CLIENT MEMORANDUM

SEC ADOPTS FINAL RULES ON COMPLIANCE PROGRAMS FOR INVESTMENT COMPANIES AND INVESTMENT ADVISERS

The Securities and Exchange Commission (the "SEC") recently adopted final rules[1] requiring registered investment companies and registered investment advisers to:

- adopt and implement written policies and procedures ("Compliance Procedures") designed to prevent violation of the federal securities laws[2] in the case of investment companies and of the Investment Advisers Act of 1940 (the "Advisers Act") in the case of investment advisers;

- review those Compliance Procedures annually for their adequacy and the effectiveness of their implementation; and

- designate a chief compliance officer who is responsible for administering the Compliance Procedures.

The final rules will become effective on February 5, 2004, and must be complied with by October 5, 2004 (the "Compliance Date").

Recently, unlawful conduct in the mutual fund industry by investment advisers and fund service providers has been discovered by both the SEC and state securities authorities. In the Adopting Release, the SEC stated that these compliance rules are necessary because it is critically important for investment companies and investment advisers to have strong systems of controls in place to prevent violations of the law and to protect the interests of shareholders and clients.

Adoption of Compliance Procedures

Under amended rule 206(4)-7 of the Advisers Act, registered investment advisers must adopt and implement Compliance Procedures reasonably designed to prevent the violation of the Advisers Act by the investment adviser or any of its supervised persons.[3]

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[1] SEC Release No. IA-2204 (December 17, 2003) (the "Adopting Release").

[2] The term "federal securities laws" means the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the SEC under any of these statutes, the Bank Secrecy Act as it applies to funds, and any rules adopted thereunder by the SEC or the Department of the Treasury.

[3] The term "supervised persons" is defined as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

Under new rule 38a-1 of the Investment Company Act of 1940, as amended (the "1940 Act"), the board of a registered investment company (a "Board"), including a majority of the independent directors, must approve an investment company's Compliance Procedures, which must include provisions for the investment company to oversee compliance by its service providers with their procedures. For this purpose "service provider" is defined as a fund's investment advisers, principal underwriters, administrators, and transfer agents (the "Service Providers"). (While the rule does not require that a Board approve Compliance Procedures for other entities that provide services to a fund (e.g., custodians, pricing services), the SEC confirmed in the Adopting Release its view that a Board would evaluate those other entities' compliance systems as well.) A Board, including a majority of the independent directors, must also approve -- but need not adopt -- the Compliance Procedures of the investment company's Service Providers. In an effort to reduce overlap, an investment company complex may adopt one set of Compliance Procedures for all of its investment companies and affiliated Service Providers. Rule 38a-1 provides investment company complexes with flexibility in determining which of its affiliated Service Providers should be covered by its Compliance Procedures.

A Board must base its approval of any Compliance Procedures on a finding that such procedures are reasonably designed to prevent a violation of the federal securities laws by the investment company and its Service Providers. In making its determination, a Board may utilize summaries of the compliance programs prepared by the chief compliance officer, legal counsel or other persons familiar with the compliance programs. Any such summaries should familiarize a Board with the important features of the compliance programs and explain how the compliance programs address significant compliance risks. A Board should further consider the nature of the investment company's exposure to compliance failures[4] and actual history of compliance problems. When approving an unaffiliated Service Provider's Compliance Procedures, a Board may rely on a third-party report in making its evaluation of whether to approve the procedures as long as the report:

- describes the Service Provider's compliance program as the program relates to the types of services provided to the investment company;
- discusses the types of compliance risks material to the investment company; and
- assesses the adequacy of the Service Provider's compliance controls.

Issues to Address in Compliance Procedures Under Rule 38a-1

Rule 38a-1 does not set forth the specific procedures a fund or its service providers must have. However, in the Adopting Release, the SEC suggests that, in its view, it is important that Compliance Procedures address the following areas, in addition to those set forth below for investment advisers:

[4] For example, in the case of a money market investment company, the Board should consider whether the Compliance Procedures sufficiently address the investment company's compliance with rule 2a-7 of the 1940 Act.

