



## Investment Adviser Code of Ethics Rule

### Introduction

On May 26, 2004, the Securities and Exchange Commission ("SEC") voted to adopt a new code of ethics rule for investment advisers, Rule 204A-1 under the Investment Advisers Act of 1940 ("Advisers Act") and related amendments to the recordkeeping rules under the Advisers Act, Form ADV, and the code of ethics rule under the Investment Company Act of 1940 ("1940 Act"). On July 2, 2004, the release containing the final rule ("Final Release") became public.<sup>1</sup> We attended the SEC open meeting at which the new rule and amendments were adopted, and have summarized the relevant portions of that meeting and the Final Release.

Rule 204A-1 under the Advisers Act ("Rule 204A-1") requires each registered investment adviser to adopt a code of ethics that sets out standards of conduct expected of advisory personnel, safeguards material nonpublic information about client transactions and requires advisers' "access persons" to report their personal securities transactions, including transactions in any mutual fund managed by the adviser. Rule 204A-1 was proposed and adopted in response to the SEC's concern regarding the number of recent SEC enforcement actions in which investment advisers were alleged to have violated their duty of loyalty. The Rule is intended to reinforce the fiduciary principles that govern the conduct of advisory firms and their personnel.<sup>2</sup>

Highlighting the importance of an adviser's code of ethics, Chairman Donaldson remarked at the SEC's open meeting that, "Opportunity may only knock once, but temptation leans on the door bell. As much as we may wish to, we will never be able to set and enforce rules that govern every situation in which an investment adviser's employees might be tempted to exploit the adviser's clients for personal profit. We have no choice but to rely on the advisory firms themselves to step in to the breach, establishing a culture where the highest standards of behavior are

practiced and where that doorbell is never answered."<sup>3</sup> Rule 204A-1, adopted with some changes from the proposed Rule, is designed to advance that goal.

The SEC noted in the Final Release that Rule 204A-1 is intended to leave advisers with enough flexibility to develop codes of ethics tailored to their specific businesses, and the SEC encouraged advisers to adopt codes of ethics that cover additional matters not required by the Rule. In the Final Release the SEC urged advisers to take great care and thought in preparing their codes of ethics, and stressed that the code should set out ideals for ethical conduct premised on fundamental principals of openness, integrity, honesty and trust. The compliance date for Rule 204A-1 and related amendments is January 7, 2005.<sup>4</sup>

### Standards of Conduct

Each code of ethics must define a standard of business conduct that the adviser requires of all its supervised persons.<sup>5</sup> The standard must reflect the fiduciary obligations of the adviser and its supervised persons and must require compliance with federal securities laws.<sup>6</sup> At the SEC open meeting, Commissioner Goldschmid noted that there is an overlap between the required provisions of the code of ethics and federal fiduciary standards and confirmed that, should a violation of the federal securities laws be discovered, all SEC sanctions remain available.<sup>7</sup>

<sup>1</sup> *Final Rule: Investment Adviser Code of Ethics*, Rel. No. IA-2256 (July 2, 2004) ("*Final Release*").

<sup>2</sup> *Final Release*, Executive Summary.

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<sup>3</sup> SEC Chairman William Donaldson, at SEC Open Meeting (May 26, 2004).

<sup>4</sup> *Final Release*, III.

<sup>5</sup> "'Supervised person' means any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." 15 U.S.C. § 80a-2(a)(25).

<sup>6</sup> *Final Release*, II.A.

<sup>7</sup> SEC Commissioner Harvey J. Goldschmid, at SEC Open Meeting (May 26, 2004).

