

Fund Democracy  
Consumer Federation of America  
Consumer Action  
North American Securities Administrators Association

March 28, 2008

BY EMAIL AND US MAIL

The Honorable Christopher Cox  
Chairman  
U.S. Securities and Exchange Commission  
100 F Street, N. E.  
Washington, D.C. 20549-1090

re: Sarbanes-Oxley Whistleblower Provision

Dear Chairman Cox,

We are writing on behalf of Fund Democracy, Consumer Federation of America, Consumer Action, and North American Securities Administrators Association to request that the Commission take the interpretive position that the whistleblower provision in the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) generally applies to employees of a mutual fund’s investment adviser. It has come to our attention that, in at least two whistleblower cases,<sup>1</sup> a mutual fund’s investment adviser has argued that its employees are not covered by the whistleblower provision because the adviser is not a public company. We are concerned that investment advisers may manufacture other arguments for exempting their employees from the whistleblower provision. As discussed further below, excluding employees of mutual fund investment advisers from the whistleblower provision directly contradicts the text and the intent of the provision and threatens to undermine the protection of the securities laws for America’s tens of millions of fund shareholders.

#### BACKGROUND

The impetus for Sarbanes-Oxley was a series of corporate scandals, the most prominent of which involved the collapse of two companies: Enron, Inc. and Worldcom. The legislative history of the Act is replete with references to specific corporate scandals, and many of the Act’s provisions can be traced directly to the conduct of the executives,

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<sup>1</sup> Fund Democracy’s founder and president, Mercer Bullard, became aware of this issue while acting as a compensated expert witness in one of these cases. This letter is not intended and should not be read to express any opinion regarding that particular case or any other case, and we are not asking that the Commission opine upon any particular case.

accountants, and lawyers for the affected companies.<sup>2</sup> Whistleblowers such as Enron's Sherron Watkins and Worldcom's Cynthia Cooper played a major role in exposing fraudulent conduct at their companies.

In the aftermath of the Enron and Worldcom scandals, Congress was concerned that such "corporate whistleblowers are left unprotected under current law."<sup>3</sup> Senator Patrick Leahy noted that "when sophisticated corporations set up complex fraud schemes, corporate insiders are often the only ones who can disclose what happened and why."<sup>4</sup> Congress believed that the lack of protection for insiders when they attempt to prevent fraud was:

a significant deficiency because often, in complex fraud prosecutions, these insiders are the only firsthand witnesses to the fraud. They are the only people who can testify as to 'who knew what, and when,' crucial questions not only in the Enron matter but in all complex securities fraud investigations. Although current law protects many government employees who act in the public interest by reporting wrongdoing, there is no similar protection for employees of publicly traded companies who blow the whistle on fraud and protect investors. With one in every two Americans investing in public companies, this distinction fails to serve the public good.<sup>5</sup>

Congress accordingly enacted Section 806 of Sarbanes-Oxley, which generally prohibits discrimination against employees of public companies (*i.e.*, companies registered or reporting under the Securities Exchange Act) in retaliation for assisting in the investigation of a violation of the federal securities laws. The whistleblower provision has been called "the single most effective measure possible to prevent recurrences of the Enron debacle and similar threats to the nation's financial markets."<sup>6</sup> It is a crucial component of Sarbanes-Oxley's overall approach to combating corporate fraud.

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<sup>2</sup> For example, the Act's restrictions on loans to executives were prompted, in part, by reports of substantial loans made to executives of Enron, Worldcom, Adelphia, Qwest, AES and Global Crossing. See Senate Report at n.59.

<sup>3</sup> S.Rep. 107-146 at 10 (May 6, 2002).

<sup>4</sup> Beverley Earle and Gerald Madek, *The Mirage Of Whistleblower Protection Under Sarbanes-Oxley: A Proposal For Change*, 44 Am. Bus. L. J. 1, 4 (Spring 2007) (quoting 148 Cong. Rec. S 6,439-440 (daily ed. July 9, 2002) (statement of Sen. Leahy)).

<sup>5</sup> S.Rep. 107-146 at 10 (May 6, 2002).

<sup>6</sup> Richard Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 Wm. & Mary L. Rev. 65, 68 (Oct. 2007) (quoting Taxpayers Against Fraud).

Soon after the scandals that led to the enactment of Sarbanes-Oxley, the mutual fund industry was engulfed in the biggest scandal in its long history.<sup>7</sup> The abuses underlying the market timing scandal were brought to light by precisely the kind of whistleblowing that Sarbanes-Oxley was intended to protect. The allegations contained in the complaint that launched the market timing scandal were brought to the New York Attorney General's attention by Noreen Harrington, an executive at Canary Capital Partners.<sup>8</sup> Peter Scannell, an employee of Putnam, reported to the staffs at the Securities and Exchange Commission and the Massachusetts Securities Division that, among other things, the investment adviser of the Putnam family of mutual funds and affiliates of the adviser were permitting trading in fund shares that violated fund disclosure documents. In describing his experiences to a U.S. Senate subcommittee, Scannell specifically commended the Act's whistleblower provision.<sup>9</sup>

There is no question that mutual funds are public companies to which the whistleblower provision applies. The issue here is whether the whistleblower provision applies to employees of fund managers. Fund managers that are not public companies have taken the position that the whistleblower provision does not apply to their employees, and fund managers that are public companies may argue that the whistleblower provision does not apply to them for other reasons. These positions directly contradict the text and intent of the whistleblower provision.

