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November 27, 2002

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-40-02
Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 in Companies' Quarterly and Annual Reports

Dear Mr. Katz:

The Committee on Investment Management Regulation of the Association of the Bar of the City of New York (the "Committee") is composed of lawyers with diverse perspectives on investment management issues, including members of law firms, and counsel to financial services firms, investment company complexes and investment advisers. A list of our current members is enclosed.

This letter responds to the request of the Securities and Exchange Commission (the "Commission") on the Commission's Release 33-8138; 34-46701; IC-25775, File No. S7-40-02 (October 22, 2002) (the "Release") seeking comments on the rules under Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 (the "Act"). The Committee will address only issues arising out of the application of Sections 404 and 406 to registered investment companies.

A. Sections 404 and 405

General. The Committee believes that certain of the "technical changes" designed to "conform" the rules and forms applicable to registered investment companies to the changes proposed under Section 404 for operating companies are not technical but substantive and are inconsistent with Section 405. The Committee believes, however, that the refinement in the meaning of "internal controls" for purposes of Section 302 of the Act achieved in the Release[1] could usefully be applied to certifications required of registered investment companies and

1 See text accompanying note 113 of the Release. See also Question 20 of SEC Division of Corporation Finance: Sarbanes-Oxley Act of 2002 – Frequently Asked Questions (November 8, 2002).

suggests how that could be achieved.

Proposed changes are not "technical". Section 404 directs the Commission to prescribe rules requiring each annual report filed under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") to: (1) state management's responsibilities for establishing and maintaining adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting.

Section 405 excepts registered investment companies from Section 404 and provides:

> Nothing in section 401, 402, or 404, the amendments made by those sections, or the rules of the Commission under those sections shall apply to any investment company registered under Section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8).

The Release proposes, among other things, to amend Item 307 of Regulations S-K and S-B, as well as Forms 20-F and 40-F, to implement the provisions of Section 404. These amendments apply to operating companies.

Unfortunately, although acknowledging that Section 404 does not apply to registered investment companies, the Release also proposes "technical changes" to rules and forms applicable to registered investment companies "in order to conform to the rule changes that we are proposing for operating companies and for other reasons". The "technical" changes would require reports filed by registered investment companies pursuant to Section 13(a) or 15(d) of the Exchange Act to, in effect, state management's responsibilities for establishing and maintaining adequate internal control structure and procedures for financial reporting. This is precisely a representation required by Section 404 of the Act. As a result, the Committee respectfully submits that the proposed "technical changes" are without a basis in the Act and directly contradict Section 405. In addition, the attribution of the proposal to "other reasons" is particularly unhelpful even in trying to ascertain policy reasons why the Commission appears to think that the provisions of Section 404 should, notwithstanding Section 405, apply to registered investment companies.[2]

Congress certainly recognized in adopting Section 405 that registered investment companies do not require the remedial action contemplated by Section 404. Registered investment companies are currently required annually to file reports of their auditors on internal controls as an exhibit to Form N-SAR. Operating companies have never been subject to a

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2 The Commission asserts in footnote 129 of the Proposing Release that it is not extending Section 404 to registered investment companies because it is not extending certain elements of the proposed amendments applicable to operating companies. In light of the specific language of Section 404 — "Nothing in Section 404 … or the rules of the Commission under [that section] shall apply to any investment company" (emphasis added) — this assertion is unpersuasive. Most of the provisions not extended to investment companies are not, in any event, specifically required by Section 404 and the only requirement that would not be extended by the proposed rules is the accountant attestation contemplated by Section 404(b).

similar requirement and presumably Congress adopted Section 404 at least in part to remedy that distinction between operating companies and registered investment companies. The Committee is particularly troubled that, not only are investment companies subject without discernible benefit to rules under many of the provisions of the Act which though applicable are ill-suited for investment companies, but they are being subjected to rules under provisions of the Act from which Congress expressly excluded them under the rubric of "technical amendments" and "conforming changes".

Appropriate Refinement of "Internal Controls". The Committee appreciates the efforts made by the Commission to refine the meaning of "internal controls" within Section 302 of the Act. The Committee notes that Release Nos. 33-8124; 34-46427; IC-25722 (August 29, 2002) (the "302 Release") appeared to interpret "internal controls" for purposes of Section 302 as meaning those embodied in Section 13(b) of the Exchange Act and specifically distinguished them from the definition of internal control in AICPA Professional Standards AU Section 319.06.[3] However, the Release instead adopts the concept of internal controls in AU 319. The Committee believes that certifying officers and investors will benefit from applying the definition of internal controls in AU 319 and that limiting the proposed amendments to Rule 30a-2, Form N-SAR and proposed Form N-CSR to reflect only that refinement is an appropriate technical amendment to the Rule and these Forms. These benefits would be achieved without contradicting Section 405 if only Rule 30a-2(b)(4)(v) and (vi) and the corresponding portions of the certification in Form N-SAR and proposed Form N-CSR (in each case, paragraphs 4e)i) and ii) and 4f)) were adopted as proposed. As discussed above, the Committee does not believe that the remaining amendments to Rule 30a-2(b)(4), including the lead-in and subclause (ii), and the corresponding portions of the certification in Form N-SAR and proposed Form N-CSR are appropriate.