- Pricing of Portfolio Securities and Investment Company Shares - Procedures must require that an investment company: (1) monitor for circumstances that may necessitate fair value prices; (2) establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; (3) provide a methodology by which to determine a portfolio security's current fair value; and (4) regularly review the appropriateness and accuracy of the method used in valuing securities.

- Processing of Investment Company Shares - Procedures must require that an investment company: (1) segregate investor orders received before the investment company prices its shares from those that were received after the investment company prices its shares and (2) obtain assurances that the provisions in the transfer agent's Compliance Procedures that address late trading are effectively administered. Reliance on contractual provisions in an agreement with an intermediary obligating that party to segregate orders received by time of receipt in order to prevent "late trading" based on a previously determined price does not suffice as a procedure.

- Identification of Affiliated Persons - Procedures must identify any affiliated persons and be designed to prevent unlawful transactions with them.

- Protection of Nonpublic Information - Procedures must incorporate insider trading policies adopted pursuant to section 204A of the Advisers Act and, further, prohibit misuse of nonpublic information, including the: (1) trading of fund shares on the basis of material nonpublic information about the fund's portfolio by advisory personnel of the investment adviser and (2) disclosure to third parties of material information about the investment company's portfolio, trading strategies and pending transactions.

- Compliance with Investment Company Governance Requirements - Procedures must guard against an improperly constituted Board, the failure of the Board to properly consider matters entrusted to it, and the failure of the Board to request and consider information required by the 1940 Act from the Service Providers.

- Market Timing - Procedures must provide for the monitoring of shareholder trades or flows of money in and out of an investment company in order to detect market timing activity and consistency in the enforcement of an investment company's policies regarding market timing.[5]

[5] If an investment company permits waivers of its market timing policies, the Compliance Procedures should be reasonably designed to prevent waivers that would harm the investment company or its shareholders or subordinate the interests of the investment company or its shareholders to those of the adviser or any other affiliated person or associated person of the adviser.

Issues to Address in Investment Adviser's Compliance Procedures Under Rule 206(4)-7

As under rule 38a-1, Rule 206(4)-7 does not enumerate specific elements that must be included in an investment adviser's Compliance Procedures, thus allowing advisers to tailor the procedures to their particular circumstances. Each investment adviser must identify potential conflicts with its clients and other compliance factors creating risks for clients and develop procedures addressing those conflicts and risks. The Compliance Procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred. In the Adopting Release, the SEC stated that, at a minimum, an adviser's procedures should address the following:

- Portfolio management processes, including allocation of investment opportunities among clients;
- Trading practices, including best execution, soft dollar arrangements and trade aggregation;
- Proprietary trading of the investment adviser and personal trading activities of supervised persons;
- Accuracy of disclosures made to investors, clients and regulators, including in advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

In the case of Compliance Procedures both for investment companies and investment advisers, these matters are in addition to procedures that are already required by law, including rule 17j-1 procedures, proxy voting policies, privacy policies, insider trading policies and anti-money laundering procedures. Rules 206(4)-7 and 38a-1 do not require the consolidation of all compliance policies and procedures into a single document. Furthermore, rules 206(4)-7 and 38a-1 do not require that investment advisers or investment companies memorialize every action that must be taken. In the Adopting Release, the SEC states that the allocation of responsibility within the organization for the timely performance of many obligations may be sufficient as a compliance procedure or policy.

Designation and Approval of Chief Compliance Officer

Registered investment companies and registered investment advisers must each designate a single chief compliance officer ("CCO") to administer the Compliance Procedures. The use of multiple compliance officers with differing areas of responsibility is not permitted. A CCO should be competent and knowledgeable regarding the federal securities laws (the Advisers Act in the case of the CCO of an investment adviser) and empowered with full responsibility and authority to develop and implement the Compliance Procedures. The Adopting Release states that the CCO should have enough seniority and authority in an organization to "compel" others to comply with the Compliance Procedures.

