

January 25, 2004

## Proposed SEC Rule Concerning Investment Adviser Codes of Ethics

The Securities and Exchange Commission (the “SEC”) has proposed a new rule and related rule amendments under the Investment Advisers Act of 1940, as amended (the “Advisers Act”): “Investment Adviser Codes of Ethics” (the “Proposed Rule”).<sup>1</sup> Comments on the Proposed Rule must be submitted to the SEC by March 15, 2004. This memorandum outlines the requirements of the Proposed Rule.

### A. Introduction

Investment advisers owe their clients a duty of undivided loyalty. In order to ensure satisfaction of this duty, many advisers adopt codes of ethics. These codes often establish compliance procedures and impose ethical obligations beyond those required by law. Nevertheless, as evidenced by recent news, many advisers and their personnel have not fulfilled their fiduciary duties to clients. In response, the SEC undertook the following actions in the past few months:

- adopted rules designed to deter and detect violations of the Advisers Act;<sup>2</sup>
- proposed to require better disclosures by mutual funds;<sup>3</sup> and

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<sup>1</sup> Proposed Rule: Investment Adviser Codes of Ethics, 17 CFR Parts 270, 275 and 279; Release Nos. IA-2209, IC-26337, File No. S7-04-04; RIN: 3235-AJ08 (January 20, 2004). The new rule would be 204A-1 under the Advisers Act.

<sup>2</sup> Final Rule: Compliance Programs of Investment Companies and Investment Advisers, 17 CFR Parts 270 and 275, Release Nos. IA-2204, IC-6299, File No. S7-03-03 RIN: 3235-AI77 (December 17, 2003). Paul, Weiss, Rifkind, Wharton & Garrison LLP (“Paul, Weiss”) has drafted a memorandum on the Final Rule. Please contact us for a copy of the memorandum.

<sup>3</sup> Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 17 CFR Parts 239 and 274. Release Nos. 33-8343, IC-26287, File No. S7-26-03; RIN 3235-AI99 (December 11, 2003). Proposed Rule: Disclosure of Breakpoint Discounts by Mutual Funds, 17 CFR Parts 239 and 274; Release Nos. 33-8347, 34-48939, IC-26298, File No. S7-28-03; RIN 3235-AI95 (December 17, 2003). Concept Release: Request for Comments on Measures to Improve Disclosure

- proposed safeguards against late trading.<sup>4</sup>

## II. The Proposed Rule

The SEC's Proposed Rule would build on this new foundation of rules and regulations and require each adviser registered with the SEC to adopt and enforce a code of ethics applicable to the adviser's supervised persons.<sup>5</sup> The Proposed Rule essentially is designed to prevent fraud by reinforcing fiduciary principles. Each adviser's code of ethics would be required to:<sup>6</sup>

- set forth standards of conduct expected of advisory personnel (including compliance with the federal securities laws);
- safeguard material nonpublic information about client transactions;
- require advisers' "access persons" to report their personal securities transactions, including transactions in any mutual fund managed by the adviser;
- require access persons to obtain the adviser's approval before investing in an initial public offering ("IPO") or private placement;
- require prompt reporting, to the adviser's chief compliance officer or another person designated in the code of ethics, of any violations of the code;
- require the adviser to provide each supervised person with a copy of the code and any amendments; and
- require the supervised persons to acknowledge, in writing, their receipt of these copies.

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of Mutual Fund Transaction Costs, Release Nos. 33-8349, IC-26313, File No. S7-29-03 RIN: 3235-A194 (December 18, 2003). Paul, Weiss has drafted memoranda on the Concept Release and the two Proposed Rules. Please contact us for copies of these memoranda.

<sup>4</sup> Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, 17 CFR Parts 270, Release No. IC-26288, File No. S7-27-03 RIN: 3235-AJ01 (December 17, 2003). Paul, Weiss has drafted a memorandum on the Proposed Rule. Please contact us for a copy of the memorandum.

<sup>5</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.

<sup>6</sup> *Id.*

The SEC drafted the Proposed Rule so that each adviser could develop a code that takes into consideration the nature of its business and address any additional relevant matters.<sup>7</sup>

A. Standards of Conduct

The Proposed Rule would require that each code of ethics set forth standards of conduct that the adviser expects of all its supervised persons.<sup>8</sup> These standards would reflect the fiduciary obligations of the adviser and its supervised persons and would require compliance with the federal securities laws.<sup>9</sup> Advisers would be free, however, to impose higher standards.

