



GlobalNote

SEC Rules Requiring Registered Investment Advisers to Implement Written Compliance Program¹

This memorandum is addressed to the requirements imposed by Rule 206(4)-7 promulgated under the Investment Advisers Act of 1940, as amended (the “Advisers Act”)

Introduction

Rule 206(4)-7 of the requires an investment adviser registered with the SEC to (i) adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws; (ii) revise those policies and procedures annually for their adequacy and effectiveness; and (iii) designate a chief compliance officer to be responsible for administering the policies and procedures.² The SEC adopted Rule 206(4)-7 to curb abusive practices and to prevent their recurrence. The SEC believes that by requiring investment advisers to design and implement a comprehensive internal compliance program will serve to reduce the risk that its advisory clients will be harmed by violations of securities laws.³

Rule 206(4)-7 does not enumerate specific elements that an investment adviser must include in its policies and procedures. Rather, an investment adviser is required to adopt policies and procedures tailored to the nature of such investment adviser’s operations. Moreover, such policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred and promptly correct any violations that

¹ This memo is for education purposes only and should not be construed as legal advice to any person in any jurisdiction.

² Securities and Exchange Commission; “Compliance Programs of Investment Companies and Investment Advisers”; final rule. 68 Fed. Reg. 74714-74730 (December 24, 2003). Note that this memorandum only addresses the requirements and impact of this final rule on registered investment advisers. This memorandum does not address the requirements and impact on registered investment companies, i.e., mutual funds. See also THSH Memorandum “SEC Proposed Rules: Compliance of Registered Investment Companies and Registered Investment Advisers” (February 2003).

³ 68 Fed. Reg. at 74723-74724.

have occurred.⁴ Failure to implement adequate policies and procedures will constitute a violation of the SEC's rules.⁵

Rule 206(4)-7 was effective on February 5, 2004 and the compliance date was October 5, 2004.⁶ Accordingly, by that date a registered investment adviser should have adopted a written compliance program that addresses the provisions of the Advisers Act that apply to such investment advisers and designated a chief compliance officer.⁷ Moreover, the first annual review of such an investment adviser's compliance program must be completed no later than eighteen months after adoption and approval of its compliance program.⁸

Who Must Comply with Rule 206(4)-7?

First and foremost, Rule 206(4)-7 applies only to investment advisers registered with the SEC.⁹ Rule 206(4)-7 does not apply to unregistered investment advisers and to advisers that are registered with their respective state regulatory authority. As such, hedge fund managers that are exempt from federal and state registration are not required to adopt a written compliance program pursuant to Rule 206(4)-7.¹⁰

What Must a Registered Investment Adviser Do under Rule 206(4)-7?

A. Written Policies and Procedures

Under Rule 206(4)-7(a), it is unlawful for a registered investment adviser to provide investment advice unless such an investment adviser has adopted and implemented written policies and procedures designed to prevent violations of the Advisers Act and the rules adopted by the SEC under the Advisers Act by the investment adviser or any of its supervised persons.¹¹ An investment adviser must consider its fiduciary and regulatory obligations under the Advisers Act and then formalize policies and procedures to address them.

⁴ 68 Fed. Reg. at 74716.

⁵ 68 Fed. Reg. at 74715.

⁶ 68 Fed. Reg. at 74723.

⁷ 68 Fed. Reg. at 74723.

⁸ 68 Fed. Reg. at 74723.

⁹ 68 Fed. Reg. at 74715.

¹⁰ Unregistered investment advisers that rely on the exemption from registration pursuant to Section 203(b)(3) of the Advisers Act should nevertheless review the requirements under Rule 206(4)-7 in light of the SEC staff's recommendation to revise Section 203(b)(3) of the Advisers Act so that hedge fund managers that rely on Section 203(b)(3) would be required to register with the SEC and therefore would be required to comply with Rule 206(4)-7 as well. See Part VII.A. of the "Implications of the Growth of Hedge Funds," Staff Report to the United States Securities and Exchange Commission (September 2003) (the "SEC Staff Hedge Fund Report").

