



Compliance Programs of Investment Companies and Investment Advisers

INTRODUCTION

On December 3, 2003, the Securities and Exchange Commission (“SEC”) adopted new rules under the Investment Advisers Act of 1940 (“Advisers Act”) and the Investment Company Act of 1940 (“1940 Act”) that require each investment company (“fund”) and investment adviser (“adviser”) registered with the SEC as such to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer (“CCO”) to be responsible for administering the policies and procedures.¹ Additionally, fund directors must approve the policies and procedures of the fund’s service providers. Set out below is an explanation of the new rules, as well as required and recommended actions to be taken by funds and advisers.

IMPLEMENTATION TIMELINE

The new rules became effective on February 5, 2004 and advisers and funds must comply with the rules no later than October 5, 2004. *Note that a number of these actions require fund board approval, and that funds and their advisers should build sufficient time into their implementation timelines to obtain these approvals.*

Advisers

- Adopt the adviser’s required policies and procedures and designate one individual as the CCO of the adviser no later than October 5, 2004.

¹ See 17 C.F.R. §§ 270.38a-1 (Compliance Procedures and Practices of Certain Investment Companies), 275.204-2 (Books and Records to be Maintained by Investment Advisers) and 275.206(4)-7 (Compliance Procedures and Practices); see also *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, Rel. Nos. IC-26299 and IA-2204 (Dec. 17, 2003) (“Adopting Release”).

- Conduct a review of the adviser’s policies and procedures no later than eighteen months after the required policies and procedures have been adopted by the adviser (by April 5, 2006, at the latest).

Funds

- Obtain board approval of the policies and procedures of the fund and each of the fund’s service providers and of the designation and compensation of the CCO of the fund no later than at the meeting of the board prior to October 5, 2004.
- Conduct a review of the policies and procedures of the fund and the fund’s service providers no later than eighteen months after the required policies and procedures have been approved by the board (by April 5, 2006, at the latest).
- Schedule the presentation by the fund’s CCO of his or her first annual report to the board for the board meeting that is within 60 days of the completion of the annual review (by June 4, 2006, at the latest).
- Schedule a meeting between the fund’s CCO and the independent directors of the board for no later than October 5, 2005.

ADOPTION AND IMPLEMENTATION OF POLICIES AND PROCEDURES

Rule 206(4)-7 under the Advisers Act (the “Adviser Compliance Rule”) and Rule 38a-1 under the 1940 Act (the “Fund Compliance Rule,” and together with the Adviser Compliance Rule, the “Rules”) require advisers and funds to adopt and implement certain compliance programs. The failure of an adviser or fund to have adequate compliance policies and procedures in place—even without harm to investors—will constitute a violation of the Rules.

Advisers

The Adviser Compliance Rule makes it unlawful for an adviser to provide investment advice to clients

unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation, by the adviser and the adviser's supervised persons², of the Advisers Act and the rules that the SEC has adopted under the Advisers Act.³ Although the Rule does not enumerate specific elements that an adviser must include in its policies and procedures, the SEC stated that an adviser's policies and procedures, *at a minimum*, should address the following issues to the extent that they are relevant to the adviser:

1. 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;
2. Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
3. Proprietary trading of the adviser and personal trading activities of supervised persons;
4. The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements;
5. Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
6. 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;
7. Marketing advisory services, including the use of solicitors;
8. Processes to value client holdings and assess fees based on those valuations;
9. Safeguards for the privacy protection of client records and information; and
10. Business continuity plans.

The adviser's compliance policies and procedures need not be consolidated into a single document. The SEC also expressly clarified that each adviser should adopt policies and procedures that take into

² Section 202(a)(25) the Advisers Act defines a supervised person as "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 or control of the investment adviser." 17 C.F.R. § 275.202(a)(25).

³ The recently proposed code of ethics rule for advisers, if adopted, would arguably increase the scope of an adviser's compliance programs to include compliance with the federal securities laws. See *Proposed Rule: Investment Adviser Codes of Ethics*, Rel. No. IA – 2209 (Jan. 20, 2004).

consideration the nature of that adviser's operations, and that it would expect smaller advisory firms without conflicting business interests to require much simpler policies and procedures than larger firms that have multiple potential conflicts of interest as a result of their affiliations or other lines of business.

S&S Recommended Actions:

- ✓ Identify potential conflicts of interests and other compliance issues that may create risk for the adviser and its clients in light of the adviser's business.
- ✓ Review current policies and procedures to determine whether they are reasonably designed to prevent violations of the Advisers Act by the adviser and the adviser's supervised persons, and if not, prepare new policies or amend those existing.
- ✓ Ensure that all current policies and procedures are in writing.
- ✓ Determine which of the ten issues listed above are applicable to the adviser's business and draft policies and procedures addressing these issues to the extent they are not already covered in the adviser's existing policies and procedures.
- ✓ Develop a process for reviewing and updating policies and procedures.
- ✓ Adopt the adviser's policies and procedures no later than October 5, 2004.

Funds

Under the Fund Compliance Rule, a fund must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by each investment adviser (including subadvisers), principal underwriter, administrator, and transfer agent of the fund ("service providers").⁴ A fund's policies and procedures must, therefore, address a fund's obligations not only under the 1940 Act and the Advisers Act, but also the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, Title V of the Gramm-Leach-Bliley Act, the Bank Secrecy Act, and any SEC or other agency's applicable rules under each.

The SEC clarified in the Adopting Release that the Fund Compliance Rule provides fund complexes with flexibility to apply the Rule in the manner best suited to the particular fund complex. A fund complex may, for example, adopt policies and procedures that would cover solely the activities of the funds, and would approve the policies and procedures of each of its service providers, or,

⁴ 17 C.F.R. § 270.38a-1(a).

alternatively, a fund complex can adopt policies and procedures that cover the activities of the funds, the adviser and affiliated underwriters and transfer agents, while approving the policies and procedures of other service providers, such as subadvisers, over which it has oversight responsibility.

Board Approval

The Fund Compliance Rule requires a fund's board of directors, including a majority of its independent directors, to approve the policies and procedures of the fund and each of its service providers, 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 its service providers. The SEC explained that directors may satisfy their obligations under the Rule by reviewing summaries of compliance programs prepared by the CCO, legal counsel or other persons familiar with the compliance programs. The summaries should be designed to familiarize the directors with the salient features of the programs and provide them with a good understanding of how the compliance programs address particularly significant compliance risks.

The SEC further stated that boards should consider the following factors when determining whether to approve the fund's or a service provider's policies and procedures:

1. The nature of the fund's exposure to compliance failures;
2. The adequacy of the policies and procedures in light of their recent compliance experiences, which may demonstrate weaknesses in the compliance programs; and
3. Best practices used by other fund complexes.

The SEC also urged boards to consult with fund counsel (and independent directors with their counsel), compliance specialists and other experts familiar with compliance practices successfully employed by similar funds or service providers.

The SEC noted that if a fund uses an unaffiliated service provider that provides similar services to a large number of funds, the fund's policies and procedures will satisfy the requirements of the Fund Compliance Rule if the fund uses a third-party report of the service provider's procedures instead of the procedures themselves when the board is evaluating whether to approve the service provider's compliance program. The third-party report must describe the service provider's compliance program as it relates to the types of services provided to the fund, discuss the types of compliance risks material to the fund, and assess the adequacy of the service provider's compliance controls.

Policies and Procedures

The SEC explained that the policies and procedures of a fund, its adviser or other service providers should address the issues identified above for advisers, to the extent applicable, as well as the following critical areas:

1. Pricing of portfolio securities and fund shares;
2. Processing of fund shares (note that the SEC indicated that simply having procedures designed to prevent late trading is not sufficient, but that a fund should also take affirmative steps to protect itself and its shareholders against late trading by obtaining assurances from its transfer agent that its policies and procedures are effectively administered);
3. Identification of affiliated persons;
4. Protection of nonpublic information;
5. Compliance with fund governance requirements; and
6. Market timing.

