

entities: (i) Exempt small firms from the requirement to designate a chief compliance officer, (ii) exempt small advisers from all of the new requirements, (iii) identify procedures that are relevant to small firms, (iv) identify issues that do not apply to small advisers or advisers that do not manage assets and therefore would not have to be addressed in their compliance policies and procedures, (v) create a template that firms could adapt to fit their unique characteristics, or (vi) permit small advisers to maintain records outside their office space in an easily accessible location.

The FRFA explains that the rules do not introduce new reporting requirements, but do introduce new compliance requirements, including new recordkeeping obligations. The FRFA sets forth the requirements of the rule (which are described above in detail) and explains that all funds and advisers, regardless of size, are subject to the compliance requirements. The FRFA also explains that while most firms already have instituted a compliance program and have designated someone charged with implementing it, small advisers are disproportionately represented among the firms that have not taken such steps. The FRFA notes that these firms will bear costs in developing and implementing policies and procedures.¹³⁰ The FRFA explains that the new rules and rule amendments are designed to achieve their objectives without imposing undue costs on affected firms.

The FRFA discusses the alternatives considered by the Commission in adopting the new rules and rule amendments that might minimize adverse effects on small advisers, including: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rules, or any part thereof, for small entities.

We do not presently believe that the establishment of special compliance requirements or timetables for small

entities is feasible or necessary.¹³¹ Modifying these requirements for small funds or advisers would place their clients at unnecessary risk. The requirement that each fund or adviser implement written policies and procedures reasonably designed to prevent violation of the Federal securities laws, is essential to promote systematic and organized reviews by funds and advisers of their operations and activities. The requirement that funds obtain board approval of their programs and annually report about the programs to their boards is necessary to preserve the crucial oversight role of fund boards of directors.¹³² Annual reviews are integral to detecting and correcting any gaps in the program before irrevocable or widespread harm is inflicted upon investors. The required designation of a chief compliance officer is necessary to achieve centralized supervisory authority over all aspects of the compliance program and to reduce the likelihood of gaps in the compliance program. The requirement that funds and advisers keep file copies of their written policies, procedures, reports, and other records for five years, imposes an inconsequential burden on small funds and advisers. The establishment of a special compliance timetable to allow a transition period of more than six months would delay the rules' investor protection benefits without assisting small funds and advisers.

The Commission does not presently believe that clarification, consolidation, or simplification of compliance requirements for small entities is feasible or necessary. The compliance requirements, which are integral to the effectiveness of the rules, are not technical or complex in any sense. The FRFA explains that some commenters requested more specific guidance about the type of compliance policies and procedures that would be required. In the Proposing Release and in this release, we have provided illustration and guidance to firms about the topics that should be addressed by their compliance policies and procedures. Because of the great variety across firms, any template that we could provide would be voluminous and would require extensive tailoring to the unique characteristics of each firm. Thus, it does not appear that Commission templates would effectuate significant burden reduction.

The FRFA explains that the new rules, to the greatest extent possible, embody performance rather than design standards. The rules do not enumerate specific required elements of the policies and procedures, but will allow all firms, including small firms, to tailor their internal compliance programs to the nature and scope of their own business. The FRFA explains that the rules do not set forth a list of attributes that the chief compliance officer must possess and permit firms to designate an existing employee with other responsibilities to fill that role, which the staff anticipates that most small firms will do.

The FRFA explains that we do not believe that the objectives of the rules could be achieved if small entities were exempted from coverage of any part of the proposals. It has been our experience that strong internal compliance programs are essential to investor protection in funds and advisers of all sizes.

VIII. Statutory Authority

We are adopting new rule 38a-1 under the Investment Company Act pursuant to the authority set forth in sections 31(a) and 38(a) of the Act (15 U.S.C. 80-30(a) and 80a-37(a)).¹³³ We are adopting new rule 206(4)-7 pursuant to the authority set forth in sections 206(4) and 211(a) under the Advisers Act (15 U.S.C. 80b-6(4) and 80b-11(a)).¹³⁴ We are adopting

¹³³ Section 38(a) authorizes the Commission to "make * * * such rules and regulations * * * as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in (the Investment Company Act)." We are adopting rule 38a-1 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including sections 9(b) (authority to prohibit certain persons from serving in certain capacities with respect to investment companies), 31(b) (authority to examine funds), 36(a) (authority to bring actions for the breach of fiduciary duty); and 42 (authority to enforce the provisions of the Investment Company Act) of the Investment Company Act (15 U.S.C. 80a-9(b), 80a-30(b), and 80a-41). Further, requiring the maintenance of internal compliance policies and procedures and an annual compliance report falls under the authority granted to us under section 31(a), which authorizes us to require funds to maintain and preserve records, including memoranda, books, and other documents.

¹³⁴ Section 206(4) permits the Commission to define and prescribe rules to prevent conduct that is unlawful under section 206. Rule 206(4)-7 defines an activity that is unlawful under section 206. Further, section 211(a) of the Advisers Act authorizes the Commission to "make * * * such rules and regulations * * * as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in (the Act)." We are adopting rule 206(4)-7 as necessary and appropriate to the exercise of the authority specifically conferred on us elsewhere in the Act, including sections 203(e) (authority to censure, place limitations on, suspend, or revoke the registration of certain investment advisers), 204

¹³⁰ The staff estimates that approximately half of these firms will develop these policies internally, while the remaining firms will seek outside assistance from compliance consultants, the number of which is expected to rise after the new rules are adopted.

¹³¹ As stated above, the rules impose no reporting requirements.

¹³² In the case of investment advisers, for which such governance issues are not present, we have not included comparable requirements.