¹¹ Rule 206(4)-7(b) of the Advisers Act. The term "supervised persons" means "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." See Section 202(a)(25) of the Advisers Act.

According to the SEC, in designing the policies and procedures, an investment adviser should first identify conflicts and other compliance factors that create risk exposure for the adviser and its clients in light of the adviser's particular operations and then design policies and procedures that address those risks.¹² At a *minimum*, the SEC has stated that the following issues should be addressed to the extent that they are relevant to an investment adviser:

- # Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the investment adviser and applicable regulatory restrictions;¹³
- # Trading practices, including procedures by which the investment adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (soft dollar arrangements) and allocates aggregated trades among clients;¹⁴
- # Proprietary trading of the investment adviser and personal trading activities of supervised persons;¹⁵
- # The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;¹⁶
- # Safeguarding of client assets from conversion or inappropriate use by advisory personnel;¹⁷
- # The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;¹⁸

¹² 68 Fed. Reg. at 74716.

¹³ A registered investment adviser that votes proxies on behalf of its clients is required to adopt and to implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients. See Rule 206(4)-6 of the Advisers Act.

¹⁴ An investment adviser that engages in the use of soft dollars (whether within the exceptions under Section 28(e) of the Securities Exchange Act of 1934 or outside Section 28(e)) is required to disclose its soft dollar practices to clients and should internally document and periodically review how it allocates soft dollars for research and other services to demonstrate its compliance with the best execution obligations. See Securities and Exchange Act Release No. 23170 (Apr. 23, 1986).

¹⁵ Pursuant to Section 204A of the Advisers Act, registered investment advisers are required to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the investment adviser and any of its associated persons from misusing material, nonpublic information. Also, pursuant to Rule 204-2(a)(12) of the Advisers Act, a registered investment adviser is required to maintain policies and procedures that address, report, and review the personal securities transactions of its employees and their family members.

¹⁶ The advertising of a registered investment adviser's services and its performance results are governed by Rule 206(4)-1 of the Advisers Act and by a series of SEC no-action letters. See e.g. Gallagher and Associates, Ltd. (July 10, 1995) (prohibition on testimonials); Clover Capital Management, Inc. (Oct. 28, 1986) (performance advertisement); Investment Company Institute (Aug. 24, 1987) (performance advertisement must be net of fees); JP Morgan Investment Management, Inc. (May 7, 1996) (model fees); Association for Inv. Management & Research (Dec. 18, 1996) (accounts to include in determining actual performance); Horizon Asset Mgmt, LLC (Sept. 13, 1996) (portability of past performance); and Great Lake Advisors, Inc. (Apr. 3, 1992) (portability of past performance).

¹⁷ A registered investment adviser deemed to have custody is required in general to (i) maintain cash and securities with a qualified custodian and (ii) distribute account statements to each of its clients pursuant to Rule 206(4)-2 of the Advisers Act.

- # Marketing advisory services, including the use of solicitors;¹⁹
- # Processes to value client holdings and assess fees based on those valuations;
- # Safeguards for the privacy protection of client records and information;²⁰ and
- # Business continuity plans.²¹

Rule 206(4)-7 does not require an investment adviser to consolidate all compliance policies and procedures into a single document.²² As such, it is permissible for an investment adviser to maintain several written compliance manuals in which each manual addresses a specific aspect of the Advisers Act. Furthermore, an investment adviser is not required to memorialize every action that must be taken in order to remain in compliance with the Advisers Act.²³

B. Annual Review

Rule 206(4)-7(b) requires a registered investment adviser to review its policies and procedures annually to determine their adequacy and effectiveness of implementation.²⁴ Moreover, an investment adviser should document its annual review.²⁵ When reviewing its compliance program, an investment adviser should consider any compliance matters that arose in the previous year, any changes in its business activities or any changes to the Adviser Act that may require a revision to its policies and procedures.²⁶