## ANALYSIS

We believe that the whistleblower provision clearly applies to employees of fund managers to the extent that the employees are involved in ensuring a fund's compliance with the securities laws. As discussed further in the attached memorandum, the only way that the whistleblower provision could apply with respect to fund compliance would be to apply the provision to the fund manager's employees. A mutual fund typically has no employees because almost all mutual funds carry out all of their operations through third-party service providers, including activities necessary to ensure compliance with the federal securities laws. As noted by the SEC staff, "Although investment companies have officers, they usually are employed and compensated by the sponsor. Thus, an investment company has no employees that are truly its own."<sup>10</sup> The only "employee" to

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<sup>7</sup> See generally, Mercer Bullard, Mercer Bullard, *The Mutual Fund as Firm: Fund Arbitrage, Frequent Trading and the SEC's Response to the Mutual Fund Scandal*, 42 *Houston L. Rev.* 1271 (2006).

<sup>8</sup> See *Complaint, New York v. Canary Capital Partners, LLC* (N.Y. Sup. Ct. 2003).

<sup>9</sup> See Testimony of Peter Scannell before the Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate Committee on Government at 17 (Jan. 27, 2004); see also Todd Wallack, *Anatomy of a Scandal Anonymous Tip Helped Mutual Fund Regulators Find Where To Dig Up Bodies*, *San Francisco Chronicle* at B1 (Dec. 23, 2003) ("In March, an unnamed whistleblower told Massachusetts securities regulators that Morgan Stanley executives pressured brokers to steer clients toward their in-house mutual funds, prompting both Massachusetts Secretary of State William Galvin and New York State Attorney General Eliot Spitzer to investigate.").

<sup>10</sup> *Protecting Investors: A Half Century of Investment Management Regulation*, SEC Division of Investment Management, at 251 n.3 (May 1992).

whom the whistleblower provision could apply in relation to a fund's compliance with the federal securities laws therefore is an employee of the fund's investment adviser. Congress intended that Sarbanes-Oxley apply to mutual funds (it expressly exempted them where appropriate), and the only logical interpretation of the whistleblower provision that would fulfill Congress's intent would be one that applied the provision to a mutual fund adviser's employees.

The logical necessity of applying the whistleblower provision to employees of a mutual fund's investment adviser is further illustrated by other considerations. For example, the compliance structure mandated for mutual funds assumes that fund compliance will be effectuated by fund manager employees. A mutual fund is required to appoint a chief compliance officer ("CCO") who is typically employed by the fund's investment adviser. The fund's CCO is primarily responsible for the fund's securities law compliance and therefore is the individual for whom protection under the whistleblower provision is most important. It would be illogical for the application of the whistleblower provision to a fund's CCO – that is, the key compliance officer for a public company that is clearly covered by the provision – to depend on the happenstance of the direct employment of the CCO by the fund's investment adviser or the adviser's status as a public company.

The terms, structure and application of other provisions of Sarbanes-Oxley and rules thereunder also illustrate the logical necessity of applying the whistleblower provision to employees of a mutual fund's investment adviser. Section 307 of Sarbanes-Oxley generally requires that lawyers representing public companies before the Commission report material securities law violations up the company's management chain. As with other services, legal services are often provided to mutual funds by their investment advisers' attorneys. The Commission specifically ruled that such attorneys are subject to Section 307 with respect to their representation of a fund even if the investment adviser who employs them is privately-held. It would be illogical to hold that Section 307 applied to an employee of a privately-held investment adviser but that Section 806 did not, especially considering that the ultimate purpose of both provisions is to promote compliance with the securities laws through provisions specifically designed to affect the conduct of individuals who are involved in securities law compliance. It also would be illogical for the Commission to take up the question of whether Section 307 applied to a privately-held adviser with respect to fund compliance matters if it had not assumed that Section 307, and therefore Section 806, also applied to attorneys employed by publicly held advisers.

Section 406 requires that the Commission adopt rules generally requiring that public companies provide disclosure regarding codes of ethics for certain officers of the company. For operating companies, the Commission required disclosure of codes applicable to "principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions."<sup>11</sup> In contrast, the rules for

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<sup>11</sup> 17 C.F.R. § 229.406 (2007).

mutual funds extended to codes applicable to “principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, *regardless of whether these individuals are employed by the registrant or a third party.*”<sup>12</sup> Again, the Commission recognized that the unique structure of mutual funds necessitated expanding the scope of its rules to codes of ethics that apply to employees of entities other than the fund itself. Interpreting Section 806 not to apply to employees of a fund’s investment adviser would directly contradict the application of similar provisions of the Sarbanes-Oxley Act to these employees.

## CONCLUSION

The mutual fund market timing scandal provided a stark reminder of the important role that whistleblowers can play in ensuring compliance with the federal securities laws. Whistleblowers were directly responsible for drawing regulators’ attention to the kind of fraudulent conduct that Sarbanes-Oxley intended to address. It is inconceivable that Congress did not intend that mutual fund shareholders enjoy the benefits afforded to shareholders of other publicly traded companies with respect to whistleblowers.

