Paul|Weiss

February 28, 2003

Investment Funds Group Update: SEC Proposes Rule On Compliance Programs of Investment Advisers

The Securities and Exchange Commission ("SEC") recently published for comment proposed Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and amendments to Rule 204-2 under the Advisers Act (collectively, the "Proposed Rule"). Generally, the Proposed Rule would require investment advisers registered with the SEC to:

- adopt and implement compliance policies and procedures reasonably designed to prevent violations of the Advisers Act (and the rules and regulations adopted thereunder);
- review the compliance policies and procedures at least on an annual basis; and
- appoint a chief compliance officer to administer the compliance policies and procedures.

The Proposed Rule is part of the SEC's investor protection program. As part of this program and the SEC's new "risk-based" approach, one of the preliminary factors being considered by it is the strength of an investment adviser's framework and system of internal controls. As a result, the SEC is expected to focus (in staff examinations and otherwise) on the effectiveness of these controls in preventing, detecting and correcting violations of the federal securities laws. The SEC believes that investment advisers with effective internal compliance programs are less likely to violate the federal securities laws.

I. Compliance Policies and Procedures

Under the Proposed Rule, investment advisers registered with the SEC would be required to adopt and implement written internal compliance programs reasonably designed to prevent violations of the Advisers Act (and the rules and regulations adopted thereunder) by the adviser and its supervised persons. In general terms, the policies and procedures should be designed to prevent violations (by, for example, separating operational functions such as trading and reporting), detect violations of securities laws (by, for example, requiring a supervisor to review employees' personal securities transactions), and correct promptly any material violations.

The Proposed Rule does not enumerate the specific elements that investment advisers would need to include in their policies and procedures. Rather, it provides general standards leaving it to a particular investment adviser to tailor its compliance program to the nature of its operations. The SEC has indicated that the policies and procedures of investment advisers would need to address at a minimum:

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

2, rue du Faubourg Saint-Honoré
75008 Paris, France
(33-1) 53.43.14.14

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100, Japan
(81-3) 3597-8120

2918 China World Tower II
No. 1, Jianguomenwai Dajie
Beijing 100004, People's Republic of China
(86-10) 6505-6822

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

- portfolio management, including allocation of investment opportunities among clients and consistency of portfolios with guidelines established by clients, disclosures and regulatory requirements;
- trading practices, including procedures by which the investment adviser satisfies its "best execution" obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregate trades among clients;
- supervision of trading personnel;
- the completeness and accuracy of disclosures made to investors, including historical performance information and advertisements;
- safeguarding of client assets from inappropriate use by advisory personnel;
- the accurate creation of necessary records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- valuation and pricing of client assets and assessment of fees based on those valuations;
- safeguards for the protection of client records and information; and
- business continuity plans.

Because investment advisers may delegate compliance functions to outside service providers, their policies and procedures would also need to provide for effective oversight of these service providers.

II. Annual Review

Under the Proposed Rule, investment advisers would need to review their policies and procedures at least annually to determine the adequacy and the effectiveness of their implementation. The procedures would need to be designed to require investment advisers to evaluate periodically whether their policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.

III. Compliance Officer

Under the Proposed Rule, investment advisers would need to designate an individual who would be responsible for administering the compliance policies and procedures. This chief compliance officer would need to be competent and knowledgeable regarding the applicable federal securities laws and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures on behalf of the investment adviser.

IV. Recordkeeping

Under the Proposed Rule, investment advisers would need to maintain copies of their policies and procedures. In addition, they would need to keep accurate records documenting their annual review and would need to keep all required documents for at least a period of five years.

The SEC is seeking comments on the Proposed Rule on or before April 18, 2003. As part of the process, the SEC is also seeking comments on ways to involve the private sector in fostering compliance by investment advisers with the federal securities laws. In this regard, the SEC is considering among other things periodic compliance reviews by third parties, the formation of self-regulatory organizations and a fidelity bonding requirement for investment advisers. We will monitor developments in this area and, to the extent necessary, provide any updates as well as suggested compliance procedures and policies.

* * *

The summary set forth herein is intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Investment Funds Group, including:

Robert M. Hirsh *rhirsh@paulweiss.com*	(212) 373-3108	Yvonne Y.F. Chan *ychan@paulweiss.com*	(212) 373-3255
Steven R. Howard *showard@paulweiss.com*	(212) 373-3508	Marco V. Masotti *mmasotti@paulweiss.com*	(212) 373-3034

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP