

improperly constituted board,<sup>64</sup> 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 fund adviser and other service providers.<sup>65</sup>

• **Market Timing.** In a companion release today, we are proposing amendments to our mutual fund disclosure rules to require funds to disclose their policies on “market timing,” *i.e.*, the excessive short-term trading of mutual fund shares that may be harmful to the fund.<sup>66</sup> Many funds’ prospectuses already disclose market timing policies, and failure to adhere to those disclosed policies violates the antifraud provisions of the Federal securities laws.<sup>67</sup> Moreover, a fund adviser that waives or disregards those policies for the benefit of itself or a third party has breached its fiduciary responsibilities to the fund.<sup>68</sup> Thus, under rule 38a–1 a fund must have procedures reasonably designed to

ensure compliance with its disclosed policies regarding market timing. These procedures should provide for monitoring of shareholder trades or flows of money in and out of the funds in order to detect market timing activity, and for consistent enforcement of the fund’s policies regarding market timing.<sup>69</sup> If the fund permits any 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 person or associated person of the adviser. In this regard, we strongly urge fund boards to require fund advisers, or other persons authorized to waive market timing policies, to report to the board at least quarterly all waivers granted, so that the board can determine whether the waivers were proper.

## B. Annual Review

### 1. Investment Advisers

Rule 206(4)–7 requires each registered adviser to review its policies and procedures annually to determine their adequacy and the effectiveness of their implementation.<sup>70</sup> The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures. For example, an adviser that is acquired by a broker-dealer or by the corporate parent of a broker-dealer should assess whether its policies and procedures are adequate to guard against the conflicts that arise when the adviser uses that broker-dealer to execute client transactions, or invests client assets in funds or other securities distributed or underwritten by the broker-dealer.

Although the rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments. For example, we expect all registered advisers will begin reviewing their policies and procedures in light of our adoption of these rules.

### 2. Investment Companies

Similarly, rule 38a–1 requires a fund to review its policies and procedures, as well as those of its service providers, annually.<sup>71</sup> The rule does not require a fund board to conduct the review; the board would, however, have the benefit of the review in the report submitted by the compliance officer. We expect all funds will begin reviewing their compliance policies and procedures currently, not only in light of the adoption of these rules, but also in light of the recent revelations of unlawful practices involving fund market timing, late trading, and improper disclosures and use of nonpublic portfolio information.

## C. Chief Compliance Officer

### 1. Investment Advisers

Rule 206(4)–7 requires each adviser registered with the Commission to designate a chief compliance officer to administer its compliance policies and procedures.<sup>72</sup> An adviser’s chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm.<sup>73</sup> Thus, 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.<sup>74</sup>

<sup>71</sup> Rule 38a–1(a)(3).

<sup>72</sup> Rule 206(4)–7(c). We are also making a technical amendment to the item related to chief compliance officers on Form ADV, the registration form that advisers use to register with us under the Advisers Act. Form ADV, Part 1, Schedule A, Item 2(a) (17 CFR 279.1). The revision requires each registered adviser and each applicant for registration as an adviser to identify a *single* compliance officer.

<sup>73</sup> Having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities. Thus, a chief compliance officer appointed in accordance with rule 206(4)–7 (or rule 38a–1) would not necessarily be subject to a sanction by us 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 section 203(e)(6) of the Advisers Act (15 U.S.C. 80b–3(e)(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.

<sup>74</sup> The rule does not require advisers to hire an additional executive to serve as compliance officer, but rather to designate an individual as the adviser’s chief compliance officer. Several commenters who complained of the burdens this proposed requirement would impose on them

<sup>64</sup> A board lacking a sufficient number of disinterested directors, for example, would be improperly constituted. To avoid this, fund procedures should provide for a process of determining that independent director candidates are not “interested persons” and, after their election, for a periodic reassessment that they continue not to be interested persons. See rule 31a–2 (17 CFR 270.31a–2(a)(4)) under the Investment Company Act (requiring the maintenance of “any record of the initial determination that a director is not an interested person of the investment company and each subsequent determination that the director is not an interested person \* \* \* includ[ing] any questionnaire and any other document used to determine that a director is not an interested person of the company”).

<sup>65</sup> Section 15(c) requires fund directors “to request and evaluate \* \* \* such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.” A board that fails to acquire sufficient information about the advisory fee and other fund expenses will be unable to negotiate effectively on behalf of the fund. As a result, the fund may pay a higher than necessary advisory fee, fail to benefit from economies of scale as a result of insufficient breakpoints in the advisory fee, or bear too many operating expenses.

<sup>66</sup> See Section II.A. of the Companion Disclosure Release, *supra* note 8.

<sup>67</sup> Failure to adhere to statements made in the prospectus may render the prospectus disclosure materially misleading and thus violate provisions of the Federal securities laws that prohibit fraud. See, e.g., section 17(a) of the Securities Act (15 U.S.C. 77q), section 10(b) of the Securities Exchange Act (15 U.S.C. 78j) and rule 10b–5 (17 CFR 240.10b–5) thereunder, and section 34(b) of the Investment Company Act (15 U.S.C. 80a–33(b)).

<sup>68</sup> An investment adviser has a fiduciary duty to act in the best interests of a fund it advises. Section 206 under the Advisers Act (15 U.S.C. 80b–6) and section 36(a) under the Investment Company Act (15 U.S.C. 80a–35(a)). See also *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971); *Brown v. Bullock*, 194 F. Supp. 207, 229, 234 (S.D.N.Y.), *aff’d*, 294 F.2d 415 (2d Cir. 1961); *In re Provident Management Corp.*, Securities Act Release No. 5115 (Dec. 1, 1970) at text accompanying note 12.

<sup>69</sup> See, e.g., C. Meyrick Payne, *Strengthening the Role of Mutual Fund Directors after the Canary Scandal*, Management Practice Bulletin (Oct. 2003) ([http://www.mfgovern.com/reports/2\\_canaryscandal.html](http://www.mfgovern.com/reports/2_canaryscandal.html)) (explaining that “periodic sales and redemption data” are useful for detecting practices such as late trading and market timing).

<sup>70</sup> Rule 206(4)–7(b).