A recent SEC settlement illustrates the importance of the Commission’s confirming that the whistleblower provision covers employees of fund managers. In *Heartland Advisers Inc.*, the Commission alleged that six executives of a mutual fund manager were responsible for the mispricing of two mutual funds’ shares.<sup>13</sup> The mispricing led to a one-day decline of 69.4% and 44% in the value of the funds. The settlement describes the executives as being responsible for the funds’ day-to-day compliance with pricing rules under the securities laws. The mispricing occurred in 2000, and one cannot help but wonder whether one of more of those executives would have chosen to correct the mispricing at its inception if the protections of the whistleblower provision had been available at that time. If fund managers are able to escape application of the whistleblower provision, then employees who find themselves in the same position as the Heartland executives will have to choose between objecting to illegal conduct and getting fired, or remaining silent and ultimately finding themselves named defendants in an administrative proceeding.

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<sup>12</sup> Item 2, Form N-CSR (emphasis added).

<sup>13</sup> See Administrative Proceeding File No. 3-12936 (Jan. 25, 2008).

We hope that the Commission will agree that clarifying that the whistleblower provision applies to fund manager employees is an appropriate and necessary step to protect mutual fund shareholders from the kinds of abuses that Sarbanes-Oxley was designed to address. Thank you for your consideration of our request.

Respectfully submitted,

Mercer Bullard  
President and Founder  
Fund Democracy

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

Ken McEldowney  
Executive Director  
Consumer Action

Karen Tyler  
Commissioner, North Dakota Securities  
Department  
NASAA President

cc:

The Honorable Paul S. Atkins  
The Honorable Kathleen L. Casey  
Brian Cartwright, Esq.  
Andrew Donohue, Esq.

## MEMORANDUM

TO: U.S. Securities and Exchange Commission

FROM: Mercer Bullard, Founder and President, Fund Democracy

DATE: March 28, 2008

Re: Applicability of Sarbanes-Oxley Whistleblower Provision to Mutual Fund Investment Advisers

### **I. Executive Summary**

This memorandum analyzes the question of whether the whistleblower provision of Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) applies to employees of mutual fund managers.<sup>14</sup> For the following reasons, it is my opinion that the whistleblower applies to employees of mutual fund managers to the extent that the employees are involved in ensuring a fund’s compliance with the securities laws.

The only way that the whistleblower provision could apply with respect to fund compliance would be to apply the provision to the fund manager’s employees. A mutual fund typically has no employees because almost all mutual funds carry out all of their operations through third-party service providers, including activities necessary to ensure compliance with the federal securities laws. As noted by the SEC staff, “Although investment companies have officers, they usually are employed and compensated by the sponsor. Thus, an investment company has no employees that are truly its own.”<sup>15</sup> The only “employee” to whom the whistleblower provision could apply in relation to a fund’s compliance with the federal securities laws therefore is an employee of the fund’s investment adviser. Congress intended that Sarbanes-Oxley apply to mutual funds (it expressly exempted them where appropriate), and the only logical interpretation of the whistleblower provision that would fulfill Congress’s intent would be one that applied the provision to a mutual fund manager’s employees.

The logical necessity of applying the whistleblower provision to employees of a mutual fund’s investment adviser is further illustrated by other considerations. For example, the compliance structure mandated for mutual funds assumes that fund compliance will be effectuated by fund manager employees. A mutual fund is required to appoint a chief compliance officer (“CCO”) who is typically employed by the fund’s investment adviser. The fund’s CCO is primarily responsible for the fund’s securities law compliance and therefore is the individual for whom protection under the

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<sup>14</sup> I became aware of this issue while acting as a compensated expert witness in one of these cases. This memorandum is not intended and should not be read to express any opinion regarding that particular case or any other case.

<sup>15</sup> Protecting Investors: A Half Century of Investment Management Regulation, SEC Division of Investment Management, at 251 n.3 (May 1992).

whistleblower provision is most important. It would be illogical for the application of the whistleblower provision to a fund's CCO – that is, the key compliance officer for a public company that is clearly covered by the provision – to depend on the happenstance of the direct employment of the CCO by the fund's investment adviser or the adviser's status as a public company.

The terms, structure and application of other provisions of Sarbanes-Oxley and rules thereunder also illustrate the logical necessity of applying the whistleblower provision to employees of a mutual fund's investment adviser. Section 307 of the Act generally requires that lawyers representing public companies before the Commission report material securities law violations up the company's management chain. As with other services, legal services are often provided to mutual funds by their investment advisers' attorneys. The Commission specifically ruled that such attorneys are subject to Section 307 with respect to their representation of a fund even if the investment adviser who employs them is privately-held. It would be illogical to hold that Section 307 applied to an employee of a privately-held investment adviser but that Section 806 did not, especially considering that the ultimate purpose of both provisions is to promote compliance with the securities laws through provisions specifically designed to affect the conduct of individuals who are involved in securities law compliance. It also would be illogical for the Commission to take up the question of whether Section 307 applied to a privately-held adviser with respect to fund compliance matters if it had not assumed that Section 307, and therefore Section 806, also applied to attorneys employed by publicly held advisers.

Section 406 requires that the Commission adopts rules generally requiring that public companies provide disclosure regarding codes of ethics for certain officers of the company. For operating companies, the Commission required disclosure of codes applicable to "principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions."<sup>16</sup> In contrast, the rules for mutual funds extended to codes applicable to "principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, *regardless of whether these individuals are employed by the registrant or a third party.*"<sup>17</sup> Again, the Commission recognized that the unique structure of mutual funds necessitated expanding the scope of its rules to codes of ethics that apply to employees of entities other than the fund itself. Interpreting Section 806 not to apply to employees of a fund's investment adviser would directly contradict the application of similar provisions of the Sarbanes-Oxley Act to these employees.