¹⁸ In general, a registered investment adviser is required to maintain books and records with respect to its advisory services for a period of five years (the first two years on-site at the adviser's office) pursuant to Rule 204-2(e)(1) of the Advisers Act. The types of documents to be maintained are described in Rule 204-2(a)(1)-(16), Rule 204-2(b), Rule 204-2(c), and Rule 204-2(e)(2) of the Advisers Act. It is permissible to maintain such records in electronic format provided that the investment adviser can furnish a copy to the SEC within twenty-four hours. See Rule 204-2(g) of the Advisers Act; Release No. IA-1945 (May 24, 2001).

¹⁹ A registered investment adviser that uses a third-party to solicit clients, i.e., a finder, must comply with the procedures set forth in Rule 206(4)-3 of the Advisers Act.

²⁰ A registered investment adviser is required to adopt a written policy that describes how such an investment adviser maintains and protects the nonpublic personal information of its natural person clients and to provide such clients with a written notice of the investment adviser's privacy policy pursuant to Regulation S-P.

²¹ Interestingly, the adoption of a business continuity plan is now a fiduciary obligation even though this requirement is not explicitly stated in the Advisers Act. According to the SEC, an investment adviser's fiduciary obligation includes the obligation to take steps to protect its clients' interests from being placed at risk as a result of such an investment adviser's inability to provide advisory services after a natural disaster or the death of the owner or key personnel. See 68 Fed. Reg. at 74716, note 22.

²² 68 Fed. Reg. at 74716.

²³ 68 Fed. Reg. at 74716.

²⁴ Rule 206(4)-7(b) of the Advisers Act. Note that an investment adviser may review its compliance program more frequently. According to the SEC, "[a]lthough the rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments. 68 Fed. Reg. at 74720.

²⁵ Any records documenting the annual review must be maintained for at least five years after the end of the investment adviser's fiscal year in which the review was conducted, the first two years on-site at the investment adviser's office. See Rule 204-2(a)(17)(ii) of the Advisers Act.

²⁶ 68 Fed. Reg. at 74720.

Note that it is neither mandated nor implied that a third-party such as an auditor or other service provider conduct the annual review.

C. Designation of Chief Compliance Officer

Rule 206(4)-7(c) requires a registered investment adviser to designate a chief compliance officer to administer its compliance policies and procedures.²⁷ The chief compliance officer is to be identified on Form ADV, Part I, Schedule A, Item 2(a).²⁸ The compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.²⁹ The compliance officer is to be an employee of the investment adviser and is to have sufficient seniority and authority within the investment adviser's organization to compel others to adhere to the compliance policies and procedures. Accordingly, an investment adviser can not hire a third-party such as a service provider to serve as the chief compliance officer.

Note that the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. According to the SEC, a chief compliance officer appointed in accordance with Rule 206(4)-2 would not necessarily be subject to a sanction for failure to supervise other advisory personnel.³⁰ Also, if a compliance officer does have supervisory responsibilities, such a compliance officer can continue to rely on the defense provided for in Section 203(e)(6) of the Advisers Act which provides that a person shall not be deemed to have failed to reasonably supervise another person if: (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedure; and (iii) the supervising person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.³¹

D. Recordkeeping

The SEC added Rule 204-2(a)(17) to require registered investment advisers to maintain a copy of the investment adviser's policies and procedures formulated pursuant to Rule 206(4)-2³² and to maintain any records documenting their annual review.³³ Such records may be maintained electronically.³⁴ According to the SEC, these new recordkeeping requirements will assist the SEC's examination staff in determining whether the

²⁷ Rule 206(4)-7(c) of the Advisers Act.

²⁸ Each registered investment adviser and each applicant for registration as an adviser is to identify a *single* compliance officer. 68 Fed. Reg. at 74720, note 72 (emphasis in original text).

²⁹ 68 Fed. Reg. at 74720.

³⁰ 68 Fed. Reg. at 74720, note 73.

