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SEC Adopts Rule Requiring Investment Adviser Codes of Ethics

On July 2, 2004, the Securities and Exchange Commission ("SEC") issued Rule 204A-1 under the Investment Advisers Act of 1940, as amended ("Advisers Act"). The rule requires all investment advisers subject to SEC registration ("advisers") to adopt and enforce codes of ethics ("Codes") setting forth standards of conduct for advisory personnel, and to address conflicts arising from personal trading by advisory personnel ("Code of Ethics Rule"). The SEC concurrently issued conforming amendments to Rule 204-2 ("Recordkeeping Rule") and Form ADV under the Advisers Act, as well as Rule 17j-1 under the Investment Company Act of 1940, as amended ("1940 Act").[1]

The Code of Ethics Rule is part of a package of regulatory initiatives that responds to recent enforcement actions against advisers and is intended to reinforce the fiduciary principles governing the conduct of advisers and advisory personnel.

Code of Ethics Requirements

The Code of Ethics Rule requires advisers to establish, maintain, and enforce a Code that, at a minimum:

- includes standards of business conduct that are expected of supervised persons[2] and that reflect the adviser's fiduciary duties;
- requires supervised persons to comply with applicable federal securities laws;[3]
- requires certain supervised "access persons" to report their personal securities holdings and transactions, including transactions in mutual funds advised by the adviser or an affiliate;

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

2 Section 202(a)(25) of the Advisers Act defines "supervised person" as "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." This statutory term is used in place of the term "advisory representative" formerly defined in Rule 204-2(a)(12)(iii)(A) and (13)(iii)(A) to establish the personal securities transaction recordkeeping requirements of advisers prior to the Code of Ethics Rule.

3 Under Rule 204A-1(e)(4), the term "federal securities laws" is defined to include (i) the Securities Act of 1933, as amended; (ii) the Securities Exchange Act of 1934, as amended; (iii) the Sarbanes-Oxley Act of 2002; (iv) the Investment Company Act of 1940, as amended ("1940 Act"); (v) the Advisers Act; (vi) Title V of the Gramm-Leach-Bliley Act of 1999; (vii) any rules adopted by the Commission under any of these statutes; (viii) the Bank Secrecy Act as it applies to funds and investment advisers, and (ix) any rules adopted thereunder by the Commission or the Department of the Treasury. This definition is identical to the definition of the same term as set forth in Rule 38a-1(e)(1) under the 1940 Act.

- requires "access persons" to pre-clear any personal investments in initial public offerings and limited offerings;
- requires supervised persons to promptly report any violations of the adviser's code either to the firm's chief compliance officer ("CCO") or to other designated persons provided the CCO also receives reports of all violations; and
- requires the adviser to provide each supervised person with a copy of the Code and any amendments, and requires the supervised persons to acknowledge, in writing, their receipt of the Code.

Standards of Business Conduct

The Code of Ethics Rule requires an adviser's code of ethics to set forth a standard of conduct that the adviser's supervised persons are required to meet. While no particular standard is mandated, the standards an adviser chooses should, at a minimum, reflect its fiduciary obligations and those of its supervised persons. Advisers may, of course, require higher standards of conduct such as those established by professional or trade groups (e.g., ICAA, AIMR). However, advisers planning to adopt model codes established by such groups should remember that any such Code must meet the minimum requirements of the Code of Ethics Rule. Any third-party code failing to meet the minimum requirements must be appropriately supplemented.

Compliance with Applicable Federal Securities Laws

The Code of Ethics Rule requires advisers to incorporate into their codes a written policy requiring compliance with all federal securities laws and to adopt procedures to implement that policy. In requiring compliance with all federal securities laws, the Code of Ethics Rule is broader than recently adopted Rule 206(4)-7 under the Advisers Act ("Compliance Program Rule"), which requires that an adviser's compliance procedures be reasonably designed to prevent violations of the Advisers Act. The Code of Ethics Rule's broader reach indicates that advisers and their chief compliance officers ("CCOs") should not limit their compliance efforts simply to the Advisers Act.

Protection of Material Non-Public Information

The SEC decided not to adopt the proposed requirement that advisers include in their Codes a provision restricting access to sensitive information to a "need to know" basis.[4] In declining to adopt this requirement, the SEC cited commenters' concerns that such a restriction would be impractical, particularly in small firms with limited office space. However, the SEC noted in the adopting release that advisers continue to be obligated to maintain and enforce policies and procedures to prevent the misuse of material nonpublic information under Section 204A of the Advisers Act, and noted that this includes by implication the obligation to protect portfolio information.[5]

Personal Securities Trading

In order to prevent advisory personnel from trading for their own accounts in a manner harmful to clients, codes must require the adviser to obtain and review personal trading reports regarding the personal trading activities of each of its "access persons."[6] Access persons must submit holdings and transaction reports for "reportable securities" in which they have or acquire any direct or indirect beneficial ownership.