## **II. Background**

The impetus for Sarbanes-Oxley was a series of corporate scandals, the most prominent of which involved the collapse of two companies: Enron, Inc. and Worldcom.

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<sup>16</sup> 17 C.F.R. § 229.406 (2007).

<sup>17</sup> Item 2, Form N-CSR (emphasis added).

The legislative history of the Act is replete with references to specific corporate scandals, and many of the Act's provisions can be traced directly to the conduct of the executives, accountants, and lawyers for the affected companies.<sup>18</sup> Whistleblowers such as Enron's Sherron Watkins and Worldcom's Cynthia Cooper played a major role in exposing fraudulent conduct at their companies.

In the aftermath of the Enron and Worldcom scandals, Congress was concerned that such "corporate whistleblowers are left unprotected under current law."<sup>19</sup> Senator Pat Leahy noted that "when sophisticated corporations set up complex fraud schemes, corporate insiders are often the only ones who can disclose what happened and why."<sup>20</sup> Congress believed that the lack of protection for insiders when they attempt to prevent fraud was:

a significant deficiency because often, in complex fraud prosecutions, these insiders are the only firsthand witnesses to the fraud. They are the only people who can testify as to 'who knew what, and when,' crucial questions not only in the Enron matter but in all complex securities fraud investigations. Although current law protects many government employees who act in the public interest by reporting wrongdoing, there is no similar protection for employees of publicly traded companies who blow the whistle on fraud and protect investors. With one in every two Americans investing in public companies, this distinction fails to serve the public good.<sup>21</sup>

Congress accordingly enacted Section 806 of Sarbanes-Oxley, which generally prohibits discrimination against employees of public companies (*i.e.*, companies registered or reporting under the Securities Exchange Act) in retaliation for assisting in the investigation of a violation of the federal securities laws. The whistleblower provision has been called "the single most effective measure possible to prevent recurrences of the

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<sup>18</sup> For example, the Act's restrictions on loans to executives were prompted, in part, by reports of substantial loans made to executives of Enron, Worldcom, Adelphia, Qwest, AES and Global Crossing. See Senate Report at n.59.

<sup>19</sup> S.Rep. 107-146 at 10 (May 6, 2002).

<sup>20</sup> Beverley Earle and Gerald Madek, *The Mirage Of Whistleblower Protection Under Sarbanes-Oxley: A Proposal For Change*, 44 Am. Bus. L. J. 1, 4 (Spring 2007) (quoting 148 Cong. Rec. S 6,439-440 (daily ed. July 9, 2002) (statement of Sen. Leahy)).

<sup>21</sup> S.Rep. 107-146 at 10 (May 6, 2002) ("Corporate employees who report fraud are subject to the patchwork and vagaries of current state laws, although most publicly traded companies do business nationwide. Thus, a whistleblowing employee in one state may be far more vulnerable to retaliation than a fellow employee in another state who takes the same actions. Unfortunately, as demonstrated in the tobacco industry litigation and the Enron case, efforts to quiet whistleblowers and retaliate against them for being 'disloyal' or 'litigation risks' transcend state lines. This corporate culture must change, and the law can lead the way.").

Enron debacle and similar threats to the nation's financial markets.”<sup>22</sup> It is a crucial component of Sarbanes-Oxley’s overall approach to combating corporate fraud.

Soon after the scandals that led to the enactment of Sarbanes-Oxley, the mutual fund industry was engulfed in the biggest scandal in its long history.<sup>23</sup> The abuses underlying the market timing scandal were brought to light by precisely the kind of whistleblowing that Sarbanes-Oxley was intended to protect. The allegations contained in the complaint that launched the market timing scandal were brought to the New York Attorney General’s attention by Noreen Harrington, an executive at Canary Capital Partners.<sup>24</sup> Peter Scannell, an employee of Putnam, reported to the staffs at the Securities and Exchange Commission and the Massachusetts Securities Division that, among other things, the investment adviser of the Putnam family of mutual funds and affiliates of the adviser were permitting trading in fund shares that violated fund disclosure documents. In his testimony before a U.S. Senate subcommittee describing his whistleblowing experiences, Scannell specifically commended the Act’s whistleblower provision.<sup>25</sup>

There is no question that mutual funds are public companies to which the whistleblower provision applies. The question addressed in this memorandum is whether the whistleblower provision applies to employees of fund managers. Fund managers that are not public companies have taken the position that the whistleblower provision does not apply to their employees, and fund managers that are public companies may argue that the whistleblower provision does not apply to them for other reasons. It is my opinion that these positions directly contradict the text and intent of the whistleblower provision.

### **III. Analysis**

#### **A. Operation and Structure of Mutual Funds**

A mutual fund is a pool of investment securities in which individuals and entities invest to gain access to the securities markets. Mutual funds are structurally different

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<sup>22</sup> Richard Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 Wm. & Mary L. Rev. 65, 68 (Oct. 2007) (quoting Taxpayers Against Fraud).

<sup>23</sup> See generally, Mercer Bullard, *The Mutual Fund as Firm: Fund Arbitrage, Frequent Trading and the SEC’s Response to the Mutual Fund Scandal*, 42 Houston L. Rev. 1271 (2006).

