest and an affiliated entity an equity interest would constitute a joint transaction necessitating an exemptive order.

The compliance program should include policies, procedures, and training intended to ensure adherence to restrictions on affiliate

transactions and conditions stated in exemptive orders. All affected employees should be provided with current information so that affiliated persons can be identified. It may be necessary to update lists regularly given the rapid changes in the financial industry. Procedures should be established to prevent prohibited transactions and to monitor for any transactions that violate those procedures. Given the complexity of some of the restrictions against affiliated transactions, it is advisable that compliance procedures identify persons, inside or outside the organization, who can provide legal advice when needed.

Privacy of Consumer Financial Information

The 1999 Gramm-Leach-Bliley Act, amending the Glass Steagall Act, contains wide-ranging consumer financial privacy provisions, including a requirement that federal financial regulators adopt rules to govern the use of consumers' personal information. In carrying out this mandate, the SEC adopted Regulation S-P, effective July 1, 2001, which applies to all investment companies, investment advisers, and broker-dealers. The SEC has indicated that compliance with Regulation S-P will be an area of focus in its examination program after July 1, 2001.

Regulation S-P requires firms to notify consumers and customers of their policies and practices regarding nonpublic personal information. Subject to exceptions, a firm must give consumers and customers the right to "opt out" of the disclosure of nonpublic personal information to non-affiliated third parties. An ICI white paper titled "Privacy of Consumer Financial Information," published in January 2001, highlights the key features of Regulation S-P and suggests strategies for addressing compliance issues.

A fund complex must adopt a compliance strategy to implement and maintain a privacy policy on a day-to-day basis. Its compliance program must track the delivery of the required notices to consumers and customers and, where applicable, track and implement the opt-out elections.

The Need for "Chinese Walls" to Prevent the Misuse of Inside Information

There may be times when an investment adviser, in the course of managing fund assets, obtains material, nonpublic information regarding a publicly traded security. The adviser should adopt procedures, tailored to its organizational structure, to create a Chinese Wall between the portfolio personnel who may have access to inside information and other personnel in the fund complex. Directors of funds whose activities could result in fund personnel receiving inside information—e.g., when serving on a creditor's committee—should be mindful of the need for procedures to monitor such information and prevent its misuse.

Insider trading has long been prohibited under the anti-fraud and anti-manipulation provisions of the U.S. securities laws, including Section 10-b and Rule 10b-5 of the 1934 Act. Although the term "insider trading" is not defined in the securities laws, it generally refers to the following activities:

- The use of material, non-public information, in violation of a duty of trust or confidence, to engage in transactions in publicly traded securities.
- The communication to others of material, nonpublic information, in violation of a duty of trust or confidence, regarding publicly traded securities.

The penalties for insider trading are severe and include:

- Civil injunctions.
- Damages.
- Disgorgement of profits.
- Imprisonment.

- Fines assessed against the person who committed the violation.
- Potential fines assessed against the employer or other person controlling the insider.

In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) to deter and prosecute insider-trading violators. Section 15(f) of the 1934 Act and Section 204A of the Advisers Act, adopted in connection with the promulgation of ITSFEA, require broker-dealers and investment advisers to establish, maintain, and enforce written procedures reasonably designed to prevent the misuse of material, nonpublic information by the persons associated with such entities.

Following the enactment of ITSFEA, the SEC's Division of Market Regulation engaged in a comprehensive review of broker-dealer Chinese Wall procedures implemented in response to newly adopted Section 15(f) of the 1934 Act. In 1990, the SEC published a report of its findings, conclusions, and recommendations. Among other things, the SEC report identified certain necessary elements of an adequate Chinese Wall, including review of employee and proprietary trading, memorialization and documentation of firm procedures, substantive monitoring by the firm's compliance department of interdepartmental communications, and procedures concerning proprietary trading when the firm is in possession of material, nonpublic information. For firms engaging in investment banking, research, or arbitrage activities, the SEC also concluded that some form of "watch" and "restricted" lists should be maintained, as well as reviews of employee and proprietary trading in securities on those lists. The SEC also found that firms needed to emphasize their efforts in overseeing and enforcing their Chinese Wall procedures, including documenting investigations of inappropriate activity.

Investment advisers have not had the benefit of anything so concrete as the 1990 SEC report to guide them in structuring their Chinese Wall

procedures. The SEC has not issued definitive guidelines for complying with Section 204A of the Advisers Act; however, it has stated that such procedures must be specifically tailored to the adviser's business and clients. In addition to the appropriate use of Chinese Walls and restricted lists, the SEC endorsed the appointment of a compliance officer to centralize responsibility for overseeing compliance and for providing guidance to employees.

Given the mandate of Section 15(f) of the 1934 Act and Section 204A of the Advisers Act, broker-dealers and investment advisers that have adopted Chinese Wall procedures remain subject to sanctions if their procedures are found to be inadequate, even without allegations of insider trading. In one case, the SEC emphasized the failure of respondents to tailor compliance policies to the firm's specific circumstances. A broker-dealer and investment adviser traded the securities of a company where one individual served as chairman and CEO of the company and as an investment adviser. Although no insider trading was alleged, the settlement involved a cease-and-desist order, payment of $100,000 in penalties, and an order to implement adequate procedures.[12]

Confronted with Rule 10b-5, the requirements of ITSFEA, the recommendations of the 1990 SEC report, and matters such as *Gabelli*, investment advisers should place very high priority on the promulgation and enforcement of Chinese Wall policies and procedures.

