



# Federal Register

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**Friday,  
July 9, 2004**

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**Part III**

## **Securities and Exchange Commission**

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**17 CFR Parts 270, 275, and 279  
Investment Adviser Codes of Ethics; Final  
Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 270, 275, and 279

[Release Nos. IA-2256, IC-26492; File No. S7-04-04]

RIN 3235-AJ08

### Investment Adviser Codes of Ethics

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission is adopting a new rule and related rule amendments under the Investment Advisers Act of 1940 that require registered advisers to adopt codes of ethics. The codes of ethics must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel. Among other things, the rule requires advisers' supervised persons to report their personal securities transactions, including transactions in any mutual fund managed by the adviser. The Commission is also adopting amendments to rule 17j-1 to conform certain provisions to the new rule. The rule and rule amendments are designed to promote compliance with fiduciary standards by advisers and their personnel.

**DATES:** *Effective Date:* August 31, 2004. *Compliance Date:* January 7, 2005.

**FOR FURTHER INFORMATION CONTACT:** Robert L. Tuleya, Attorney-Adviser, or Jennifer Sawin, Assistant Director, at (202) 942-0719, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0506.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission ("Commission" or "SEC") is adopting (i) rule 204A-1 [17 CFR 275.204A-1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act" or "Act"); (ii) amendments to rule 204-2 [17 CFR 275.204-2] and Form ADV [17 CFR 279.1] under the Advisers Act; and (iii) amendments to rule 17j-1 [17 CFR 270.17j-1] under the Investment Company Act of 1940 [15 U.S.C. 80a] ("Company Act").<sup>1</sup>

<sup>1</sup> Unless otherwise noted, when we refer to rule 17j-1 or any paragraph of the rule, we are referring to 17 CFR 270.17j-1 of the Code of Federal Regulations in which the rule is published, and when we refer to rule 204-2 or any paragraph of the rule, we are referring to 17 CFR 275.204-2 of the Code of Federal Regulations in which the rule is published.

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### Executive Summary

The Commission is adopting new rule 204A-1 under the Advisers Act to require registered investment advisers to adopt codes of ethics. The rule requires an adviser's code of ethics to set forth standards of conduct and require compliance with Federal securities laws. Codes of ethics must also address personal trading; they must require advisers' personnel to report their personal securities holdings and transactions, including those in affiliated mutual funds, and must require personnel to obtain pre-approval of certain investments. The Commission is amending the Advisers Act recordkeeping rule to require advisers to keep copies of their codes of ethics and records relating to the code. The Commission is also amending the client disclosure requirements under part II of Form ADV to require advisers to describe their codes of ethics to clients.

### I. Background

In January of this year, we proposed to require every adviser registered with us to adopt and enforce a written code of ethics applicable to its supervised persons.<sup>2</sup> Our proposal was designed to prevent fraud by reinforcing fiduciary principles that must govern the conduct of advisory firms and their personnel.

<sup>2</sup> *Investment Adviser Codes of Ethics*, Investment Advisers Act Release No. 2209 (Jan. 20, 2004) [69 FR 4040 (Jan. 27, 2004)].

The proposal was part of a package of regulatory initiatives with which we have responded to a number of recent enforcement actions against advisers or their personnel alleging violations of their fiduciary obligations to clients, including mutual fund clients.<sup>3</sup>

Advisers' codes would be required to contain provisions reminding employees of their obligations to clients as well as provisions requiring reporting of personal securities transactions and holdings. In order to ensure that advisers' employees are made aware of their firms' standards, advisers would have to obtain (and keep) a written acknowledgement from each supervised person confirming that he or she received a copy of the code of ethics and any amendments. While the code of

<sup>3</sup> See, e.g., *In the Matter of Strong Capital Management, Inc.*, Investment Advisers Act Release No. 2239 (May 20, 2004) ("Strong") (adviser disclosed material nonpublic information about fund portfolio holdings to hedge fund, and permitted own chairman and hedge fund to engage in undisclosed market timing of funds managed by adviser); *In the Matter of Massachusetts Financial Services Co.*, Investment Advisers Act Release No. 2213 (Feb. 5, 2004) (2 senior executives of adviser permitted undisclosed market timing in certain funds in the complex managed by the adviser); *In the Matter of Alliance Capital Management, L.P.*, Investment Advisers Act Release No. 2205 (Dec. 18, 2003) ("*Alliance*") (disclosure of material nonpublic information about certain mutual fund portfolio holdings permitted favored client to profit from market timing); *In the Matter of Robert T. Littell and Wilfred Meckel*, Investment Advisers Act Release No. 2203 (Dec. 15, 2003) (portfolio manager of hedge fund made misrepresentations to investors and potential investors concerning performance, management oversight, and risk management practices); *In the Matter of Zion Capital Management LLC and Ricky A. Lang*, Investment Advisers Act Release No. 2200 (Dec. 11, 2003) ("*Zion*") (adviser favored an advisory account in which he had an interest, allocating profitable trades to this account while allocating numerous unprofitable trades to another client); *In the Matter of George F. Fahey*, Investment Advisers Act Release No. 2196 (Nov. 24, 2003) (president of investment adviser made misrepresentations to clients as to risk of investment strategy and value of investments); *In the Matter of Putnam Investment Management LLC*, Investment Advisers Act Release No. 2192 (Nov. 13, 2003) ("*Putnam*") (adviser failed to reasonably supervise employees who market timed funds managed by the adviser and failed to disclose their timing activities); *In the Matter of Wendell D. Belden*, Investment Advisers Act Release No. 2191 (Nov. 6, 2003) (associate of adviser defrauded clients by misleading them about their investment options and the security of their invested principal and by investing their money in a manner calculated to enrich himself at their expense); *In the Matter of James Patrick Connelly, Jr.*, Investment Advisers Act Release No. 2183 (Oct. 16, 2003) (adviser's vice chairman permitted more than a dozen clients to market time certain funds in the complex managed by the adviser in exchange for stable investments in other funds in the complex); *In the Matter of Marshall E. Melton and Asset Management & Research, Inc.*, Investment Advisers Act Release No. 2151 (Jul. 25, 2003) (investment adviser made material misrepresentations to its clients to induce them to invest their funds in limited liability companies controlled by adviser's principal).

ethics would have to contain certain minimum provisions, our proposal left advisers with substantial flexibility to design individualized codes that would best fit the structure, size and nature of their advisory businesses.

We received 44 comment letters in response to our proposal. Most commenters supported requiring advisers to have written codes of ethics, and supported the flexibility that our proposal offered. Today, we are adopting new rule 204A-1 with certain changes that respond to commenters' recommendations.

## II. Discussion

### A. Standards of Conduct and Compliance With Laws

Rule 204A-1 requires each adviser's code of ethics to set forth a standard of business conduct that the adviser requires of all its supervised persons.<sup>4</sup> The rule does not require the adviser to adopt a particular standard, but the standard chosen must reflect the adviser's fiduciary obligations and those of its supervised persons, and must require compliance with the federal securities laws.<sup>5</sup>

This provision, which we are adopting as proposed, establishes only a minimum requirement. Advisers are free to set higher standards for their employees, such as those established by professional or trade groups.<sup>6</sup> Of course, any other code adopted for use must meet the minimum requirements of the rule, or be supplemented to meet the minimum requirements.<sup>7</sup>

We urge advisers to take great care and thought in preparing their codes of ethics, which should be more than a compliance manual. Rather, a code of ethics should set out ideals for ethical conduct premised on fundamental principals of openness, integrity, honesty and trust. A good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct, and should challenge employees to live up not only to the

letter of the law, but also to the ideals of the organization.<sup>8</sup>

### B. Protection of Material Nonpublic Information

We proposed to require codes of ethics to prevent access to material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions by individuals who do not need the information to perform their duties.<sup>9</sup> Commenters supported our objective of controlling access to information as a first line of defense against misuse, but noted that it may be impractical to segregate employees, particularly in smaller firms that have limited office space. We are not requiring this provision in the code of ethics, but remind advisers that they must maintain and enforce policies and procedures to prevent the misuse of material nonpublic information,<sup>10</sup> which we believe includes misuse of material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions.<sup>11</sup> Advisers' duty of care also requires that they safeguard this sensitive information.<sup>12</sup> Advisers should carefully consider how

<sup>8</sup> See joint comment letter from the Ethics Resource Center and Thelen Reid & Priest LLP (Apr. 6, 2004) (available from the Commission's public reference room in File No. S7-04-04).

<sup>9</sup> Proposed rule 204A-1(a)(3).

<sup>10</sup> Section 204A [15 U.S.C. 80b-4a]. Advisers' required procedures under section 204A usually also contain a summary of insider trading law and procedures for determining whether information has become public. These may be distinct from the adviser's section 204A procedures to guard against misuse of material nonpublic information about client recommendations, trading, and holdings. Many advisers may choose to integrate their section 204A procedures into their codes, but they are not required to do so.

<sup>11</sup> See, e.g., *Strong*, *supra* note (adviser that released nonpublic information about fund portfolio holdings to select market timers violated section 204A); *Alliance*, *supra* note (adviser that released, to select market timers, material nonpublic information concerning portfolio holdings of fund managed by the adviser violated section 204A); *Putnam*, *supra* note (adviser whose portfolio manager traded on nonpublic information regarding portfolio holdings and transactions of fund managed by the adviser violated section 204A).

