THE SEC'S NEW COMPLIANCE PROGRAM RULE FOR INVESTMENT ADVISERS: WHEN PROCEDURE BECOMES SUBSTANCE

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Introduction

New rule 206(4)-7 of the Securities and Exchange Commission ("SEC" or "Commission") may be the most significant rule the SEC has adopted for investment advisers, even though it is procedural rather than substantive.[1] The rule requires SEC-registered advisers to:

- Adopt compliance procedures that are reasonably designed, in light of the adviser's business, to prevent violations of the Investment Advisers Act of 1940 (the "Act") and the rules thereunder (the "Rules");
- Appoint a "chief compliance officer" ("CCO") to design and operate the program;
- Review the program at least annually.

The rule does not prohibit any acts or require any substantive conduct, such as disclosure or maintenance of capital requirements. Nevertheless, rule 206(4)-7 will probably have a major impact on how advisers run their businesses.[2] As discussed below, the rule has the potential to:

- Require many advisers to establish comprehensive, detailed and relatively costly compliance programs. (The rule requires advisers to have policies and procedures to prevent the violation of *any* provision of the Act or Rules (collectively, the "Act/Rules") that the adviser could, in light of the nature of its business, violate.)
- Expand the scope of what is considered a violation of the Act/Rules.
- Elevate non-fraud violations of the Act/Rules to fraud violations.
- Give broad discretion to SEC examiners to cite advisers for violations of rule 206(4)-7.
- Dictate to advisers how to operate their compliance programs.
- Create a position within the adviser's organization—the CCO—that in effect reports as much to the SEC as to the adviser's senior management.

The rule's impact on advisers is increased by the fact that it was adopted under the Act's antifraud provision. Thus an adviser who is found to have violated 206(4)-7 will have engaged in "fraud." Fraud violations can have more serious consequences for advisers than non-fraud violations, for example in responding to due diligence questions of prospective clients and in completing regulatory forms such as applications for Commodity Futures Trading Commission ("CFTC") registration.

Moreover, a 206(4)-7 violation is a fraud violation even though the underlying Act/Rule provision is a purely technical, non-fraud requirement. For example, an adviser can violate 206(4)-7 because it doesn't have a procedure for maintaining a required but relatively unimportant record—and even though the adviser in fact maintained the record.

For a rule that will affect advisers so significantly, the rationale for the rule—and the SEC's authority to adopt it—are surprisingly weak.

The main rationale is that compliance programs prevent violations. The SEC infers this from its experience that compliant advisers typically have strong voluntary compliance programs. But the SEC cites no evidence that compliance programs in fact reduce violations and are not merely attributes of compliant advisers.

The main authority for 206(4)-7 is the Commission's power to adopt rules that "define" what are fraudulent acts and prescribe measures that prevent those defined acts.[3] But 206(4)-7 doesn't define what is a fraudulent act and the SEC doesn't appear to be asserting it's fraudulent for an adviser *not* to have a compliance program.

Rule 206(4)-7 continues a recent SEC trend of requiring advisers to establish *procedures* relating to specific types of conduct, as distinguished from the SEC imposing substantive *standards* for that conduct.[4] Perhaps required procedures are preferable to specific prohibitions, but they can be costly, and whether they actually work is questionable. They represent a tendency for the SEC, where it has a concern about a practice but perhaps doesn't know what standards to establish, to "do something" by requiring procedures.

Discussion

The Rationale for Rule 206(4)-7

The SEC gives three reasons for adopting rule 206(4)-7.

- It's good for advisory clients. Strong compliance systems protect clients because the systems reduce the number of regulatory violations, which hurt clients.
- The rule is good for the securities markets. It will promote capital formation, because it will bolster investor confidence in advisers, and investors will therefore buy more securities.
- The rule is good for the SEC. Advisers with weak compliance are more likely to violate securities laws. The SEC can thus be more efficient in its inspection of advisers, by focusing on the ones with the weaker systems.

As to whether compliance systems reduce violations, the SEC is undoubtedly right that advisers with weak compliance programs are more prone to violate. But the SEC

doesn't cite any statistical or other support for its conclusion that strong compliance systems in fact cause compliance. It seems equally likely that compliance systems are merely attributes of compliance. Advisers that have gone to the trouble of voluntarily establishing comprehensive compliance systems may be violation-free to begin with. Advisers that are violation-prone may continue in their ways even if forced to adopt detailed compliance programs.