## The Protection of Material Nonpublic Information

Although Rule 204A-1, as proposed, included a provision that would have required advisers to restrict access to client information on a “need to know” basis, the Rule, as adopted, does not contain this provision. The staff, convinced by commentators that restricting information flow so severely would stifle the creativity of many advisers who work in a collegial atmosphere, particularly at smaller firms that have limited office space, instead reminded advisers that other statutes address the concerns that led to the proposed provision.<sup>8</sup> These statutes include Section 204A of the Advisers Act, which requires advisers to implement policies and procedures reasonably designed to protect material nonpublic information from misuse.<sup>9</sup>

## Personal Securities Trading

Rule 204A-1 provides that each adviser’s code of ethics must require an adviser’s “access persons” to periodically report their personal securities transactions and holdings to the adviser’s chief compliance officer (“CCO”) or other designated persons. The code of ethics must also require the adviser to review those reports.<sup>10</sup> This provision is modeled on Rule 17j-1 under the 1940 Act, which requires investment companies to have procedures in place to prevent their personnel from abusing their access to information about the investment company’s securities trading and requires access persons to submit reports periodically containing information about their personal securities holdings and transactions.<sup>11</sup>

## Personal Trading Procedures

Rule 204A-1 does not include specific provisions regarding personal trading of access persons other than pre-clearance of investments in initial public offerings and private placements. In the Final Release, however, the SEC listed the following elements that are commonly included in an adviser’s code of ethics and noted that all advisers should consider these elements in drafting their own procedures:

- Prior written approval before access persons can place a personal securities transaction (“pre-clearance”).
- Maintenance of lists of issuers of securities that the advisory firm is analyzing or recommending

<sup>8</sup> SEC Staff Attorney Robert Tuleya, at SEC Open Meeting (May 26, 2004).

<sup>9</sup> 15 U.S.C. § 80b-4(a).

<sup>10</sup> 17 C.F.R. 275.204A-1(a)(3).

<sup>11</sup> 17 C.F.R. § 270.17j-1.

for client transactions, and prohibitions on personal trading in securities of those issuers.

- Maintenance of “restricted lists” of issuers about which the advisory firm has inside information, and prohibitions on any trading (personal or for clients) in securities of those issuers.
- “Blackout periods” when client securities trades are being placed or recommendations are being made and access persons are not permitted to place personal securities transactions.
- Reminders that investment opportunities must be offered first to clients before the adviser or its employees may act on them, and procedures to implement this principle.
- Prohibitions or restrictions on “short-swing” trading and market timing.
- Requirements to trade only through certain brokers, or limitations on the number of brokerage accounts permitted.
- Requirements to provide the adviser with duplicate trade confirmations and account statements.
- Procedures for assigning new securities analyses to employees whose personal holdings do not present apparent conflicts of interest.<sup>12</sup>

In addition to the personal securities transaction procedures listed above, the following is a list of other provisions the SEC suggests advisers consider when drafting their own codes of ethics:

- Limitations on acceptance of gifts.
- Limitations on the circumstances under which an access person may serve as a director of a publicly traded company.
- Detailed identification of who is considered an access person within the organization.
- Procedures for the firm and its compliance personnel to review periodically the code of ethics as well as to review reports made pursuant to it.<sup>13</sup>

## Access Persons

“Access persons” are defined in Rule 204A-1 as supervised persons who have access to nonpublic information regarding clients’ purchase or sale of securities, are involved in making securities recommendations to clients, or who have access to recommendations that are nonpublic.<sup>14</sup> A supervised

<sup>12</sup> *Final Release*, II.C.1.

<sup>13</sup> *Final Release*, n. 17.

<sup>14</sup> 17 C.F.R. 275.204A-1(e)(1).

person who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds is also an access person, although a supervised person would not be an access person solely because he or she has nonpublic information regarding the portfolio holdings of a client that is not an investment company. When Chairman Donaldson noted at the SEC open meeting that comments were varied regarding which employees should be subject to the reporting requirement, the staff explained that Rule 204A-1 tracks industry practices for determining who is an access person by requiring reports only from personnel in positions of access to information, rather than requiring firms to police who in fact had acquired information.<sup>15</sup>

Portfolio management personnel will be considered access persons and, in some advisory firms, client service representatives who communicate investment advice to clients will also be considered access persons. In many advisory firms, directors, officers and partners will be considered access persons.<sup>16</sup> Administrative, technical and clerical personnel may also be considered access persons if their functions or duties give them access to nonpublic information.<sup>17</sup>