Use of the Internet and Information Technology

Increasingly, funds use the Internet to communicate with their shareholders and to seek potential new investors. Funds also use the Internet to make disclosures regarding their portfolio holdings and to facilitate electronic proxy voting. In addition, investors can receive the latest market information, access their accounts, place transaction orders, and review other pertinent information on many fund Web sites. SEC examiners are reviewing the information technology systems

used by funds and their distributors to assess the reliability of information they produce and whether they fulfill regulatory obligations.

Improper Use of Fund Assets

It is imperative that the adviser observe the proper allocation of expenses specified in the investment advisory agreement and that fund assets not be used improperly to benefit the adviser. In one action that illustrates the many ways in which an adviser can misuse a fund and the fund's assets for the adviser's benefit,[13] the SEC found that the adviser:

- Did not disclose to the independent directors that the accounting manager performing the fund's audit expressed concern that charging the fund with 100% of transfer-agent fees and 100% of auditing fees was "aggressive accounting" and could subject the fund to exposure.
- Obligated the fund to pay up to $200,000 to market two other portfolios.
- Caused the fund to enter into a five-year lease for office space used by others.
- Caused the fund to advance $40,000 to a subsidiary of the adviser ($20,000 of which was ultimately forfeited).
- Caused the fund to acquire a call option from an investment adviser client on unfavorable terms to the fund.
- Caused the fund to use its 12b-1 fees to pay fund expenses that the adviser was obligated to pay.

The SEC rejected the adviser's defense that it reasonably relied on legal advice and that its conduct was not willful in any of its violations.

Special Compliance Situations

Special compliance programs are applicable to funds with multiple managers acting as subadvisers, advisers operating on a global basis, and private investment companies (i.e., hedge funds).

Multiple Managers and Subadvisers

In recent years, a number of fund sponsors have employed a multi-manager approach for their funds or series of funds employing a number of subadvisers. In these situations, the fund's manager must monitor the activities of the subadviser by not only assessing the portfolio performance, but also satisfying itself that the subadviser has adequate compliance programs. The manager should establish procedures with respect to each subadviser to ensure that it is kept informed of any compliance or control deficiencies. In this regard, the role of the manager, with respect to subadvisers, is not unlike that of the board in assessing the regulatory compliance of the manager.

Global Operations

Increasingly, U.S. investment advisers are investing in foreign securities, offering shares of their investment products in foreign jurisdictions, and creating and offering investment products in foreign jurisdictions. These global activities subject the adviser and its funds to the regulations of the foreign jurisdictions depending, of course, on the extent of the adviser's activities in the jurisdictions and how local regulations apply to these activities. Clearly, compliance with applicable foreign regulation needs careful study.

Investment advisers operating globally must coordinate their worldwide compliance efforts and manage local regulatory relationships on a proactive basis. It is important that foreign offices not be neglected or allowed to exist as "silos." The adviser should meet regularly with all of its local regulators, ascertain the hot topics in the local environment,

and adjust its compliance programs accordingly. A number of jurisdictions are increasing their regulatory and inspection activities.

The compliance programs should identify the cross-jurisdictional common denominators and, at the same time, recognize that the regulatory schemes in each jurisdiction differ. The SEC's regulations are not necessarily the most stringent in all respects, and local anomalies and inconsistencies must be identified and built into compliance programs. One highly respected global compliance head commented that a trap for the unwary is to think, "If it is good enough for the SEC...."

The inspection process in certain jurisdictions can be especially problematic. Other jurisdictions do not necessarily use the SEC's approach to matters such as accessing records, conducting internal audit reports, and observing attorney-client privilege. Anecdotes abound about nightmarish inspection experiences, especially in Japan. Many of these agencies have Memoranda of Understandings (MOUs) with the SEC and among each other. Certain agencies (including the SEC) are now engaging in joint inspections and attempting to develop best-examination policies. It is therefore important for the industry to understand and support the MOUs and the development of joint standards.

Hedge Funds and Private Investment Companies

In recent years, there has been a great expansion in pooled investment entities that are exempt from the registration and reporting requirements of the 1940 Act. These exempt entities are largely private investment companies, or so-called "hedge funds." While exempt from the registration provisions of the 1940 Act, private investment companies are subject to the anti-fraud provisions of federal securities laws and have been the focus of considerable SEC enforcement. In 2000, the SEC brought several actions involving fraudulent practices by

hedge funds and their advisers, where managers either lost or misappropriated investor funds or manipulated performance reports.

Sponsors and advisers of private investment companies can be subjected to claims under U.S. and foreign securities laws alleging mismanagement of customer accounts, breach of fiduciary duty, ERISA liability, misleading sales practices, and errors and omissions in rendering professional services to customers. Directors, officers, members of the board of management, general partners, managing general partners, trustees, and employees can be subjected to claims alleging wrongful acts brought against them by shareholders, regulators, creditors, and other third parties. Advisers of private investment companies must maintain effective internal controls and compliance programs that address compliance concerns such as valuation, portfolio transactions, conflicts of interest, and insider trading.