<sup>24</sup> Complaint, *New York v. Canary Capital Partners, LLC* (N.Y. Sup. Ct. 2003).

<sup>25</sup> See Testimony of Peter Scannell before the Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate Committee on Government at 17 (Jan. 27, 2004); see also Todd Wallack, *Anatomy of a Scandal Anonymous Tip Helped Mutual Fund Regulators Find Where To Dig Up Bodies*, San Francisco Chronicle at B1 (Dec. 23, 2003) (“In March, an unnamed whistleblower told Massachusetts securities regulators that Morgan Stanley executives pressured brokers to steer clients toward their in-house mutual funds, prompting both Massachusetts Secretary of State William Galvin and New York State Attorney General Eliot Spitzer to investigate.”).

from other businesses in some important respects. Like other businesses, mutual funds operate under the direction of a board of directors. They generally do not, however, have any employees. Mutual funds typically farm out all of their service needs to third parties. These services include primarily: custody of fund assets, transfer agency services, management of the fund's portfolio, distribution of the fund's securities, and shareholder services. The fund's board of directors negotiates contracts with the fund's service providers and oversees the operation of the fund, but the personnel they oversee typically are not employees of the fund, but employees of a third-party service provider.

Mutual funds also are unusual in that they are almost always created by one of their service providers, which in most cases is the fund's investment adviser. "Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser. . . . the adviser generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors."<sup>26</sup> The adviser drafts the fund's organizational documents, selects its board of directors, invests seed money, manages the fund's portfolio, and arranges for the distribution of fund shares. As a practical matter, the *de facto* control exercised over the fund by its adviser continues throughout the fund's life.<sup>27</sup>

The external management structure of mutual funds reflects the reality that virtually all of a mutual fund's activities are conducted by its sponsor, which is usually the fund's investment adviser.<sup>28</sup> As stated by Robert Pozen at the time that he was President and CEO of Fidelity Management and Research Co.: "Virtually all mutual funds are externally managed. They do not have employees of their own. Instead, their operations are conducted by affiliated organizations and independent contractors."<sup>29</sup> As Pozen also has noted, "No issuer of securities is subject to more detailed regulation than mutual funds,"<sup>30</sup> and a significant part of the operations conducted by a fund's investment entail the development, implementation and monitoring of policy and procedures that are reasonably designed to ensure that the fund operates in compliance with all applicable legal rules. Fund boards have no employees to whom to delegate securities law compliance duties.<sup>31</sup> Fund boards rely on employees of the fund's adviser

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<sup>26</sup> Investment Company Governance, Investment Company Act Rel. No. 26323 at Part I (Jan. 15, 2004) (quoting Burks v. Lasker, 441 U.S. 471, 481 (1979) (quoting Galfand v. Chestnutt Corporation, 545 F.2d 807, 808 (2d Cir. 1976))).

<sup>27</sup> See id. ("a fund adviser is frequently in a position to dominate the board because of the adviser's monopoly over information about the fund and its frequent ability to control the board's agenda.").

<sup>28</sup> The only significant exception to the external management structure is the Vanguard fund family. The Vanguard funds jointly own the fund manager – The Vanguard Group – and thusly employ directly the persons responsible for ensuring the funds' compliance with the federal securities laws.

<sup>29</sup> Robert Pozen, *The Mutual Fund Business*, at 22 (1999).

<sup>30</sup> *Id.* at 56 (quoting a former SEC Chairman).

<sup>31</sup> The Commission has observed that: "[i]nvestment companies . . . typically do not have employees because they are externally managed, with investment advisory and other services provided by affiliated

for this purpose.

The unique structure of mutual funds means that, as a practical matter, the only “employee” to whom the whistleblower provision could apply in relation to a fund’s compliance with the federal securities laws is an employee of the fund’s investment adviser. Interpreting the term “employee” in the whistleblower provision not to apply to employees of a fund’s investment adviser simply because the adviser happened not to be a public company or for some other equally arbitrary reason would strip millions of shareholders in mutual funds of the whistleblower protections that Congress intended to apply to shareholders of all public companies.

The most prominent scandal in the history of the mutual fund industry involved shareholder abuses that were brought to light by precisely the kind of whistleblower to which the whistleblower provision is intended to apply.<sup>32</sup> The allegations contained in the complaint that launched the market timing scandal were brought to the New York Attorney General’s attention by Noreen Harrington, an executive at Canary Capital Partners.<sup>33</sup> In early 2003, Peter Scannell, an employee of Putnam, reported to the staff at the Securities and Exchange Commission and the Massachusetts Securities Division that, among other things, the investment adviser of the Putnam family of mutual funds and affiliates of the adviser were permitting trading in fund shares that violated fund disclosure documents. In describing his experiences to a U.S. Senate subcommittee, Scannell specifically commended Sarbanes-Oxley’s whistleblower provision.<sup>34</sup>

## **B. Role of the Mutual Fund Chief Compliance Officer**

The text and administrative history of Rule 38a-1 under the Investment Company Act show that securities law compliance by a mutual fund is generally expected to be effectuated through the fund’s investment adviser and that Section 806 therefore must apply to an employee of the investment adviser. Rule 38a-1 assumes, as a practical

