The SEC has issued new and proposed rules at a fevered pace since the enactment of Sarbanes-Oxley last year. Most of the new and proposed rules have not been directly aimed at the investment management industry. Recently, however, the SEC adopted a new rule that has a direct impact on federally-registered investment advisers. The SEC has also proposed a rule that, if adopted, will have an even greater impact on federally-registered investment advisers.

The SEC has adopted Rule 206(4)-6 under the “antifraud” provisions of the Investment Advisers Act of 1940 (the “Advisers Act”). Rule 206(4)-6 is designed to delineate an investment adviser’s fiduciary duty to its clients with respect to voting proxies on securities held in client accounts.

Specifically, Rule 206(4)-6 makes it a fraudulent, deceptive or manipulative act, practice or course of business for a federally-registered investment adviser to exercise voting authority over clients’ securities unless the adviser:

- has adopted and implemented written policies and procedures designed to ensure that the adviser votes proxies in the best interests of its clients;
- describes these policies and procedures to its clients and provides copies upon request; and
- discloses to its clients how to obtain information on how the adviser voted proxies.

In adopting the new rule, the SEC stated that an adviser need not vote every proxy if it is not in the client’s best interest to do so, such as where the costs associated with voting the proxy are likely to exceed any benefits to the client.

In addition, the SEC suggested that there are various ways in which an adviser can ensure that proxies are voted in the best interests of its clients where there are conflicts between the interests of the adviser and those of its clients. Some of these suggestions include:

- disclosing the conflict to clients and obtaining their consent before voting;
- advising clients to select third parties to vote the proxies; or
- voting in accordance with a predetermined policy or based upon the recommendations of an independent third party.

The policies and procedures adopted by advisers must:

- be in writing;
- be reasonably designed to ensure that the adviser votes in the best interests of clients; and
- describe how the adviser addresses material conflicts between its own interests and the interests of its clients when voting proxies on their behalf.

Which advisers are subject to the new rule?

The new rule applies to investment advisers registered with the SEC that exercise proxy voting authority over their clients’ securities. Advisers that have implicit authority to vote proxies on behalf of their clients are also covered by the new rule. The new rule does not apply to advisers that are not registered with the SEC or to advisers that provide their clients with advice about voting proxies but do not have authority to vote the proxies.

What should the policies and procedures look like?

The policies and procedures adopted by advisers must:

- be in writing;
- be reasonably designed to ensure that the adviser votes in the best interests of clients; and
- describe how the adviser addresses material conflicts between its own interests and the interests of its clients when voting proxies on their behalf.
The SEC noted that other alternatives are available and that the effectiveness of these alternatives “will turn on how well they insulate the decision on how to vote client proxies from the conflict.”

What types of disclosure are required?

The new rule requires advisers to disclose to clients how they can obtain information on how their proxies were voted. In addition, the new rule requires advisers to describe their proxy voting policies and procedures to clients (and to provide them to clients upon request). The description should be a summary of the policies and procedures and should indicate that a copy of the actual policies and procedures is available upon request.

What records must be kept?

In connection with adopting new Rule 206(4)-6, the SEC amended Rule 206(4)-2 – the record-keeping rule applicable to federally-registered advisers – to require such advisers to retain:

- their proxy voting policies and procedures;
- proxy statements they receive regarding client securities;
- records of votes they cast on behalf of clients;
- records of client requests for proxy voting information; and
- any documents prepared by the adviser that were material to making a decision on how to vote (or that memorialized the basis for the decision).

The revised record-keeping rule permits advisers to use proxy statements filed on the EDGAR system instead of keeping their own copies. In addition, an adviser may rely on a third party, such as a proxy voting service, to keep proxy statements and records of votes cast by the adviser if the third party agrees to provide the documents promptly upon request.

Federally-registered investment advisers must comply with Rule 206(4)-6 and revised Rule 206(4)-2 no later than August 6, 2003.

Proposed Rule Regarding Compliance Programs and Request for Comments

In addition to adopting new Rule 206(4)-6, the SEC has proposed a rule dealing with the adoption and implementation of general policies and procedures designed to prevent the violation of the federal securities laws. In the release in which it proposed this rule, the SEC also solicited comments from the public regarding other possible private-sector initiatives to ensure compliance with the federal securities laws.

Proposed Rule

The proposed rule\(^1\) would require federally-registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act (and the rules and regulations thereunder), to review those policies and procedures no less frequently than annually and to appoint a chief compliance officer.

Written Policies and Procedures

Registered investment advisers are, of course, subject to the provisions of the Advisers Act and the rules and regulations thereunder in connection with their investment advisory/management activities. In addition, they are often subject to other federal securities laws (and related rules and regulations) in connection with those activities. The proposed rule, however, would require a federally-registered adviser to adopt written policies and procedures only with respect to the Advisers Act (and the rules and regulations thereunder) that apply to its investment advisory/management operations. The policies and procedures that an investment adviser develops must be designed to prevent violations of the Advisers Act (and the rules and regulations thereunder) by both the adviser and its supervised persons.