Many mutual fund sponsors who are registered investment advisers also sponsor private investment companies. The OCIE has stated that because the adviser typically receives a percentage of capital gains for managing private investment companies, it may have an incentive to favor private investment companies over registered funds, which have a lower advisory fee. The OCIE has stated that it will examine trade allocations as part of its inspection program to determine whether the allocations are conducted in a fair manner. The OCIE has also stated that it is concerned about the possibility of manipulation resulting from the use of short sales by hedge funds when public funds have long positions in the same security. Advisers should have compliance procedures in place to address these potentially abusive practices.

LESSONS TO BE LEARNED FROM EXCESSIVE-FEE CASES

Since 1981, five major Section 36(b) excessive-fee cases have been tried. In each case, the court held that there had not been a violation of Section 36(b).[14]

The cases firmly established the standard that "[t]o be guilty of a violation of §36(b), ... the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining," with the test being "essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances."[15]

These cases also established factors that independent directors should consider in determining the reasonableness of management compensation:

- The nature, extent, and quality of the services provided.
- The performance of the fund.
- Comparative fees paid by similar funds.
- The control of the operating expenses of the fund.
- The manner in which the portfolio transactions of the fund are handled.
- The costs and benefits to the adviser and its affiliates with respect to its relationship with the fund.

Of these factors, the courts are focusing more and more on the costs incurred by the adviser and its affiliates in providing services to a fund and the benefits accruing to the adviser and its affiliates from those services. As a matter of fact, in *Krinsk* and *Kalish*, the question of

profitability was the central issue. However, the cost-and-benefit analysis is quite difficult for a number of reasons:

- The difficulty of ascertaining profitability. (In the *Krinsk* opinion, Judge Walter noted that cost accounting is an art, not a science.)
- The extent to which independent experts should be retained to assist in the cost accounting process.
- The propriety of considering marketing expenditures as an appropriate cost.
- The lack of a quantitative standard as to what level of profitability will be considered unreasonable.
- The extent to which intangible collateral "fall-out" benefits must be quantified and considered.

While the answers to these questions are not at all clear and industry practice varies, certain conclusions can be drawn. Independent directors should be given information about costs and benefits. The profitability study should identify the methods used for allocating costs and the assumptions made in the analysis. One cost accounting approach taken by certain fund groups is to identify the range of assumptions that can be made in the cost accounting methodology and derive a profit range based on the various assumptions. There does not appear to be anything wrong with providing directors with information about distribution costs; however, it is important to identify and show separately the marketing and promotional costs incurred by the adviser and its affiliates. The adviser should provide a cost analysis for the entire fund complex and demonstrate how such costs are allocated to the various funds. Nothing mandates that the profitability study be conducted by an independent expert, although this may be helpful, especially to the extent that it establishes the appropriate methodology.

If the adviser prepares the cost data (as is usually the case), it is quite helpful from a credibility standpoint if the profitability figures are those used by the adviser for internal management purposes.

The court opinions in these cases, particularly the district court opinions, provide informative and interesting reading for independent directors and illustrate the nature of the deliberations that they should conduct. Many directors have commented that reviewing these opinions has been an immense help in focusing their attention on the importance of the decision-making process under the 1940 Act, as well as raised their sensitivity to the factors that must be addressed in determining the reasonableness of advisory fees and resolving other 1940 Act issues.

In 2000, the U.S. General Accounting Office and the SEC both released reports on mutual fund fees, addressing topics such as statistical trends, competition in the mutual fund industry, disclosure practices, and the role of fund directors. In its report, the SEC reinforced the notion that the 1940 Act statutory framework, and its primary reliance on disclosure and procedural safeguards, was adequate; however, the SEC concluded that there was room for improvement. Specifically, the SEC called for more disclosure concerning independent directors, strengthening the power of independent directors, and continuing and improving investor education.[16]

THE DISCLOSURE CASES: THE SEC AND THE COURTS

A fund and its management prepare registration statements, shareholder reports, and proxy statements describing the fund and its operations. Directors should be comfortable that fund management, in preparing these materials, follows procedures reasonably designed to ensure the timeliness, accuracy, and completeness of the documents. Directors may be subject to liability for untrue statements or omissions of material facts in a fund's registration statement under Sections 11 and 12 of the 1933 Act. The directors' primary defense to such liability is based on "due diligence." To establish that defense, directors must show that after reasonable investigation, they had reasonable grounds to believe, and did believe, that the registration statement did not contain any materially misleading statements or omissions.

SEC Disclosure Reforms

Fund disclosure reform was an area of intense focus by the SEC staff in the 1990s. In 1998, the SEC adopted "plain English" rules aimed at simplifying and improving fund disclosure documents and eliminating "boilerplate" language and "legalese." Although rule and form amendments clarify regulatory requirements, issues remain concerning liability that may result from simplified, streamlined risk disclosure.

The SEC has also issued guidance on other disclosure issues, such as the use of prior-performance information in fund-offering materials. More recently, the SEC adopted rules to ensure that fund names are not misleading and to require disclosure of performance information, taking into account the tax ramifications of fund investing. The NASD also adopted rules regulating the use of performance information and risk-volatility ratings in fund advertising.

Lessons to Be Learned from Disclosure Cases

In the 1980s, investment company private litigation centered on the excessive advisory-fee cases. In the 1990s, private litigation was directed more toward poor portfolio performance, particularly when losses occurred due to investments in derivative instruments or forward-currency contracts. In the past, suits against investment advisers for poor performance have generally not been successful. More recent suits have taken a different approach and have been premised on disclosure violations.