<sup>12</sup> As we noted in our proposing release, the obligation to safeguard sensitive client information would not preclude the adviser from providing necessary information to, for example, persons providing services to the adviser or the account such as brokers, accountants, custodians, and fund transfer agents, or in other circumstances when the client consents. In addition, if the adviser has supervised persons who are also associated persons of a broker-dealer, self-regulatory organization rules may require the broker-dealer to have certain information about the adviser's client accounts. Two commenters noted that, under certain circumstances, NASD rule 3040 requires the broker-dealer to supervise its registered representatives' activities for advisory accounts.

to control dissemination of sensitive information both within their organizations and outside them.

### C. Personal Securities Trading

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 or other designated persons.<sup>13</sup> The code of ethics must also require the adviser to review those reports.<sup>14</sup> Reviewing these reports will allow advisers as well as the Commission's examination staff to identify improper trades or patterns of trading by access persons. The reports are modeled largely on those required by rule 17j-1 under the Company Act.<sup>15</sup>

#### 1. Personal Trading Procedures

As discussed in more detail below, while rule 204A-1 requires advisers' codes of ethics to contain provisions requiring access persons to report securities transactions and holdings, it does not require advisers to adopt many of the detailed prophylactic measures common to many codes.<sup>16</sup> Commenters agreed with this approach, which we took to accommodate the vast differences among advisory firms registered with us and the variety of risks associated with employee securities transactions. Advisory firms that have already adopted codes of ethics, however, commonly include many of the following elements, or address the following issues, which we believe that all advisers should consider in crafting their own procedures for

<sup>13</sup> Rule 204A-1(a)(3). We are not suggesting that the chief compliance officer must personally review all reports. In addition, we expect most advisers will designate another individual to review personal securities reports submitted by the chief compliance officer.

<sup>14</sup> Rule 204A-1(a)(3).

<sup>15</sup> Rule 17j-1 requires that fund advisers adopt written codes of ethics and have procedures in place to prevent their personnel from abusing their access to information about the fund's securities trading, and requires "access persons" to submit reports periodically containing information about their personal securities holdings and transactions. Rule 17j-1(c)(1) and (d) under the Investment Company Act. Most funds, and therefore most fund advisers, must have codes of ethics under rule 17j-1. Money market funds and funds that invest only in certain non-covered securities, however, are not required to adopt codes of ethics under rule 17j-1. Rule 17j-1(c)(1)(i). As of May 1, 2004, approximately 1500 advisers, or 18 percent of the firms registered with us, reported that they manage fund portfolios.

<sup>16</sup> For example, pre-clearance of personal securities transactions, *see infra* note and accompanying text, is mandated to some degree in most advisory firms that have adopted a code of ethics.

<sup>4</sup> Rule 204A-1(a)(1).

<sup>5</sup> Rule 204A-1(a)(1) and (2).

<sup>6</sup> Many professional and trade organizations, such as the Financial Planning Association, the Association for Investment Management and Research, the Certified Financial Planner Board of Standards, the Investment Counsel Association of America, and the American Institute of Certified Public Accountants, have developed professional codes of ethics or model codes for their members' use.

<sup>7</sup> While advisers are also free to structure their codes as best fits their organizations, an adviser using multi-document codes should ensure that all parts are integrated and understandable, so it is clear to supervised persons that these documents constitute the firm's code of ethics.

employees' personal securities trading.<sup>17</sup>

- Prior written approval before access persons can place a personal securities transaction ("pre-clearance").<sup>18</sup>

- 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.<sup>19</sup>

<sup>17</sup> In addition to personal securities transaction procedures, the following is a list of other provisions that many advisers include in codes of ethics, and that advisers should consider when deciding what to include in their own codes: 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; and 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>18</sup> In some organizations, all personnel must pre-clear all trades with the firm's compliance personnel. In other firms, only access persons must pre-clear, or only certain types of transactions must be pre-cleared. Some advisers have begun using compliance software to pre-clear personal trades on an automated basis, rather than have compliance personnel process the requests. Pre-clearance procedures may also identify who has authority to approve a trade request, the length of time an approval is valid, and procedures for revoking an approval, as well as procedures for verifying post-trade reports or duplicate confirmations against the log of pre-clearance approvals.

<sup>19</sup> Advisers may use blackout periods to guard against employees trading ahead of clients or on the same day as clients' trades are placed. See *In the Matter of Roger Honour*, Investment Advisers Act Release No. 1527 (Sept. 29, 1995). Prohibiting personal trading at the same time as client trading can also serve as a measure to prevent employees from allocating trades in a manner that defrauds clients. See, e.g., *In the Matter of Nicholas-Applegate Capital Management*, Investment Advisers Act Release No. 1741 (Aug. 12, 1998) (adviser's senior trader placed personal trades alongside trades for employee plan, allocating profitable trades to his personal account and unprofitable ones to the employee plan's account); *SEC v. Moran*, 922 F.Supp. 867 (S.D.N.Y. 1996) (advisory principal allocated shares to his family and personal accounts even though additional shares would need to be purchased for client accounts on the following day at higher prices). The Commission has previously indicated its approval of blackout periods for advisory personnel. See Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth (1966) ("PPI Report") at 196 (noting with approval that the staff's 1962-63 Special Study of the Securities Markets had concluded that all funds and advisers should have policies precluding certain insiders from buying and selling securities at the same time as a fund they manage).

- 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.<sup>20</sup>

- Prohibitions or restrictions on "short-swing" trading and market timing.<sup>21</sup>

- 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>22</sup>

## 2. "Access Persons" Subject to the Reporting Requirements

Under rule 204A-1, the adviser's code must require certain supervised persons, called "access persons," to report their personal securities transactions and holdings.<sup>23</sup> An access person is a supervised person who has access to nonpublic information regarding clients' purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are nonpublic.<sup>24</sup> A supervised person who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds is also an access person.<sup>25</sup>

We are adopting the definition of "access person" as proposed. Some

<sup>20</sup> In several of our enforcement cases involving personal trading, advisory personnel took investment opportunities for themselves (or for an account in which they had an interest) instead of for clients, even where the investment became available only because of the client's other securities purchases. See *In the Matter of Joan Conan*, Investment Advisers Act Release No. 1446 (Sept. 30, 1994); *In the Matter of Kemper Financial Services, Inc.*, Investment Advisers Act Release No. 1494 (June 6, 1995).

<sup>21</sup> Advisers that prohibit short-term trading generally mandate disgorgement of any profits if an employee effects a short-term trade.

<sup>22</sup> Initial and annual holdings reports will facilitate an adviser's assessment of whether an individual's personal securities holdings present a conflict of interest.

<sup>23</sup> Rule 204A-1(a)(3). Section 202(a)(25) of the Advisers Act [15 U.S.C. 80b-2(a)(25)] defines "supervised person." An adviser's supervised persons are its partners, officers, directors (or other persons occupying a similar status or performing similar functions) and employees, as well as any other persons who provide advice on behalf of the adviser and are subject to the adviser's supervision and control.

<sup>24</sup> Rule 204A-1(e)(1).

<sup>25</sup> *Id.* A supervised person would not be an access person solely because he has nonpublic information regarding the portfolio holdings of a client that is not an investment company. The individual is unlikely to be able to exploit that information in any way that would benefit himself.

commenters suggested that we adopt a narrower definition covering only those employees who actually obtained nonpublic information, the approach rule 17j-1 takes for mutual fund advisers.<sup>26</sup> Others suggested that all advisory employees be covered.<sup>27</sup> Our approach takes the middle course. It treats as access persons employees who are in a position to exploit information about client securities transactions or holdings, and thus provides the adviser with a tool to protect its clients.

Access persons will include portfolio management personnel and, in some organizations, client service representatives who communicate investment advice to clients. These employees have information about investment recommendations whose effect may not yet be felt in the marketplace; as such, they may be in a position to take advantage of their inside knowledge. Administrative, technical, and clerical personnel may also be access persons if their functions or duties give them access to nonpublic information. Organizations in which employees have broad responsibilities, and where information barriers are few, may see a larger percentage of their staff subject to the reporting requirements. In contrast, organizations that keep strict controls on sensitive information may have fewer access persons.<sup>28</sup>

In many advisory firms, directors, officers and partners will also be access persons. Rule 204A-1, as proposed, contains a presumption that, if the firm's primary business is providing investment advice, then all of its directors, officers and partners are access persons.<sup>29</sup> Commenters supported this approach rather than rule 17j-1's special rules and revenue-based test for advisory firms "primarily engaged" in a business other than advising funds or advisory clients.<sup>30</sup>

<sup>26</sup> Rule 17j-1 includes individuals as access persons only if they make, participate in, or obtain information regarding, the purchase and sale of the fund's securities, or if their functions relate to the making of any recommendations for such transactions. Rule 17j-1(a)(1)(i), 17j-1(a)(2)(i).

<sup>27</sup> While the definition of "access person" under rule 204A-1 will not require all employees to submit personal securities transaction reports, some firms may elect to require reporting from all personnel. This approach, while not required, offers certainty as to whether reports are required from a given individual.

<sup>28</sup> As proposed, persons who are not "supervised persons" of the adviser would not be access persons. This represents a change from the current adviser recordkeeping rule, rule 204-2(a)(12). Commenters supported the change.

<sup>29</sup> Rule 204A-1(e)(1)(ii).

<sup>30</sup> Rule 17j-1(a)(1)(i)(A) and (B). See also current rule 204-2(a)(13)(iii)(D). Today we are also adopting parallel changes to 17j-1 to remove this revenue-based test. See *infra* Section II.J of this Release.