In adopting rules under the Act, the SEC is required by Act section 202(c) to consider whether the rule will promote efficiency. If the SEC has little or no evidence that compliance programs reduce violations, its compliance with section 202(c) is questionable. And 206(4)-7 will clearly have some inefficiencies, because of the costs it will impose on many advisers.

As to whether the rule will bolster client confidence in advisers, this seems a curious justification for a requirement that could impose significant costs on advisers. The client confidence concept comes from Act section 202(c), which requires the SEC to consider not only the efficiency of a proposed rule but also whether it will promote capital formation. One would think that section 202(c) was intended mainly as a *restraint* on the SEC—to caution it against adopting potentially burdensome rules that have an *adverse* impact on capital formation. In 206(4)-7, however, the Commission has turned this around, citing capital formation as a reason for adopting a potentially costly new rule. Under this reasoning, the SEC could apparently justify some very burdensome requirements, on the ground that they will increase client confidence in advisers.

As to whether the rule will make SEC examinations more efficient, this objective may make the most sense. SEC inspections can undoubtedly uncover violations, and yet at the same time can be burdensome. If 206(4)-7 creates a reliable indicator for the SEC to allocate its inspections more efficiently, the rule can help the more compliant firms. The issue is whether the burdens imposed by the rule outweigh this benefit.

Antifraud Violation

Although 206(4)-7 deals solely with procedure, it is an antifraud rule. It was adopted under the Act's antifraud section and a violation of the rule will constitute fraud. The consequences of a fraud violation can be significant. For example, a violator would probably have to answer yes to the due diligence question of a prospective client about whether the adviser had ever engaged in fraud. Similarly, if applying for CFTC registration, the adviser would have to answer yes to the question on the CFTC registration form about whether it had engaged in a fraud violation. There are probably other potentially applicable regulatory schemes that distinguish between fraud and non-fraud violations.

The antifraud nature of the rule is troublesome because an adviser could violate the rule by failing to have a procedure to prevent a violation of a non-fraud provision of the Act/Rules, even though the adviser never violated the provision. In effect, 206(4)-7 can convert a "non violation" if you will of a technical SEC rule into a fraud violation, with its potentially serious consequences.

Take an extreme example. SEC rule 204-2(a)(2) requires advisers to keep for five years auxiliary ledgers reflecting capital accounts. Suppose an adviser was in full compliance with the requirement but failed to have a procedure providing for the ledgers to be kept for the full five years. This would probably violate 206(4)-7, and thus constitute fraud. It's hard to imagine the SEC charging a 206(4)-7 violation in such situations. But the possibility exists, raising questions of fundamental fairness and due process.

This ability of 206(4)-7 to create an antifraud violation out of a non-fraud violation also calls into question the SEC's use of Act section 206(4) as authority for the rule. That section says the Commission can adopt rules that define what are fraudulent acts, and establish requirements to prevent such acts. But many of the acts that 206(4)-7 prevents, such as the failure to keep records, aren't fraudulent.

Power to the SEC

Rule 206(4)-7 probably gives the SEC more discretion in charging a regulatory violation than any other Rule, or any provision of the Act. All the SEC need find is a single respect in which the adviser's compliance program isn't, in the SEC's view, "reasonably designed" to prevent a violation of the Act/Rules. Such a finding shouldn't be difficult—if the SEC wants to make it. Some advisers are subject to relatively few provisions of the Act/Rules. But for most advisers there are many potential violations.

It's highly unlikely the SEC would sue an adviser for a technical violation of 206(4)-7. But advisers can't be sure of that. Many will feel compelled to devote appreciable resources to building and maintaining compliance programs so that they will be perceived by SEC examiners as fully addressing every potential violation. And many advisers may do this not so much to avert SEC lawsuits as to avoid embarrassing written findings of possible 206(4)-7 violations by SEC examiners—findings that may have to be disclosed to existing or prospective clients.

Rightly or wrongly, advisers will be concerned about such findings, from a perception that it will be easier for an examiner to note a possible violation of 206(4)-7 than detect a violation of an underlying, substantive provision of the Act/Rules.