A significant tension exists between the SEC's efforts to create a more concise and readable prospectus and the courts' focus on adequacy and sufficiency of fund risk disclosure. In a number of cases involving fund disclosure, the courts have endorsed the "bespeaks caution" doctrine, which says that specific, tailored cautionary language in a fund's prospectus increases the likelihood that a claim based on an alleged omission or misrepresentation will be dismissed. In the fund context, because the "bespeaks caution" doctrine results in additional pages of risk factor disclosure, it is at cross purposes with the SEC's efforts to simplify and streamline prospectus disclosure.

The federal courts that have recognized the "bespeaks caution" doctrine have emphasized that for the alleged misleading statement to be rendered immaterial, the cautionary language must be substantive, context-specific, and not consist of vague or blanket disclaimers that merely warn that the investment has risks. These are fact-intensive cases. They focus on what disclosure was made and how the fund operated in the context of that disclosure. For example, in the *Hyperion* case,[17] the court granted the defendants' motion to dismiss, stating that the prospectuses "clearly bespeak caution through a mantra of caveats, disclaimers and qualifications."[18] The *Hyperion* court stated that roadshow statements that misrepresented either investment strategy or risk must be read in relation to the prospectus disclosures, and that a misrepresentation is material, and therefore actionable, only if it

significantly alters the total mix of information available to the investors. In similar cases, courts granted the defendants' motion to dismiss because, in the courts' view, the prospectus clearly bespoke caution because the various risks inherent in purchasing shares were disclosed in detail.

While a number of federal courts have recognized the "bespeaks caution" doctrine, it should be understood that this doctrine is available as a defense only when investment risks are fully disclosed. The doctrine is not a panacea for the fund industry, and it has been applied in different ways in the lawsuits affecting funds at the motion-to-dismiss stage. The application of the "bespeaks caution" doctrine is particularly difficult for a court when arriving at its decision on a motion to dismiss, because the court must accept as true the material facts alleged by the plaintiff and draw all reasonable inferences in the plaintiff's favor. A court may grant a motion to dismiss only if it determines that there are no facts that the plaintiff could present to support its claim for relief. In several fund-related cases, the courts stated that before rendering a decision in defendants' favor, they needed to hear and consider the factual evidence that the plaintiffs would present at trial. Obviously, proceeding to trial greatly increases the costs of defense.

Some disclosure cases are settled without reaching the merits prior to trial. While settlement does save the parties the expense of costly litigation, settlements in some cases can indicate facts that are less than favorable to defendants. In other cases, courts have denied the defendants' motions to dismiss, suggesting that the court needed to hear greater factual detail because the disclosure material on its face was not sufficient to disprove the plaintiffs' allegations.

Other cases raise interesting and different disclosure issues. Certain cases have focused on the failure to provide adequate disclosure of fund fees, including Rule 12b-1 payments to fund affiliates in connection with money market sweep account funds and management fees based on

assets from a closed-end fund's issuance of both common and preferred stock. In a recent enforcement proceeding, a fund's prospectus was found to be misleading because the fund failed to disclose that the performance results reported were dependent on the fund's significant investments in "hot" IPOs during its "incubator" period. In another recent proceeding, a fund was found liable for deviating from its stated investment objective without adequately disclosing that fact.

Although disclosure claims can be very different, these cases illustrate the importance of adequate fund disclosure. Fund management must follow procedures reasonably designed to ensure the timeliness, accuracy, and completeness of the fund's prospectuses and other disclosure documents, and the disclosure must be continually reviewed and updated to accurately describe the current investment activities of the fund and present adequate, substantive, context-specific risk disclosure.

MONITORING SALES PRACTICES

In recent years, the SEC has become increasingly concerned about investor protection, sales practices, and suitability. In addition, the NASD has scrutinized sales practices and performance presentation by NASD members who sell fund shares. The increased complexity of sales and service charges, the adequacy of prospectus disclosure with respect to such charges, and advertising of past performance have been particular areas of concern.

A fund is responsible for its own prospectus, sales literature, advertisements, and other reports or information generated by it. On the other hand, a fund generally does not have direct legal responsibility for the sales practices of its distributor or its selling dealers and their respective registered representatives or sales agents, nor is it required to determine the suitability of the product for a client. However, improper sales practices may result in litigation or enforcement proceedings. Any such proceeding can adversely affect the distribution of the fund's shares, even if the fund and its management are not directly involved in the proceeding.

Accordingly, fund management should take steps to monitor the sales practices of those selling its shares. Fund management may request that the distributor report to it from time to time on sales practices and procedures adopted by the distributor and the dealers to minimize investor confusion, educate and train registered representatives, and comply with NASD rules governing sales practices of member firms and suitability requirements. One way for a director to monitor sales practices is to request information about investor complaints. Fund management may also obtain information from the distributor concerning its procedures for ensuring sales-practice compliance with the SEC and the NASD.

The SEC's rules under the 1933 Act and NASD regulations govern information contained in fund and investment adviser advertisements.

Generally, fund directors will not be liable for improper or misleading advertisements unless they knew or should have known about the misleading nature of the advertisements. Violation of the advertising rules has been a particular focus of the SEC's inspection and enforcement programs. In 2000, the SEC conducted a special review of fund performance records to ensure that the performance representations were accurately computed and not misleading in any way.