An investment adviser's CCO shall be designated by the investment adviser, while an investment company's CCO will need the investment company's Board, including a majority of the independent directors, to approve the CCO's designation. An investment company's CCO will report directly to the Board and the Board has the sole authority to set the CCO's compensation and terminate the CCO's employment as CCO of the investment company. (Of course, an investment company's Board cannot terminate a CCO's employment with any Service Provider.) In order to further strengthen the CCO's independence, rule 38a-1 stipulates that an investment company's officers, directors, employees, investment adviser and principal underwriter, or any person acting under the direction of these persons, are prohibited from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the CCO.

The Adopting Release states that the SEC expects that an investment company's CCO would be employed by its investment adviser or administrator, rather than being an employee of a fund. This employment nexus may be beneficial because it would provide the CCO with a more active role in the investment company's operations and the CCO would not be entirely dependent upon information that was filtered through an investment company's senior management.

An investment company's CCO is required to monitor whether the Service Providers to the fund have implemented effective Compliance Procedures administered by competent personnel. The CCO should familiarize himself with each Service Provider's operations and be aware of the aspects of the Service Provider's operations that expose the investment company to compliance risks. The CCO should make arrangements to have direct access to a Service Provider's compliance personnel and these personnel should provide the CCO with periodic reports and special reports in the event of compliance problems. The Adopting Release suggests that it may be appropriate to amend an investment company's contracts with its Service Providers to require the Service Providers to certify periodically that they are in compliance with applicable federal securities laws and to permit (or require) third-party audits of the effectiveness of a Service Provider's compliance controls.

Annual Review of Compliance Procedures

After the Compliance Procedures have been developed, approved and implemented, rules 206(4)-7 and 38a-1 require an annual review to determine their adequacy and the effectiveness of

their implementation. *The first annual review must be completed within eighteen months after the initial adoption or approval of the Compliance Procedures.*

An investment adviser's annual review should include any compliance matters that arose during the previous year, any changes in the business activities of the investment adviser (or its affiliates) and any amendments to any applicable regulations that might require a change to its Compliance Procedures. Interim revisions may be appropriate in response to significant compliance events or changes in the investment adviser's business.

The CCO of an investment company must conduct an annual review of the Compliance Procedures of both the investment company and its Service Providers. The CCO must submit to the Board an annual written report on the operation of the Compliance Procedures for both the investment company and its Service Providers within sixty calendar days after the completion of the CCO's annual review. The CCO's report must address:

- the operation of the Compliance Procedures of the investment company and its Service Providers since the last report;
- any material alterations to the Compliance Procedures since the last report;
- any recommendations for material changes to the Compliance Procedures as a result of the CCO's annual review; and
- any material compliance matters[6] since the date of the last report.

While not a formal part of the annual review, a CCO is required to meet in executive session (outside of the presence of management and the interested directors) with the independent directors of an investment company at least once a year in order to facilitate an unimpeded flow of information between the parties.

In the Adopting Release, the SEC stated that it expected all investment companies to begin reviewing their current compliance procedures and policies in light of the recent industry revelations of unlawful practices involving market timing, late trading and improper disclosures and trading on the basis of nonpublic portfolio information.

Recordkeeping Requirements

Investment advisers and investment companies must maintain copies of their Compliance Procedures for at least five years from the time that they are in effect. Additionally, investment companies must maintain the CCO's annual written reports and any Board materials provided in

[6] "Material compliance matters" is defined as any compliance matter about which the investment company's Board of directors would reasonably need to know to oversee investment company compliance, and that involves, without limitation: (1) a violation of the federal securities laws, (2) a violation of the Compliance Procedures or (3) a weakness in design or implementation of the Compliance Procedures by the investment company or its Service Providers.

connection with its approval of any Compliance Procedures. These records may be maintained electronically.

Actions That Need to Be Taken

On or before the Compliance Date, the following must occur:

Investment Advisers:

- Designation of a CCO; and
- Preparation and approval of Compliance Procedures.

Investment Companies:

- Designation of a CCO;
- Board approval of CCO and CCO's compensation; and
- Preparation and approval of Compliance Procedures for the investment company and each Service Provider to the investment company.

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