## Reports

Under Rule 204A-1, an adviser's code of ethics must require access persons to report their personal securities transactions and holdings, other than for certain non-reportable securities such as money market instruments and direct obligations of the government of the United States, which present little opportunity for the type of improper trading that the reports are designed to identify. Access persons are required to include in their reports holdings and transactions in shares of investment companies managed by the adviser or a control affiliate, thereby closing a regulatory gap that existed under Rule 17j-1 under the 1940 Act. Rule 17j-1 under the 1940 Act requires access persons of investment companies to report holdings or transactions in securities held or to be acquired by the investment company, but it does not require access persons to report holdings or transactions in shares of open-end funds, including mutual funds they manage.<sup>18</sup>

An adviser's code of ethics must require a complete report of each access person's securities holdings no later than ten days after the person becomes an access person and at least once each 12-month period. The

<sup>15</sup> Tuleya, at SEC Open Meeting (May 26, 2004).

<sup>16</sup> An advisory firm's directors, officers and partners are presumed to be access persons if the firm's primary business is providing investment advice. 17 C.F.R. 275.204A-1(e)(1)(ii).

<sup>17</sup> *Final Release*, II.C.2.

<sup>18</sup> 17 C.F.R. § 270.17j-1.

holdings reports must be current as of a date not more than 45 days prior to the individual becoming an access person (initial report) or the date the report is submitted (annual report).<sup>19</sup> An adviser's code of ethics must also require access persons to submit quarterly securities transaction reports no later than thirty days after the end of each calendar quarter. Rule 204A-1, as adopted, does not require quarterly reports if the access person had no securities transactions during that quarter. Quarterly reports must cover, at a minimum, all transactions during the quarter. To avoid duplication, the Final Release also includes conforming amendments to Rule 17j-1 under the 1940 Act.<sup>20</sup>

## Initial Public Offerings and Private Placements

The code of ethics must require that access persons obtain the adviser's approval before investing in an initial public offering ("IPO") or private placement.<sup>21</sup> Since most people rarely have an opportunity to invest in these types of securities, an access person's IPO or private placement purchase raises questions as to whether the access person is misappropriating an investment opportunity that should first be offered to eligible clients. Advisory firms with only one access person would not be required to have pre-clearance of these investments.<sup>22</sup>

## Violations

### Reporting

Rule 204A-1 provides that an adviser's code of ethics must require prompt internal reporting of any violations of the code of ethics.<sup>23</sup> An investment adviser can choose to have supervised persons report violations to either the CCO or to other persons designated in the code of ethics, although an advisory firm that designates someone other than the CCO to receive reports of code violations must have procedures requiring that the CCO also receive reports of all violations periodically.<sup>24</sup>

### Enforcement and Penalties

Rule 204A-1 requires internal enforcement of an adviser's codes of ethics, but leaves sanctions for particular violations to the determination of each adviser. When asked by Chairman Donaldson whether it would be beneficial to either dictate the nature of sanctions or to direct the advisers to do so in their

<sup>19</sup> 17 C.F.R. 275.204A-1(b)(1).

<sup>20</sup> *Final Release*, II.J.

<sup>21</sup> 17 C.F.R. 275.204A-1(c).

<sup>22</sup> 17 C.F.R. 275.204A-1(d).

<sup>23</sup> 17 C.F.R. 275.204A-1(a)(4).

<sup>24</sup> 17 C.F.R. 275.204A-1(a)(3).

respective codes, the staff explained that, to the extent the infringements were not violations of the federal securities laws, it was preferable to leave such decisions to individual advisers.<sup>25</sup> The SEC noted in the Final Release, however, that many advisers have adopted a system of fines and penalties so that employees have a meaningful understanding of the importance of the code of ethics and the consequences of violating it.<sup>26</sup>

## Educating Employees

Under Rule 204A-1, an adviser's code of ethics must require the adviser to provide each supervised person with a copy of the adviser's code of ethics and any amendments to the code, and each supervised person is required to acknowledge receipt of the code in writing.<sup>27</sup> In the Final Release, the SEC stated that it expects that most advisory firms will ensure that their employees have received adequate training on the principles and procedures of their codes, despite employee education not being a requirement of the code.<sup>28</sup>