A. "Access Person"

The Code of Ethics Rule defines an "access person" as any supervised person who either (i) has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or (ii) is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic.[7] If providing investment advice is the primary business of the adviser, its directors, officers, and partners are presumed to be access persons.[8] However, if the adviser's primary business is something other than rendering investment advice, whether a director, officer, or partner is an access person will

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4 *Proposed Rule: Investment Adviser Code of Ethics*, Rel. No. IA-2209 (Jan. 20, 2004).

5 See Adopting Release, *supra* note 1, at 7.

6 The Commission noted that the CCO need not review all trading reports personally, but did not make clear which person should share that responsibility. In addition, the Commission stated that it "expects" that most advisers would designate an individual to review the personal securities reports of the CCO himself, but did not elaborate further on whether self-review by a CCO would be a suspect practice under the Rule. *Id.* at n.13.

7 Rule 204A-1(e)(1).

8 Rule 204A-1(e)(1)(ii).

depend on whether the individual has access to non-public client information.[9]

Access persons include portfolio management personnel and may include client service representatives who communicate investment advice to clients. Administrative, technical, and clerical personnel may be access persons if their functions or duties give them access to non-public information. A supervised person would not be an access person solely because he has non-public information about the portfolio holdings of a client that is not an investment company, since that information is less susceptible to exploitation for personal gain.[10] Persons who are not supervised persons of the adviser—for example, employees of affiliated organizations including broker-dealers, custodians, and banks—would not be access persons and are therefore not subject to the reporting requirements of the Rule.[11]

B. "Reportable Security"

Under the Code of Ethics Rule all securities[12] are "reportable" except:

- transactions and holdings in direct obligations of the Government of the United States;
- money market instruments including bankers' acceptances, bank certificates of deposit, commercial paper, repurchase agreements, and other high quality short-term debt instruments;
- shares of money market funds;
- transactions and holdings in shares of other types of mutual funds, unless the adviser or a control affiliate acts as the investment adviser or principal underwriter for the fund;[13] and
- transactions in units of a unit investment trust if the unit investment trust is invested exclusively in unaffiliated mutual funds (i.e., variable insurance products).[14]

The exceptions constitute securities thought by the SEC to present little opportunity for the type of improper trading that the reporting requirements are designed to uncover.

C. Reporting Requirements

An adviser's code must require access persons to report their personal securities holdings (1) at the time the individual becomes an access person, and (2) at least annually thereafter. The holdings report must be current as of a date not more than 45 days prior to either the individual's becoming an access person, or to the date the report is submitted. Codes must also require access persons to make quarterly reports of their securities holdings. These reports are due no later than 30 days after the close of the calendar quarter. These time windows, more flexible than those in the proposed rule, facilitate the use of brokerage statements to prepare or substitute for the required report.[15]

Under the Code of Ethics Rule, reporting is not required:

- with respect to transactions effected pursuant to an automated investment plan;[16]
- with respect to securities held in accounts over which the access person has no direct or indirect influence or control; and
- in the case of an advisory firm with only one access person,[17] as long as the firm maintains

9 Conforming amendments to Rule 17-j under the 1940 Act eliminate the revenue-based test for determining whether an investment adviser's primary business is advising funds and other advisory clients and, therefore, whether the adviser is an access person.

10 *See supra* note 1, at n.25.

11 *Id.* at 12.

12 The term "security" is defined in Section 2(a)(18) of the Advisers Act.

13 The Adopting Release states that this exception extends only to open-end funds registered in the United States; it does not include transactions and holdings in shares of both affiliated and unaffiliated closed-end funds, nor in offshore funds. These latter categories are both reportable. *Id*. at n.46.

14 Rule 204A-1(e)(9), (10).

15 *Id*. at 14. As proposed, the Code of Ethics Rule, like Rule 17j-1 under the 1940 Act would have required these reports to have been made within 10 days. Responding to criticism, the SEC not only extended the deadline for purposes of the Code of Ethics Rule but also amended Rule 17j-1 to provide for an extended deadline as well. Advisers with existing Codes adopted pursuant to Rule 17j-1 should review and amend those Codes to implement the more flexible reporting deadlines.

16 However, a transaction that overrides the pre-set schedule or allocations of the plan must be included in a quarterly transaction report. *Id*. at 15.