### 3. Initial and Annual Holdings Reports

The code of ethics must require a complete report of each access person's securities holdings, at the time the person becomes an access person and at least once a year thereafter.<sup>31</sup>

Commenters supported these reporting requirements, which are similar to those required by rule 17j-1.<sup>32</sup> The 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). We had proposed to require initial holdings reports to be current as of the date the individual becomes an access person, and annual reports to be current within 30 days prior to submission, but many commenters told us these requirements were not flexible enough to allow access persons to use brokerage statements as the basis of their reports.<sup>33</sup>

### 4. Quarterly Transaction Reports

The code of ethics must require quarterly reports of all personal securities transactions by access persons, which are due no later than 30 days after the close of the calendar quarter.<sup>34</sup> The code of ethics may excuse access persons from submitting transaction reports that would duplicate information contained in trade confirmations or account statements that the adviser holds in its records,

provided the adviser has received those confirmations or statements not later than 30 days after the close of the calendar quarter in which the transaction takes place.<sup>35</sup>

We have not adopted a requirement we proposed that would have required access persons that had no personal securities transactions during the quarter to submit a report confirming the absence of transactions. Commenters argued that reports confirming absence of transactions were unnecessary and burdensome, particularly when the adviser was relying on transaction records received from the access person's broker-dealer during the course of the quarter.

### 5. Exceptions From Reporting Requirements

Rule 204A-1 permits three exceptions to personal securities reporting. No reports are required:

- With respect to transactions effected pursuant to an automatic investment plan.<sup>36</sup>
- With respect to securities held in accounts over which the access person had no direct or indirect influence or control.<sup>37</sup>
- In the case of an advisory firm that has only one access person, so long as the firm maintains records of the holdings and transactions that rule 204A-1 would otherwise require be reported.<sup>38</sup>

### 6. Reportable Securities

Access persons must submit holdings and transaction reports for "reportable securities" in which the access person has, or acquires, any direct or indirect beneficial ownership.<sup>39</sup> An access

person is presumed to be a beneficial owner of securities that are held by his or her immediate family members sharing the access person's household.<sup>40</sup>

Rule 204A-1 treats all securities<sup>41</sup> as reportable securities, with five exceptions designed to exclude securities that appear to present little opportunity for the type of improper trading that the access person reports are designed to uncover:<sup>42</sup>

- Transactions and holdings in direct obligations of the Government of the United States.<sup>43</sup>
- Money market instruments—bankers' acceptances, bank certificates of deposit, commercial paper, repurchase agreements and other high quality short-term debt instruments.<sup>44</sup>
- Shares of money market funds.<sup>45</sup>
- 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.<sup>46</sup>
- Transactions in units of a unit investment trust if the unit investment trust is invested exclusively in unaffiliated mutual funds.<sup>47</sup>

interpreted in the same manner as for purposes of rule 16a-1(a)(2) under the Securities Exchange Act of 1934 in determining whether a person has beneficial ownership of a security for purposes of section 16 of that Act. Rule 204A-1(e)(3). This is the same as the standard under rule 17j-1. Rule 17j-1 1999 Adopting Release, *supra* note. It is also the standard used under our current adviser recordkeeping rule. See rule 204-2(a)(12)(iii)(B). Rule 204A-1, again like rule 17j-1, provides that any required report may contain a disclaimer of beneficial ownership by the person making the report.

<sup>40</sup> Rule 16a-1(a)(2)(ii)(A) [17 CFR 240.16a-1(a)(2)(ii)(A)].

<sup>41</sup> The term "security" is defined in section 2(a)(18) of the Act. [15 U.S. 80b-2(a)(18)].

<sup>42</sup> Rule 204A-1(e)(10). No investment adviser is required to take advantage of these exceptions; an adviser is free to require its access persons to report their holdings and transactions in all securities, notwithstanding these exceptions.

<sup>43</sup> Rule 204A-1(e)(10)(i).

<sup>44</sup> Rule 204A-1(e)(10)(ii). We have interpreted "high quality short-term debt instrument" to mean any instrument having a maturity at issuance of less than 366 days and which is rated in one of the highest two rating categories by a Nationally Recognized Statistical Rating Organization, or which is unrated but is of comparable quality. *Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and Their Investment Advisers and Principal Underwriters*, Investment Company Act Release No. 21341 (Sept. 8, 1995) [60 FR 47844 (Sept. 14, 1995)] (proposing amendments to rule 17j-1) at n. 66.

<sup>45</sup> Rule 204A-1(e)(10)(iii).

<sup>46</sup> Rule 204A-1(e)(9) and (10)(iv). Transactions and holdings in shares of closed-end investment companies would be reportable regardless of affiliation. The exception extends only to open-end funds registered in the U.S.; therefore, transactions and holdings in offshore funds would also be reportable.

<sup>47</sup> Rule 204A-1(e)(10)(v). This exception is aimed at variable insurance contracts that are funded by

Continued

<sup>31</sup> Rule 204A-1(b)(1).

<sup>32</sup> Rule 17j-1(d)(1)(i) and (iii). As under rule 17j-1, an access person can satisfy the initial or annual holdings report requirement by timely filing and dating a copy of a securities account statement listing all their securities holdings, if the statement provides all information required by the rule and the code of ethics. Similarly, if a supervised person has previously provided such statement to the adviser, or has previously been reporting or supplying brokerage confirms for all securities transactions and the adviser has maintained them as a composite record containing all the requisite information, the access person can satisfy the initial or annual holdings report requirement by timely confirming the accuracy of the statement or composite in writing. See *Personal Investment Activities of Investment Company Personnel*, Investment Company Act Release No. 23958 (Aug. 20, 1999) [64 FR 46821 (Aug. 27, 1999)] ("Rule 17j-1 1999 Adopting Release"), at n. 34. The rule would not, however, permit an access person to avoid filing an initial or annual holdings report simply because all information has been provided over a period of time in various transaction reports. One reason for requiring a holdings report is so that the adviser's compliance personnel and our examiners have ready access to a "snapshot" of the access person's holdings and are not required to piece the information together from transaction reports.

<sup>33</sup> We modeled our proposal on requirements in rule 17j-1. We are today adopting amendments to these requirements in rule 17j-1 to conform them to rule 204A-1. See *infra* Section II.J of this Release.

<sup>34</sup> Rule 204A-1(b)(2). In response to comments, we extended the deadline from the 10-day deadline we had proposed, and we have made similar changes to rule 17j-1. See *infra* Section II.J of this Release.

<sup>35</sup> The rule does not require all of the information required in a transaction report to appear in the duplicate trade confirmation or account statement. That is, some of the required information could appear in the confirmation or statement, and the remainder could be submitted by access persons in their reports.

<sup>36</sup> Rule 204A-1(b)(3)(ii). However, any transaction that overrides the pre-set schedule or allocations of the automatic investment plan must be included in a quarterly transaction report. We are also adopting a parallel exception under rule 17j-1. See *infra* Section II.J of this Release.

<sup>37</sup> Rule 204A-1(b)(3)(i).

<sup>38</sup> Rule 204A-1(d). We had proposed this exception for firms that have only one supervised person, because that individual would otherwise be required to make reports to himself; commenters suggested that we should extend to firms with one access person, because these are still essentially one-man shops. We agree that a sole proprietor who has a clerical assistant or bookkeeper for his business should still be able to use this exception so long as that employee is not also an access person. These small advisers would still be subject to the other provisions of the rule, including the requirements to adopt a code of ethics and safeguard material nonpublic information.

<sup>39</sup> Rule 204A-1(b)(1)(i)(A) and (b)(2)(i). Rule 204A-1 provides that beneficial ownership is to be

The rule thus requires access persons to report shares of mutual funds advised by the access person's employer or an affiliate, and is designed to help advisers (and our examiners) identify abusive trading by personnel with access to information about a mutual fund's portfolio.<sup>48</sup>

#### D. 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>49</sup> Most individuals rarely have the opportunity to invest in these types of securities; an access person's IPO or private placement purchase therefore raises questions as to whether the employee is misappropriating an investment opportunity that should first be offered to eligible clients, or whether a portfolio manager is receiving a personal benefit for directing client business or brokerage.<sup>50</sup> Advisory firms with only one access person would not be required to have that access person pre-clear these investments.<sup>51</sup> We are adopting this provision as proposed.<sup>52</sup>

#### E. Reporting Violations

Under rule 204A-1, each adviser's code of ethics must require prompt internal reporting of any violations of

insurance company separate accounts organized as unit investment trusts. Such separate accounts typically are divided into subaccounts, each of which invests exclusively in shares of an underlying open-end fund. Commenters suggested that these investments be excepted to the same extent as the underlying open-end funds.

<sup>48</sup> Portfolio managers' short-term trading in fund shares has been an issue in our recent enforcement actions. See, e.g., *Putnam*, *supra* note 3.

<sup>49</sup> Rule 204A-1(c).

<sup>50</sup> See, e.g., *In the Matter of Monetta Financial Services, Inc., Robert S. Bacarella, and Richard D. Russo*, Investment Advisers Act Release No. 2136 (Jun. 9, 2003) (investment adviser to mutual funds improperly allocated IPO shares in which funds could have invested to certain access persons of the funds without adequate disclosure or approval); *In the Matter of Ronald V. Speaker and Janus Capital Corporation*, Investment Company Act Release No. 22461 (Jan. 13, 1997) (portfolio manager made a profit on same day purchase and sale of debentures in which fund could have invested, and failed to disclose transactions to the fund or obtain prior consent of the fund); *U.S. v. Ostrander*, 999 F.2d 27 (2d Cir. 1993) (affirming conviction of portfolio manager for accepting unlawful compensation where she purchased privately offered warrants of a company whose securities she acquired for the fund).

