

MEMO# 6248

September 28, 1994

SEC STAFF REPORT ON PERSONAL INVESTING BY INVESTMENT COMPANY PERSONNEL

September 28, 1994 TO: BOARD OF GOVERNORS NO. 98-94 CLOSED-END FUND MEMBERS NO. 29-94 MEMBERS - ONE PER COMPLEX NO. 69-94 SEC RULES MEMBERS NO. 68-94 RE: SEC STAFF REPORT ON PERSONAL INVESTING BY INVESTMENT COMPANY PERSONNEL

The SEC yesterday released the Division of Investment Management's long-awaited report on "Personal Investment Activities of Investment Company Personnel." The significant aspects of the Report are briefly summarized below and a copy of the Report is attached. Findings The Report sets out the results of the staff's examination of the personal investment activities of fund managers employed by 30 fund groups and the restrictions and procedures placed on those activities by the fund groups. In addition, the Report analyzes Section 17(j) of the Investment Company Act of 1940 and Rule 17j-1 thereunder, which are the principal provisions regulating the investment activities of fund personnel. Finally, the Report includes an assessment of the recommendations included in the Report of the Institute's Advisory Group on Personal Investing (the "Advisory Group Report"). The data reviewed by the staff "indicates that fund managers generally have not engaged in extensive investing for their personal accounts" and that "[w]hen engaging in [such] transactions, fund managers appear to avoid potential conflicts of interest situations." There were, however, a small group of funds who reported extensive personal investment activity by their fund managers. In several instances, fund personnel reportedly purchased or sold securities shortly ahead of their funds. The staff is currently examining such transactions. Recommendations Based on these findings, the Report concludes that the existing regulatory framework governing the personal investment activities of fund personnel generally has worked well, but could be improved. The Report's recommendations are as follows: C The Commission should require every fund to publicly disclose its policies regarding personal investing by fund personnel; C The Commission should require each fund's board of directors or trustees to review the fund's code of ethics and compliance matters relating to the code at least annually; C The Commission should require fund personnel to disclose to their employers their personal securities holdings at the commencement of employment; C The National Association of Securities Dealers, Inc. ("NASD") should be asked to consider adopting a rule requiring its member broker-dealers to notify a fund's investment adviser when one of the adviser's employees opens a brokerage account and, upon request, to transmit duplicate trade confirmations and account statements to the adviser; C The NASD should be asked to consider prohibiting the participation by certain personnel in "hot issue" public offerings; and C Section 17(j) of the 1940 Act should be amended to include purchases and sales of instruments other than

securities (such as futures and commodities), and to clarify that the Section also applies to transactions by a fund's access persons involving securities and other instruments related to, but not necessarily the same as, securities held or to be acquired by the fund.

Ban on Personal Trading; Advisory Group Report's Recommendations

The Report states that in developing these recommendations, the staff also considered two additional issues that have been the subject of public discussion. Those include whether personal investing by access persons should be banned entirely and whether the standards of conduct recommended by the Advisory Group Report, or other similar or comparable standards, should be mandatory for all funds through Commission rules.

Ban on Personal Investing

The staff's decision not to recommend a ban on personal trading was based on several factors. First, the staff determined that a ban was not warranted based on its findings that potentially abusive transactions comprised a small percentage of all personal securities transactions by fund insiders. Second, the majority of personal transactions do not create the potential conflicts of interest with fund shareholders that Section 17(j) and Rule 17j-1 were designed to prevent. Thus, rather than protecting shareholders, a ban on personal trading could harm them because it might cause talented individuals to work for money managers not subject to the 1940 Act. Finally, the staff was not convinced that a ban would curb further abusive trading by fund insiders.

Advisory Group Report's Recommendations

The Report commends the Advisory Group for "taking a decisive initiative in addressing the conflicts of interest that can result from personal investing by fund personnel." Moreover, the Report states that the staff expects "all funds to adopt the [Advisory Group] Report's recommendations, in whole or in substantial part, absent special circumstances." The staff concluded, however, that these recommendations should not be adopted as Commission rules because of the need for flexibility in designing codes of ethics and because no one set of standards would be appropriate for every fund. The staff intends to monitor whether funds are adopting the Advisory Group Report's recommendations. Specifically, the staff will request a report from the Institute as to the number of members that have adopted the recommendations and any interpretive, administrative, or other problems that members have experienced in implementing the recommendations. On the basis of that report, the staff may reconsider amending Rule 17j-1 to provide for uniform code of ethics standards.

Chairman Levitt's Endorsement of the Staff's Report

The staff's Report was released at a hearing held yesterday before the House Subcommittee on Telecommunications and Finance concerning, among other things, personal investing activities of investment company personnel. Chairman Levitt's testimony endorsed the Report's recommendations. Specifically, he stated that the Commission "intends to move quickly to put in place several of the Report's recommendations." He also expressed the view that "these initiatives, together with the industry's general acceptance of the principles reflected in the [Advisory Group] Report, will enhance ethical standards throughout the fund industry and thereby bolster investor confidence." Paul Schott Stevens General Counsel Attachment