Expanding the Scope of What Is a Violation

A potentially troublesome aspect of 206(4)-7 is that it could become a device for the SEC to expand significantly the scope of what is an Act/Rule violation. Because of the generality of various Act/Rule provisions (such as the antifraud sections) there is often uncertainty whether a questionable act rises to the level of an Act/Rule violation, as distinguished from merely being an unsafe or unsound prac-

tice. The SEC generally exercises its regulatory discretion to view the closer calls as violations. There are two ways that 206(4)-7 could expand that discretion.

First, in charging a 206(4)-7 violation, the SEC need not establish that the activity for which the adviser lacked a prevention procedure was in fact an Act/Rule violation. Probably all the SEC need have is a belief that the underlying activity was a violation. This gives the SEC wide latitude in determining what is an underlying violation for 206(4)-7 purposes. Presumably an adviser could rebut a 206(4)-7 charge by establishing that the underlying activity wouldn't have been a violation. But this isn't completely clear, and by then the reputational damage would likely have occurred.

Second, in the course of interpreting 206(4)-7 the Commission and its staff are likely to specify activities that advisers should address in their compliance programs. Even if some of these activities are not in fact violations of the Act/Rules, the interpretations could have the effect of making them violations. Advisers will thus have to treat the activities as if they were violations in designing their compliance programs.

Chief Compliance Officer ("CCO")

The CCO provisions of 206(4)-7 represent the first time the SEC has told advisers how to run a part of their business—in this case their compliance operations. The CCO provisions establish various details of how investment advisers must organize their internal operations to comply with 206(4)-7. Specifically:

- Each adviser must appoint a CCO to design and carry out the compliance program mandated by 206(4)-7.
- The CCO must be "empowered" with "full responsibility and authority" to create the program.
- The CCO must have a position of "sufficient authority" to "compel others" in the adviser's organization to follow the program.
- An adviser may have only one CCO.
- The CCO must be "competent" and "knowledgeable" about the Act.

While the Commission had previously required advisers to maintain compliance procedures in several specific areas (such as electronic storage of records), it had not dictated how those procedures should be carried out. The CCO provisions of 206(4)-7, however, tend to micro-manage the compliance process, specifying who within the organization must design and monitor the procedures, that individual's level of responsibility within the organization, and even his job qualifications.

The SEC has arguably created in the CCO a position within each adviser's organization who reports as much to the SEC as the adviser's senior management. This is because:

- The CCO will likely have personal liability for a 206(4)-7 violation if the adviser doesn't allow him to operate a program that complies with 206(4)-7.
- In that case the CCO will have to resign as CCO, or perhaps resign altogether from the adviser.
- 206(4)-7 requires advisers to report to the SEC changes in their CCOs.
- A CCO change will alert the SEC to a possible violation of 206(4)-7.

This independence of the CCO could create various internal tensions within the adviser's organization. Suppose the CCO says he'll quit if he doesn't get a pay raise. Ordinarily such a threat would be a routine personnel matter for the adviser to deal with. But if a CCO quits, the stakes for the adviser can be much higher, as noted above. Or suppose the adviser wants to fire the CCO for incompetence or inappropriate job-related conduct. Again, this will cause a reportable change in CCOs, with possible adverse consequences for the adviser. While these examples are perhaps far-fetched, they illustrate how the CCO provisions of 206(4)-7 reach into an adviser's internal operations.

The Proceduralization of Compliance

SEC compliance for advisers is increasingly a matter of adopting, maintaining and reviewing procedures, and having those procedures inspected by SEC examiners. The procedures an adviser must maintain are as follows:

- To prevent the use of insider trading information.[5]
- To safeguard records that are stored electronically.[6]
- To establish policies for the voting of proxies on client-held securities.[7]
- To safeguard the privacy of client information held by the adviser.[8]
- To prevent and detect violations of the Act or Rules.[9]

This proceduralization of compliance has several regulatory policy implications. First, there is obviously the human nature danger that the emphasis on procedure will detract from compliance with substantive requirements, particularly the important provisions such as conflict of interest disclosure. And it will be understandable for advisers to focus on procedure compliance. They will likely conclude—probably correctly—that they run a greater risk of being charged with a 206(4)-7 violation than underlying Act/Rule violations, simply because it will generally be easier for SEC examiners to detect 206(4)-7 violations.