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and unaffiliated parties pursuant to contracts with the investment company.” Insider Trades During Pension Fund Blackout Periods, Investment Company Act Rel. No. 25795, at Part II.B(1)(d) (Nov. 6, 2002)). This characteristic of the industry has often been acknowledged by the Investment Company Institute, the lobbying organization for fund managers. For example, in commenting on the proposal cited *supra*, the ICI stated: “We urge the Commission to take into account the differences between investment companies and operating companies in its consideration of adopting proposed Regulation BTR. Unlike operating companies, *investment companies typically do not have employees*, and, therefore, typically do not maintain employee pension plans.” Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute to Jonathan Katz, Secretary, SEC (Dec. 13, 2002) (emphasis added) (“The vast majority of investment companies do not have employees because they are externally managed, with investment advisory and other services provided by affiliated and unaffiliated parties pursuant to contracts with the investment company.”).

<sup>32</sup> See generally, Bullard, *supra* note 10.

<sup>33</sup> See Complaint, *supra* note 11.

<sup>34</sup> See Testimony of Peter Scannell, *supra* note 12.

matter, that the fund’s sponsor is responsible for fund compliance.<sup>35</sup> The Rule requires that a fund’s board approve not only the fund’s compliance procedures, but also “those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund, which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund.”<sup>36</sup> The board must find that the compliance procedures are reasonably designed to prevent securities law violation “*by the fund*” because it is assumed that funds’ effect securities law compliance through third parties. Accordingly, when the Commission has brought enforcement actions based on funds’ violations of the federal securities law, the defendants invariably have been the funds’ investment advisers.<sup>37</sup>

Rule 38a-1 also requires that mutual funds designate a chief compliance officer (“CCO”) responsible for administering the fund’s securities law policies and procedures, but it assumes that this individual will not be an employee of the fund. As indicated in the release adopting the rule, the Commission viewed mutual fund compliance as functionally operating through its service providers:

We expect that a fund’s chief compliance officer will often be employed by the fund’s investment adviser or administrator. We are not adopting a requirement that the chief compliance officer be employed by only the fund because we believe that such a provision would actually weaken her effectiveness. Funds today typically have no employees, and delegate management and administrative functions, including the compliance function, to one or more service providers. If we were to preclude the chief compliance officer from being an employee of an adviser or any other service provider, she would be divorced from all fund operations.<sup>38</sup>

To emphasize, the Commission designed the Rule on the assumption that mutual funds “typically . . . delegate . . . the compliance function to one or more service providers.” If a public company’s securities law compliance function is typically delegated to third parties that exercise effective control over the public company, it would be illogical to exclude employees of such third parties from the whistleblower provision. The SEC’s preference for locating the CCO with a fund service provider should not provide the basis for deeming the whistleblower provision inapplicable to the individual most responsible for a fund’s securities law compliance. If that were the case, the same

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<sup>35</sup> See Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Rel. Nos. 25925 (Feb. 5, 2003) (proposing rule 38a-1) & 26299 (Dec. 17, 2003) (adopting rule 38a-1) (“CCO Adopting Release”).

<sup>36</sup> *Id.*

<sup>37</sup> See, e.g., cases cited at CCO Adopting Release at nn. 6 – 7.

<sup>38</sup> *Id.* at text accompanying nn. 88 – 89

policy that sought to strengthen fund compliance by locating the CCO in a service provider would have the effect of weakening compliance by removing whistleblower protection from the very employees the Commission believed were in the best position to ensure fund compliance.

The structure of rule 38a-1 further reflects the central role that service providers play with respect to fund compliance in its treatment of funds' responsibilities regarding the content of and changes to their securities compliance policies and procedures. Fund industry commenters had expressed concern that fund directors would be required "to review lengthy compliance manuals and devote considerable time at each meeting to approving numerous amendments." The Commission responded that fund directors "could satisfy their obligations under the rule by reviewing summaries of compliance programs prepared by the chief compliance officer, legal counsel or other persons familiar with the compliance programs. The summaries should familiarize directors with the salient features of the programs (including programs of service providers) and provide them with a good understanding of how the compliance programs address particularly significant compliance risks."<sup>39</sup> The rule thereby treats service provider compliance as an extension of fund compliance.<sup>40</sup>

Rule 38a-1 essentially merges fund compliance with compliance of fund service providers as related to the fund. For example, the rule specifically provides that the CCO must provide the fund board with an annual written report that addresses the operations of the policies and procedures of "each investment adviser, principal underwriter, administrator, and transfer agent of the fund," and "[e]ach Material Compliance Matter" occurring since the last report.<sup>41</sup> A Material Compliance Matter expressly includes material violations of the federal securities laws by the fund's investment adviser, principal underwriters, administrator or transfer agent, as well as violations of and weaknesses in applicable policies and procedures of these service providers.<sup>42</sup> Rule 38a-1 combines CCO responsibilities as to fund compliance and service provider compliance because securities compliance by funds is practicably indistinguishable from applicable

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<sup>39</sup> *Id.* at text accompanying n. 33.