B. Protection of Material Nonpublic Information

The Proposed Rule 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, unless those individuals need the information to perform their duties.<sup>10</sup> The Proposed Rule would also require advisers to restrict access to client information on a "need to know" basis, but would not preclude the adviser from providing necessary information to fund service-providers.<sup>11</sup>

C. Personal Securities Trading

The SEC's Proposed Rule would require each adviser's code of ethics to mandate quarterly and annual personal trading reports from "access persons."<sup>12</sup> "Access

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<sup>7</sup> *Id.* In fact, the SEC encourages advisers to adopt broader codes that may be more appropriate for that adviser. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.

<sup>8</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.A.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at Section II.B.

<sup>11</sup> *Id.* For example, brokers, accountants, custodians, and fund transfer agents.

<sup>12</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Sections II.C and II.D. The Proposed Rule would contain an exception for an adviser with only one employee (*i.e.*, the adviser himself). This sole

persons” are defined as supervised adviser personnel who have “access to nonpublic information regarding client securities recommendations, trading and holdings.”<sup>13</sup> Administrative, technical, and clerical personnel may also be deemed access persons if their duties make them privy to nonpublic information.<sup>14</sup> In general therefore, the number of advisory personnel subject to the reporting requirements would depend on the size of the organization and the breadth of information barriers.<sup>15</sup> The Proposed Rule would also create a legal presumption that, if the firm’s primary business is providing investment advice, then all of its directors, officers and partners are access persons.<sup>16</sup>

Under the Proposed Rule, the quarterly reports would be due no later than 10 days after the close of the calendar quarter.<sup>17</sup> In the event an access person had no personal securities transactions during the quarter, the report would contain a statement to that effect and would still be required.<sup>18</sup> The Proposed Rule would not require access persons to submit

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employee would not be required to make reports on personal securities transactions and holdings, but would be required to maintain records of his personal trades and provide them to SEC examiners, if and when requested. These small advisers would still be subject to the other provisions of the Proposed Rule. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.

<sup>13</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.2.

<sup>14</sup> *Id.* Employees of other organizations, including affiliated organizations such as broker-dealers, custodians, and banks that may acquire information about client securities transactions in the course of their duties, would not be subject to reporting requirements. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.2.

<sup>15</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.2.

<sup>16</sup> *Id.* On the other hand, if the firm has another primary business, then whether a director, officer or partner is an access person would turn on whether the individual has access to nonpublic client information. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.2.

<sup>17</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.6.

<sup>18</sup> *Id.* Transactions effected pursuant to an automatic investment plan would not have to be reported. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.6.

transaction reports that would duplicate information contained in trade confirmations or account statements that the adviser holds in its records.<sup>19</sup>

The Proposed Rule would require access persons to report to the adviser's chief compliance officer their personal holdings and transactions in securities in which they have beneficial ownership.<sup>20</sup> In order to close a regulatory gap under the 1940 Act, the Proposed Rule also would require access persons of an adviser to report their holdings and transactions in shares of investment companies managed by the adviser or a control affiliate.<sup>21</sup> Transactions and holdings in shares of other types of mutual funds would not be reportable unless the adviser or a control affiliate acts as the investment adviser or principal underwriter for the fund.<sup>22</sup>

The access persons' reports would allow advisers and the SEC's examination staff to identify potentially improper trades or patterns of trading by access persons. However,

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<sup>19</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.7.

<sup>20</sup> *Id.* at Section II.C.2. The SEC stated in 1999 that beneficial ownership under Rule 17j-1, promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act") should be interpreted in the same manner as for purposes of rule 16a-1(a)(2), under the Exchange Act, in determining whether a person has beneficial ownership of a security. The SEC is proposing to include that same provision in the Proposed Rule. However, several types of securities would appear to present little opportunity for the type of improper trading that the access person reports are designed to uncover. Money market instruments – bankers' acceptances, bank certificates of deposit, commercial paper, repurchase agreements and other high quality short-term debt instruments – and direct obligations of the Government of the United States would therefore be exempt from reporting requirements. Shares of money market funds would also be exempt. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.3.

<sup>21</sup> *Id.* at Section II.C.4. Section 17(j) of the 1940 Act authorizes the SEC to adopt rules preventing fraud or deceptive practices in connection with the purchase or sale of "any security held or to be acquired" by an investment company. Rule 17j-1 therefore does not require access persons of investment companies to report personal securities trades in mutual funds they manage. Moreover, the legislative exclusion of mutual funds reflects an assumption that trading in mutual fund shares posed little risk of abuse, because those shares are priced daily. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.4.

<sup>22</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.C.4.

the SEC is not proposing specific provisions regarding personal trading, other than pre-clearance of certain investments.<sup>23</sup> The SEC does note that advisers should consider the following issues when drafting policies and procedures for employees' personal securities trading:<sup>24</sup>

- prior written approval before access persons can place a personal securities transaction ("pre-clearance");
- maintenance of "restricted lists" of issuers of securities that the advisory firm is analyzing or recommending for client transactions, and prohibitions on personal trading 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; and
- procedures for assigning new securities analyses to employees whose personal holdings do not present apparent conflicts of interest.

