

A Primer on New Rules for Investment Advisers

The Securities and Exchange Commission (“SEC”), by its adoption of several new rules for registered investment advisers, has added to the panoply of regulatory requirements for this pervasively regulated industry. While new regulatory initiatives were expected in light of recent well-publicized cases of conflicts of interest, market timing and IPO allocations, these new rules impose substantive operating requirements for the entire industry. The new rules include Rules 206(4)-7 and 204A-1 under the Investment Advisers Act of 1940 (“IA Act”).¹

The new rules affect not only registered investment advisory firms (“RIA firms”) but also any broker-dealers that have relationships with advisory firms. In addition, while many advisers to hedge funds are presently exempt from registration with the SEC under IA Rule 203(b)(3) because hedge funds that either limit the number or type of investors typically fall within the exception to the definition of “investment company,” this may be about to change as well. The SEC recently proposed new Rule 203(b)(3)-2, which would effectively remove this exemption for many hedge fund advisers. (Note: The private adviser exemption under Rule 203(b)(3) exempts advisers with fewer than 15 clients and who do not hold themselves out as investment advisers.)

This Alert is intended to summarize the new requirements in effect for compliance policies and procedures, annual reviews, adoption of codes of ethics and violation reporting.

The New Rules

The two new IA rules are the basis for the new requirements. Rule 204A-1 generally requires registered advisers to adopt codes of ethics meeting standards that are set forth in the rule. These codes are required to set conduct standards for associated persons of RIA firms. They also must require reporting of certain personal securities transactions by certain personnel, require pre-approval of certain transactions and establish record-keeping requirements to evidence compliance. All investment advisers must be in compliance with this rule by January 7, 2005. Moreover, under Rule 206(4)-7, RIA firms must now implement written policies and procedures as well as designate a “chief compliance officer.” Firms must be in compliance with this rule by October 5, 2004.

¹ By virtue of new Rule 38a-1 of the Investment Company Act of 1940, registered investment companies are required to adopt and implement similar policies and procedures.

Written Compliance Policies and Procedures

RIA firms must adopt and implement written compliance policies and procedures that are reasonably designed to prevent the firm (and its personnel) from violating the IA Act (and its rules). In its release adopting Rule 206(4)-7, the SEC states that “the policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.” The SEC further states that “each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks.”

So, what should the compliance policies and procedures cover? The SEC suggests that, at a minimum, the policies and procedures should address the following (to the extent they are pertinent):

- (a) Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients’ objectives, disclosures by the RIA and regulatory restrictions;
- (b) Trading practices, including best execution, soft dollar arrangements and the allocation of aggregated trades among clients;
- (c) Proprietary trading of the adviser and personal trading activities of personnel;
- (d) The accuracy of disclosures made to regulators, investors and clients, including account statements and advertisements;
- (e) Safeguarding client assets from improper use or theft by advisory personnel;
- (f) The accurate creation of required records and their maintenance in a way that secures them from unauthorized alteration or use and protects them from untimely destruction;
- (g) Processes to value client holdings and assess fees;
- (h) Safeguards for protecting the privacy of client information and records;
- (i) Business continuity plans (*i.e.*, contingency plans to protect clients’ interests in the event of a disaster).

The Chief Compliance Officer

Rule 206(4)-7 also requires that all investment advisers designate a single individual within their firm as the “chief compliance officer” to administer the firm’s written compliance policies and procedures. The SEC release states that this person should be “competent and knowledgeable regarding the Advisers Act” and

should have full responsibility and authority to develop and enforce compliance policies and procedures for the firm. The compliance officer “should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.”

Persons designated by an adviser to serve in this position may well be subject to the same kind of oversight and burdens as have been borne by the designated chief compliance officer of a broker/dealer that is a member of the New York Stock Exchange, which makes a single designated official responsible for overall regulation and supervision within the firm. However, while this duty has long been a part of the compliance burden on the broker/dealer community, it is new to the advisory field.