S&S Recommended Actions:

- ✓ Identify potential conflicts of interests and other compliance issues that may create risk for the fund.
- ✓ Review the fund's current policies and procedures to determine whether they are reasonably designed to prevent violations of the federal securities laws by the fund, and if not, prepare new policies or amend those existing.
- ✓ Ensure that all policies and procedures are in writing.
- ✓ Determine which of the sixteen issues listed above are applicable to the fund and draft policies and procedures addressing these issues to the extent they are not already covered in the fund's policies and procedures.
- ✓ Request and review copies of the fund's service providers' policies and procedures to determine whether they are reasonably designed to prevent violations of the federal securities laws.
- ✓ Amend the fund's policies and procedures to provide for the fund to oversee its service providers' compliance.
- ✓ If desired, prepare, or retain someone to prepare, summaries of compliance policies and procedures for the board of directors to review as part of its approval process.
- ✓ If applicable and desired, request and review third-party reports of the policies and procedures of service providers.
- ✓ Develop process for reviewing and updating policies and procedures.
- ✓ Obtain board approval of the policies and procedures of the fund and each of the fund's service providers no later than October 5, 2004.

ANNUAL REVIEW

Advisers

The Adviser Compliance Rule requires each adviser to review its policies and procedures to determine the adequacy and effectiveness of their implementation on an annual basis.⁵ The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures. Although the Rule requires only annual reviews, the SEC commented that advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments. The SEC further noted that it expects all registered advisers to begin now reviewing their policies and procedures in light of the adoption of the Rule.

S&S Recommended Actions:

- ✓ Begin reviewing current policies and procedures to determine their adequacy and the effectiveness of their implementation.
- ✓ Develop a schedule or timeline and assign responsibility for reviewing each of the adviser's policies and procedures, and consider the factors that may necessitate interim reviews. All of the adviser's policies and procedures do not need to be reviewed contemporaneously.
- ✓ Determine and set the date by which the first annual review must be completed. *Advisers must complete their first annual review no later than eighteen months after the initial adoption of the adviser's policies and procedures, which adoption must occur no later than October 5, 2004.*

Funds

Like the Adviser Compliance Rule, the Fund Compliance Rule requires each fund to review its policies and procedures, as well as those of its service providers, annually.⁶ The board of directors of the fund is not required to conduct the annual review, but will have the benefit of the review in the report submitted by the CCO, as described below. The SEC noted that it expects all funds to begin now reviewing their policies and procedures in light of the adoption of the Rule and in light of the recent revelations of unlawful practices involving fund market timing, late trading, and improper disclosures and use of nonpublic information.

⁵ 17 C.F.R. § 275.206(4)-7(b).

⁶ 17 C.F.R. § 270.38a-1(a)(3).

S&S Recommended Actions:

- ✓ Begin reviewing current policies and procedures of the fund and the fund's service providers to determine their adequacy and the effectiveness of their implementation.
- ✓ Develop a schedule or timeline and assign responsibility for reviewing each of the fund's and service providers' policies and procedures, and consider the factors that may necessitate interim reviews. All of the fund's and service providers' policies and procedures do not need to be reviewed contemporaneously.
- ✓ Determine and set the date by which the first annual review must be completed. *Funds must complete their first annual review no later than eighteen months after the approval of the policies and procedures by the board of directors, which approval must be obtained no later than October 5, 2004.*
- ✓ Determine date by which the CCO must submit his or her annual report to the board, which must be within 60 calendar days of the completion of the first annual review.

CHIEF COMPLIANCE OFFICER

Advisers

The Adviser Compliance Rule requires each adviser to designate a CCO to administer its compliance policies and procedures.⁷ The SEC explained that the CCO 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. The CCO should have a position of sufficient seniority and authority to compel others to adhere to the policies and procedures.

S&S Recommended Actions:

- ✓ Designate one individual as the CCO of the adviser no later than October 5, 2004.
- ✓ Amend Form ADV to disclose who has been designated as CCO.

Funds

The Fund Compliance Rule requires each fund to designate a CCO to administer its compliance policies and procedures.⁸ The fund's CCO should be competent and knowledgeable regarding the federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the

⁷ 17 C.F.R. § 275.206(4)-7(c).