The NASD has also focused on investor suitability, particularly with respect to issues raised when relatively high-risk funds are sold to conservative investors and when higher-fee classes of multiple-class funds are sold to investors for whom a lower-fee class is more appropriate.

CONSIDERATIONS INVOLVING RULE 12B-1 DISTRIBUTION PLANS AND MULTI-CLASS ARRANGEMENTS

The SEC had long taken the position that the sale of fund shares principally benefits the adviser because advisory fees increase as assets of the fund increase. As a result, a fund was not permitted to use its own assets to pay, even in part, any marketing or promotional expenses and, prior to the adoption of Rule 12b-1, distributors of load funds financed their distribution activities primarily from front-end sales charges or indirectly out of the advisory fee. By adopting Rule 12b-1 in 1980, the SEC permitted funds, subject to specified conditions (largely procedural), to use their assets to pay filing expenses. At the present time, a majority of funds have Rule 12b-1 distribution plans that are used to provide continuing compensation to sellers of fund shares, typically in the form of asset-based distribution fees. The fund industry has developed a wide variety of deferred sales charge distribution financing techniques designed to enable the distributor to recoup distribution costs over time. In recent years, funds have been permitted to issue multiple classes of shares, with each class subject to a different distribution arrangement while representing an interest in the same portfolio of securities.

According to Rule 12b-1, a fund's plan and agreements relating to the plan must initially be approved at a meeting called for this purpose by:

- The vote of at least a majority of the fund's outstanding voting securities.
- The board as a whole.
- The independent directors.

Thereafter, each agreement must be approved on an annual basis by the board in the same manner as the initial approval and must be

terminable (without penalty) at any time by a vote of the fund's shareholders. The board must review payments made under the Rule 12b-1 plan on a quarterly basis.

In considering the establishment or renewal of a fund's Rule 12b-1 plan, the board of directors has an express duty to request and evaluate, and the distributor has an express duty to furnish, information that may reasonably be necessary to make an informed determination. To approve the plan, the board must decide, in exercising its reasonable business judgment and in light of its fiduciary duties under state law and under the 1940 Act, whether the plan is reasonably likely to benefit the fund and its shareholders.

Directors should approach their consideration of the distribution and service plan and related agreement with the same care as they do that of an investment advisory agreement. If a distributor is affiliated with the fund's adviser, Rule 12b-1 distribution payments to the distributor will be subject to the fiduciary standards of Section 36(b) of the 1940 Act. Under such circumstances, it is appropriate for the board to consider these payments in light of the standards and factors discussed in connection with the approval of the advisory contract. The board must be satisfied that the amounts to be paid by the fund are reasonable in light of the distribution services that have been performed, and that they represent a charge within the range of what would have been negotiated at arm's length. A fundamental factor to be considered in connection with all Rule 12b-1 plans is whether the distribution method under consideration provides for a reasonable financing alternative, given the facts and circumstances of the particular funds and the type of investor to which the plan is directed.

Before a fund issues multiple classes of shares, a majority of the directors, and a majority of the independent directors, must approve a written plan required by Rule 18f-3 under the 1940 Act. The plan sets forth the separate shareholder service and/or distribution arrangements

and expenses allocation for each class, as well as any related conversion features or exchange privileges. In doing so, the directors must find that the plan is in the best interest of each class and the fund as a whole. In making this finding, the board should focus on the relationship among the classes and examine potential conflicts of interest among classes regarding allocation of fees, services, and voting rights.

The directors must adopt compliance procedures to monitor Rule 12b-1 distribution plans and multi-class arrangements. These procedures must ensure that the procedural requirements related to those arrangements are followed and that the expenditures are permitted and are properly allocated. Rule 12b-1 fees cannot be used to pay expenses other than the distribution expenses specified in the plan. For funds without Rule 12b-1 plans, procedures must be in place to determine that the fund is not paying distribution expenses. There is a thin line between permissible administrative expenses (e.g., processing costs) and Rule 12b-1 types of distribution expenses.

PERMISSIBLE INDEMNIFICATION AND INSURANCE UNDER THE 1940 ACT

Section 17(h) of the 1940 Act prohibits any instrument under which an investment company is organized or administered (e.g., charter documents, indenture of trust, by-laws, etc.) from containing provisions that protect (or purport to protect) the company's directors or officers against any liability of the company or its securities holders to which they would otherwise be subject; for example *willful misfeasance*, *bad faith*, *gross negligence*, *or reckless disregard of the duties involved in the conduct of their office* ("disabling conduct"). Section 17(i) of the 1940 Act contains similar provisions in connection with any investment advisory or underwriting agreements.

It should be noted that the SEC has taken the position that Sections 17(h) and (i) of the 1940 Act are not violated if a fund advances attorney's fees or other expenses incurred by its directors, officers, investment adviser, or principal underwriter in defending a proceeding, provided certain conditions are met.[19] The conditions include an undertaking by or on behalf of the recipient of the advance to repay the advance unless it is determined that the recipient is entitled to indemnification. The individual charged with violating Sections 17(h) and (i) will be entitled to indemnification by the fund, either by a vote of a majority of a quorum of disinterested, non-party directors, or a counsel opinion stating that the individual did not engage in disabling conduct. As an alternative to obtaining this approval or opinion, Release No. 11330 requires either:

- A security deposit from the party to whom the advance is made, or
- The fund be insured against losses arising by reason of any lawful advances (i.e., no disabling conduct is involved).