D. Initial Public Offerings and Private Placements

The Proposed Rule would require access persons to obtain the adviser's approval before investing in an initial public offering ("IPO") or private placement.<sup>25</sup> The SEC believes that an access person's purchase of shares in an IPO or private placement may raise

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<sup>23</sup> *Id.* at Section II.C.1.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at Section II.D. The SEC added a similar provision to rule 17j-1 in 1999.

questions as to whether the employee is misappropriating an investment opportunity or receiving a personal benefit for directing client business or brokerage.<sup>26</sup>

E. Reporting of Violations

The Proposed Rule would require prompt internal reporting of any violations of the code of ethics.<sup>27</sup> Reports of violations would have to be made to the adviser's chief compliance officer or to another person designated in the code of ethics.<sup>28</sup> Reports may come from violators themselves or from others within the firm who learn of a fellow employee's inappropriate actions.

F. Acknowledged Receipt of Code of Ethics

The Proposed Rule would require the adviser to provide each supervised person with a copy of the code of ethics and any amendments, and require each supervised person to acknowledge, in writing, his receipt of those copies.<sup>29</sup> The SEC believes an investment adviser's procedure for informing its employees about its code of ethics would be critical to obtaining good compliance and avoiding accidental violations of the code.

G. Additional Provisions

The SEC suggests that advisers consider including other provisions in their codes of ethics, such as:<sup>30</sup>

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;

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<sup>26</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.D.

<sup>27</sup> *Id.* at Section II.E.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at Section II.F.

<sup>30</sup> *Id.* at Section II.G.

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; and

discussion of penalties for violating the code of ethics.

H. Adviser Review.

The Proposed Rule would require that advisers maintain and enforce the provisions of their codes of ethics.<sup>31</sup> Enforcement of the code would include reviewing the securities holdings and transaction reports of the adviser's access persons. The SEC expects that the responsibility for enforcing the adviser's code of ethics will lie substantially with the adviser's chief compliance officer, to whom personal trading reports must be submitted.

I. Recordkeeping.

The SEC is also proposing to amend rule 204-2 under the Advisers Act to reflect the codes of ethics that advisers would adopt.<sup>32</sup> Current regulations lay out fairly complex requirements for the information that advisers must keep regarding personal securities transactions.<sup>33</sup> The Proposed Rule would simplify recordkeeping by instead referring to the adviser's required code of ethics. Advisers would have to keep copies of their code of ethics and their supervised persons' written acknowledgment of receipt of the code.<sup>34</sup> They would also have to keep records of violations of the code, and records of actions taken as a result of violations. In addition, advisers would have 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' acquisition of securities in IPOs and limited offerings.<sup>35</sup> Finally, the Proposed Rule also would require that records of access persons' personal

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<sup>31</sup> *Id.* at Section II.H.

<sup>32</sup> *Id.* at Section II.I.

<sup>33</sup> Rules 204-2(a)(12) and (13).

<sup>34</sup> Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.I.

<sup>35</sup> *Id.*

securities reports (and duplicate brokerage confirmations or account statements in lieu of those reports)<sup>36</sup> be maintained electronically in an accessible computer database.<sup>37</sup>

J. Amendment to Form ADV.

The SEC is proposing to amend Part II of Form ADV to require advisers to describe their codes of ethics to clients and to furnish clients with a copy of the code of ethics upon request.<sup>38</sup> This disclosure would help clients understand the culture and standards at the advisory firm, how the adviser handles sensitive information and what steps the adviser has taken to prevent employees from misusing their inside positions. The SEC believes that these disclosures should serve to encourage advisers to implement more effective procedures.

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If you have any questions about the Proposed Rule or would like to consider submitting a comment on any part of the Proposed Rule, please do not hesitate to contact us.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents.

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<sup>36</sup> Currently, access persons under rule 17j-1 need not make a quarterly transaction report under that rule if “all of” the information in the report would duplicate information required to be recorded under Advisers Act rules.<sup>36</sup> The SEC is proposing to revise that to state 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. To avoid duplicative reports, some advisers to investment companies may require their access persons to provide reports that cover all information required under rule 17j-1 and all information required under the Advisers Act code of ethics – for example, an access person’s quarterly report might include information on new securities accounts (required under rule 17j-1) as well as on transactions in affiliated mutual funds (required under rule 204A-1). Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.K.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at Section II.J. The SEC emphasized the importance of disclosure in 1999 when it amended rule 17j-1 to require funds’ codes of ethics to be filed with the SEC electronically and thus available to the public. Proposed Rule: Release Nos. IA-2209, IC-26337 at Section II.J.

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