Second, required procedures tend to promote rigidity. And they tend not to reward creativity and flexibility, which can be the key to preventing violations of important general requirements, such as full disclosure and acting in a fiduciary capacity. It's often difficult to reduce these subjective but vital principles to checklists and policy manuals. Yet rules

like 206(4)-7 tend toward such pigeonholing.

Third, required procedures typically lack the ability to prioritize violation risk. But some Act/Rule violations are clearly more harmful to clients than others. For example, compare an adviser's failure to disclose its aggressive use of soft dollars with a failure to keep a relatively unimportant record. Yet under 206(4)-7, these failures have roughly equal significance. They both violate 206(4)-7 and subject the adviser to reputational damage and SEC sanctions.

Fourth, as discussed above, it's by no means clear that compliance procedures in fact prevent violations, and procedures clearly impose regulatory costs.

Fifth, required compliance procedures may promote a uniformity that can be counter-productive. To comply with 206(4)-7, many small and mid-sized advisers may find it more efficient to buy compliance procedure packages (basically manuals and checklists) from compliance vendors, rather than create their own compliance programs that are tailored to their businesses. These packages will likely be standardized, one-size-fits-all documents. They will probably have features that allow the adviser to customize them to its operations. But advisers may have little incentive to customize. This will require effort, and there will be safety in numbers in using one of the industry-standard compliance packages that many others are using. As a result, there will be a sameness of compliance policies and procedures that probably won't serve the industry very well.

Statutory Authority

The Commission's authority to adopt 206(4)-7 isn't altogether clear. The Commission cites as authority Act sections 206(4) and 211(a).

Act section 206(4) prohibits advisers from engaging in "fraudulent, deceptive or manipulative" acts and directs the SEC to adopt rules that "define" what acts are "fraudulent, deceptive or manipulative" and prescribe means that are designed to prevent those defined acts. But rule 206(4)-7 doesn't purport to "define" what is a fraudulent act. Rather, it's aimed at preventing acts that have either been defined in previous SEC rules as fraudulent, or that are prohibited by non-fraud provisions of the Act/Rules. The SEC does not appear to be asserting it's fraudulent for an adviser *not* to have a compliance program. It's therefore hard to see how rule 206(4)-7 satisfies the "define" requirement of Act section 206(4).

Another problem with basing rule 206(4)-7 on Act section 206(4) is that 206(4) applies to all advisers, whether registered or not. Rule 206(4)-7 affects only SEC-registered advisers. It's hard to see how the Act section is authority for the rule if the rule doesn't apply equally to unregistered advisers.

Act Section 211(a), also cited by the SEC, authorizes the SEC to adopt rules that are "appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere" in the Act. The "elsewheres" cited by the SEC are Act section 203 (power to discipline advisers), 204 (power to examine advisers) and 209 (power to enforce the Act). But this seems like a tenuous connection. The SEC hardly needs to require advisers to have extensive compliance programs to assist the Commission in these areas.

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Footnotes

[1] The release of the Securities and Exchange Commission ("SEC" or "Commission") announcing the adoption of the rule (the "Release") is Investment Adviser Act Release No. 2204; Investment Company Act Release No. 26299, Dec. 18, 2003, at http://www.sec.gov/rules/finalia-2204.htm.

[2] This article does not address the companion rule to 206(4)-7, new SEC rule 38-1.

[3] Section 206(4) of the Investment Advisers Act of 1940 (the "Act").

[4] E.g., SEC rule 204-2(g)(3), which requires advisers that use electronic media to store required records, establish and maintain procedures to maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction, limit access to the records to properly authorized personnel, and to reasonably ensure that any reproduction of a non-electronic original record on electronic storage media is complete, true, and legible when retrieved; and SEC rule 206(4)-6, which states that if an adviser exercises voting authority over client securities, it must adopt and implement written policies and procedures that are reasonably designed to ensure that the securities are voted in the best interest of clients (the procedures must include how the adviser would address material conflicts that may arise between its interests and those of the client), disclose to clients how to get information from the adviser about how it voted their securities, and describe to clients its proxy voting policies and procedures.

[5] Act section 204A.

[6] SEC rule 204-2(g)(3).

[7] SEC rule 206(4)-6.

[8] SEC regulation S-P.

[9] SEC rule 206(4)-7.