<sup>51</sup> Rule 204A-1(d). Firms with only one access person are generally one-person operations. It would make little sense to require the individual to pre-clear investments with himself. See *supra* note 38.

<sup>52</sup> Advisers that elect to prohibit their access persons from investing in IPOs and private placements would not have to include this pre-clearance provision.

the code.<sup>53</sup> Violations must be reported to the adviser's chief compliance officer. An investment adviser can choose to have supervised persons report violations to either the chief compliance officer or to other persons designated in the code of ethics. But an advisory firm that designates someone other than the chief compliance officer to receive reports of code violations from supervised persons must have procedures requiring that the chief compliance officer also receives reports periodically of all violations. We caution advisers, however, that it is incumbent on them to create an environment that encourages and protects supervised persons who report violations. Advisers should consider how they can best prevent retaliation against someone who reports a violation; many advisers may choose to permit anonymous reporting, others may decide that retaliation constitutes a further violation of the code, and still others may find other methods to ensure that concerned employees feel safe to speak freely.

We are not, as some commenters suggested, adopting a system of fines or other penalties for violations of a code of ethics, nor are we requiring codes of ethics to include a discussion of penalties. We note, however, that many advisers do so, so that employees have a meaningful understanding of the importance of the code and of the consequences of violating it.<sup>54</sup>

#### F. Educating Employees About the Code of Ethics

Under rule 204A-1, an adviser's code of ethics must require the adviser to provide each supervised person with a copy of the code of ethics and any amendments.<sup>55</sup> The code must also require each supervised person to acknowledge, in writing, his receipt of those copies.<sup>56</sup> While some commenters opposed this requirement, most who addressed it were supportive. Some commenters went further, and recommended we mandate that advisers educate employees as to the code of ethics. An investment adviser's

<sup>53</sup> Rule 204A-1(a)(4). We adopted a similar provision under section 406 of the Sarbanes-Oxley Act. See Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177 (Jan 23, 2003) [68 FR 5109 (Jan. 31, 2003)].

<sup>54</sup> Our understanding is that penalties for violations vary from one firm to another, and depend on the type of violation involved. Employees may be required to cancel trades, disgorge profits or sell positions at a loss, and may face internal reprimands, fines, or firing.

<sup>55</sup> Rule 204A-1(a)(5).

<sup>56</sup> *Id.* These written acknowledgements may be made electronically.

procedures for informing its employees about its code of ethics are critical to obtaining good compliance and avoiding inadvertent violations of the code. Although we do not believe it is necessary to require employee education as an element of codes of ethics, we expect most advisory firms will ensure that their employees have received adequate training on the principles and procedures of their codes. Many firms that have already implemented codes of ethics hold periodic orientation or training sessions with new and existing employees to remind them of their obligations under the code; others may require employees to certify that they have read and understood the code of ethics, and require annual recertification that the employee has re-read, understands and has complied with the code. We are not mandating any of these procedures, but they are among best practices for advisers.

#### G. Adviser Review and Enforcement

Rule 204A-1 requires that advisers maintain and enforce their codes of ethics.<sup>57</sup> We expect that the adviser's chief compliance officer, or persons under his authority, will have primary responsibility for enforcing the adviser's code of ethics.<sup>58</sup> Enforcement of the code must include reviewing access persons' personal securities reports.<sup>59</sup> As discussed below, we are not adopting the proposed requirement that records of these reports be maintained in an accessible electronic database. However, we question seriously whether a larger investment advisory firm will be able adequately to review such reports manually or on paper. Review of personal securities holding and transaction reports should include not only an assessment of whether the access person followed any required internal procedures, such as pre-clearance, but should also compare the personal trading to any restricted lists; assess whether the access person is trading for his own account in the same securities he is trading for clients, and

<sup>57</sup> Rule 204A-1(a). Some firms may, in their code, reserve the right to waive compliance with certain of the code's provisions. Of course, if a code provision is required by new rule 204A-1 (or by rule 17j-1), the advisory firm cannot waive a supervised person's compliance with that provision.

<sup>58</sup> Advisers to investment companies must provide the investment company's board of directors with an annual report describing any issues arising under the code of ethics. See rule 17j-1(c)(2)(ii). Such annual report must include a discussion of any material violations of the code and whether any waivers that might be considered important by the board were granted during the period.

<sup>59</sup> Rule 204A-1(a)(3).

if so whether the clients are receiving terms as favorable as the access person takes for himself; periodically analyze the access person's trading for patterns that may indicate abuse, including market timing; investigate any substantial disparities between the quality of performance the access person achieves for his own account and that he achieves for clients; and investigate any substantial disparities between the percentage of trades that are profitable when the access person trades for his own account and the percentage that are profitable when he places trades for clients.

#### H. Recordkeeping

We are amending rule 204-2 under the Advisers Act to reflect new rule 204A-1. Because the codes of ethics will already cover personal securities transaction and holdings reports, we have been able to simplify rules 204-2(a)(12) and (13) significantly.<sup>60</sup> As amended, rule 204-2(a)(12) requires advisers to keep copies of their code of ethics, records of violations of the code and actions taken as a result of the violations, and copies of their supervised persons' written acknowledgement of receipt of the code. As discussed earlier, rule 204A-1 requires prompt internal reporting of violations of the code of ethics,<sup>61</sup> but we are not requiring advisers to keep records of these whistleblower reports.<sup>62</sup> Commenters have persuaded us that requiring these records could have a chilling effect on employees' willingness to report violations, particularly in smaller organizations. Rule 204-2(a)(13), as amended, covers records of access persons' personal trading. It requires advisers to keep 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' acquisition of securities in IPOs and limited offerings.

We proposed, but are not requiring, records of access persons' personal securities reports (and duplicate brokerage confirmations or account statements in lieu of those reports) to be maintained electronically in an accessible computer database. Commenters were concerned that the

<sup>60</sup> Currently, these sections lay out fairly complex requirements for the information that an adviser must keep regarding personal securities transactions of "advisory representatives," which include the adviser's personnel, directors, officers and partners.

<sup>61</sup> See *supra* note 53.

<sup>62</sup> An adviser could, for example, record the facts and circumstances surrounding a violation of the code, but omit mention of the employee who brought the problem to the adviser's attention.

requirement would be unduly burdensome and would require them to input large quantities of data manually. Although we are not adopting this requirement, as discussed above, we have strong expectations that most advisers will need to maintain these records electronically in order to meet their responsibilities to review these records and monitor compliance with their codes.

The standard retention period required for books and records under rule 204-2 is five years, in an easily accessible place, the first two years in an appropriate office of the investment adviser.<sup>63</sup> Advisers must maintain the records required under amended rule 204-2(a)(12) and (13) for this standard period, subject to special holding requirements for certain categories of records as specified in amended rule 204-2(a)(12) and (13). Codes of ethics must be kept for five years after the last date they were in effect. Supervised person acknowledgements of the code must be kept for five years after the individual ceases to be a supervised person.<sup>64</sup> Similarly, the list of access persons must include every person who was an access person at any time within the past five years, even if some of them are no longer access persons of the adviser.<sup>65</sup>

#### I. Amendment to Form ADV

We are amending part II of Form ADV, as proposed, to require advisers to describe their codes of ethics to clients and, upon request, to furnish clients with a copy of the code of ethics.<sup>66</sup> This disclosure will serve two functions: first, it will help clients understand the adviser's ethical culture and standards, how the adviser controls sensitive information and what steps it has taken to prevent employees from misusing their inside positions at clients' expense. Clients will be able to select

<sup>63</sup> Rule 204-2(e) (retention period of five years from the end of the fiscal year during which the last entry was made on such record).

<sup>64</sup> One commenter suggested that the acknowledgement be kept only for five years after it was made. We are not adopting this suggestion, because it could mean that an adviser would have no records of acknowledgement from long-term employees.

<sup>65</sup> In addition, records supporting decisions to approve access persons' acquisitions of IPOs or private placements must be retained for at least five years after the end of the fiscal year in which the approval is granted.

<sup>66</sup> We are amending Item 9 of Form ADV Part II, which asks whether the adviser or a "related person" (that is, a person that controls the adviser, is controlled by the adviser, or is under common control with the adviser) participates or has an interest in client transactions. In April 2000, we proposed a new version of part 2 that called for a narrative disclosure brochure, and which moved this disclosure topic to Item 10.

advisers whose ethical commitment meets their expectations. Second, disclosure will act as sunlight, encouraging advisers to implement more effective procedures by exposing them to view, and encouraging advisers to adhere strictly to the procedures they disclose.<sup>67</sup>

#### J. Amendments to Rule 17j-1

As proposed, we are revising a provision of rule 17j-1 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.<sup>68</sup> Currently, the rule contains an exception only if "all of" the information in the report would duplicate information required to be recorded under Advisers Act rules. The reports we are requiring under the Advisers Act are not identical to those required under rule 17j-1, and this amendment avoids unnecessary duplication.