³¹ 68 Fed. Reg. at 74720, note 73.

³² Rule 204-2(a)(17)(i) of the Advisers Act.

³³ Rule 204-2(a)(17)(ii) of the Advisers Act.

³⁴ See Rule 204-2(g) of the Advisers Act.

investment adviser is adhering to Rule 206(4)-7 and in identifying weaknesses in the compliance program.³⁵

Impact on Registered Investment Advisers that Are Hedge Fund Managers

A. Specific Issues of Concern by the SEC

Registered investment advisers that are hedge fund managers will have to craft their compliance program to address specific concerns raised by the SEC that the SEC considers to be particular to hedge funds. Such particular concerns include the following:

1. Conflicts of Interest

According to the SEC, the compliance program must address portfolio management processes, including the allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the investment adviser and applicable regulatory restrictions.³⁶ What this requirement likely means to registered hedge fund managers is that the fund manager must identify and disclose any conflicts of interest it has and possibly document the rationale for allocating investments in favor of one account or hedge fund over another managed account and/or hedge fund. The SEC staff believes that hedge funds "often have substantial conflicts of interest, both with the hedge fund and with other non-hedge fund investors."³⁷ By disclosing conflicts of interest to its clients, an investment adviser may discharge its fiduciary obligations. However, the SEC staff feels that the disclosures currently being provided to some hedge fund investors could be improved. In particular, the SEC staff is concerned with the side-by-side management of client accounts.³⁸ Furthermore, the SEC staff believes that the relationship between a hedge fund and the investment adviser incorporates a number of significant incentives that have the potential to motivate an investment adviser to favor its hedge fund client over its other clients and may result in preferential allocations in favor of the hedge fund.³⁹

Despite the SEC's staff's concerns that hedge fund managers may be allocating favorable investments to its hedge fund's portfolio at the expense of its other managed accounts, the SEC has yet to issue guidance as to how to resolve conflicts of interest. As such, what the SEC expects from registered investment advisers that are hedge fund managers with respect to disclosing and resolving conflicts of interest currently remains unclear.

2. Valuation

³⁵ 68 Fed. Reg. at 74723.

³⁶ 68 Fed. Reg. at 74716.

³⁷ See Part VI.E. of the SEC Staff Hedge Fund Report.

³⁸ See Part VI.E. of the SEC Staff Hedge Fund Report.

³⁹ See Part VI.E. of the SEC Staff Hedge Fund Report.

According to the SEC, a registered investment adviser's compliance program must address the processes of valuing client holdings.⁴⁰ What this requirement likely means to registered hedge fund managers is that the fund manager must adopt a policy that details how such an adviser values the positions in the hedge funds portfolio and perhaps hire an independent third party to serve a check with respect to the valuation of a fund's portfolio. The SEC staff feels that the lack of independent checks on a hedge fund adviser's valuation of a hedge fund's portfolio is among the most serious concerns the SEC staff has identified in the course of their investigation of the hedge fund industry.⁴¹ Moreover, the SEC staff is particularly concerned with the valuation of illiquid securities in a hedge fund's portfolio.⁴² Furthermore, the SEC staff has found that hedge fund advisers have broad discretion to value securities and often exercise ultimate judgement over valuation.⁴³ In light of the absence of any form of independent oversight over hedge fund pricing, the quality and fairness of the prices of a hedge fund's portfolio seems suspect from the perspective of the SEC staff.

What the SEC expects from registered investment advisers that are hedge fund managers with respect to valuation remains an open question. The SEC has yet to issue any concrete guidelines on valuation despite the SEC staff's critical commentary of hedge fund valuation. Until the SEC issues proposed rules or staff guidance on how hedge funds are to value their portfolio, there will be uncertainty as to how to draft policies and procedures that address a hedge fund's valuation. Registered fund managers should strongly consider requesting the SEC for greater guidance so that the SEC can clarify its expectations on valuations from hedge fund managers.

