

SUPPORTING STATEMENT
Rule 38a-1

A. JUSTIFICATION

1. Necessity for the Information Collection

Rule 38a-1 (17 CFR 270.38a-1) under the Investment Company Act of 1940 (15 U.S.C. 80a) (“Investment Company Act”) is intended to protect investors by fostering better fund compliance with securities laws. The rule requires every registered investment company and business development company (each, a “fund”) to: (i) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws; (ii) obtain the fund board of director’s approval of those policies and procedures; (iii) annually review the adequacy of those policies and procedures and the policies and procedures of each investment adviser, principal underwriter, administrator, and transfer agent of the fund, and the effectiveness of their implementation; (iv) designate a chief compliance officer to administer the fund’s policies and procedures and prepare an annual report to the board that addresses certain specified items relating to the policies and procedures; and (v) maintain for five years the compliance policies and procedures and the chief compliance officer’s annual report to the board.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) was enacted on July 21, 2010.¹ Section 939A of the Dodd-Frank Act requires the Securities and Exchange Commission to review its regulations for any references to or requirements regarding credit ratings that require the use of an assessment of the credit-worthiness of a security or money market instrument, remove these references or requirements and substitute in those

¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

regulations other standards of credit-worthiness in place of the credit ratings that we determine to be appropriate.²

To implement section 939A of the Dodd-Frank Act, on March 2, 2011, the Commission issued a release proposing to amend rule 5b-3 under the Investment Company Act (17 CFR 270.5b-3) to remove the credit rating reference contained therein and replace it with an alternative credit quality standard.³ The proposed amendments to rule 5b-3 would increase the collection of information burdens under rule 38a-1.

² Section 939A(a)-(b) of the Dodd-Frank Act.

³ See [cite proposing release].

Rule 5b-3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of the securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act (15 U.S.C. 80a-5(b)(1), 80a-12(d)(3)) if certain conditions are satisfied.⁴ One of the conditions specifies the types of collateral permitted under the rule and includes securities rated in the highest rating category by certain NRSROs or unrated securities that are of comparable quality. In place of the rating requirement, the proposed amendment would require a fund's board of directors (or its delegate) to determine that the securities collateralizing a repurchase agreement consist of securities that the fund's board of directors (or its delegate) determines are issued by an issuer (or unconditionally guaranteed by an issuer) that has the highest capacity to meet its financial obligations and are highly liquid. Pursuant to rule 38a-1, a fund that relies on the exemption in rule 5b-3 must have written procedures reasonably designed to ensure compliance with the rule. In response to the proposed amendments, if adopted, such a fund may revise such policies and procedures. The collection of information under rule 38a-1 is mandatory for funds that rely on rule 5b-3.

2. Purpose of the Information Collection

The purpose of the information collection requirements in rule 38a-1 is to ensure that funds maintain comprehensive, written internal compliance programs that promote compliance with the federal securities laws. The information collections also assist the Commission's examination staff in assessing the adequacy of funds' compliance programs.

3. Role of Improved Information Technology

⁴ Section 5(b)(1) of the Investment Company Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). Section 12(d)(3) of the Investment Company Act generally prohibits a fund from acquiring an interest in a broker, dealer or underwriter.

Rule 38a-1 does not require the reporting of any information or the filing of any documents with the Commission. Rule 38a-1 does require funds to maintain written policies and procedures. Each fund also is required to maintain for at least five years a copy of the annual compliance report provided to the fund's board of directors. The Electronic Signatures in Global and National Commerce Act (P.L. 106-229, 114 Stat. 464 (June 30, 2000)) and the conforming amendments to rules under the Investment Company Act permit funds to maintain records electronically.

4. Efforts to Identify Duplication

Rule 38a-1 imposes a broad requirement that funds have in place written compliance policies and procedures. Funds also are subject to certain requirements elsewhere in the federal securities laws that require them to maintain written policies and procedures. The staff believes, however, that any duplication of recordkeeping requirements is limited. Moreover, rule 38a-1 does not require funds to maintain duplicate copies of records covered by these more targeted requirements, and a firm's compliance policies and procedures are not required to be maintained in a single location. The staff believes, therefore, that any duplication of regulatory requirements does not impose significant additional costs on funds.

5. Effect on Small Entities

Funds, regardless of their size, are subject to the requirements of rule 38a-1. Effective internal compliance programs are essential for firms of all sizes. Rule 38a-1 affords funds the flexibility to tailor their compliance programs to the nature of their businesses. Small firms, which generally have less complex and more limited operations, would likely need less extensive compliance programs than their larger counterparts. Thus, rule 38a-1 does not inappropriately burden small entities. The Commission believes that it could not adjust the rule to lessen the burden on small entities of complying with the rule without jeopardizing the interests of investors in small funds.

6. Consequences of Less Frequent Collection

Less frequent information collection would be incompatible with the objectives of rule 38a-1. The annual reviews of policies and procedures required under rule 38a-1 are integral to detecting and correcting any gaps in the program before irrevocable or widespread harm is inflicted upon investors, and extending the time between reviews increases the likelihood that such harm could go unchecked.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

Rule 38a-1 requires funds and advisers to maintain their internal compliance policies and procedures and documents related to the annual review of those policies and procedures for at least five years. Although this period exceeds the three-year guideline for most kinds of records under 5 CFR 1320.5(d)(2)(iv), the staff believes that this is warranted because the rule contributes to the effectiveness of the Commission's examination and inspection program. Because the period between examinations may be as long as five years, it is important that the Commission have access to records that cover the entire period between examinations.

