

our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred,¹⁵ and correct promptly any violations that have occurred.¹⁶

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. We expect that an adviser's policies and procedures, at a minimum, should address the following issues to the extent that they are relevant to that adviser:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by

manipulative, and deceptive actions with respect to the fund); Advisers Act rule 206(4)–6 (17 CFR 275.206(4)–6) (requiring investment advisers to adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes securities in the best interest of clients); Advisers Act section 204A (15 U.S.C. 80b–4a) (requiring each adviser registered with us to have written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the adviser or persons associated with the adviser); Regulation S-P (“Privacy of Consumer Financial Information”) (17 CFR 248.30) (requiring investment advisers to “adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information”).

¹⁵ Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns, including, for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the adviser's fulfillment of its duty of best execution), or an analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities).

¹⁶ In the Proposing Release, we noted that the compliance policies and procedures should be designed to prevent, detect, and correct promptly any material violation of the federal securities laws (or in the case of advisers, the Advisers Act). A number of commenters suggested that these objectives were unrealistic and recommended that the rules be designed instead to promote compliance with the securities laws. While we understand that compliance policies and procedures will not prevent every violation of the securities laws, we believe that prevention should be a key objective of all firms' compliance policies and procedures.

the adviser, and applicable regulatory restrictions;¹⁷

- 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 aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;¹⁸
- The accuracy of disclosures made to investors, clients, and regulators, including account statements and 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;¹⁹
- Marketing advisory services, including the use of solicitors;²⁰
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information;²¹ and

¹⁷ Rule 206(4)–6 under the Advisers Act (17 CFR 275.206(4)–6) requires registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes securities 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).

¹⁸ Section 204A of the Advisers Act (15 U.S.C. 80b–4a) requires registered investment advisers to have written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the advisers or persons associated with the advisers. Rule 17j–1(c)(1) under the Investment Company Act (17 CFR 270.17j–1(c)(1)) requires funds and 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, manipulative, and deceptive actions with respect to the fund.

¹⁹ Rule 204–2(g)(3) under the Advisers Act (17 CFR 275.204–2(g)(3)) and rule 31a–2(f)(3) under the Investment Company Act (17 CFR 270.31a–2(f)(3)) require advisers and funds that maintain records in electronic formats to establish and maintain procedures to safeguard the records.

²⁰ Rule 206(4)–3 under the Advisers Act (17 CFR 275.206(4)–3) requires written agreements setting forth procedures to govern solicitation activities conducted by certain third parties on behalf of an adviser.

²¹ Regulation S–P requires investment advisers to “adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and

- Business continuity plans.²²

Rule 206(4)–7 does not require advisers to consolidate all compliance policies and procedures into a single document. Nor does it require advisers to memorialize every action that must be taken in order to remain in compliance with the Advisers Act. In some cases, it may be enough for the compliance policies and procedures to allocate responsibility within the organization for the timely performance of many obligations, such as the filing or updating of required forms.²³

2. Investment Companies

Rule 38a–1 requires fund boards to adopt written policies and procedures reasonably designed to prevent the fund from violating the Federal securities laws.²⁴ The procedures must provide for the oversight of compliance by the fund's advisers, principal underwriters,²⁵ administrators,²⁶ and

information.” Regulation S–P (“Privacy of Consumer Financial Information”) (17 CFR 248.30). Regulation S–P also applies to funds.

²² We believe that an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations.

²³ Advisers who are also registered as broker-dealers are not required to segregate their investment adviser compliance policies and procedures from their broker-dealer compliance policies and procedures.

²⁴ Rule 38a–1(a)(1). For purposes of rule 38a–1, “Federal securities laws” means the Securities Act of 1933 (15 U.S.C. 77a), the Securities Exchange Act of 1934 (15 U.S.C. 78a), the Sarbanes-Oxley Act of 2002 (Pub. L. 107–204, 116 Stat. 745 (2002)), the Investment Company Act, the Advisers Act, Title V of the Gramm-Leach-Bliley Act (15 U.S.C. 6801) (governing disclosure of nonpublic personal information), any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act (31 U.S.C. 5311–5314; 5316–5332) (imposing restrictions designed to prevent financial intermediaries from being used in money laundering activities) as it applies to funds, and any rules adopted thereunder by the Commission or the Department of the Treasury. Rule 38a–1(e)(1).

²⁵ A “principal underwriter” of a fund (other than a closed-end fund) is “any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company.” Section 2(a)(29) of the Investment Company Act (15 U.S.C. 80a–2(a)(29)).

²⁶ An “administrator” is “any person who provides significant administrative or business management services to an investment company.” Investment Company Act rule 0–1(a)(5) (17 CFR 270.0–1(a)(5)).