K&L ALERT

Investment Management

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SEC Adopts Final Rules Mandating Compliance Programs for Investment Companies and Investment Advisers

The Securities and Exchange Commission adopted new Rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that require investment companies ("funds")[1] and investment advisers registered with the SEC to adopt and implement internal programs designed to prevent violation of the federal securities laws ("compliance programs"). As described in more detail below, the new Rules require each fund and registered investment adviser (even one that does not advise a registered fund) to adopt and implement a written compliance program, review the program annually for adequacy and effectiveness, and designate a chief compliance officer ("CCO") responsible for administering the program. Failure to have an adequate compliance program in place will constitute a violation of the SEC's Rules, independent of any other securities law violation. The new Rules will thus permit the SEC to address a failure to have adequate compliance controls in place before any such failure harms investors.

On or before October 5, 2004, each fund and adviser must have designated a CCO and must have adopted compliance programs that satisfy the requirements set forth in the Rules. For funds, the CCO and compliance programs must also have been approved by the board. Each fund and adviser must complete the first annual review of its compliance program no later than eighteen months after its adoption or approval, and the fund's CCO must submit his or her first annual report to the board within sixty calendar days of the completion of the annual review.

INVESTMENT COMPANIES

Adoption and Implementation of Mandatory Compliance Program

Rule 38a-1 under the Investment Company Act requires each fund to adopt and implement policies and procedures reasonably designed to prevent the fund from violating the federal securities laws. For this purpose, "federal securities laws" means the Investment Company Act, the Advisers Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, and portions of the Gramm-Leach-Bliley Act and the Bank Secrecy Act. The compliance program must include oversight by the fund of compliance by its advisers, principal underwriters, administrators, and transfer agents (collectively, "service providers") through which the fund conducts its activities.

The Rule requires a fund's board, including a majority of its independent directors, to approve the compliance program of the fund and of each of its service providers. Furthermore, the fund's compliance program must include provisions for the fund to oversee compliance by its service providers. Board approval must be based on a finding that the fund's compliance program is reasonably designed to prevent violation of the federal securities laws by the fund and its service providers. In deciding whether to

1 A "fund" refers to a registered investment company or a business development company, which is a special type of closed-end investment company. A "mutual fund" refers to a registered investment company that is an open-end management company.

approve the proposed compliance programs, a fund's board can rely on summaries of the compliance programs that are prepared by the fund's CCO or by its service providers. During this approval process, the SEC suggests that fund boards seek input from their legal counsel and compliance experts, and consider industry best practices.

In the release adopting the Rule, the SEC states that fund compliance programs should address the issues outlined for advisers below, as well as the following "critical" areas:

- *Pricing of Portfolio Securities and Fund Shares* – policies and procedures should be adopted to require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable; provide a methodology by which the fund determines current fair value; and regularly review the appropriateness and accuracy of the methods used in valuing securities, and adjust as necessary.

- *Processing of Fund Shares* – procedures should be adopted that segregate investor orders received before a fund's pricing time from those received after the fund's pricing time. Because orders are ultimately transferred to transfer agents, the SEC expanded the service providers covered by the Rule to include transfer agents. Reliance on existing contractual provisions with transfer agents and other intermediaries that obligate those parties to segregate orders to prevent late trading would be insufficient to meet the requirements of the new Rule. Funds are expected to approve and periodically review the policies and procedures of transfer agents as well as take affirmative steps to protect against late trading by obtaining assurances that those policies and procedures are effectively administered.[2]

- *Identification of Affiliated Persons* – policies and procedures should be adopted to identify first and second-tier affiliates of a fund, the fund's principal underwriters, and affiliated persons of the fund's principal underwriters to prevent unlawful transactions with them.

- *Protection of Nonpublic Information* – policies and procedures should be adopted to address other potential misuses of nonpublic information, including disclosure to third parties of material information about the fund's portfolio, its trading strategies, and pending transactions and the purchase or sale of fund shares by advisory personnel based on material, nonpublic information about the fund's portfolio.

- *Compliance with Fund Governance Requirements* – policies and procedures should be designed to guard against an improperly constituted board, the failure of the board to properly consider matters entrusted to it, and the failure of the board to request and consider information required by the Investment Company Act from the adviser and other service providers.