⁸ 17 C.F.R. § 270.38a-1(a)(4).

firm. The fund's CCO, like the CCO of an adviser, should have a position of sufficient seniority and authority to compel others to adhere to the policies and procedures. A fund may choose to designate its adviser's CCO as the fund's CCO and, in doing so, the board should determine what portion of the CCO's compensation, if any, should be considered to be an expense of the fund. Conversely, a fund that chooses to designate a separate CCO from that of the adviser should consider whether any portion of the CCO's compensation should be charged to the adviser.

The Fund Compliance Rule contains several provisions designed to promote the independence of the CCO from the management of the fund that should be considered when weighing whether to have a joint CCO for the adviser and the fund.⁹

1. The CCO will serve at the pleasure of the board.
 - (a) The board, including a majority of the independent directors, must approve the designation of the CCO.
 - (b) The board, including a majority of the independent directors, must approve the compensation of the CCO, or any changes in the CCO's compensation.
 - (c) The board, including a majority of the independent directors, may remove the CCO from his or her responsibilities to the fund at any time and can prevent the adviser or another service provider from doing so.
2. The CCO must report directly to the board and must annually furnish the board with a written report on the operation of the fund's policies and procedures and those of its service providers. The report must address, at a minimum, the following topics:
 - (a) The operation of the policies and procedures of the fund and each service provider since the last report;
 - (b) Any material changes to the policies and procedures since the last report;
 - (c) Any recommendations for material changes to the policies and procedures as a result of the annual review; and

⁹ The SEC requested comments, which were due February 5, 2004, on the provisions of the Fund Compliance Rule designed to protect a fund's CCO from undue influence by fund management.

(d) Any material compliance matters¹⁰ since the date of the last report.

3. The CCO must meet in executive session with the independent directors at least once a year alone.
4. The fund's officers, directors, employees and its adviser, principal underwriter, or any person acting under the direction of these persons, are prohibited from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the fund's CCO in the performance of his or her responsibilities under the Fund Compliance Rule.¹¹

The SEC noted that the CCO should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks. Further, arrangements with service providers should provide the CCO with direct access to the service providers' compliance personnel, and should provide the CCO with periodic reports and special reports in the event of compliance problems. In addition, a fund's CCO should consider requiring service providers to certify periodically that they are in compliance with applicable federal securities laws and arranging a third-party audit to evaluate the effectiveness of a service provider's compliance controls.

S&S Recommended Actions:

- ✓ Determine whether the fund and adviser will have a common CCO, or whether each will designate its own CCO, and determine the compensation.
- ✓ Obtain board approval (including a majority of the independent directors) of the individual selected to be the fund's CCO and the compensation of the CCO no later than October 5, 2004.
- ✓ Determine the date on which the fund's CCO will meet separately with the fund's independent directors.
- ✓ Arrange for the fund's CCO to meet with the fund's service providers or otherwise obtain the information necessary to fulfill the CCO's oversight role of these providers.

¹⁰ A "material compliance matter" means "any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance, and that involves, without limitation: (i) a violation of the federal securities laws by the fund, its investment adviser, principal underwriter, administrator or transfer agent (or officer, directors, employees or agents thereof), (ii) a violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent, or (iii) a weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent. 17 C.F.R. § 270.38a-1(e)(2). In the Adopting Release, the SEC requested additional comments on the definition of "material compliance matter."

¹¹ 17 C.F.R § 270.38a-1(c).

RECORDKEEPING

The Rules require advisers and funds, respectively, to maintain in an easily accessible place copies of all policies and procedures that are in effect or were in effect at any time during the previous five years, as well as any records documenting their annual review.¹² In addition, the Fund Compliance Rule

requires funds to maintain materials provided to the board in connection with its approval of the fund's and its service providers' policies and procedures and the annual written reports by the fund's CCO. These records may be maintained electronically.

S&S Recommended Action:

- ✓ Establish a system for maintaining the records and documentation required by the Rules.

¹² 17 C.F.R. §§ 275.204-2 and 270.38a-1.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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