D&O and E&O liability insurance protects the fund against potential indemnification expenses and also offers further protection to directors

against potential defense costs and liabilities that may result from their service to the fund. The availability of insurance may be important if, for instance, the fund is incapable of providing indemnification or unwilling to indemnify former directors, or if state or federal law limits indemnification or advancement of expenses.

Funds typically purchase D&O and E&O liability insurance policies jointly with other funds in their complex permitted under Rule 17(d)-1 of the 1940 Act, as well as with the funds' adviser and/or underwriter. The SEC recently amended Rule 17d-1(d) to require coverage for bona fide claims made against any director who is not an interested person of the investment company, or against the investment company if it is a co-defendant in the claim with the disinterested director, by another person insured under the joint liability insurance policy (i.e., opening up the insured vs. insured exclusion). This coverage requirement was driven by two recent cases, *Navellier* and *Yackhtman*, where the investment adviser, which was an insured under a standard policy (which prohibited lawsuits by one insured against another insured), brought actions against the independent directors, also insureds.[20] As an alternative, the fund board may consider purchasing coverage for the funds only and requiring the adviser to secure separate insurance, thereby eliminating potential coverage gaps.

Another reason for the fund board to consider splitting the coverage is the trend by advisory firms, which generally negotiate the policy terms and conditions on behalf of the funds, to include coverage that benefits the adviser, not the funds. For example, many D&O and E&O liability insurance policies include coverage for ERISA liability for the advisory firm's benefit plans, employment practices liability for the adviser, and D&O liability for the advisory firm. Given that these joint policies are written with an aggregate limit of liability, a loss resulting from an advisory firm's mismanagement can exhaust the liability coverage available to the fund and the board. To date, the SEC has not addressed these potential pitfalls of joint insurance programs.

In addition to reviewing the policy terms and conditions, the board should take into consideration the insurer's financial strength, claims-paying reputation, underwriting expertise, and the use and impact of reinsurance on the insurer's ability to meet its obligations.

APPENDIX A: REPORT OF THE ICI-APPOINTED ADVISORY GROUP ON BEST PRACTICES OF FUND DIRECTORS

The specific recommendations of the Advisory Group are set forth below.

Super-Majority of Independent Directors

The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

Persons Formerly Affiliated with the Adviser, Principal Underwriter, and Certain Affiliates

The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter, or their affiliates not serve as independent directors of the fund.

Control of the Nominating Process by Independent Directors

The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

Compensating Independent Directors

The Advisory Group recommends that independent directors establish the appropriate compensation for serving on fund boards.

Fund Ownership Policy

The Advisory Group recommends that fund directors invest in funds on whose boards they serve.

Qualified Independent Counsel and Other Experts

The Advisory Group recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The

Advisory Group also recommends that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

Annual Questionnaire on Relationships with the Adviser and Other Service Providers

The Advisory Group recommends that independent directors complete, on an annual basis, a questionnaire on business, financial, and family relationships, if any, with the adviser, principal underwriter, other service providers, and their affiliates.

Organization and Operation of the Audit Committee

The Advisory Group recommends: (1) that investment company boards establish audit committees for each fund composed entirely of independent directors; (2) that a fund's audit committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the audit committee secure from the auditor an annual representation of its independence from management; and (4) that the audit committee have a written charter that spells out its duties and powers.

Separate Meetings of Independent Directors

The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

Lead Independent Director of Directors

The Advisory Group recommends that independent directors designate one or more "lead" independent directors.

Insurance Coverage and Indemnification

The Advisory Group recommends that fund boards obtain D&O or E&O liability insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors.

Unitary or Cluster Boards

The Advisory Group recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

Retirement Policy

The Advisory Group recommends that fund boards adopt policies on retirement of directors.

Evaluation of Board Performance

The Advisory Group recommends that fund directors periodically evaluate the board's effectiveness.

Orientation and Education

The Advisory Group recommends that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

APPENDIX B: CERTAIN REPRESENTATIVE ENFORCEMENT PROCEEDINGS

Failure to Comply with Investment Policies and Restrictions

Piper Capital Management (Initial Decisions Release No. 175, 2000 SEC LEXIS 2626, November 30, 2000).

Fundamental Portfolio Advisors, Inc. (Initial Decisions No. 180, 2001 SEC LEXIS 156, January 29, 2001).

Mitchell Hutchins Asset Management Inc. (Investment Company Act Release No. 22805, 1997 SEC LEXIS 1793, September 2, 1997) and Ellen Griggs (Investment Company Act Release No. 1750, 1998 SEC LEXIS 1949, September 14, 1998).

Valuation and Pricing Violations

Piper Capital Management (see above).

Heartland Group, Inc. (Ligitation Release No. 16938, 2001 SEC LEXIS 513, March 22, 2001).

Michael P. Traba (Exchange Act Release No. 41761, 1999 SEC LEXIS 1643, August 19, 1999).

Parnassus Investments (Investment Company Act Release No. 22685, 1997 SEC LEXIS 1155, May 28, 1997 and Initial Decision No. 131, 1998 SEC LEXIS 1877, September 3, 1998).

Thomas M. Rogge (Investment Company Act Release No. 20908, 1995 SEC LEXIS 453, February 22, 1995) and Van Kampen American Capital Asset Management, Inc. (Investment Advisers Act Release No. 1525, September 29, 1995).

Best Execution

Fleet Investment Advisors, Inc. (Investment Advisers Act Release No. 1821, 1999 SEC LEXIS 1805, September 9, 1999).

Soft Dollars

Dawson-Samberg Capital Management (Investment Advisers Act Release No. 1889, 2000 SEC LEXIS 1604, August 3, 2000).

Marvin & Palmer Associates (Investment Advisers Act Release No. 1841, 1999 SEC LEXIS 2073, September 30, 1999).

Sweeney Capital Management Inc. (Litigation Release No. 15664, 1998 SEC LEXIS 399, March 10, 1998).

Oakwood Counselors Inc. (Investment Advisers Act Release No. 1614, 1997 SEC LEXIS 304, February 10, 1997).

Trade and IPO Allocations

Founders Asset Management, LLC (Investment Advisers Act Release No. 1879, 2000 SEC LEXIS 1239, June 15, 2000).

Monetta Financial Services, Inc. (Initial Decisions Release No. 162, 2000 SEC LEXIS 574, May 27, 2000). McKenzie Walker Investment Management Inc. et. al. (Investment Advisers Act Release No. 1571, 1996 SEC LEXIS 1887, July 16, 1996).

Kemper Financial Services (Investment Company Act Release No. 21113, 1995 SEC LEXIS 1311, June 6, 1995).

Personal Trading

Alliance Capital Management, L.P. (Investment Advisers Act Release No. 1630, 1997 SEC LEXIS 906, April 28, 1997) and Roger W. Honour (Investment Advisers Act Release No. 1527, 1995 SEC LEXIS 2567, September 29, 1995).

Ronald V. Speaker and Janus Capital Corporation (Investment Company Act Release No. 22461, 1997 SEC LEXIS 85, January 13, 1997).

John V. Kaweske (Investment Advisers Act Release No. 1539, 1995 SEC LEXIS 3226, November 28, 1995).

Kemper Financial Services, Inc. (see above).

Affiliated Transactions

Concord Growth Corporation (Investment Company Act Release No. 23470, 1998 SEC LEXIS 941, September 28, 1998).

Performance Advertising

NASD Regulation, Inc., Letter of Acceptance, Waiver and Consent, No. CAF000012 (Kemper Distributors, Inc., Respondent, May 11, 2000).

The Dreyfus Corporation (Investment Advisers Act Release No. 1870, 2000 SEC LEXIS 941, May 10, 2000).

Van Kampen Investment Advisory Corporation et. al. (Investment Company Act Release No. 23996, 1999 SEC LEXIS 1795, September 8, 1999).

Misleading Past Performance Data

Meridian Investment Management Corporation, et. al. (Investment Advisers Act Release No. 1779, 1998 SEC LEXIS 2790, December 28, 1998).

Valicenti Advisory Services, Inc. (SEC Admin. Proc. File No. 3-8854, 1998 SEC LEXIS 2447, November 18, 1998).

Hedge Fund Fraud

SEC v. Michael L. Smirlock and LASER Advisers Inc. (Litigation Release No. 16838, 2000 SEC LEXIS 2822, December 21, 2000).

SEC v. Ashbury Capital Partners, L.P., et al. (Litigation Release No. 16770, 2000 SEC LEXIS 2253, October 17, 2000).

SEC v. Michael T. Higgins, et al. (Litigation Release No. 16547, 2000 SEC LEXIS 943, May 1, 2000).

Sean P. Brennan and Keith E. Walsh (Investment Advisers Act Release No. 1775, 1998 SEC LEXIS 2778, December 23, 1998).

Fraudulent Use of Fund Assets

Terence Michael Coxon (Initial Decision No. 140, 1999 SEC LEXIS 662, April 1, 1999).

Sales Practices Violations

Spectrum Administration, Inc., Ronald Kindschi and Michael Flanagan (Investment Advisers Act Release No. 1776, 1998 SEC LEXIS 2652, December 9, 1998).

FSC Securities Corp. (Exchange Act Release No. 40765, 1998 SEC LEXIS 2651, December 9, 1998).

Richard Hoffman and Kirk Montgomery (Securities Act Release No. 7615, 1998 SEC LEXIS 2656, December 9, 1998).

ABOUT THE AUTHOR

Thomas R. Smith, Jr., is a partner in the New York office of Sidley Austin Brown & Wood. He is vice chairman of the Management Committee and a member of the Executive Committee. Mr. Smith was Brown & Wood LLP's managing partner, having served in that capacity from 1996 until the merger of Sidley & Austin and Brown & Wood in May of 2001. He started his career at Brown & Wood in 1963 and was made a partner in 1971.

Mr. Smith's practice is focused on securities with special emphasis on pooled investment entities (such as investment companies and real estate investment trusts). He is a specialist in matters related to the Investment Company Act of 1940 and has extensive experience with both U.S.-registered and offshore global fund products. His practice in the U.S. fund area involves representation of independent directors as well as funds and investment advisers. For 15 years, Mr. Smith was co-chair of the Subcommittee on Investment Companies and Investment Advisers of the Federal Regulation of Securities Committee of the Section on Business Law of the American Bar Association. He was also co-chair of the committee's task force that produced *Fund Director's Guidebook*, published in 1996, and he is currently co-chair of the task torce to prepare the second edition of the *Guidebook*.

