

**MEMO# 17015**

January 28, 2004

## **SEC PROPOSES NEW INVESTMENT ADVISER CODE OF ETHICS REQUIREMENT**

[17015] January 28, 2004 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-04 COMPLIANCE ADVISORY COMMITTEE No. 11-04 INVESTMENT ADVISERS COMMITTEE No. 2-04 SEC RULES COMMITTEE No. 11-04 SMALL FUNDS COMMITTEE No. 8-04 RE: SEC PROPOSES NEW INVESTMENT ADVISER CODE OF ETHICS REQUIREMENT The Securities and Exchange Commission has proposed a new rule, Rule 204A-1, under the Investment Advisers Act of 1940 that would require each registered investment adviser to adopt a code of ethics.<sup>1</sup> Advisers would be required to set forth in the code of ethics standards of conduct for advisory personnel, provisions reasonably designed to prevent access to material nonpublic information, and a requirement that access persons of the adviser report their personal securities transactions and holdings, including transactions in any mutual fund managed by the adviser. Each adviser would be permitted to develop its own code that takes into consideration the nature of its business. The proposal is summarized below. Comments on the proposal must be filed with the SEC by Monday, March 15th. The Institute will hold a conference call on Tuesday, February 3rd at 2:00 p.m. EST to discuss the proposal. The dial-in number for the call is 888-455-9648 and the pass code is 35520 . If you plan to participate on the call, please send an e-mail to Monica Carter-Johnson at [mcarter@ici.org](mailto:mcarter@ici.org). If you are unable to participate in the call, please provide your comments before the call, if possible, to Dorothy Donohue by phone (202-218-3563), fax (202-326-5827), or e-mail ([ddonohue@ici.org](mailto:ddonohue@ici.org)).

I. Standards of Conduct Proposed Rule 204A-1(a)(1) would require each code of ethics to set forth a standard of business conduct that the adviser requires of all its supervised persons. The standard would be required to reflect the adviser's fiduciary obligations and those of its supervised persons and to require compliance with the federal securities laws. <sup>1</sup> See SEC Release Nos. IA-2209, IC-26337 (January 20, 2004) (the "Release"). A copy of the Release is available on the SEC's website at <http://www.sec.gov/rules/proposed/ia-2209.htm>. <sup>2</sup> The SEC requests comment on, among other things, (1) whether it should specify a particular standard of conduct that all codes of ethics must incorporate and, if so, what standard should be adopted; and (2) whether the code should require supervised persons to comply with all laws and regulations, rather than only the federal securities laws.

II. Protection of Material Nonpublic Information Proposed Rule 204A-1(a)(3) would require that each code of ethics include provisions reasonably designed to prevent access to material nonpublic information about the adviser's securities recommendations and client securities holdings and transactions. Individuals that need to know this information to perform their duties would be permitted to have access to the information. The Release notes that this requirement would not preclude the adviser from providing necessary information to persons providing services to the adviser or account (i.e., brokers, accountants, custodians, and fund transfer agents). The Release requests comment on, among other things: (1) whether computer files containing

nonpublic information should be required to be identified and segregated; and (2) whether codes of ethics should be required to integrate a summary of law on insider trading and procedures from the adviser's Section 204A procedures. III. Personal Securities Trading Proposed Rule 204A-1(d) would require the code of ethics to call for the adviser's "access persons" to periodically report their personal securities transactions and holdings to the adviser's chief compliance officer.<sup>3</sup> In addition, the code of ethics would have to require access persons to obtain the adviser's approval before investing in an initial public offering or private placement. The Release requests comment on, among other things: (1) whether any advisers should be exempted from any part of Rule 204A; (2) whether any of the proposed changes should be extended to Rule 17j-1; (3) whether there is a significant need for Rule 204A-1 and Rule 17j-1 to be as uniform as possible; and (4) whether Rule 204A-1 should prohibit access persons from investing in IPOs and private placements for their own accounts.

A. Personal Trading Procedures The SEC has not proposed any specific provisions regarding personal trading, other than requiring pre-clearance of investments in an initial public offering or a private placement. The Release requests comment on whether the rule should require any of several enumerated "best practice" procedures to appear in an adviser's code. The procedures identified include: pre-clearance; maintenance of restricted lists; "blackout periods"; prohibitions or restrictions on short swing trading and market timing; requirements to trade only through 2 Access persons generally are advisory personnel who have access to nonpublic information regarding client securities recommendations, trading, and holdings. 3 An adviser with only one employee (i.e., the adviser himself) would be excepted from this requirement but would be required to maintain records of his personal trades and provide them to SEC examiners upon request. 3 certain brokers, or limitations on the number of brokerage accounts permitted; requirements to provide the adviser with duplicate trade confirmations and account statements; and procedures for assigning new securities analyses to employees whose personal holdings do not present conflicts of interest. The Release also requests comment on whether there are other common procedures that advisers should consider as best practices, and, if so, whether they should be included in the adopting release. In addition, the Release requests comment on whether codes should be required to include certain provisions, such as, limitations on acceptance of gifts, and limitations on the circumstances under which an access person may serve as a director of a publicly traded company.