In the proposing release, we also requested comment whether, to the extent rule 204A-1 as adopted differed from rule 17j-1, we should make conforming changes to rule 17j-1. With limited exception, commenters addressing this issue expressed a desire to keep the rules as parallel as possible and suggested that rule 17j-1 be modified in some respects. We are persuaded that four changes should be made to rule 17j-1. First, rule 17j-1 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 holdings report), or submitting the report (annual holdings report).<sup>69</sup> Second, quarterly transaction reports will be due no later than 30 days after the close of the quarter, rather than 10 days as currently provided.<sup>70</sup> Third, quarterly transaction reports need not be submitted with respect to transactions effected pursuant to an automatic investment plan.<sup>71</sup>

Fourth, we are revising the definition of "access person."<sup>72</sup> Under the amended rule, an access person includes an advisory person of a fund or its investment adviser. We are eliminating the revenue-based test for determining whether an investment

<sup>67</sup> An investment adviser that disclosed its policies and procedures but then materially deviated from them may be subject to action under section 206 of the Advisers Act.

<sup>68</sup> Rule 17j-1(d)(2)(iv).

<sup>69</sup> Rule 17j-1(d)(1)(i) and (iii).

<sup>70</sup> Rule 17j-1(d)(1)(ii).

<sup>71</sup> Rule 17j-1(d)(2)(vi).

<sup>72</sup> Rule 17j-1(a)(1)(i).



adviser's primary business is advising funds and other advisory clients. Advisers with other primary businesses used this test to exclude certain of their officers, directors and general partners from being considered access persons under the rule. We are replacing the revenue-based test with the same legal presumption we are adopting in new rule 204A-1—that directors, officers and general partners are presumed to be access persons if the firm's primary business is investment advisory.<sup>73</sup>

### III. Effective Date

The effective date of the new rule and amendments is August 31, 2004. Advisers must comply with the new rule and rule amendments by January 7, 2005. By this compliance date, each adviser must have adopted its code of ethics and be prepared to maintain and enforce it. In addition to fundamentals such as articulating its chosen standards of conduct, each adviser's preparation will necessarily include identifying its access persons, providing a copy of the code of ethics to each supervised person and receiving their acknowledgement. Also by January 7, 2005, each adviser must have an initial holdings report from each access person, and must arrange for the submission of quarterly transaction reports. Access persons' personal securities transaction reports for the calendar quarter ended March 31, 2005 will be due no later than April 30, 2005. Until advisers begin to comply with new rule 204A-1, the amendments to rule 204-2, and the amendments to Form ADV Part II, they must continue to comply with the personal securities transaction recordkeeping requirements of our current rule 204-2(a)(12) and (13).

### IV. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits resulting from our rules. The new rule we adopt today requires investment advisers to establish, maintain, and enforce codes of ethics for their supervised persons. These codes of ethics must establish standards of business conduct reflecting the fiduciary obligations of the adviser and its personnel and impose personal securities reporting measures designed to prevent access persons from abusing information about clients' securities transactions. We are also adopting related recordkeeping and client disclosure amendments under the

<sup>73</sup> In addition, the directors, officers and general partners of a fund are presumed to be access persons of the fund.

Advisers Act and conforming amendments under the Company Act.<sup>74</sup>

In our Proposing Release, we carefully analyzed the costs and benefits of our proposed rule and amendments and requested comment regarding the costs and benefits. Most commenters supported requiring advisers to have written codes of ethics, although several commenters expressed reservations at the potential costs of the proposed electronic recordkeeping requirement for personal securities transactions. Only one commenter specifically addressed our cost-benefit analysis.

We are adopting the rule and amendments substantially as proposed, with some revisions in response to comments, including elimination of the proposed electronic recordkeeping requirement for personal securities transactions. We believe our original analyses regarding the benefits and costs of the rule and amendments remain accurate. Most of the benefits and costs under the new rule and amendments, however, are not quantifiable.

#### A. Benefits

Codes of ethics under new rule 204A-1 should benefit advisory clients as well as advisory firms. The codes will impress upon advisers' supervised persons the significance of the fiduciary aspects of their professional responsibilities, formulating these into standards of conduct to which their employers will hold these individuals accountable. Codes of ethics will also be an important part of advisers' efforts to prevent fraudulent personal trading by their supervised persons. As a result, these codes increase investor protection by forestalling supervised persons from engaging in misconduct that defrauds clients. In addition, the Form ADV amendments, which require advisers to describe their codes of ethics to clients and to furnish copies to clients upon request, put clients in a better position to evaluate whether their advisers' codes of ethics meet their expectations. If a client is not confident that an advisory firm has taken appropriate measures to prevent its personnel from placing their own interests ahead of their clients' interests, the client will be

<sup>74</sup> We are adopting amendments to rule 204-2, the recordkeeping rule under the Advisers Act, to address documentation of advisers' compliance with rule 204A-1. We are also amending Part II of Form ADV, which specifies certain information investment advisers must disclose to their clients, to require advisers to include a discussion of their codes of ethics and make copies available to clients upon request. We are adopting amendments to rule 17j-1, the code of ethics rule under the Company Act, to conform certain of its provisions to those in new rule 204A-1.

able to seek a different adviser whose measures he approves.

Rule 204A-1 will reinforce existing measures that require investment advisers to guard against employee misconduct. It goes beyond section 204A of the Advisers Act, which focuses on policies and procedures to prevent misuse of material nonpublic information by advisory firm personnel. Rule 204A-1 expands advisers' policies to address other situations in which such personnel could potentially benefit at the expense of firm clients. It also goes beyond Company Act rule 17j-1, which focuses on fraud in connection with securities held or to be acquired by an investment company advised by an adviser. Rule 204A-1 expands advisers' policies to address advisory personnel's holdings and transactions in shares of investment companies managed by the adviser. Codes of ethics will also assist advisers in meeting their obligations under Advisers Act rule 206(4)-7 to adopt policies and procedures reasonably designed to prevent their supervised persons from violating the Advisers Act.

Rule 204A-1 will benefit investment advisers by renewing their attention to their fiduciary and other legal obligations, and by increasing their vigilance against inappropriate behavior by employees. This may have the effect of diminishing the likelihood that their firms will be embroiled in securities violations, Commission enforcement actions, and private litigation. For an adviser, the potential costs associated with a securities law violation may consist of much more than merely the fines or other penalties levied by the Commission or civil liability. The reputation of an adviser may be significantly tarnished, resulting in lost clients. Advisers may be denied eligibility to advise funds.<sup>75</sup> In addition, advisers could be precluded from serving in other capacities.<sup>76</sup>

Our revision of advisers' recordkeeping obligations for personal securities transactions will also benefit investment advisers. The amended rules are easier to understand than the

<sup>75</sup> Section 9(a) of the Investment Company Act [15 U.S.C. 80a-9(a)] prohibits a person from serving as an adviser to a fund if, within the past 10 years, the person has been convicted of certain crimes or is subject to an order, judgment, or decree of a court prohibiting the person from serving in certain capacities with a fund, or prohibiting the person from engaging in certain conduct or practice.

<sup>76</sup> See, e.g., 29 U.S.C. 1111(a) (prohibiting a person from acting in various capacities for an employee benefit plan, if within the past 13 years, the person has been convicted of, or has been imprisoned as a result of, any crime described in section 9(a)(1) of the Investment Company Act [15 U.S.C. 80a-9(a)(1)]).



complex provisions currently contained in Advisers Act rule 204–2(a)(12) and (13). The requirement that advisers maintain information about their access persons' personal securities transactions will enable firms to detect trading patterns that may indicate abuse.<sup>77</sup> In addition, the requirement that each access person provide initial and annual holdings reports allows investment advisers to better monitor conflicts that may arise when an access person participates in investment decisions involving securities the access person holds in his or her portfolio, and to assess whether access persons are filing accurate quarterly transaction reports.

#### *B. Costs*

The new rule and amendments will result in some additional costs for advisers. It is possible that advisers may pass these costs along to their clients in the form of advisory fees.<sup>78</sup> Advisers, however, are already required to maintain various policies and procedures that would constitute core elements of their codes of ethics, and therefore many of these costs are already reflected in fees clients currently pay. Advisers are required, under section 204A of the Advisers Act, to maintain and enforce written policies and procedures reasonably designed to prevent the firm or its employees from misusing material nonpublic information. Also, the approximately 1,500 advisers who advise registered investment companies currently have codes of ethics to prevent their "access persons" from abusing their access to information about the fund's securities trading, pursuant to Company Act rule 17j–1.<sup>79</sup> In addition, advisers are required under Advisers Act rule 206(4)–7 to adopt policies and procedures reasonably designed to prevent their supervised persons from violating the Advisers Act. Accordingly, we believe requiring written codes of ethics will impose few new costs on advisers.

Similarly, our rule to require access persons to report personal securities

transactions should cause only minor cost increases. Advisers are already required to maintain records of their advisory representatives' personal securities transactions on a quarterly basis under Advisers Act rules 204–2(a)(12) and (13). The additional reporting required of access persons under our new rule—an annual report of securities holdings—should impose only minor additional costs.<sup>80</sup> Because most SEC-registered investment advisers have so few employees, we believe the cost of these additional reports will be minor. As of December 2003, 49% of investment advisers registered with us reported that they had five or fewer non-clerical employees, and another 18% reported that they had only six to ten non-clerical employees.<sup>81</sup> The majority of larger SEC-registered advisers are already subject to Company Act rule 17j–1 because they advise investment companies, and consequently obtain annual reports from their "access persons" that contain virtually the same information as would be required under our proposals. These larger firms are also in a position to limit the number of supervised persons subject to the reporting requirements, by imposing stringent controls on who obtains access to client securities information.