Mr. Smith is a regular speaker at conferences and has written extensively on investment company and real estate investment trust matters. He is a member of the board of The Legal Aid Society, a member of the New York City Partnership, a member of the executive committee of the Mutual Fund Directors Education Council, a member of the Committee to Enhance Diversity in the Profession of The Association of the Bar of the City of New York, and was the chairman of The 2000 Law Firm Appeal for the Lawyers Alliance for New York.

ACKNOWLEDGMENT

The author would like to acknowledge the contributions and editing assistance of Brown & Wood LLP partners Laurin B. Kleiman and Dennis C. Hensley.

ENDNOTES

1 In this loss control booklet, "independent directors" means directors who are not "interested persons" as defined in Section 2(a)(19) of the 1940 Act, and "inside directors" means directors who are "interested persons."

2 "Role of Independent Directors of Investment Companies," IC-40-24816, 2001 SEC LEXIS 15 (January 2, 2001).

3 "Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness," Investment Company Institute (June 24, 1999).

4 See Sec. 2(19)(A)(ii). The 1940 Act defines "member of the immediate family" to mean "any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and includes step and adoptive relationships." See the final paragraph under Sec. 2(19).

5 John Wiley & Sons, 1994, p. 24.

6 Subcommittee of Investment Companies and Investment Advisers, Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association (September 8, 2000).

7 *Fogel v. Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975), *modified*, 668 F.2d 100 (2d. Cir. 1981).

8 This issue arose in 1997 in a federal court holding on a procedural point involving an interpretation of Maryland law. See *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783 (S.D.N.Y. 1997).

9 *Krantz v. Fidelity Mgmt. & Research*, 98 F. Supp. 2d 150, 158 (D. Mass. 2000).

10 552 F.2d 402 (2d Cir. 1977).

11 *Id.* at 405.

12 In the Matter of Gabelli & Co., Inc., 1934 Act Release No. 35057, 1994 LEXIS 3744 (Dec. 8, 1994).

13 In the Matter of Terence Michael Coxon, Initial Decisions No. 140, 1999 SEC LEXIS 662 (April 1, 1999).

14 *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F. Supp. 1038 (S.D.N.Y. 1981); *aff'd*, 694 F.2d 923, 928 (2d Cir. 1982); *cert. denied*, 461 U.S. 906 (1983) ("*Gartenberg I*"), which involved the Merrill Lynch Ready Assets Trust.

Gartenberg v. Merrill Lynch Asset Management, Inc., 573 F. Supp. 1293 (S.D.N.Y. 1983); *aff'd*, 740 F.2d 190 (2d Cir. 1984) ("*Gartenberg II*"), which involved the Merrill Lynch Ready Assets Trust.

Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y. 1987), *aff'd per curiam*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 108 S.Ct. 1594 (1988) ("*Schuyt*"), which involved Rowe Price Prime Reserve Fund.

Krinsk v. Fund Asset Management, Inc., 715 F. Supp. 472 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir.), *cert. denied*, 493 U.S. 919 (1989) ("*Krinsk*"), which involved CMA Money Fund.

Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir.), *cert. denied*, 112 S.Ct. 75 (1991) ("*Kalish*"), which involved Franklin Custodian Funds, Inc.

15 *Gartenberg I*, 694 F.2d 923, 928.

16 Report on Mutual Fund Fees and Expenses, Division of Investment Management, Securities and Exchange Commission (December 2000).

17 Hyperion Securities Litigation, No. 93 Civ. 7179, 1995 U.S. Dist. LEXIS 10020 (S.D.N.Y. July 12, 1995), *aff'd sub nom. Olkey v. Hyperion 1999 Term Trust*, 98 F.3d 2 (1996).

18 See 1995 U.S. Dist. LEXIS 10020 at *21.

19 Investment Company Act Release No. 11330, Securities and Exchange Commission (September 2, 1980).

20 As part of its 1999 fund governance rule proposals, the SEC staff discussed the issues raised by limitations on coverage of directors under joint insurance policies. See Investment Company Act Release No. 24082 (October 14, 1999). For further information about the Navellier and Yacktman cases, see Paul H. Dykstra & Pike-Bokhari, The Yacktman Battle: Manager Bites Watchdogs, Investment Lawyer (Nov./Dec. 1998); You're Fired! No, You're Fired! (Sept. 28, 1998) (http://www.money.com/money/fundamentalist/archive/980928.html); Mutual-Fund Directors Face Changes in Role (February 5, 1999) (http://147.134.144.14/finance361/Readings%20and%20Resources/mutualfu.htm).

Chubb Group of Insurance Companies

Warren, NJ 07059
www.chubb.com

For promotional purposes, Chubb refers to member insurers of the Chubb Group of Insurance Companies underwriting coverage. This guide is advisory in nature. It is offered as a resource to be used together with your professional insurance advisor in maintaining a loss prevention program. This guide is necessarily general in content and intended to give an overview of certain aspects of labor in the United States. It should not be relied on as legal advice or a definitive statement of the law in any jurisdiction. For such advice, an applicant, insured, or other reader should consult their own legal counsel. No liability is assumed by reason of the information this document contains.

Form 17-01-0097 (Ed. 9/01)