B. Persons Subject to the Reporting Requirement Proposed Rule 204A-1 would require the adviser's access persons to report their personal securities holdings and transactions. Proposed Rule 204A-1(e)(1) would define "access person" as a supervised person who has access to nonpublic information regarding clients' securities transactions, is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic. Employees of affiliated organizations would not be considered access persons. The Release requests comment on whether the definition of access person should be broadened or narrowed, and whether access persons should include employees of companies that control, or are controlled by, the adviser. Proposed Rule 204A-1 would create a legal presumption that, if the advisory firm's primary business is providing investment advice, then all of its directors, officers, and partners are access persons. If the firm has another primary business, then whether such an individual is an access person would depend on whether the individual has access to material nonpublic client information. The Release requests comment on whether the rule should specify a test for the adviser's primary business and, if so, whether the rule should use Rule 17j-1's revenue-based test or some other measure. The Release also asks if Rule 17j-1 should be amended to replace the current revenue-based test with a legal presumption similar to that in proposed Rule 204A-1.

C. Reportable Securities and Beneficial Ownership Several types of securities would be exempt from reporting requirements because they appear to present

little opportunity for abuse. Money market instruments, direct obligations of the United States government, money market fund shares, and shares of other mutual funds (unless the adviser or a control affiliate acts as the investment adviser or principal underwriter for the fund) would be exempt from reporting requirements. The Release requests comment on whether investments in index funds also should be excluded from reporting requirements. 4

D. Reporting of Investment Company Shares Rule 204A-1 would require all advisers' code of ethics to call for reporting of holdings and transactions in affiliated mutual funds. The Release requests comment on: (1) whether reporting of holdings and transactions in all mutual fund shares should be required; (2) whether supervised persons who have information about the holdings of non-fund clients should also be included as access persons; and (3) whether Rule 17j-1 should be amended to include as an access person those individuals who obtain information about the existing securities holdings in the adviser's investment companies. E. Personal Securities Reporting Proposed Rule 204A-1 would require access persons to report their securities holdings at the time the person becomes an access person and at least annually thereafter. The proposed rule also would require access persons to make quarterly reports of all personal securities transactions. The Release requests comment on: (1) the required frequency of the reports; (2) whether reporting obligations under Rule 204A-1 and Rule 17j-1 should be consistent; and (3) whether any transactions should be exempt from the quarterly reporting requirement. IV. Reporting of Violations Proposed Rule 204A-1(a)(5) would require prompt internal reporting of any violations of the code to the adviser's chief compliance officer or another person designated in the code. The Release requests comment on whether advisers should be required to identify at least two persons to whom reports of violations can be submitted and whether codes should be required to call for reporting of apparent violations of the code. V. Acknowledged Receipt of the Code Proposed Rule 204A-1(a)(6) would require the adviser to provide each supervised person with a copy of the code of ethics and any amendments thereto, and each supervised person to acknowledge, in writing, receipt of those copies. The Release requests comment on whether all codes should be required to contain procedures for educating employees about the code and to inform employees about changes made to the code. VI. Adviser Review and Enforcement Proposed Rule 204A-1(a) would require advisers to maintain and enforce their codes of ethics by reviewing their access persons' securities holdings and transactions. The Release 5 states that the responsibility for enforcing the code is expected to lie substantially with the adviser's chief compliance officer. VII. Recordkeeping Rule 204-2(a)(13) under the Advisers Act would require advisers to keep copies of their codes, their supervised persons' written acknowledgement of receipt of the code, records of violations of the code, and records of actions taken as a result of violations. In addition, advisers would be required to keep a record of the names of their access persons, holdings and transaction reports made by access persons, and records of decisions approving access persons' acquisitions of securities in IPOs and limited offerings. Records of access persons personal securities reports would be required to be kept electronically in an accessible computer database. The Release requests comment on whether advisers should be required to keep records of waivers or exemptions granted from the code and whether there is a need to exempt smaller advisory firms from the electronic recordkeeping requirement. VIII. Amendments to Form ADV Item 9 of Form ADV would be amended to require advisers to describe their codes and, upon request, to furnish clients with a copy of the code. Dorothy M. Donohue Associate Counsel

should not be considered a substitute for, legal advice.