<sup>40</sup> Similarly, the Commission stated that, with respect to service providers that are not affiliated with the fund, the fund's directors need only obtain "a third-party report on the service provider's procedures instead of the procedures themselves when the board is evaluating whether to approve the service provider's compliance program." *Id.* at text accompanying n. 35. This relaxed standard further reinforces the assumption underlying the rule that fund compliance, as a practical matter, is carried out almost entirely through its service providers. *See* Letter from Craig Tyle, General Counsel, Investment Company Institute to Jonathan Katz, Secretary, Securities and Exchange Commission (Apr. 17, 2003) (commenting on proposed rule 38a-1) (arguing for fund directors' ability to rely on services providers' policies and procedures on ground that this "would better accommodate *existing fund compliance structures*, which have worked well." (emphasis added)).

<sup>41</sup> *See* Rule 38a-1(a)(4)(iii).

<sup>42</sup> *See* Rule 38a-1(e)(2).

securities compliance by their service providers.

The way in which the Commission designed the position of Chief Compliance Officer reveals its view that fund compliance functions primarily reside outside the fund. Rule 38a-1 requires that the fund board approve the designation and compensation of the CCO and have the authority to remove the CCO. The Commission imposed this requirement in order “to promote the independence of the chief compliance officer from the management of the fund,”<sup>43</sup> because it understood that the external management structure of mutual funds enables the fund’s investment adviser to control the fund and to exercise undue influence regarding fund compliance matters. To address this concern, the Commission required that the CCO meet annually in executive session with the independent directors “without anyone else (such as fund management or interested directors) present”<sup>44</sup> and prohibited “the fund's officers, directors, employees or its adviser, principal underwriter, or any person acting under the direction of these persons, from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the fund's chief compliance officer in the performance of her responsibilities under the rule.”<sup>45</sup>

On a similar note, the Commission argued in favor of the CCO position in part on the ground that it would enhance compliance “by centralizing responsibility for the compliance function.”<sup>46</sup> The view that compliance would be “centralized” in the CCO, coupled with the Commission’s view that the CCO generally should be an employee of the fund’s investment adviser, further illustrates the Commission’s assumption that service providers generally play the central role in ensuring fund compliance with the federal securities laws.

### **C. Structure and Application of the Sarbanes-Oxley Act**

The terms, structure and application of certain provisions of Sarbanes-Oxley demonstrate that the whistleblower requirement should apply to mutual funds regardless of whether their fund managers are public companies. Nowhere in Sarbanes-Oxley is this more evident than in Section 307, which relates to the reporting obligations of attorneys

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<sup>43</sup> CCO Adopting Release at text accompanying n. 76; *see also id.* at text accompanying n. 87 (“The rule provides the board with a powerful tool to exercise its oversight responsibilities over fund compliance matters. The new rule also strengthens the hand of compliance personnel by establishing a direct line of reporting to fund boards that is not controlled by management. We have observed that compliance failures have occurred when a fund service provider has denied information to the fund's board, or has been less than forthright, because the service provider viewed full disclosure as detrimental to its own interests. Under the new rule, the chief compliance officer will be responsible for keeping the board apprised of significant compliance events at the fund or its service providers and for advising the board of needed changes in the fund's compliance program.”).

<sup>44</sup> *Id.* at text accompanying n. 85; *see* Rule 38a-1(a)(4)(iv).

<sup>45</sup> CCO Adopting Release at text accompanying n. 86; *see* Rule 38a-1(c).

<sup>46</sup> CCO Adopting Release at text following n. 102.

practicing before the Commission. Section 406 provides further support for the view that the whistleblower provision must apply to employees of a privately-held investment adviser to a mutual fund.

Section 307 of the Act required the Commission to adopt rules setting forth minimum standards of conduct for attorneys appearing and practicing before the Commission in the representation of issuers. In 2003, the Commission adopted Rules 205.1 to 205.7 to implement Congress's directive. The rules generally require that lawyers report to their supervisors and, if necessary, to the company's board of directors any material violations of federal or state securities laws, material breaches of fiduciary duty arising under federal or state law, or similar material violations of federal or state law.

Section 307 raises a question that is analogous to the question addressed in this memorandum: If a mutual fund appears and is represented before the Commission not by its own attorneys, but by the fund manager's attorneys, would the fund manager's attorneys be deemed to be "appearing," "representing" or "practicing" before the Commission on behalf of the fund for purposes of Section 307? The SEC's answer to this question is worth quoting at length because it demonstrates so clearly why a fund manager's employees must qualify as fund whistleblowers under Section 806:

An attorney employed by a privately-held investment adviser who prepares, or assists in preparing, materials that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company, or will be incorporated into any document filed with or submitted to the Commission, is appearing and practicing before the Commission. Such an attorney, *though employed by a privately-held investment adviser*, is representing the investment company before the Commission. Where such an attorney discovers evidence of a material violation by an officer of the investment adviser that is related to the investment company, the attorney is obliged to report that evidence to the [chief legal officer] of the investment company under 205.3(b). The investment adviser is an agent of the investment company and owes the investment company a fiduciary duty under common law and under Section 36 of the Investment Company Act of 1940.<sup>47</sup>

Here, the Commission specifically noted that Section 307 applied even if the fund manager was "privately-held," a clear signal that the Commission similarly would consider a whistleblower employed by a privately-held fund manager to covered by Section 806. Both Sarbanes-Oxley provisions are intended to accomplish the same objective – to enhance monitoring of public companies' compliance with federal securities laws. Section 307 accomplishes this goal by tasking attorneys with responsibility for reporting violations, and Section 806 protects employees (including

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<sup>47</sup> Implementation of Standards of Professional Conduct for Attorneys, Investment Company Act Rel. No. 25829, at Part V (Nov. 21, 2002) (emphasis added).

attorneys) from retaliation for reporting violations. It should go without saying that the Commission assumed that there was no doubt that Section 307 applied to attorneys employed by publicly-held investment advisers.