B. Section 406

Section 406(a) of the Sarbanes-Oxley Act directs the Commission to issue rules requiring a company that is subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act (an "issuer") to disclose whether or not the issuer has adopted a code of ethics for its senior financial officers. The Sarbanes-Oxley Act states that the rules also must require issuers that have not adopted such a code of ethics to explain why they have not done so.

The Release proposes amendments to apply Section 406(a) to registered investment companies. The Commission proposes to amend Forms N-SAR and N-CSR to require a registered investment company to (i) disclose annually whether each of the investment company, its investment adviser, and its principal underwriter has adopted a written code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions of, respectively, the investment company, its investment adviser, and its principal underwriter; and (ii) if the investment company, its investment adviser, or its principal underwriter has not adopted a code of ethics, explain why it has not done so.

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3 See text accompanying note 59 of the 302 Release.

The Committee believes that the code of ethics disclosure requirement, as applied to registered investment companies is unnecessarily broad and does not give adequate weight to the extent to which investment companies and their investment advisers and principal underwriters are already subject to extensive regulation under the federal securities laws.

In proposing to apply code of ethics disclosure to investment companies and the specified principal service providers, the Commission states that it believes that "the proposals should apply with equal force to investment companies and operating companies." The Committee agrees that standards for ethical behavior should apply with equal, if not greater, force to investment companies and their service providers. We do not believe, however, that a disclosure initiative is necessary to effect this goal: investment companies, their investment advisers and their principal underwriters are currently subject to regulatory regimes that are designed to address these very issues substantively rather than through disclosure.

Under the Investment Company Act, investment companies and their advisers and principal underwriters, and their respective directors, officers and employees, are subject to carefully crafted provisions designed to address, if not eliminate, those conflicts of interest most likely to affect investment companies and their shareholders adversely. Section 1 of the Investment Company Act addresses a catalog of potential abuses and conflicts of interest that the Act was intended to eliminate. Sections 17 and 18 of the Investment Company Act in particular, and the rules thereunder, prohibit, limit or establish procedures under which those conflicts are resolved. A requirement that an investment company either adopt a code of ethics to address the issues which Congress and the Commission have already determined to be central to the public interest in the regulation of investment companies (or to disclose that it has not) creates a superfluous requirement that does not appear to be warranted by any regulatory or corporate governance failures.

Even if the Commission has concluded that it must impose this requirement on investment companies because of the literal requirements of Section 406(a), it has not provided any meaningful rationale for requiring an investment company to disclose whether its investment adviser or its principal underwriter have adopted a written code of ethics. The Commission states that the proposed disclosure requirements covers these entities because these are the entities with respect to which conflicts of interest and other ethical issues are most likely to arise.[4] Yet, as discussed above, these entities are already subject to substantive limitations on their behavior crafted with specific attention to the conflicts of interest posed by the relationship between investment companies, on the one hand, and their investment advisers and principal

4 The Commission also notes that these are the same entities that are covered by the code of ethics requirement of Rule 17j-1. Section 17(j) of the Investment Company Act, however, specifically contemplated that the Commission could adopt code of ethics requirements that addressed these entities. The fact that they were omitted from Section 406(a) may suggest that Congress did not intend to subject investment companies to this provision. In the absence of any meaningful legislative history, it is difficult to determine the intent of Congress in this respect, but there is nothing in the legislative history or the language of the Sarbanes-Oxley Act to suggest that Section 406(a) should be applied to investment companies in the manner proposed.

underwriters and their respective directors, officers and employees, on the other.

Registered investment advisers, for example, are fiduciaries and subject to the highest standards of conduct.[5] Moreover, registered investment advisers, whether or not they are issuers required to file reports under Sections 13(a) or 15(d) of the Exchange Act, are subject to extensive books and records requirements, the duty to supervise their personnel and SEC inspections designed to assure that they have policies and procedures designed to fulfill their fiduciary responsibilities and otherwise to assure legal compliance. Finally, Section 203(e)(6) of the Investment Advisers Act provides a powerful incentive for the management of a registered investment adviser to establish procedures and a system of controls that can "reasonably be expected to prevent and detect" violations of the federal securities laws.[6]

Principal underwriters, as registered broker-dealers, are also subject to a similar pervasive scheme of regulation (in addition to the provisions of the Investment Company Act that address the relationships between investment companies and their principal underwriters). For example, they are subject to substantive regulation under the Securities Exchange Act of 1934 as well as the rules of the various self regulatory organizations. These include books and records requirements, the duty to supervise and being subject to SEC and SRO inspections.

The Committee therefore urges the Commission to reconsider the necessity and desirability of extending the code of ethics requirement to investment advisers and principal underwriters of investment companies.

The Committee has similar concerns with respect to the way in which the rule applies to sponsors, principal underwriters and trustees of unit investment trusts. In connection with trustees, we note that UIT trustees are required by Section 26 to be banks. The Committee suggests that the Commission coordinate with the federal banking regulators to determine whether the Commission's effort to impose code of ethics requirements on the officers of banks that are not issuers is either warranted or appropriate.

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5 *See, e.g., S.E.C. v. Capital Gains Research Bureau,* 375 U.S. 18 (1963).

6 Establishment and implementation of such procedures provides a basis for concluding that an associated person of an investment adviser has not failed reasonably to supervise any person who has violated the federal securities laws.

The Committee would be pleased to meet with the Commission or its staff to discuss or amplify the comments in this letter.

Very truly yours,

/s/ John E. Baumgardner, Jr.

John E. Baumgardner, Jr.
Chair

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