B. Other Compliance Issues Hedge Fund Managers Should Note

Registered investment advisers that are hedge fund managers should also note the following when drafting their compliance program:

1. Custody Rule

Under Rule 206(4)-2 of the Advisers Act (the Custody Rule), the client is each beneficial owner in the fund, and, as such, each investor in the fund is to receive the account statement.⁴⁴

2. Advertising

While the compliance program will have to address advertising with respect to the Advisers Act, a registered investment adviser operating a hedge fund is also subject to

⁴⁰ 68 Fed. Reg. at 74716.

⁴¹ See Part VI.B. of the SEC Staff Hedge Fund Report.

⁴² See Parts IV.G. and VI.B. of the SEC Staff Hedge Fund Report.

⁴³ See Parts IV.G. and VI.B. of the SEC Staff Hedge Fund Report.

⁴⁴ See Rule 206(4)-2(a)(3)(iii) of the Advisers Act. An alternate provision to comply with the obligation to distribute account statements to clients under the custody rule is available to registered investment advisers of pooled investment vehicles such as hedge funds. See Rule 206(4)-2(b)(3) of the Advisers Act.

additional rules and SEC no-action letters that govern the advertising of privately placed pooled investment vehicles.⁴⁵ Accordingly, it is advisable that a hedge fund manager's compliance program include restrictions on its ability to advertise its hedge fund(s).

Future Developments

In the near future, registered investment advisers should expect to adopt an anti-money laundering program pursuant to Section 352 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act").⁴⁶ The proposed rule would require investment advisers to conduct due diligence on certain managed accounts and pooled investment vehicles. Investment advisers would be required to: (i) establish and implement policies, procedures and internal controls reasonably designed to detect and to prevent money laundering and terrorist financing; (ii) provide for independent testing for compliance, (iii) designate a person or persons responsible for implementing and monitoring the anti-money laundering program; and (iv) provide for ongoing employee training.⁴⁷

Currently, the SEC has not released any SEC staff guidance as to how to conduct an internal review of an investment adviser's compliance program. Not knowing what areas to review may render the annual review obligation to become a counter-productive exercise, especially if investment advisers are reviewing areas that the SEC does not consider to be critical. Since the compliance date is not until October 5, 2004 and annual reviews are not to be conducted until 2005, the investment advisory industry should consider requesting the SEC for a SEC staff release as to what areas should be considered when conducting an annual review similar to the self-audit guide that the National Futures Association provides to its members.⁴⁸ Despite the SEC's statements that there is no "one-size fits all" compliance program, by setting forth what is required by all registered investment advisers and by describing what should be reviewed under *each* provision of the Advisers Act, investment advisers will have a better grasp as to what to assess with respect to provisions of the Advisers Act applicable to such an adviser's operations.

⁴⁵ See Rule 501(c) of the Investment Company Act of 1940, as amended. See e.g. Royce Exchange Fund (Aug. 28, 1996); In the Matter of Harry Harootunian and Professional Planning & Technologies, Inc. and In the Matter of Robert Testa, Exchange Act Release No. 32981 (Sept. 29, 1993); In the Matter of Kenman Corp., Exchange Act Release No. 21962 (Apr. 19, 1985); Santa Barbara Securities (Apr. 8, 1983); and Woodtrails-Seattle Limited (Aug. 9, 1982).

⁴⁶ Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers; proposed rules; 68 Fed. Reg. 23646-23653 (May 5, 2003).

⁴⁷ 68 Fed. Reg. at 23648.

⁴⁸ Entities registered with the Commodity Futures Trading Commission and the NFA are required to be members of the National Futures Association. Pursuant to NFA Compliance Rule 2-9, an NFA member is required to conduct an annual self-audit to determine its compliance with the applicable provisions of the Commodity Exchange Act, as amended, and the applicable NFA Rules. The self-audit is made available to NFA members on the NFA website. See "Self Examination Checklist: For FCMs, IBs, CPOs, and CTAs", available at: <<http://www.nfa.futures.org/compliance/selfexam.asp>>.