8. Consultation Outside the Agency

In the release proposing amendments to rule 5b-3, the Commission requests public comment on the effect on information collections for rule 38a-1 under these amendments. The Commission will consider all comments received on the proposal. In addition, the Commission and the staff of the Division of Investment Management participate in an ongoing dialogue with representatives of the investment company industry through public conferences, meetings, and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens confronting the industry.

9. Payment or Gift to Respondents

Not applicable.

10. Assurance of Confidentiality

The information collected pursuant to rule 38a-1, when provided to the Commission in connection with examinations or investigations, will be accorded the same level of confidentiality accorded to other responses provided to the Commission in the context of its examination and oversight program.

11. Sensitive Questions

Not applicable.

12. Estimates of Hour Burden

For funds relying on the exemption in rule 5b-3, the rule currently permits collateral securities to include securities rated in the highest rating category by certain NRSROs and unrated securities that are of comparable quality. We do not anticipate that the proposed amendments to rule 5b-3 would significantly change collection of information burdens under rule 38a-1 because we believe funds would likely rely on their current policies and procedures to determine the credit quality of collateral securities to comply with rule 5b-3, as we propose to amend it. We understand that credit quality standards for securities collateralizing repurchase agreements are contained in the repurchase agreements between funds and counterparties. We expect that those standards currently include a rating and any additional criteria a fund manager considers necessary to ensure that the credit quality of the collateral securities meets the fund's requirements, or, for unrated securities, a comparable credit quality standard. Counterparties provide collateral securities to conform to these standards and funds confirm that the securities are conforming. Funds could continue to use evaluations of outside sources, including credit ratings, that the board (or its delegate) determines are credible and reliable in making its credit quality determinations under the proposed rule. We expect that funds would likely continue to rely on their current policies and procedures (*i.e.*, using credit quality standards that include ratings currently set forth in their repurchase agreements with the counterparties). Thus, we do not expect that the proposed amendments would significantly change the current collection of information burden estimates for rule 38a-1.⁵

⁵ The current approved annual burden for rule 38a-1 under the Paperwork Reduction Act is 254,703 hours. This burden is calculated on the basis of fund complexes as opposed to individual fund portfolios because most funds are located within a fund complex and the experience of the Commission's examination and oversight staff suggests that each fund in a complex is able to draw extensively from the fund complex's "master" compliance program to assemble appropriate compliance policies and procedures. The additional hourly burden under rule 38a-1 that would result from the proposed amendments to rule 5b-3 described herein is calculated based on the number of individual fund portfolios because money market funds would not be affected by the proposed change (*see infra* note 6) and because individual fund portfolios within a fund complex

Nevertheless, funds may review their repurchase agreements and policies and procedures that address rule 5b-3 compliance and make technical changes to those documents in response to the proposed amendments, if adopted. Staff estimates that it will take on average 1.5 hours of a senior business analyst's time for an individual fund portfolio to perform this review and make any technical changes, for an estimated burden of 12,690 hours for all fund portfolios (other than money market fund portfolios)⁶ at a total cost of \$2,944,080.⁷ Amortized over three years, we estimate that the total burden would be 4230 hours at a cost of \$981,360. We anticipate that the fund's board would review the fund manager's recommendation, but that this cost of review would be incorporated in the fund's overall annual board costs and would not result in any particular additional cost.

These estimates are made solely for the purposes of the Paperwork Reduction Act. They are not derived from a comprehensive or even representative survey or study of the costs of Commission rules.

13. Estimate of Total Annual Cost Burden

may have differing policies and procedures relating to credit quality standards for collateral securities.

⁶ For purposes of this PRA analysis, we assume that all fund portfolios (except money market fund portfolios) enter into repurchase agreements and rely on rule 5b-3. We have not included money market fund portfolios in our estimates because money market funds seeking similar treatment with respect to diversification are subject to different requirements under rule 2a-7. See rule 2a-7(a)(5). The staff's estimate of the number of fund portfolios is based on staff examination of industry data as of December 31, 2010.

⁷ This estimate is based on the following calculation: (8460 fund portfolios x 1.5 hours = 12,690 hours); (12,690 hours x \$232 per hour = \$2,944,080). The staff estimates that the internal cost for time spent by a senior business analyst is \$232 per hour. This estimate is derived from SIFMA's Management and Professional Earnings in the Securities Industry 2010, modified by the Commission's staff to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

The staff estimates that rule 38a-1 does not impose any other material cost burdens on funds, apart from the cost of the burden hours. Although rule 38a-1 requires funds to maintain certain records for five years, these records may be maintained electronically and, even if maintained in hard copy, are unlikely to be voluminous.

14. Estimate of Cost to the Federal Government

Rule 38a-1 does not impose a cost on the federal government. Rule 38a-1 does not require funds to file any documents with the Commission. Commission staff may, however, review records produced pursuant to the rule in order to assist the Commission in carrying out its examination and oversight program.

15. Explanation of Changes in Burden

The estimated total annual burden hours increased slightly from 254,703 to 258,933 hours. The increase in hours is attributable to the additional burden that may result from making technical changes to written policies and procedures that we describe above.

16. Information Collection Planned for Statistical Purposes

Not applicable.

17. Approval to not Display Expiration Date

Not applicable.

18. Exceptions to Certification Statement

Not applicable.

B. COLLECTION OF INFORMATION EMPLOYING STATISTICAL METHODS

Not applicable.