- *Market Timing* – procedures should be reasonably designed to ensure compliance with a fund's disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the fund in order to detect market-timing activity, and for consistent enforcement of the fund's policies regarding market timing. If the fund permits waivers of those policies, the procedures should be reasonably designed to prevent waivers that would harm the fund or its shareholders or subordinate the interests of the fund or its shareholders to those of the adviser or any other affiliated or associated person. Permitted waivers should be reported to the board

2 The adopting release states that, when a fund has employed the services of a service provider, such as a transfer agent, that is not affiliated with the fund, the fund's compliance program will satisfy the requirements of the Rule if the fund uses a third-party report to assess the adequacy of the service provider's compliance controls. An example of such a report is *Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 70, Reports on Processing Transactions by Service Organizations* (American Institute of Certified Public Accountants.)

quarterly to allow the board to determine if they were proper.

Annual Review

Rule 38a-1 requires each fund to review its compliance program as well as those of its service providers annually. The Rule does not require a fund board to conduct the review. Rather, a board could receive a report summarizing the results of the annual review from the fund's CCO, who would have reviewed the fund's compliance program and those of each service provider. In addition to the required annual review, the SEC anticipates that funds will review their compliance programs periodically, as necessary in light of ongoing industry regulatory developments.

Chief Compliance Officer

Rule 38a-1 requires each fund to appoint a CCO who would be responsible for administering the fund's compliance program approved by the board under the Rule. The adopting release provides little guidance to assist in a fund board's designation or approval of a CCO, and it is possible that such guidance as the SEC has provided might change as fund complexes attempt to comply with the new requirements. However, the adopting release states that the 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 fund; and
- familiar with fund service providers' operations, especially with aspects of service provider operations that expose the fund to compliance risks.

The SEC also emphasized that the fund's CCO should have a position of seniority and authority sufficient to compel others to adhere to the fund's compliance program. This all suggests that a fund's board should consider not only the qualities of the candidate being designated as CCO, but also the structure of the position within which the CCO will fulfill his or her duties to the fund.

The adopting release states that a fund's CCO serves in his or her position at the pleasure of the fund's board, is required to report directly to the board, and must:

- be responsible for administering the fund's compliance program;
- provide the fund's board a written report annually on the adequacy and effectiveness of the fund's compliance program including: (i) the operation of the compliance program and those of the service providers; (ii) any material changes to the compliance program; (iii) any recommendation for material changes to the compliance program as a result of the annual review; and (iv) any material compliance matters;[3]
- always bring "serious" compliance issues to the attention of the fund's board (reporting of serious compliance issues cannot be delayed until an annual report is due);
- meet at least once annually in executive session with the independent directors without management or the interested directors present (counsel to the independent directors may attend these executive sessions); and
- oversee the fund's service providers to assure that each has implemented effective compliance programs administered by competent personnel.

The adopting release points out that the appointment of a CCO is a key element in the investor protections being adopted and that current compliance practices at some companies may isolate fund boards from compliance personnel, impeding their ability to exercise oversight responsibilities effectively. Rule 38a-1 provides fund boards with direct access to a single person with overall compliance responsibility for the fund who answers directly to the board. The

3 The CCO will be directly responsible for apprising the board of any "material compliance matter," which is defined in the rule as "any compliance matter about which the fund's board of directors would reasonably need to know to oversee fund compliance," and that involves: (1) a violation of federal securities laws by the fund or its service providers; (2) a violation of the policies adopted by the fund or its service providers; or (3) a weakness in the design of the policies adopted by the fund or its service providers.

adopting release suggest that this direct line of communication will also strengthen the hand of compliance personnel because information will not flow through management before reaching the board.

While there is no interpretation of the new Rules thus far, it is clear that a fund's CCO can be the same person as the CCO of its adviser. In fact, the SEC has implied that this would be preferable. The adopting release anticipates that a fund's CCO will be employed by the investment adviser or administrator, and suggests that having the CCO employed only by the fund could actually weaken his or her effectiveness since the CCO would then be divorced from day-to-day fund operations. Recognizing that a CCO who is an employee of the adviser might be conflicted in his or her duties, the Rule attempts to address these concerns by requiring a fund's CCO to report directly to the board. A CCO that fails to fully inform a board of a material compliance failure or who fails to aggressively pursue non-compliance would risk his or her position.

The Rule contains provisions designed to promote the independence of a fund's CCO in any event. The Rule provides that:

- the fund's board, including a majority of the independent directors, must approve the designation of the CCO;
- the fund's board, including a majority of the independent directors, must approve the compensation of the CCO, and any changes in his or her compensation, including any bonuses;
- the fund's board, including a majority of the independent directors, can remove the CCO from his or her responsibilities to the fund;
- the fund's board, including a majority of the independent directors, can prevent the adviser or the fund's officers from removing the CCO from his or her responsibilities to the fund; and
- the officers, directors, or employees of the fund, its adviser, principal underwriter or any persons under their direction are prohibited from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence the CCO.

