

Client Advisory

December 2003

Advisers Must Have Written Compliance Policies and Procedures Under New SEC Rule

The Securities and Exchange Commission recently adopted a new rule that will require registered investment advisers to

- adopt and implement written policies and procedures reasonably designed to prevent violations of law by the adviser and its supervised persons,
- review annually the adequacy of the policies and procedures and the effectiveness of their implementation, and
- appoint a Chief Compliance Officer to be responsible for administering the policies and procedures.

There will be a nine-month phase in period for new Rule 206(4)-7 to enable advisers to prepare and implement written policies and procedures. The compliance date will be October 5, 2004, nine-months after expected publication of the rule in the Federal Register. By the compliance date, advisers are required to have adopted their written policies and procedures and appointed the Chief Compliance Officer. The first annual review of the policies and procedures is to be completed no later than 18 months after their adoption.

Rule 206(4)-7 was proposed in February 2003. It was adopted at an SEC open meeting on December 3, 2003, together with new Rule 38a-1 under the Investment Company Act of 1940, which will impose similar requirements on registered investment companies. The SEC billed adoption of these rules as one of several actions taken to combat late trading and market timing abuses in the mutual fund industry. ***Rule 206(4)-7 applies to all registered advisers, however, regardless of whether they have any mutual fund clients.***

Under the Advisers Act, it has always been incumbent upon advisers to adopt and maintain procedures to detect and prevent violations of the federal securities laws, and a system for applying such procedures. As SEC staff resources have become strained, the Commission has focused its examination efforts on testing the effectiveness of advisers' controls and related compliance procedures and placing the onus on the adviser's management to rectify any weaknesses that the staff discovers. While the SEC has not dictated exactly what procedures advisers must have, it said that, at a minimum, the following would have to be addressed:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures, and regulatory requirements;
- 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 aggregate trades among clients;

- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, including information in advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- 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;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the protection of client records and information; and
- Business continuity plans.

To administer these policies and procedures, the SEC is requiring each adviser to appoint a Chief Compliance Officer. This individual must be “competent and knowledgeable” regarding the applicable federal securities laws, “should be empowered with full responsibility and authority to develop and enforce” appropriate policies and procedures, and should have “a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.”

Finally, the new rule calls for each adviser to review its policies and procedures at least annually. Interim reviews may be appropriate in light of interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments. For example, the SEC stated that it expects advisers to begin now to review their policies and procedures in light of adoption of the rule. The policies and procedures, as well as documentation of the annual review, will have to be maintained as records of the adviser.

We have extensive experience in developing policies and procedures for both registered and unregistered investment advisers, as well as for broker-dealers, commodities market professionals and other financial intermediaries. We will be happy to work with you to harmonize your business practices with the requirements of the Advisers Act and rules there under and to develop practicable policies and procedures that both reflect the operational concerns of your business and meet the requirements of the new rule.

Investment Advisers Act Release No. 2204, announcing adoption of the rule, may be viewed at <http://www.sec.gov/rules/final/ia-2204.htm>.

We Can Help

To discuss the implications of the New Rule, please contact one of the following Katten Muchin Zavis Rosenman attorneys:

	Direct Dial	Email
Henry Bregstein	212.940.6615	henry.bregstein@kmzr.com
Daren R. Domina	212.940.6517	daren.domina@kmzr.com
Basil V. Godellas	312.902.5431	basil.godellas@kmzr.com
Jack P. Governale	212.940.8525	jack.governale@kmzr.com
Arthur W. Hahn	312.902.5241	arthur.hahn@kmzr.com
Edward J. Johnsen	212.940.8894	edward.johnsen@kmzr.com
Marla J. Kreindler	312.577.5621	marla.kreindler@kmzr.com
Michael J. Metzger	202.625.3696	michael.metzger@kmzr.com
William Natbony	212.940.8930	william.natbony@kmzr.com
Wesley G. Nissen	312.902.5365	wesley.nissen@kmzr.com
Michael M. Philipp	312.902.5367	michael.philipp@kmzr.com
Fred M. Santo	212.940.8720	fred.santo@kmzr.com
Howard Schneider	212.940.8787	howard.schneider@kmzr.com
Marybeth Sorady	202.625.3727	marybeth.sorady@kmzr.com
James Van De Graaff	312.902.5227	james.vandegraaff@kmzr.com
Robert Weiss	212.940.8584	robert.weiss@kmzr.com

*Published for clients as a source of information about current developments in the law. The material contained herein is not to be construed as legal advice or opinion.
© 2003 Katten Muchin Zavis Rosenman. All rights reserved. Katten Muchin Zavis Rosenman is a law partnership including professional corporations.*

KMZ Rosenman
KATTEN MUCHIN ZAVIS ROSENMAN

www.kmzr.com

525 West Monroe Street
Suite 1600
Chicago, IL 60661-3693
Tel 312.902.5200
Fax 312.902.1061

575 Madison Avenue
New York, NY 10022-2585
Tel 212.940.8800
Fax 212.940.8776

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
Tel 310.788.4400
Fax 310.788.4471

1025 Thomas Jefferson St., N.W.
East Lobby, Suite 700
Washington, DC 20007-5201
Tel 202.625.3500
Fax 202.298.7570

401 South Tryon Street
Suite 2600
Charlotte, NC 28202-1935
Tel 704.444.2000
Fax 704.444.2050

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
Tel 650.330.3652
Fax 650.321.4746

One Gateway Center
Suite 2600
Newark, NJ 07102-5397
Tel 973.645.0572
Fax 973.645.0573