17 The Commission originally proposed this exception for firms with only one *supervised* person, because otherwise that individual would be required to report to himself. However, with the change in language to "access person," the Commission decided to extend the exception to include sole proprietorships with one

records of the holdings and transactions that would otherwise be reported under the Rule.[18]

Mandatory Pre-Clearance of Purchases of IPOs and Limited Offerings

Codes must require that access persons obtain the adviser's approval before investing in an initial public offering ("IPO") or a limited offering.[19] This requirement is meant to ensure that access persons do not (1) misappropriate an investment opportunity that should first be offered to the adviser's eligible clients or (2) if the access person is a portfolio manager, receive a personal benefit for directing client business or brokerage. Although this requirement does not apply to advisory firms with only one access person, such firms must maintain appropriate records of the access person's investments in IPOs and limited offerings.

Recommended or ''Best Practice'' Procedures

In addition to the mandatory reporting and pre-clearance requirements, the SEC also noted the following industry "best practices" relating to personal securities transaction procedures and recommended that advisers consider them when crafting their codes:

- 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 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; and
- procedures for assigning new security analyses to employees whose personal holdings do not present apparent conflicts of interest.[20]

Single Employee Advisers

It is worth reiterating that even "one man shops" must adopt codes. However, codes adopted by such advisers may omit certain reporting and pre-clearance requirements, provided that the adviser maintains records of personal trades containing the information that would otherwise be reportable, and that the records are made available to SEC examiners upon request.

Reporting of Violations and Acknowledgment of Receipt of the Code of Ethics

Codes must require prompt reporting of any violations to the adviser's CCO. Alternately, advisers may designate an individual other than the CCO to receive reports but must have procedures requiring that the CCO periodically receive reports of all violations. Codes must also require the adviser to provide each supervised person with a copy of the code and any amendments and require each supervised person to acknowledge receipt of these materials in writing.

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clerical assistant or bookkeeper, as long as the latter employee is not also an access person. These small advisers, while exempt from the reporting requirements, are still subject to the remainder of Rule 204A-1.

18 *Id.*

19 The terms "Initial public offering" and "Limited offering" are specifically defined in the Code of Ethics Rule. *See* 204A-1(e)(6) and (e)(7).

20 *Id.* at 9-11.

Recordkeeping

The Recordkeeping Rule has been amended and simplified to reflect the new Code of Ethics Rule. Rule 204-2(a)(12), as amended, now requires advisers to keep:

- copies of their code;
- records of any code violations and actions taken as a result of the violations; and
- copies of their supervised persons' written acknowledgments of receipt of the code.

Rule 204-2(a)(13), as amended, requires advisers to keep records of:

- access persons' holdings and transaction reports;
- names of all access persons for the past five years; and
- decisions approving access persons' acquisition of IPOs and limited offerings.

The records that advisers must maintain under both amended provisions must be kept for a period of five years in an easily accessible place, and for the first two years, in an office of the adviser.

Although it strongly encourages electronic recordkeeping, the SEC declined to adopt a proposed requirement that records of access persons' holding and transactions reports be maintained in an electronic database. Nonetheless, the SEC "question[ed] seriously whether a larger investment advisory firm will be able adequately to review such reports manually or on paper."

Form ADV

The SEC amended Part II, Item 9 of Form ADV to require advisers to describe their Codes to clients on Schedule F and, upon request, to furnish them with a copy of the Code.[21]

[21] Item 9, Form ADV.

Amendments to Rule 17j-1

Advisers to registered investment companies are subject to Rule 17j-1 under the 1940 Act, which regulates the personal investment activities of the fund's personnel as well as those of its adviser and principal underwriter. The SEC has amended Rule 17j-1 to state that, "to the extent that" a report made under Rule 17j-1 would duplicate information required to be recorded under Advisers Act rules including the Code of Ethics Rule, no report would be required.

In addition, the Commission has made four changes to Rule 17j-1 to bring it into conformity with the Code of Ethics Rule, to the extent possible. Rule 17j-1 includes the following new provisions:

- that the information in initial and annual holdings reports be current as of a date no more than 45 days prior to either an individual's becoming an access person, or to the submission of the report;[22]
- that quarterly transaction reports be due no later than 30 days after the close of the quarter;[23]
- that quarterly transaction reports need not be submitted with respect to transactions effected pursuant to an automatic investment plan;[24] and
- that directors, officers, and general partners of an adviser are presumed to be access persons if the firm's primary business is advisory.[25] Funds should review their Codes to determine whether amendments will be required in order to take advantage of amended Rule 17j-1.

The effective date of the rules and amendments discussed above is August 31, 2004. Advisers must comply with the new rule and amendments by January 7, 2005.

[22] Rule 17j-1(d)(1)(i) and (iii).

[23] Rule 17j-1(d)(1)(ii).

[24] Rule 17j-1(d)(2)(vi).

[25] Rule 17j-1(a)(1)(i). The incorporation of the "access person" presumption into Rule 17j-1 eliminates the revenue-based test formerly used to determine whether an adviser's primary business is advising funds and other advisory clients.

Practice group contacts

If you have questions regarding the information in this client alert, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialservices.

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