If adopted, the proposed rule will subject federally-registered investment advisers to a compliance regime similar to that imposed on registered broker-dealers, who are currently required to have comprehensive written policies and procedures designed to prevent violations of applicable federal securities laws.

The proposed rule does not lay out any specific requirements that an adviser’s policies and procedures must include because the SEC recognized that “advisers are too varied in their operations for the Commission to impose a single list of required elements.” The SEC did, however, suggest that an adviser’s policies and procedures should be designed to prevent violations (for example, by separating operational functions such as trading and reporting), to detect violations (for example, by requiring supervisory review of employee activities) and to promptly correct any material violations discovered. The SEC also stated that the policies and procedures should address the following areas:

- portfolio management process, including the allocation of investment opportunities among clients on a
reasonable basis and the maintenance of client portfolios within any guidelines established for such portfolios by the clients;

• trading practices, including best execution issues, soft dollar benefits and aggregate trade allocations among participating client accounts;

• proprietary trading by the adviser and personal trading by the adviser’s supervised persons;

• accuracy of any disclosures to clients, including Form ADV disclosures and advertising materials;

• safeguarding of client assets from conversion or inappropriate use by supervised persons;

• compliance with the record-keeping rule under the Advisers Act;

• safeguarding client information in compliance with the adviser’s privacy policy under Regulation S-P;

• accuracy of account valuations for purposes of assessing fees to clients; and

• business continuity plans.

The SEC acknowledged that some or all of these functions could be performed by third-party service providers (but noted that in such a case, the adviser’s policies and procedures should provide for effective oversight of such providers since the ultimate responsibility for compliance with the Advisers Act rests with the adviser).

Annual Review
The proposed rule would also require a federally-registered adviser to review its written policies and procedures no less frequently than annually to ensure that its policies and procedures have been properly implemented and are still effective and appropriate. The annual review should be documented by the adviser’s responsible personnel indicating that the review was conducted and what changes, if any, were made to the policies and procedures as a result of the review.

Chief Compliance Officer
Lastly, the proposed rule would require each federally-registered investment adviser to designate a Chief Compliance Officer whose job would be to administer and oversee the development, implementation and maintenance of the adviser’s compliance policies and procedures. The Chief Compliance Officer should be “competent and knowledgeable regarding the applicable federal securities laws” and should have the power and authority to develop and enforce appropriate policies and procedures to ensure compliance with the federal securities laws. We would recommend that a Chief Compliance Officer be an individual within the organization with sufficient authority and responsibility to ensure that the adviser’s supervised persons take the adviser’s policies and procedures seriously.

“Concept Release” – Additional Private Sector Involvement
The SEC also requested comments from the public on a number of ideas designed to address the problems posed by the SEC’s lack of resources for policing the investment management industry. The SEC offered three possible alternatives for addressing these problems.

Independent Compliance Reviews
One alternative would be to require each federally-registered investment adviser to undergo periodic compliance reviews by a third-party consultant who would produce a written report of its findings and recommendations and file that report with the SEC. The SEC could use reports of this type to concentrate its investigative and audit activities on areas that are consistently problematic. This would enable the SEC staff to conduct examinations more efficiently and, therefore, enable it to examine advisers on a more frequent basis. Additionally, the SEC staff would be able to identify those advisers whose compliance programs are working effectively and conduct less frequent examinations of those advisers.

Self-Regulatory Organization
The second alternative would be the organization of a self-regulatory organization (“SRO”) for the investment advisory industry analogous to the NASD for the broker-dealer industry. The SEC would expect this SRO to (a) establish business practice rules and ethical standards, (b) conduct routine examinations of investment advisers, (c) establish minimum education or experience standards for investment advisory personnel and (d) enforce its own rules by bringing actions to discipline member firms and representatives when appropriate. One significant issue with respect to this proposal is the identity of such SRO. Some industry commentators have suggested that the NASD be enlisted to act as the SRO for the investment advisory industry while others have proposed that there be a new SRO specifically for investment advisers.
Fidelity Bonding

The third alternative would be to require fidelity bonding for federally-registered investment advisers. This approach would effectively place the compliance burden on insurers who underwrite the bonds. Additionally, the fidelity bond would provide a source of compensation for any defrauded clients in the event an adviser should become insolvent or abscond with client assets.

According to the SEC, investment advisers are one of the few groups of financial service providers that handle client funds but are not required to obtain fidelity bond coverage. Moreover, under federal statute, investment advisers are not required to have a minimum capitalization (several states do have minimum net capital requirements, but investment advisers registered with the SEC are not subject to these state requirements).

Comments on the proposed rule and the alternatives for private-sector involvement in the compliance process must be received by the SEC no later than April 18, 2003.

If you have questions regarding the applicability of these rules to your business or need assistance in developing a proxy voting policy or in drafting a comment letter to the SEC regarding the proposals, please contact one of the GCD attorneys listed.

1 The SEC also proposed a companion rule relating to registered investment companies. This memorandum will limit its discussion to the proposed rule relating to federally-registered investment advisers.