

(by, for example, separating operational functions such as trading and reporting), *detect* violations of securities laws (by, for example, requiring a supervisor to review employees' personal securities transactions), and *correct* promptly any material violations.

We would expect that policies and procedures of funds and (to the extent relevant) advisers would, at a minimum, address:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures, and regulatory requirements;<sup>28</sup>
- 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;<sup>29</sup>
- 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;<sup>30</sup>

- Processes to value client holdings and assess fees based on those valuations;

- Safeguards for the protection of client records and information;<sup>31</sup> and
- Business continuity plans.

Fund procedures would ordinarily cover a number of additional areas, including:

- Pricing of portfolio securities and fund shares;<sup>32</sup>
- Processing of fund shares;
- Identification of affiliated persons with whom the fund cannot enter into certain transactions, and compliance with exemptive rules and orders that permit such transactions;<sup>33</sup>
- Compliance with fund governance requirements; and
- Prevention of money laundering.<sup>34</sup>

While funds and advisers could delegate compliance functions to service providers, their policies and procedures should provide for effective oversight of these service providers. We request comment on our proposed requirement that advisers and funds adopt compliance policies and procedures.

- Should either rule specify certain minimum policies and procedures? If so, what specific required policies and procedures should we include, and in which rule should we include them?

- We anticipate that if we adopt the Proposed Rules, we will provide guidance to funds and advisers in our adopting release similar to what we have provided above (regardless of whether the rules, as adopted, include specific minimum requirements). We request comment on the guidance that

we have provided and urge commenters to provide suggestions as to additional areas our guidance should cover.

- Should the policies and procedures of funds or advisers be designed to prevent violations by persons other than those listed in the Proposed Rules?

## B. Annual Review

Under the Proposed Rules, each fund and adviser must review its policies and procedures at least annually to determine their adequacy and the effectiveness of their implementation.<sup>35</sup> These provisions are designed to require advisers and funds to evaluate periodically whether their policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.

- Should we require more frequent review of the policies and procedures? Our proposed rules implementing Section 404 of the Sarbanes-Oxley Act would require that executives of issuers evaluate the company's internal controls for financial reporting *quarterly*.<sup>36</sup>

## C. Chief Compliance Officer

The policies and procedures of a firm, no matter how well-crafted, will be ineffective unless well-trained, competent personnel administer them. Therefore, we are proposing to require that each fund and adviser designate an individual responsible for administering the compliance policies and procedures.<sup>37</sup> The chief compliance officer should be competent and knowledgeable regarding the applicable federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the adviser or the fund complex.<sup>38</sup>

<sup>35</sup> Proposed rules 38a-1(a)(3) and 206(4)-7(b). The NASD and the NYSE recently have proposed annual reviews of the internal controls, and reports to senior management. *See supra* note 23.

<sup>36</sup> Investment Company Act Release No. 25775, *supra* note 22.

<sup>37</sup> Proposed rules 38a-1(a)(4) and 206(4)-7(c). In the case of an adviser, the individual would have to be a supervised person of the adviser. *See supra* note 21, regarding the definition of "supervised person." Although the NASD does not require its member broker-dealers to appoint a chief compliance officer, NASD Conduct Rule 3010(a)(2) does direct them to designate principals responsible for supervision, which "ensure[s] that there is an identifiable individual who has ultimate responsibility for implementing the member's supervisory system and written procedures for each type of business the member conducts." NASD Notice to Members 99-45, at 295-96 (June 1999).

<sup>38</sup> Designation of a person by an adviser as its chief compliance officer would not, in and of itself, impose upon the person a duty to supervise another person. Thus, a chief compliance officer appointed in compliance with the Proposed Rules would not necessarily be subject to a sanction by us for failure

<sup>28</sup> Rule 206(4)-6 under the Advisers Act [17 CFR 275.206(4)-6] requires investment advisers to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients. Similarly, funds must disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities. Form N-1A, Item 13(f) [17 CFR 239.15A; 274.11A]; Form N-2, Item 18.16 [17 CFR 239.14; 274.11a-1]; Form N-3, Item 20(o) [17 CFR 239.17a; 17 CFR 274.11b]; and Form N-CSR, Item 7 [17 CFR 249.331; 17 CFR 274.128].

<sup>29</sup> Section 204A of the Advisers Act [15 U.S.C. 80b-4a] requires each adviser registered with us to have written policies and procedures reasonably designed to prevent the misuse of material non-public information by the adviser or persons associated with the adviser. Rule 17j-1(c)(1) under the Investment Company Act [17 CFR 270.17j-1(c)(1)] requires a fund and each investment adviser and principal underwriter of the fund to "adopt a written code of ethics containing provisions reasonably necessary to prevent" certain persons affiliated with the fund, its investment adviser or its principal underwriter from engaging in certain fraudulent, manipulative, and deceptive actions with respect to the fund.

<sup>30</sup> Rule 31a-2(f)(3) under the Investment Company Act [17 CFR 270.31a-2(f)(3)] and rule 204-2(g)(3) under the Advisers Act [17 CFR 275.204-2(g)(3)] require funds and advisers that maintain records in electronic formats to establish and maintain procedures to safeguard the records.

<sup>31</sup> Regulation S-P ("Privacy of Consumer Financial Information") [17 CFR Part 248.30] requires funds and investment advisers to "adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information."

<sup>32</sup> Rule 2a-7(c)(7) under the Investment Company Act [17 CFR 270.2a-7(c)(7)] requires boards of money market funds to establish written procedures "reasonably designed \* \* \* to stabilize the money market fund's net asset value per share."

<sup>33</sup> Rule 10f-3(b)(10) under the Investment Company Act [17 CFR 270.10f-3(b)(10)] requires boards of funds that purchase securities in an underwriting in which certain persons serve as principal underwriters to adopt certain procedures to govern those purchases. Rule 17a-7(e) under the Investment Company Act [17 CFR 270.17a-7(e)] requires boards of funds that engage in purchase or sale transactions with certain affiliated persons to adopt procedures "reasonably designed" to achieve compliance with the conditions on such transactions set forth in the rule.

<sup>34</sup> Under 31 CFR 103.130(c), funds must develop an anti-money laundering program, which includes the establishment and implementation of "policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of the Bank Secrecy Act and the implementing regulations thereunder."