

January 23, 2004

## New SEC Rule: Compliance Programs and the Appointment of a Chief Compliance Officer for Investment Companies and Investment Advisers

The Securities and Exchange Commission (the “SEC”) is adopting new rules under the Investment Company Act of 1940, as amended (the “1940 Act”), and the Investment Advisers Act of 1940, as amended (the “Advisers” Act): “Compliance Programs of Investment Companies and Investment Advisers” (the “New Rule”).<sup>1</sup> The New Rule becomes effective on February 5, 2004. All registered investment companies (“funds”) and registered investment advisers (“advisers”) must comply with its mandates by October 5, 2004. This memorandum discusses the New Rule, which requires every fund to appoint a chief compliance officer who reports to the fund’s board of directors and to adopt and implement compliance policies and procedures that are reviewed annually by the fund’s board of directors.

### **A. Fund Chief Compliance Officer**

Each fund will be required to designate an officer to be responsible for administering the fund’s compliance policies and procedures. Both the designation of the officer and the officer’s compensation must be approved by a majority of the fund’s board of directors and the fund’s independent directors. The chief compliance officer may only be removed from his or her position by a vote of a majority of the fund’s board of directors and the fund’s independent directors.<sup>2</sup>

The officer must have sufficient authority and seniority to compel employees to obey the new compliance policies and procedures. Moreover, the officer must be knowledgeable

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<sup>1</sup> Final Rule: Compliance Programs of Investment Companies and Investment Advisers, 17 CFR Parts 270 and 275; Release Nos. IA-2204, IC-26299, File No. S7-03-03: RIN 3235-A177 (December 17, 2003).

<sup>2</sup> *Id.* at Section II.C.2.

about the federal securities laws.<sup>3</sup> In addition to administering the compliance policies and procedures, the officer must provide an annual written report to the fund board summarizing the operation of the policies and procedures, any material changes to the policies and procedures and any “material compliance matters” that have occurred.<sup>4</sup> Encompassed within the definition of “material compliance matters” are any compliance matters that the fund’s board of directors would “reasonably need to know” to oversee fund compliance, including:<sup>5</sup>

- any violations of the federal securities laws by the fund, the fund’s service providers and any officers or employees thereof;
- any violations of the fund’s compliance policies and procedures by the fund, the fund’s service providers and any officers or employees thereof;  
and
- any weaknesses in the design or implementation of the fund’s compliance policies and procedures.

The New Rule will require the chief compliance officer to report directly to the fund board and to meet alone, in executive session, with the independent directors.<sup>6</sup> This session will permit the independent directors and the officer to discuss freely any compliance issues of concern. The New Rule also will protect the chief compliance officer by prohibiting the fund’s officers, directors, employees or service providers from taking any action, directly or indirectly, that seeks to coerce, manipulate, mislead or fraudulently induce the officer in the performance of his or her duties.<sup>7</sup>

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

It should be noted that the New Rule will not prohibit the fund's compliance officer from working for the fund's adviser.<sup>8</sup> Moreover, the SEC believes that a fund compliance officer who did not work for the adviser would be limited in access to information, divorced from the fund's operations and therefore less effective in performing his or her duties.<sup>9</sup> However, the New Rule does not require that the fund's chief compliance officer be an employee of the adviser, since the SEC acknowledges the conflicts inherent in this employment relationship.

**B. Adviser's Chief Compliance Officer**

The New Rule requires advisers to designate a chief compliance officer.<sup>10</sup> Like the fund's chief compliance officer, the adviser's chief compliance officer should have the authority and seniority sufficient to compel employees' adherence to the new policies and procedures, as well as the requisite knowledge of federal securities laws. It is interesting to note that the SEC states that the fund's compliance officer likely will be the adviser's compliance officer.<sup>11</sup> The SEC's rationale for permitting a single person to assume both positions is that there will be significant overlap in responsibilities.<sup>12</sup>

**C. Fund Compliance Policies and Procedures**

Each fund will be required to adopt and implement new policies and procedures that are reasonably designed to prevent violations of the federal securities laws.<sup>13</sup> The policies and procedures also must provide for oversight of compliance by the fund's investment adviser, principal underwriter, and all administrators and transfer agents (collectively, "fund service

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<sup>8</sup> Final Rule, Release Nos. IA-2204, IC-26299 at Section III.C.2

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at Section III.C.1. New Rule 206(4).

<sup>11</sup> *Id.* at Section III.C.2., n. 88.