The CCO will oversee compliance with the Rule by the fund's service providers, each of which will have its own compliance official. A CCO is expected to take steps to assure himself or herself that each service provider has implemented effective compliance programs that are administered by competent personnel. 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. The CCO is expected to have direct access to compliance personnel at the service providers and should be provided with periodic reports and special reports in the event of compliance problems. In addition, the fund's contracts with its service providers might also require service providers to certify periodically that they are in compliance with applicable federal securities laws, or could provide for third-party audits arranged by the fund to evaluate the effectiveness of the service provider's compliance controls. Essentially, under the Rule, there should be no material constraints on the CCO in fulfilling his or her duties, including having the ability to access outside experts as appropriate.

A question has arisen as to whether an adviser can expect a fund to pay a part of the compensation for a person who serves as CCO for both the adviser and the fund. Advisers should approach this issue cautiously. Advisory agreements typically require the adviser to provide an investment program that complies with the federal securities laws and the fund's investment policies and limitations, which could be read to imply that compliance oversight is a function for which the adviser is already being paid under the contract. Thus, in order to justify additional compensation from the fund, it would seem appropriate to identify new tasks that the CCO is required to perform specifically in his or her role as CCO of the fund, and determine the compensation appropriate to those tasks.

INVESTMENT ADVISERS

Adoption and Implementation of Mandatory Compliance Program

New Rule 206(4)-7 under the Advisers Act requires each registered investment adviser to adopt and implement compliance procedures that conform to the new Rule. The Rule may eventually apply to a much larger group of advisers if the SEC follows through

on the staff's recommendation and requires that advisers to hedge funds count the investors in such funds for purposes of the exemption in Section 203(b)(3) of the Advisers Act.[4]

Under Rule 206(4)-7, it is unlawful for a registered adviser to provide investment advice unless it has adopted and implemented a written compliance program reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.[5] The Rule requires advisers to formalize policies and procedures intended to address their fiduciary and regulatory obligations under the Advisers Act.

The policies and procedures for a registered adviser need only encompass compliance considerations relevant to the operations of that particular adviser, as the Rule requires that such policies be "reasonably" designed to prevent violations of the Advisers Act. The Rule does not specify topics and practices that should be covered by the compliance program. However, the adopting release states that the compliance program should be designed to prevent violations of securities laws and include provisions for detection and remedial measures should such violations occur.

The adopting release states that at a minimum, the following issues should be addressed to the extent relevant to the adviser: (1) portfolio management processes, including allocation of investment opportunities, disclosures by the adviser, and applicable regulatory restrictions; (2) trading activities, including procedures to obtain best execution, soft dollar arrangements, and allocation of aggregated trades; (3) proprietary trading of the adviser and personal trading of supervised persons; (4) accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements; (5) safeguarding of client assets from conversion or inappropriate use; (6) accurate record-keeping and maintenance; (7) marketing advisory services; (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.

Annual Review

Rule 206(4)-7 requires each adviser to review its compliance program annually for adequacy and effectiveness of implementation. The review should consider any compliance matters that arose during the previous year and possible revisions to the program to address changes in the business activities of the adviser or its affiliates or in the Advisers Act or applicable regulations. The adopting release points out that, although the Rule only requires an annual review, interim reviews may be necessary in response to significant compliance events, changes in business arrangements, and regulatory developments.

Chief Compliance Officer

Under Rule 206(4)-7, each adviser must designate a CCO to administer its compliance program. An adviser's CCO should be competent and knowledgeable regarding the Advisers Act and empowered with full responsibility and authority to develop and enforce an appropriate compliance program for the adviser. The adopting release emphasizes that the CCO should have a position of seniority and authority sufficient to compel others to adhere to the compliance program. In relation to this requirement, the SEC is amending Form ADV to require that each registered adviser and applicant for registration as an adviser identify a single compliance officer.

The adopting release points out that the title of CCO does not, in and of itself, carry supervisory responsibilities. Thus, a CCO would not necessarily be subject to sanction by the SEC for failure to supervise other advisory personnel. A compliance officer who does have supervisory responsibilities can continue to rely on the defense provided for in

4 On September 29, 2003, the SEC released a staff report entitled "The Implications of the Growth of Hedge Funds," which presented findings from an SEC fact-finding investigation into the operations and practices of the hedge fund industry.