## Adviser Review and Enforcement

Rule 204A-1 requires advisers to maintain and enforce their codes of ethics, and the SEC expects that the adviser's CCO, or persons under his or her authority, will have primary authority for enforcing the adviser's code.<sup>29</sup> The Rule also provides that enforcement of the code requires the review of access persons' personal securities reports.<sup>30</sup> An adviser may reserve the right to waive compliance with the provisions of its code that are not required under Rule 204A-1 or Rule 17j-1 under the 1940 Act. However, an adviser to an investment company must file an annual report to the investment company's board describing any material violations of the code of ethics and whether any waivers that may be considered important by the board were granted that year.

## Other Amendments

### Recordkeeping

The Final Release amends and simplifies the recordkeeping requirements under Rule 204-2 under the Advisers Act to reflect new Rule 204A-1. Rule 204-2(a)(12) under the Adviser's Act, as amended,

requires advisers to keep copies of their code of ethics, records of code violations and any steps taken in response to the violations, and copies of their supervised persons' written acknowledgement of receipt of the code. The SEC is not requiring advisers to retain records of whistleblower reports. Rule 204-2(a)(13) under the Advisers Act, as amended, covers records of access persons' personal trading, and requires advisers to maintain a record of the names of their access persons, the holdings and transaction reports made by access persons, and records of decisions approving access persons' acquisitions of securities in IPOs and limited offerings. The SEC expects, but is not requiring, records of access persons' personal securities reports and supporting documents to be maintained electronically in an accessible computer database.<sup>31</sup>

Under Rule 204-2 under the Adviser's Act, advisers must maintain the records required under Rule 204A-1 for five years in an easily accessible place, the first two years in an appropriate office of the investment adviser. Codes of ethics must be kept for five years after they are no longer in effect. Supervised person acknowledgements of the code must be kept for five years after the person ceases to be a supervised person. The list of access persons must include every person who was an access person at any time within the past five years.<sup>32</sup>

### Amendment to Form ADV

The Final Release amends Part II of Form ADV to require advisers to describe their codes of ethics to clients and, upon request, to furnish copies to clients.<sup>33</sup>

### Amendments to Rule 17j-1 under the 1940 Act

The Final Release amends Rule 17j-1 under the 1940 Act to provide that no report would be required under Rule 17j-1 "to the extent that" the report would duplicate information required under the Advisers Act recordkeeping rules. This amendment avoids unnecessary duplication because the reports required under the Advisers Act are not identical to those required under Rule 17j-1 under the 1940 Act.

<sup>25</sup> Paul Roye, Director, Division of Investment Management, at SEC Open Meeting (May 26, 2004).

<sup>26</sup> *Final Release*, II.E.

<sup>27</sup> 17 C.F.R. 275.204A-1(a)(5).

<sup>28</sup> *Final Release*, II.F.

<sup>29</sup> 17 C.F.R. 275.204A-1(a).

<sup>30</sup> 17 C.F.R. 275.204A-1(b).

<sup>31</sup> *Final Release*, II.H.

<sup>32</sup> *Id.*

<sup>33</sup> 17 C.F.R. 279.1

Four additional changes have been made to Rule 17j-1 under the 1940 Act to limit differences between it and Rule 204A-1.<sup>34</sup> First, Rule 17j-1 under the 1940 Act, as amended, provides that the information in initial and annual holdings reports must be current as of a date no more than 45 days prior to the individual becoming an access person under the Rule (initial holding report), or

submitting the report (annual holding report). Second, quarterly transaction reports are due no later than 30 days after the close of the quarter. Third, quarterly transaction reports need not be submitted with respect to transactions effected pursuant to an automatic investment plan. Fourth, the definition of “access person”, as amended, includes an advisory person of a fund or its investment adviser and makes the legal presumption that directors, officers and general partners are presumed to be access persons if the firm’s primary business is investment advisory.

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<sup>34</sup> *Final Release, II.J.*

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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