Just as the relevant attorneys for purposes of mutual funds' compliance may be the fund manager's attorneys, the relevant employees for purposes of funds' compliance may be the fund manager's employees. It would be illogical to hold that a fund manager's attorney was subject to Section 307's reporting obligations as to fund securities law violations, but that the same attorney was not protected by Section 806 if the fund manager fired him for assisting in an investigation of the same violations.

Although attorneys retained by or who are employees of a fund's manager are arguably representing the manager and not the fund, the Commission interpreted Section 307's reference to "representation of issuers" to apply to legal services provided to the fund manager. The Commission took the position that "an attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company that the attorney has reason to believe will be submitted to or filed with the Commission by or on behalf of a registered investment company is appearing and practicing before the Commission" for purposes of Section 307.<sup>48</sup> If the investment adviser is the vehicle through which the fund obtains legal services, and the investment adviser's attorneys therefore are deemed to be representing the fund for purposes of Section 307, then it must be that, if the investment adviser is the vehicle through which a fund effects compliance with the federal securities laws, the investment adviser's employees would be deemed to be covered whistleblowers when they provide information regarding alleged securities law violations by the fund.

The SEC's rulemaking under Section 406 of Sarbanes-Oxley further evidences its understanding that compliance-related requirements must extend beyond a mutual fund to be effective. Section 406 requires the Commission to adopt rules requiring public companies to provide information about codes of ethics for "senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions." The Commission accordingly adopted Item 406, which for operating companies (but not mutual funds) requires disclosure regarding codes of ethics that apply to the company's "principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions."<sup>49</sup>

In contrast, the SEC rule that implements Section 406 for mutual funds applies to codes of ethics for a fund's "principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, ***regardless of whether these individuals are employed by the registrant or a third***

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<sup>48</sup> Implementation of Standards of Professional Conduct for Attorneys, Investment Company Act Rel. No. 25919, at Part II (Jan. 29, 2003).

<sup>49</sup> 17 C.F.R. § 229.406 (2007).

*party.*<sup>50</sup> The Commission applied Section 406 “regardless of whether these individuals are employed by the registrant or a third party” for good reason. It understood that codes of ethics typically would be effectuated by senior financial officers of third parties, *i.e.*, of the fund’s investment adviser.

The Commission initially proposed under Section 406 that funds provide information regarding codes of ethics of a fund’s investment adviser and principal underwriter.<sup>51</sup> No such proposal was suggested for other types of public companies; only for mutual funds were codes of ethics expected to be largely implemented outside of the fund. The Commission was unconcerned that the investment advisers and principal underwriters whose codes of ethics would be disclosed might not be public companies. It understood that, for general compliance purposes, the codes of ethics of these entities constituted a natural extension of Section 406’s application to the public companies that are mutual funds.

The Commission ultimately decided not to extend this requirement to codes of ethics of a fund’s investment adviser or principal underwriter because the senior financial officers of those entities might “have little to do with the operations or financial reporting of the investment company, but are instead responsible principally for the adviser's or underwriter's own operations and financial reporting.”<sup>52</sup> Thus, the Commission again recognized that although senior financial officers of the fund would usually be officers of the fund manager or other affiliate, these officers would not necessarily be senior financial officers of the fund manager or affiliate. The Commission settled on the text discussed above (“regardless of whether these individuals are employed by the registrant or a third party”) as the means by which to extend Section 406 to fund affiliates.

#### **IV. Conclusion**

The unique operation and structure of mutual funds, including the way in which mutual funds effectuate compliance with the securities laws, logically necessitates that Section 806 of the Sarbanes-Oxley Act apply to employees of privately-held investment adviser to a fund. Mutual funds generally do not have employees because all of their activities are carried out by third-party service providers. Therefore, the only employees

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<sup>50</sup> Item 2, Form N-CSR (emphasis added); *see also* Instruction 102P3(a), Form N-SAR (“Disclose whether, as of the end of the period covered by the report, the registrant has adopted a code of ethics that applies to the registrant’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, regardless of whether these individuals are employed by the registrant or a third party.”).

<sup>51</sup> *See* Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Investment Company Act Rel. No. 25775, at Part II.B(6) (Oct. 22, 2002).

<sup>52</sup> Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Investment Company Act Rel. No. 25914, at II.B (Jan. 27, 2003). Thus, the Commission again recognized that although senior financial officers of the fund would usually be officers of the fund manager or other affiliate, these officers would not necessarily be senior financial officers of the fund manager or affiliate.

to whom Section 806 *could* apply are employees of third-parties that are responsible for funds' securities law compliance, usually the fund's investment adviser.

Indeed, there is not a single occasion in my experience in private practice, as an attorney at the Securities and Exchange Commission, in my advocacy work for Fund Democracy, or in providing consulting and expert services, when securities law compliance by an externally managed fund was not, as a practical matter, effectuated by a fund service provider. In virtually every instance, that service provider was the fund's investment adviser. To hold that Section 806 does not apply to fund service providers because they are privately-held or for other reasons effectively would repeal Section 806 with respect to mutual funds owned by tens of millions of shareholders.