Many commenters expressed concern regarding the cost of the proposed requirement that advisers maintain records of personal securities transactions electronically. The Commission is not adopting the proposed electronic recordkeeping requirement.

One commenter stated that significant costs would result from the new rule's requirement that advisers review supervised persons' securities holdings and transaction reports to monitor them for abuses. The Commission recognizes that advisers will experience costs in conducting their review. The benefits to investors and to advisory firms themselves in terms of improved detection and prevention of abuses will, however, justify these costs. Moreover, the incremental cost imposed by the new rule in this regard is diminished to the extent that advisers should already be conducting such a review. An adviser's fiduciary duty of loyalty to its clients may require it to take steps to protect clients from such abuses by the adviser's personnel, and section 204A of the Advisers Act requires the adviser to

enforce its policies and procedures designed to prevent misuse of material nonpublic information.

We expect only minor cost increases from the new requirement that access persons obtain their advisers' approval before investing in an initial public offering or private placements. Our experience administering the same requirement under Company Act rule 17j–1 has been that such proposals are infrequent, even at larger advisory firms. We also believe that our new requirement that advisers describe their codes of ethics to clients in their Form ADV and provide copies on request will impose only minor cost increases. We expect few clients will request a copy of the code, and that the cost to provide it will be minimal.

#### **V. Effects on Competition, Efficiency and Capital Formation**

Section 202(c) of the Advisers Act [15 U.S.C. 80b–2(c)] mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

As discussed above, rule 204A–1 requires investment advisers to adopt codes of ethics applicable to their supervised persons. These codes of ethics must establish standards of business conduct reflecting the fiduciary obligations of the adviser and its personnel and impose personal securities reporting measures designed to prevent access persons from abusing their access to information about clients' securities transactions. We expect that the proposed rule may indirectly increase efficiency by forestalling supervised persons from engaging in misconduct that defrauds clients and harms the advisory firm, or by facilitating the adviser's early intervention to protect its clients. In addition, the existence of an industry-wide code of ethics requirement may enhance efficiency further by encouraging third parties to create new informational resources and guidance to which industry participants can refer in establishing and improving their codes.

Since the rule applies equally to all registered advisers, we do not anticipate that it introduces any competitive disadvantages. We expect that the rule may indirectly foster capital formation by bolstering investor confidence. To the extent that investors know that advisory firms have taken measures designed to prevent their supervised persons from placing their interests

<sup>77</sup> Although the Commission is not adopting the proposed requirement that advisers maintain these records electronically, as previously noted we have strong expectations that most advisers will need to maintain these records electronically in order to meet their responsibilities to review these records and monitor compliance with their codes.

<sup>78</sup> We understand, however, that many advisers have already adopted codes of ethics for their firm and their employees. We are unaware whether these firms charge higher advisory fees than firms that have not yet adopted codes of ethics.

<sup>79</sup> Based on our records of information submitted to us by investment advisers in Part 1 of Form ADV through December 10, 2003, approximately 1,500 advisers report that they manage portfolios for investment companies.

<sup>80</sup> The Commission is not adopting its proposal to require quarterly reports indicating that no transactions were effected.

<sup>81</sup> This is based on Form ADV data (under Item 5.A of Part 1A) submitted to us by 8,019 SEC-registered investment advisers through December 9, 2003.

ahead of their clients' interests, clients are more likely to make assets available through advisers for investment in the capital markets.

#### VI. Paperwork Reduction Act

As we discussed in the Proposing Release, the new rule and form amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.<sup>82</sup> These collections of information are mandatory. One of the collections of information is new. The title of this new collection is "Rule 204A-1," which the Commission submitted to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The OMB has approved this collection under control number 3235-0596 (expiring on March 31, 2007). The other collections of information take the form of amendments to currently approved collections titled "Rule 204-2," under OMB control number 3235-0278, and "Form ADV," under OMB control number 3235-0049. The Commission also has submitted the amendments to these collections to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The OMB has approved these collections under control numbers 3235-0278 (expiring on July 31, 2007) and 3235-0049 (expiring on July 31, 2007), respectively. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The collection of information under rule 204A-1 is necessary to establish standards of business conduct for supervised persons of investment advisers and to facilitate investment advisers' efforts to prevent fraudulent personal trading by their supervised persons. The collection of information is mandatory. The respondents are investment advisers registered with us, and certain of their supervised persons who must submit reports of their personal trading activities to their firms. These investment advisers use the information collected to control and assess the personal trading activities of their supervised persons. Responses to the reporting requirements will be kept confidential to the extent each investment adviser provides confidentiality under its particular practices and procedures.

The collection of information under rule 204-2 is necessary for the Commission staff to use in its

examination and oversight program. This collection of information is mandatory. The respondents are investment advisers registered with us. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.<sup>83</sup> The records that an adviser must keep in accordance with rule 204-2 must generally be retained for not less than five years.<sup>84</sup>

The collection of information under Form ADV is necessary to provide advisory clients and prospective clients with information about an adviser's code of ethics. This collection of information is mandatory. The respondents are investment advisers registered with us. Clients of these investment advisers use the information collected to assess measures the adviser has taken to prevent its supervised persons from placing their own interests ahead of the adviser's clients' interests. Responses to the disclosure requirements are not kept confidential.

#### A. Rule 204A-1

Rule 204A-1 requires SEC-registered investment advisers to establish a written code of ethics for their supervised persons.<sup>85</sup> We estimated in the Proposing Release that each adviser would spend six hours annually, on average, documenting its code of ethics, taking into consideration that investment advisers currently maintain policies and procedures that can be the basis for their code of ethics and that advisers to investment companies already have fully developed codes of ethics. Based on our estimate in the Proposing Release that 8,019 advisers would incur the burden, the burden estimate for establishing a written code of ethics was 48,114 hours.<sup>86</sup>

Rule 204A-1 also requires each adviser's code of ethics to include provisions under which the adviser provides each supervised person with a copy of the code of ethics and any amendments, and obtains written acknowledgment of receipt from the supervised person. Based on our estimates that, on average, each investment adviser has 100 supervised persons,<sup>87</sup> will hire 5 new supervised persons each year, and each adviser will amend their codes once every other year, that advisers will have to provide

a copy of their codes of ethics and obtain an acknowledgment of receipt 55 times each year.<sup>88</sup> We further estimated in the Proposing Release that it will take an investment adviser 0.05 hours on average for each iteration, for an annual burden of 2.75 hours per adviser and a total burden of 22,052.25 hours for all advisers related to informing supervised persons of adviser codes of ethics.<sup>89</sup>

Lastly, rule 204A-1 also requires each adviser's code of ethics to include provisions under which the adviser's "access persons" report their personal securities transactions and holdings to the adviser.<sup>90</sup> To estimate the annual paperwork burden stemming from this requirement we relied on the following assumptions: (1) Advisers would treat all their non-clerical employees as access persons; (2) advisers have, on average, 84 non-clerical employees;<sup>91</sup> (3) initial and annual holdings reports will take 0.7 hours on average; and (4) quarterly transaction reports will take 0.6 hours on average annually.<sup>92</sup> Using these assumptions, we estimated in the Proposing Release that the total annual burden hours for all access persons under the proposed would be 875,675 hours.<sup>93</sup>

One significant amendment to rule 204A-1 that addressed commenters concerns materially reduces the paperwork burden on advisers. Because we are no longer requiring access persons to make quarterly reports when they do not have securities transactions, we are thus adopting rule 204A-1 with revised paperwork collection requirements. Accordingly, our estimate of the total annual burden for rule 204A-1 in the Proposing Release of

<sup>88</sup> Over any two-year period, 100 copies of amendments in year 1 + 10 copies of complete code for new supervised persons in year 1 through 2 = 110 copies, divided by 2 years = 55 copies.

<sup>89</sup> 0.05 hours per copy × 55 copies per year = 2.75 hours. 2.75 hours × 8,019 investment advisers = 22,052.25 hours total.

<sup>90</sup> Rule 204A-1(a)(3).

<sup>91</sup> This average is based on Form ADV data that asks for the total number of employees. We believe this estimate overstates the typical number of access persons for an adviser, since the data is skewed significantly higher by the largest (in terms of number of employees) 100 advisers.

<sup>92</sup> We estimated in the Proposing Release that quarterly transaction reports would take 0.6 hours per access person. In a change from the proposed rule, the adopted rule does not require quarterly reports for any quarter in which the access person makes no security transactions. In the Proposing Release, we assumed for purposes of estimating access person reporting that access persons would typically file transaction reports indicating no transactions in 3 out of the 4 quarters. Thus we have reduced by half the amount of time allocated for access person transaction reporting, as discussed below.

<sup>93</sup> (0.7 hours holdings report + 0.6 hours transactions report) × (84 access persons × 8,019 investment advisers) = 875,675 hours.

<sup>83</sup> See section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

<sup>84</sup> See rule 204-2(e) [17 CFR 275.204-2(e)].

<sup>85</sup> Rule 204A-1(a).

<sup>86</sup> 8,019 advisers × 6 hours = 48,114 total annual hours.

<sup>87</sup> This estimate is based on each adviser having on average 84 non-clerical and 16 clerical employees.

<sup>82</sup> 44 U.S.C. 3501 to 3520.