5 A "supervised person" is defined 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 and control of the investment adviser."

Section 203(e)(6) of the Advisers Act.[6] Furthermore, the release states that the Rule does not require an adviser to hire an additional executive to serve as the CCO, but rather to designate an individual as the adviser's CCO.

RECORD-KEEPING

The new Rule and Rule amendments require firms to maintain copies of all compliance programs in effect at any time in the last five years, including materials provided to boards in connection with their approval of the fund's and their service providers' compliance programs and the annual written reports by the fund's CCO. Funds and advisers are also required to keep any records documenting their annual review. These records may be maintained electronically, but must be provided in electronic format to the SEC upon request.

BENJAMIN J. HASKIN
202.778.9369
bhaskin@kl.com

NDENISARYA MEEKINS
202.778.9021
nmeekins@kl.com

6 Section 203(e)(6) 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 procedures; 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.

Kirkpatrick & Lockhart LLP maintains one of the leading investment management practices in the United States, with more than 60 lawyers devoting all or a substantial portion of their practice to this area and its related specialties. *The American Lawyer* Corporate Scorecard, published in April 2003, lists K&L as a primary legal counsel to the investment companies, board members or advisory firms for 15 of the 25 largest mutual fund complexes. No law firm was mentioned more frequently in the Scorecard.

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We invite you to contact one of the members of the practice, listed below, for additional assistance. You may also visit our website at www.kl.com for more information, or send general inquiries via email to investmentmanagement@kl.com.

BOSTON

Michael S. Caccese	617.261.3133	mcaccese@kl.com
Philip J. Fina	617.261.3156	pfina@kl.com
Mark P. Goshko	617.261.3163	mgoshko@kl.com
Thomas Hickey III	617.261.3208	thickey@kl.com
Nicholas S. Hodge	617.261.3210	nhodge@kl.com

LOS ANGELES

William P. Wade	310.552.5071	wwade@kl.com

NEW YORK

Philip L. Kirstein	212.536.483	pkirstein@kl.com
Beth R. Kramer	212.536.4024	bkramer@kl.com
Richard D. Marshall	212.536.3941	rmarshall@kl.com
Robert M. McLaughlin	212.536.3924	rmclaughlin@kl.com
Keith R. Miller	212.536.4045	kmiller@kl.com
Loren Schechter	212.536.4008	lschechter@kl.com

SAN FRANCISCO

Eilleen M. Clavere	415.249.1047	eclavere@kl.com
Jonathan D. Joseph	415.249.1012	jjoseph@kl.com
David Mishel	415.249.1015	dmishel@kl.com
Mark D. Perlow	415.249.1070	mperlow@kl.com
Richard M. Phillips	415.249.1010	rphillips@kl.com

WASHINGTON

Clifford J. Alexander	202.778.9068	calexander@kl.com
Diane E. Ambler	202.778.9886	dambler@kl.com
Catherine S. Bardsley	202.778.9289	cbardsley@kl.com
Arthur J. Brown	202.778.9046	abrown@kl.com
Arthur C. Delibert	202.778.9042	adelibert@kl.com
Robert C. Hacker	202.778.9016	rhacker@kl.com
Benjamin J. Haskin	202.778.9369	bhaskin@kl.com
Kathy Kresch Ingber	202.778.9015	kingber@kl.com
Rebecca H. Laird	202.778.9038	rlaird@kl.com
Thomas M. Leahey	202.778.9082	tleahey@kl.com
Cary J. Meer	202.778.9107	cmeer@kl.com
R. Charles Miller	202.778.9372	cmiller@kl.com
Dean E. Miller	202.778.9371	dmiller@kl.com
R. Darrell Mounts	202.778.9298	dmounts@kl.com
C. Dirk Peterson	202.778.9324	dpeterson@kl.com
David Pickle	202.778.9887	dpickle@kl.com
Alan C. Porter	202.778.9186	aporter@kl.com
Theodore L. Press	202.778.9025	tpress@kl.com
Robert H. Rosenblum	202.778.9464	rrosenblum@kl.com
William A. Schmidt	202.778.9373	william.schmidt@kl.com
Lynn A. Schweinfurth	202.778.9876	lschweinfurth@kl.com
Donald W. Smith	202.778.9079	dsmith@kl.com
Martin D. Teckler	202.778.9890	mteckler@kl.com
Robert A. Wittie	202.778.9066	rwittie@kl.com
Robert J. Zutz	202.778.9059	rzutz@kl.com

Kirkpatrick & Lockhart LLP

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