

These personnel, including in some cases senior executives of fund advisers, have placed their personal interests or the business interests of the fund adviser ahead of the interests of fund shareholders, thus breaching their fiduciary obligations to the funds involved and their shareholders. These individuals have harmed the funds, their management organizations, and the confidence of fund investors.

Our response to these events is twofold. First, we are conducting an intensive investigation of funds, advisers, broker-dealers, and others.⁷ We will aggressively pursue and punish

securities trading by several of its employees, failed to have reasonable procedures to prevent misuse of material nonpublic information, and failed to reasonably supervise the employees who committed violations); In re Connelly, Securities Act Release No. 8304 (Oct. 16, 2003) (finding that a former executive of an investment adviser to a fund complex, in contravention of fund disclosures, approved agreements that permitted select investors to time certain funds in the complex); In re Markovitz, Securities Act Release No. 8298 (Oct. 2, 2003) (finding that a former hedge fund trader violated the Federal securities laws and defrauded investors by engaging in late trading of mutual fund shares).

⁷ To date, we have brought 10 enforcement actions. See *SEC v. Mutuals.com, Inc.*, Civil Action No. 303 CV 2912D (N.D. Tex. Dec. 4, 2003) (alleging that dually registered broker-dealer and investment adviser, three of its executives, and two affiliated broker-dealers assisted institutional brokerage customers and advisory clients in carrying out and concealing thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds); *SEC v. Invesco Funds Group*, Civil Action No. 03-N-2421 (PAC) (D. Colo. Dec. 2, 2003) (alleging that investment adviser, with approval of its president and chief executive officer, entered into market timing arrangements with more than 60 broker dealers, hedge funds, and advisers without disclosing these arrangements to the affected mutual funds' independent directors or shareholders); *SEC v. Security Trust Company*, Civil Action No. 03-2323 (D. Ariz. Nov. 24, 2003) (alleging that unregistered financial intermediary and three of its senior executives facilitated and participated in late trading and market timing schemes by a group of related hedge funds); *SEC v. Pilgrim*, Civil Action No. 03-CV-6341 (E.D. Penn. filed Nov. 20, 2003) (alleging that investment adviser and two senior executives permitted a hedge fund, in which one of the executives had a substantial financial interest, to engage in repeated short-term trading of several mutual funds and that one of the executives provided nonpublic portfolio information to a broker-dealer, which passed it on to its customers); *SEC v. Druffner*, Civil Action No. 03-12154-RCL (D. Mass. Nov. 4, 2003) (alleging that five brokers, with the assistance of their branch office manager, evaded attempts to restrict their trading and conducted thousands of market timing trades in numerous mutual funds); *SEC v. Scott*, Civil Action No. 03-12082-EFH (D. Mass. filed Oct. 28, 2003) (alleging that two senior investment executives of an investment adviser engaged in repeated short-term trading in their personal accounts of funds over which they had investment decision-making responsibility and about which they had access to nonpublic information); In re Sihpol, Administrative Proceeding No. 3-11261 (Sept. 16, 2003) (charging former broker with playing a key role in enabling certain hedge fund customers to engage in late trading in shares of funds). See also supra note . A number of State actions are also pending.

those who have violated the Federal securities laws and breached their fiduciary obligations to clients. When appropriate, we will actively work with other Federal law enforcement authorities and State authorities to see that the full weight of the law is brought to bear against those who have betrayed mutual funds and fund investors. Second, we will review all of our rules to determine what changes may be required to prevent this type of conduct.

We are taking our first regulatory actions designed to curb the abusive practices recently uncovered and to prevent their recurrence. In companion releases, we are proposing to amend our rules regarding mutual fund share pricing and prospectus disclosure.⁸ In this release, we are adopting new rules requiring advisers and funds to adopt strong compliance controls administered by a chief compliance officer.

II. Discussion

The Commission is adopting new rule 206(4)-7 under the Advisers Act and new rule 38a-1 under the Investment Company Act.⁹ The new rules require each registered investment adviser and each fund to adopt and implement compliance programs that conform to the new rules. Failure of an adviser or fund to have adequate compliance policies and procedures in place will constitute a violation of our rules independent of any other securities law violation. The new rules will thus permit the Commission to address the failure of an adviser or fund to have in place adequate compliance controls, before that failure has a chance to harm clients or investors.

A. Adoption and Implementation of Policies and Procedures

1. Investment Advisers

Under rule 206(4)-7, it is unlawful for an investment adviser registered with the Commission to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised

persons.¹⁰ The rule requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.¹¹

Commenters generally supported these new requirements, but some expressed concerns for how they would be applied to smaller advisers. The Commission is sensitive to the burdens the rule may impose upon smaller advisory firms.¹² The rule requires only that the policies and procedures be *reasonably* designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser. We would expect smaller advisory firms without conflicting business interests to require much simpler policies and procedures than larger firms that, for example, have multiple potential conflicts as a result of their other lines of business or their affiliations with other financial service firms.¹³ The preparation of these simpler policies and procedures and their administration should be much less burdensome.

Rule 206(4)-7 does not enumerate specific elements that advisers must include in their policies and procedures.¹⁴ Commenters agreed with

¹⁰ Rule 206(4)-7(a). See also section 202(a)(25) of the Advisers Act (15 U.S.C. 80b-2(a)(25)) (defining "supervised person" 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").

¹¹ In response to several comments, we revised the text of the rule so that a violation of the rule would be deemed to be "unlawful" rather than "a fraudulent, deceptive, or manipulative act, practice or course of business." This change, which responds to commenters' concerns regarding the optics of the rule, does not change its substance; failure to comply with its terms will result in a violation of section 206(4) of the Act.

¹² In the Proposing Release, we requested comment on whether we should except a subset of investment advisers or funds from the requirements of the rules. Some commenters suggested that we except small advisers, but we believe that the flexibility of the rules obviates the need for this exception.

¹³ Even small advisers may have arrangements, such as soft dollar agreements, that create conflicts. Advisers of all sizes, in designing and updating their compliance programs, must identify these arrangements and provide for the effective control of the resulting conflicts.

¹⁴ Advisers already are subject to requirements to maintain written compliance policies and procedures in certain areas. The new rules do not alter those requirements. See, e.g., Investment Company Act rule 17j-1(c)(1) (17 CFR 270.17j-1(c)(1)) (requiring each investment adviser and principal underwriter of a 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,

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⁸ Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) (68 FR 70388 (Dec. 17, 2003)) ("Companion Late Trading Release"); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26287 (Dec. 11, 2003) (68 FR 70402 (Dec. 17, 2003)) ("Companion Disclosure Release").

⁹ We also are adopting related amendments to rule 204-2 under the Advisers Act and a technical amendment to Form ADV.