945,841.25 hours is reduced to 743,762.25 hours.<sup>94</sup>

#### B. Rule 204-2

In the Proposing Release, we estimated that the amendments to rule 204-2 would result in an approximate 10% net decrease from the currently approved annual aggregate collection of information burden.<sup>95</sup> Eliminating the requirement that advisers retain records relating to the personal securities transactions of advisory representatives reduces the annual average burden of the rule,<sup>96</sup> while the new recordkeeping requirements under the amendments to rule 204-2 add to the burden, as does the increase of 229 advisers registered with us.<sup>97</sup>

Many commenters objected to the proposed requirement to require advisers to maintain access person reports electronically. The amended rule does not include this requirement, but this amendment does not change the information collection burden estimate.<sup>98</sup> Our total hour burden estimate for the collection of information under rule 204-2 remains 1,537,883.8 burden hours, as we estimated in our proposal.<sup>99</sup>

<sup>94</sup> Eliminating these quarterly reports decreases the burden of quarterly transaction reporting on access persons from 0.6 hours to 0.3 hours, or a total of 202,079 hours (0.3 hours × 84 access persons × 8,019 advisers = 202,079). Our revised total burden is as follows: 48,114 hours by advisers to record their codes of ethics + 673,596 hours for reporting by access persons + 22,052.25 hours for advisers to deliver copies of codes and amendments = 743,762.25.

<sup>95</sup> Prior to the adoption of the amendments herein, the approved annual aggregate information collection burden was 1,651,324.2 hours (based on 7,790 advisers) or 211.98 hours per firm for rule 204-2.

<sup>96</sup> In the Proposing Release we estimated that the reduction would be 25.2 hours per firm (0.3 hours per access person to record the transactions × 84 access persons per firm). This results in a reduction on a per firm basis to 186.78 hours (211.98 - 25.2).

<sup>97</sup> The new recordkeeping obligations under the rule include the maintenance of access person holding and quarterly transaction reports, retention of the codes of ethics, supervised person acknowledgments, records of the names of the firm's access persons, records of any violation of the codes of ethics and any action taken, and records of any decision under rule 204A-1 to permit an access person to invest in an initial public offering or private placement. In the Proposing Release we estimated that these new collections would add 5 hours on average per adviser to the annual hour burden of the rule. This results in a per firm annual burden estimate of 191.78 hours (186.78 + 5).

<sup>98</sup> In the Proposing Release, we estimated no incremental burden in connection with the proposed requirement for advisers to maintain access person reports electronically. We estimated advisory firms would be able to use their existing computer software, taking transaction data electronically from the same broker-dealers that advisory firms use to obtain electronic information about client transactions.

<sup>99</sup> 191.78 hours per adviser × 8,019 advisers = 1,537,883.8 hours.

#### C. Form ADV

In the proposing release, we estimated that the amendments to Form ADV (requiring advisers to describe their codes of ethics and furnish a copy upon request) would increase the annual collection burden under Form ADV by 6.95 hours per adviser.<sup>100</sup> One trade group commenter recommended that we allow web site posting of the code of ethics in lieu of furnishing a copy upon request. We do not believe that web access is universal at this time so we are adopting amendments to Form ADV without change and, accordingly, our total burden hour estimate remains at 102,653 burden hours.<sup>101</sup>

### VII. Final Regulatory Flexibility Analysis

The Commission proposed new rule 204A-1 and amendments to rule 204-2 and Form ADV under the Advisers Act, and amendments to rule 17j-1 under the Company Act, in a release on January 20, 2004 ("proposing release"). An Initial Regulatory Flexibility Analysis ("IRFA") was published in the proposing release. No comments were received specifically on the IRFA. The Commission has prepared the following Final Regulatory Flexibility Analysis ("FRFA") in accordance with 5 U.S.C. 604, regarding rule 204A-1 and amendments to rule 204-2 and Form ADV under the Advisers Act and amendments to rule 17j-1 under the Company Act.

#### A. Need for the Rule and Amendments

Sections I and II of this Release describe the background and reasons for the new rule and rule amendments. As we discussed in detail above, the rule and amendments are designed to promote compliance with fiduciary standards by advisers and their personnel.

#### B. Significant Issues Raised by Public Comment

The Commission received 44 letters from commenters in response to the proposing release. Commenters supported the proposal. As discussed in section II of this Release, the Commission is adopting the new rule and rule amendments substantially as proposed with some changes to respond to commenters' suggestions. Commenters opposed a proposed

<sup>100</sup> 0.25 hours preparing a description of the code of ethics + 6.7 hours responding to requests for copies of the code of ethics (based on a 10% request rate by the 670 average number of clients per adviser and 0.1 hours for delivery).

<sup>101</sup> (0.25 hours + 6.7 hours) × 8,019 advisers = 55,732 hours. 46,921 hours (existing total) + 55,732 hour increase = 102,653 hours.

requirement that advisers keep records of access persons' personal securities reports electronically in an accessible database, and the Commission is not adopting this provision of the proposal. The Commission specifically requested comments with respect to the IRFA, but did not receive any comments specifically concerning the IRFA.

#### C. Small Entities Subject to Rule

The new rule and rule amendments under the Advisers Act apply to all advisers registered with the Commission, (and the amendments to rule 17j-1 apply to all investment companies) including small entities. In developing the new rule and amendments, we have considered their potential effect on small entities. Under Commission rules, for purposes of the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had \$5 million or more on the last day of its most recent fiscal year.<sup>102</sup> The Commission estimates that approximately 570 SEC-registered investment advisers are small entities that are affected by the new rules and rule amendments.<sup>103</sup>

For purposes of the Regulatory Flexibility Act, a registered investment company ("fund") is a small business or small organization (collectively, "small entity") if the fund, together with other funds in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>104</sup> The Commission estimates that approximately 204 registered investment companies are small entities.<sup>105</sup> As discussed in section II of this Release, the amendments to rule 17j-1 (i) allow advisers to rely on a reporting exception in the rule if the adviser already maintains duplicate

<sup>102</sup> 17 CFR 275.0-7(a).

<sup>103</sup> This estimate is based on the information submitted by SEC-registered advisers in part 1A of Form ADV as of May 1, 2004.

<sup>104</sup> 17 CFR 270.0-10.

<sup>105</sup> This estimate, which is current as of December 2003, is derived from analyzing information from Form N-SAR and various databases including Lipper. Some or all of these entities may contain multiple series or portfolios. If a registered investment company is a small entity, the portfolios or series it contains are also small entities.

information under records required by certain Advisers Act rules, (ii) exempt certain transactions from required reporting, and (iii) replace with a legal presumption a revenue-based test for the primary business of the adviser. Whether the amendments to rule 17j-1 affect small entities depends on whether the small entities rely on the reporting exception or use the exemption, and whether the small entity is primarily engaged in the business of advising investment companies or other advisory clients.

#### *D. Projected Reporting, Recordkeeping, and Other Compliance Requirements*

The amendment to Form ADV imposes a new reporting requirement on advisers, requiring that they make an additional disclosure statement in their brochures describing their codes of ethics and noting that copies of the codes are available from the adviser upon request. Although new rule 204A-1 and the other rule amendments under the Advisers Act impose no other new reporting requirements on registered advisers themselves, the new rule requires advisers' codes of ethics to impose a new reporting requirement on advisers' access persons by requiring certain new personal securities holdings and transaction reports. One rule amendment under the Company Act exempts certain personal securities transactions from existing quarterly reporting requirements.

The new rule and rule amendments create certain new recordkeeping and compliance requirements. The rule amendments impose new recordkeeping requirements by requiring that advisers maintain certain records pertaining to their codes of ethics and requirements of such codes (including records of personal securities holdings and transaction reports).<sup>106</sup> The new rule imposes new compliance requirements by requiring that SEC-registered investment advisers adopt codes of ethics, obtain written acknowledgments of their supervised persons' receipt of copies of the code and any amendments, review personal securities holdings and transaction reports filed by their access persons, and pre-approve investments by their access persons in IPOs and limited offerings.

<sup>106</sup> These records are: copies of the codes of ethics, records of violations of the codes of ethics, records of personal securities transactions and holdings reports, records of persons subject to reporting under the codes of ethics, records of decisions relating to approvals of investments in IPOs or limited offerings, and records of supervised person acknowledgments of the code of ethics. Advisers are generally required to retain these records for five years.

Small entities registered with the Commission as investment advisers are for the most part subject to these new reporting, recordkeeping and compliance requirements to the same extent as larger advisers. With regard to reporting of securities holdings and transactions and to pre-approvals of certain investments, however, certain small advisers, possibly including some that are small entities, are not subject to the new requirements. Additionally, we anticipate that most advisers will very rarely need to address violations to their codes of ethics and, similarly, should infrequently be asked by an access person to consider pre-approval of an investment in an IPO or limited offering. Small advisers will likely deal with violations or IPO and limited offering pre-approvals on an even more limited scale due to the smaller size of their operations. Furthermore, it is important to note that some of the new reporting, recordkeeping and compliance requirements replace, clarify or simplify existing requirements to which advisers, including those that are small entities, are already subject. To the extent that such requirements clarify or simplify existing requirements, the rule and amendments may actually alleviate reporting, recordkeeping, or compliance burdens on advisers, including those that are small entities.

#### *E. Agency Action To Minimize Effect on Small Entities*

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities.<sup>107</sup> In connection with the new rule and rule amendments, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for such small entities.

With respect to the first alternative, the Commission believes that the flexibility built into the rules adequately addresses different compliance and reporting requirements. The Commission is not prescribing uniform codes of ethics, but gives each adviser the flexibility to design its own code in light of the firm's size and operational

structure, and the particular types of conflicts encountered by the firm in connection with its business and clients. The amendments to rule 204-2 permit the use of brokerage confirmations and statements in lieu of separate reports, at the firm's option.