Annual and Interim Reviews

Rule 206(4)-7 requires each registered adviser to perform an annual review of written policies and procedures to determine whether they are adequate and effective in their implementation. The review should consider any compliance matters that arose during the prior year; any changes in the business activities of the adviser or its affiliates; and any changes to the Advisers Act or applicable regulations that may prompt revisions to the policies or procedures. The SEC specifically notes that even though reviews are only required annually, advisers are “encouraged” to consider interim reviews in response to any significant compliance events, changes in business arrangements or regulatory developments.

In an area where “best practices” and prompt reporting of untoward regulatory developments are in the forefront, RIA firms could view the annual review process as a supplement to their ongoing process of self-evaluation and review of their compliance procedures.

The Code of Ethics

Finally, in adopting new Rule 204A-1, the SEC requires that registered investment advisers adopt a code of ethics. Each code must set high standards of conduct and require compliance with federal securities laws. Such codes should require the reporting of personal securities transactions by certain personnel and pre-approval by those personnel of certain transactions, and establish record-keeping criteria to document compliance.

Note that the rule does not specify any particular standard that must be adopted by a firm in creating its code of ethics. Rather, the SEC dictates that each firm must adopt those particular standards that reflect the firm’s individual business and the federal securities laws and fiduciary obligations. However, firms must be cognizant of the fact that the proposed provisions “establish only a minimum requirement” even though “a good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct and should challenge employees to live up not only to the letter of the law, but also to the ideals of the organization.” A firm also must gauge the effectiveness of its code of ethics. Again, this requires the chief compliance officer to take into consideration changes in the business of the firm or the nature of the

firm's clients, investment activities of the firm or developments in the securities markets and investment industry.

Advisers must establish procedures to monitor compliance with the code of ethics. An RIA firm's procedures should make clear how the firm will utilize the reports created by so-called "access persons" to check for any misconduct. The SEC defines "access person" as "a supervised person who has access to nonpublic information regarding clients' purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are nonpublic." The code of ethics must call for a complete report of each access person's securities holdings at the time he or she becomes an access person and for at least one year thereafter. The code of ethics must also require quarterly reports of all personal securities transactions made by access persons. These reports are due no later than 30 days after the close of the calendar quarter.

The three exceptions to Rule 204A-1 pertaining to personal securities reporting are:

- (1) Transactions effected pursuant to an automatic investment plan;
- (2) Securities held in accounts over which the access person had no direct or indirect influence or control; and
- (3) Advisory firms that have only one access person, as long as the firm maintains records of the holdings and transactions that Rule 204A-1 would otherwise require reporting.

The code of ethics must also require that access persons obtain the adviser's approval prior to investing in an IPO or private placement. Again, an advisory firm with only one access person would not be required to have that access person obtain pre-approval for these investments.

Reporting Violations

Under Rule 204A-1, each adviser's code of ethics must require prompt reporting of any violations of the code to the compliance officer of the firm. The SEC release specifically notes that it is "incumbent on [the advisers] to create an environment that encourages and protects supervised persons who report violations." RIA firms must also consider how to protect employees from retaliation for reporting activities required by the code of ethics. Under the rule, advisers are required to maintain and enforce their codes of ethics and the SEC expects that an adviser's chief compliance officer will have this primary responsibility.

Lastly, each firm has an affirmative duty to educate employees about the code of ethics and the standards it imposes as well as the procedures implementing the code. Be aware that employees are required to sign a form acknowledging receipt of the code. Although the SEC does not call for formal employee education of

the firm's code of ethics, it does stress the importance of informing employees about the code in order to ensure compliance and avoid inadvertent violations of the code.

Conclusion

The IA Act sets forth substantive, registration and recordkeeping rules as well as proscriptions against fraud and self-dealing. All investment advisers must adopt effective internal rules and controls, and document, supervise and ensure compliance with those rules and controls.

For Further Information

If you are a broker-dealer or an investment adviser and have any questions about this Alert or need assistance in complying with the new rules, please contact Robert P. Bramnik at 312.499.0121 or rpbarnik@duanemorris.com, Brian D. Alprin at 202.776.7820 or bdalprin@duanemorris.com, Thomas R. Schmuhl at 215.979.1272 or trschemuhl@duanemorris.com, Stephanie Korenman at 212.692.1076 or skorenman@duanemorris.com, or the lawyer in the firm with whom you are regularly in contact.