<sup>12</sup> *Id.* at Section III.C.2.

<sup>13</sup> *Id.* at Section II.A.2.

providers").<sup>14</sup> In light of recent controversies in the mutual fund industry, the SEC directs fund boards of directors to consider the following issues in adopting new policies and procedures:<sup>15</sup>

- portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser and applicable regulatory restrictions;
- trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services and allocates aggregated trades among clients;
- proprietary trading of the adviser and personal trading by supervised employees;
- accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;
- safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- 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;
- marketing of advisory services, including the use of solicitors;
- processes to value client holdings and assess fees based on valuations;
- safeguards for privacy protection of client records and information;
- business continuity plans;
- pricing of portfolio securities and fund shares;

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<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at Section II.A.2.c.

- processing of fund shares;
- identification of affiliated persons;
- protection of nonpublic information;
- compliance with fund governance requirements; and
- market timing and late trading.

The compliance policies and procedures must be approved by a majority of the fund's board of directors and the fund's independent directors, and only after each group has determined that the policies and procedures are reasonably designed to prevent violations of the federal securities laws.<sup>16</sup> In its release of the New Rule, the SEC states that directors can satisfy this obligation by reviewing summaries of the compliance programs prepared by the chief compliance officer, legal counsel or other persons familiar with the compliance programs.<sup>17</sup> Actual review of lengthy compliance manuals will not be required.<sup>18</sup>

The SEC emphasizes that the compliance policies and procedures must only be reasonably designed to prevent violations.<sup>19</sup> In considering whether to adopt the policies and procedures, the board should consider the individual nature of each fund's exposure to compliance failures and their adequacy in light of each fund's recent compliance experiences.<sup>20</sup> The SEC also encourages fund directors to consider best practices used by other fund complexes and to consult with compliance specialists.<sup>21</sup>

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<sup>16</sup> *Id.* at Section II.A.2.b.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at Section II.A.1.

<sup>20</sup> *Id.* at Section II.A.2.b

<sup>21</sup> *Id.*

Finally, each fund must review the new policies and procedures annually to determine their adequacy.<sup>22</sup> Directors are not required to conduct the review.<sup>23</sup> The directors however will have the benefit of reviewing the annual report on compliance submitted by the chief compliance officer.<sup>24</sup>

**D. Fund Recordkeeping**

Each fund will be required to keep copies of the compliance policies and procedures, as well as any materials provided to the fund's board of directors during their annual review, in an easily accessible place. Copies of materials provided to the fund's board of directors or documenting the board's annual review of the policies and procedures must be kept for five years, the first two of which must be in an easily accessible place.<sup>25</sup>

**E. Investment Advisers**

Each adviser will be required to adopt policies and procedures reasonably designed to prevent violations of the Advisers Act.<sup>26</sup> In its release, the SEC emphasizes that the policies and procedures must only be reasonably designed to prevent violations and therefore can be tailored to the compliance concerns relevant to the particular adviser. The SEC nevertheless directs advisers to consider the same issues in adopting new compliance policies and procedures that fund boards are directed to consider, as previously discussed on page 4 of this memorandum.

The New Rule will not require advisers to compile all the policies and procedures into a single manual, nor will it require that every action be memorialized to ensure compliance.<sup>27</sup>

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<sup>22</sup> Final Rule, Release Nos. IA-2204, IC-26299 at Section II.B.2.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at Section II.D.

<sup>26</sup> *Id.* at Section II.A.1.

<sup>27</sup> *Id.*

However, the compliance policies and procedures must be reviewed annually for adequacy, and a chief compliance officer must be designated by the adviser to administer the policies and procedures.<sup>28</sup> Finally, investment advisers must keep copies of any records documenting their annual review.<sup>29</sup>

**F. Conclusions**

It is imperative that the board of directors of each fund starts the process of identifying a chief compliance officer and the preparation of compliance policies and procedures as soon as possible. In order for the chief compliance officer and the policies and procedures to be in place by October 5, 2004, approval by a fund's board of directors should be requested following a full and frank discussion of the requirements of the chief compliance officer and the contents of the compliance policies and procedures.

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If you have any questions regarding the New Rule, or would like to consider submitting a comment on any part of the New Rule, please do not hesitate to call us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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<sup>28</sup> *Id.* at Section II.C.1. New Rule 206(4) of the Advisers Act.

<sup>29</sup> Final Rule, Release Nos. IA-2204, IC-26299 at Section at II.D.