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Client Alert

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Proposed Rule under Investment Advisers Act of 1940 ("Advisers Act") Requiring Registered Investment Advisers ("RIAs") to Adopt and Implement Compliance Policies and Procedures; Other Developments Affecting RIAs

In a regulatory climate created by recent corporate accounting and investment banking scandals, the investment advisory/investment management business, long a backwater of federal securities regulation, is becoming the subject of increasing SEC scrutiny and activity.

The centerpiece of the SEC's new proactive approach is Proposed Rule 206(4)-7 under the Advisers Act (the "Proposed Rule"). The Proposed Rule would require every RIA: (1) to "adopt and implement written policies and procedures reasonably designed to prevent violations" of the Advisers Act and the rules thereunder by the RIA and its supervised persons; (2) to "review, no less frequently than annually, the adequacy of the policies and procedures established . . . and the effectiveness of their implementation"; and (3) to designate a chief compliance officer "who is responsible for administering the policies and procedures".

The Release announcing the Proposed Rule leaves it to the individual RIA to decide what compliance policies and procedures are appropriate to its individual business operations. However, it is clear that the SEC expects the compliance policies and procedures of most RIAs to be quite comprehensive and, in that sense, not unlike those found in compliance manuals of broker-dealers. The Release states that, at a minimum, an RIA's policies and procedures should address:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency with client guidelines, disclosures and regulatory requirements.
- Trading practices, including procedures to ensure best execution, use of brokerage to obtain research and other services ("soft dollar arrangements") and allocation of trades among clients.
- Proprietary trading by the RIA and personal trading by its supervised persons.
- Accuracy of disclosures, including advertisements, to clients and prospective clients.
- Safeguarding of client assets from conversion or misuse by advisory personnel.
- Accurate creation of required records and maintenance of the records so as to prevent unauthorized alteration or use and protect against untimely destruction.
- Processes to value client holdings and assess advisory fees based on these valuations.
- Safeguards to protect the confidentiality of client records and information.
- Business continuity plans.

Since smaller RIAs may lack the resources to establish an in-house compliance operation, the Release permits RIAs to delegate the compliance function to third party service providers. However, it is clear that the RIA retains responsibility for oversight of the service provider.

The Release stresses the substantial burden that policing RIA compliance imposes on the SEC staff and proposes three possible ways to increase private sector involvement in the compliance process. These are: (1) periodic private review of each RIA by an independent compliance consultant; (2) a self-regulatory organization for the investment advisory/investment management business; and (3) fidelity bonding of (or, in the alternative, capital requirements for) RIAs who handle client assets.

The Proposed Rule and the three companion proposals have been the subject of extensive comment — much of it critical — from participants in the investment advisory/investment management business and their representatives. As a consequence, the regulatory process is likely to continue for several months, the outcome is at present uncertain and any final rule may reflect substantial changes. We will keep our RIA clients informed of these developments by further memoranda.

We will also be sending our RIA clients separate memoranda dealing with other significant regulatory developments that may affect them. These include: (1) new Rule 206(4)-6 under the Advisers Act, which requires RIAs that have express or implicit authority to vote client proxies to adopt and disclose to clients, no later than August 6, 2003, policies and procedures to ensure that the proxies are voted in the best interests of the clients; (2) a proposed rule of the Financial Crimes Enforcement Network extending to RIAs managing client assets the anti-money laundering program requirements mandated by the USA PATRIOT Act for broker-dealers and other financial institutions; and (3) an SEC fact-finding examination to consider the need for additional regulation of the hedge fund industry and a follow-up two-day open roundtable discussion with representatives of the industry and others at the SEC's offices earlier this month.

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