With respect to the second alternative, the Commission believes that clarification, consolidation, or simplification of the compliance and recordkeeping requirements under the rule for small entities unacceptably compromises the investor protections of the rule. Rule 204A-1 sets out minimum requirements for advisers' codes of ethics, which are designed to promote compliance with fiduciary standards by advisers and their personnel. Eliminating some or all of these requirements would potentially impede achievement of that objective. Similarly, in establishing the categories of records to be retained under amendments to rule 204-2, the records described by the rule are necessary for the Commission to evaluate advisers' compliance with rule 204A-1 as part of the Commission's inspection program.

With respect to the third alternative, the Commission believes that the compliance and reporting requirements contained in the new rule and rule amendments already appropriately use performance standards instead of design standards. The rule enumerates few elements required for codes of ethics, allowing all firms, including small firms, to tailor the remainder of their codes of ethics to the nature and scope of their business. Rule 204A-1 does not specify what standard of conduct an adviser must require of its supervised persons, but requires only that the adviser articulate a standard in its code of ethics. Similarly, the rule does not specify which supervised persons should have access to nonpublic information about client recommendations, trading and holdings, and does not prohibit or restrict personal securities transactions by access persons, but requires only that access persons report their personal securities trading and holdings to the adviser. Furthermore, the recordkeeping requirements under rule 204-2 do not specify the means by which an adviser must keep records to demonstrate its compliance with the rule.

Finally, with respect to the fourth alternative, the Commission notes that the rule exempts advisers with only one access person from personal securities reporting and pre-clearance of investments in IPOs and private placements. The codes of ethics are designed to promote advisers' fulfillment of their fiduciary duty to

<sup>107</sup> 5 U.S.C. 603(c).

clients and to guard against personal securities trading by advisers' access persons that may be contrary to clients' interests. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Advisers Act to exempt small entities further from the rule and rule amendments or to specify different requirements for small entities.

**VIII. Statutory Authority**

We are adopting amendments to rule 17j-1 pursuant to our authority set forth in sections 17(j) and 38(a) of the Investment Company Act [15 U.S.C. 80a-17(j) and 80a-37(a)] and sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b-4 and 80b-11(a)].

We are adopting amendments to rule 204-2 pursuant to our authority set forth in sections 204 and 206(4) of the Advisers Act [15 U.S.C. 80b-4 and 80b-6(4)].

We are adopting rule 204A-1 pursuant to our authority set forth in sections 202(a)(17), 204A, 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b-2(a)(17), 80b-4a, 80b-6(4) and 80b-11(a)].

We are adopting amendments to Form ADV under section 19(a) of the Securities Act of 1933 [15 U.S.C. 77s(a)], sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78w(a) and 78bb(e)(2)], section 319(a) of the Trust Indenture Act of 1939 [15 U.S.C. 77sss(a)], section 38(a) of the Investment Company Act of 1940 [15 U.S.C. 78a-37(a)], and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)].

**Text of Rules and Form Amendments**

**List of Subjects in 17 CFR Parts 270, 275 and 279**

Investment companies, Reporting and recordkeeping requirements, Securities.

■ For reasons set forth in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

**PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940**

■ 1. The authority citation for part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

■ 2. Section 270.17j-1 is amended by:  
 ■ a. Revising paragraph (a)(1)(i);  
 ■ b. Revising paragraph (a)(2)(i);

- c. Adding new paragraph (a)(11);
- d. Revising the introductory text of paragraphs (d)(1)(i), (d)(1)(ii), and (d)(1)(iii);
- e. Revising paragraph (d)(2)(iv); and
- f. Adding new paragraph (d)(2)(vi).

The additions and revisions to read as follows:

**§ 270.17j-1 Personal investment activities of investment company personnel.**

(a) \* \* \*

(1) \* \* \*

(i) Any Advisory Person of a Fund or of a Fund's investment adviser. If an investment adviser's primary business is advising Funds or other advisory clients, all of the investment adviser's directors, officers, and general partners are presumed to be Access Persons of any Fund advised by the investment adviser. All of a Fund's directors, officers, and general partners are presumed to be Access Persons of the Fund.

\* \* \* \* \*

(2) \* \* \*

(i) Any director, officer, general partner or employee of the Fund or investment adviser (or of any company in a control relationship to the Fund or investment adviser) who, in connection with his or her regular functions or duties, makes, participates in, or obtains information regarding, the purchase or sale of Covered Securities by a Fund, or whose functions relate to the making of such recommendations with respect to such purchases or sales; and

\* \* \* \* \*

(11) *Automatic Investment Plan* means a program in which regular periodic purchases (or withdrawals) are made automatically in (or from) investment accounts in accordance with a predetermined schedule and allocation. An Automatic Investment Plan includes a dividend reinvestment plan.

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \*

(i) *Initial Holdings Reports.* No later than 10 days after the person becomes an Access Person (which information must be current as of a date no more than 45 days prior to the date the person becomes an Access Person):

\* \* \* \* \*

(ii) *Quarterly Transaction Reports.* No later than 30 days after the end of a calendar quarter, the following information:

\* \* \* \* \*

(iii) *Annual Holdings Reports.* Annually, the following information (which information must be current as

of a date no more than 45 days before the report is submitted):

\* \* \* \* \*

(2) \* \* \*

(iv) An Access Person to an investment adviser need not make a separate report to the investment adviser under paragraph (d)(1) of this section to the extent the information in the report would duplicate information required to be recorded under § 275.204-2(a)(13) of this chapter.

\* \* \* \* \*

(vi) An Access Person need not make a quarterly transaction report under paragraph (d)(1)(ii) of this section with respect to transactions effected pursuant to an Automatic Investment Plan.

**PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

■ 3. The general authority citation for part 275 is revised to read in part as follows:

**Authority:** 15 U.S.C. 80b-2(a)(11)(F), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

\* \* \* \* \*

■ 4. Section 275.204-2 is amended by revising paragraphs (a)(12), (a)(13), and (e)(1) to read as follows:

**§ 275.204-2 Books and records to be maintained by investment advisers.**

(a) \* \* \*

(12)(i) A copy of the investment adviser's code of ethics adopted and implemented pursuant to § 275.204A-1 that is in effect, or at any time within the past five years was in effect;

(ii) A record of any violation of the code of ethics, and of any action taken as a result of the violation; and

(iii) A record of all written acknowledgments as required by § 275.204A-1(a)(5) for each person who is currently, or within the past five years was, a supervised person of the investment adviser.

(13)(i) A record of each report made by an access person as required by § 275.204A-1(b), including any information provided under paragraph (b)(3)(iii) of that section in lieu of such reports;

(ii) A record of the names of persons who are currently, or within the past five years were, access persons of the investment adviser; and

(iii) A record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons under § 275.204A-1(c), for at least five years after the end of the

fiscal year in which the approval is granted.

\* \* \* \* \*

(e)(1) All books and records required to be made under the provisions of paragraphs (a) to (c)(1)(i), inclusive, and (c)(2) of this section (except for books and records required to be made under the provisions of paragraphs (a)(11), (a)(12)(i), (a)(12)(iii), (a)(13)(ii), (a)(13)(iii), (a)(16), and (a)(17)(i) of this section), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

\* \* \* \* \*

■ 5. Section 275.204A-1 is added to read as follows:

**§ 275.204A-1 Investment adviser codes of ethics.**

(a) *Adoption of code of ethics.* If you are an investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b-3), you must establish, maintain and enforce a written code of ethics that, at a minimum, includes:

(1) A standard (or standards) of business conduct that you require of your supervised persons, which standard must reflect your fiduciary obligations and those of your supervised persons;

(2) Provisions requiring your supervised persons to comply with applicable Federal securities laws;

(3) Provisions that require all of your access persons to report, and you to review, their personal securities transactions and holdings periodically as provided below;

(4) Provisions requiring supervised persons to report any violations of your code of ethics promptly to your chief compliance officer or, provided your chief compliance officer also receives reports of all violations, to other persons you designate in your code of ethics; and

(5) Provisions requiring you to provide each of your supervised persons with a copy of your code of ethics and any amendments, and requiring your supervised persons to provide you with a written acknowledgment of their receipt of the code and any amendments.

(b) *Reporting requirements.* (1) *Holdings reports.* The code of ethics must require your access persons to submit to your chief compliance officer or other persons you designate in your code of ethics a report of the access

person's current securities holdings that meets the following requirements:

(i) *Content of holdings reports.* Each holdings report must contain, at a minimum:

(A) The title and type of security, and as applicable the exchange ticker symbol or CUSIP number, number of shares, and principal amount of each reportable security in which the access person has any direct or indirect beneficial ownership;

(B) The name of any broker, dealer or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit; and

(C) The date the access person submits the report.

(ii) *Timing of holdings reports.* Your access persons must each submit a holdings report:

(A) No later than 10 days after the person becomes an access person, and the information must be current as of a date no more than 45 days prior to the date the person becomes an access person.

(B) At least once each 12-month period thereafter on a date you select, and the information must be current as of a date no more than 45 days prior to the date the report was submitted.

(2) *Transaction reports.* The code of ethics must require access persons to submit to your chief compliance officer or other persons you designate in your code of ethics quarterly securities transactions reports that meet the following requirements:

(i) *Content of transaction reports.* Each transaction report must contain, at a minimum, the following information about each transaction involving a reportable security in which the access person had, or as a result of the transaction acquired, any direct or indirect beneficial ownership:

(A) The date of the transaction, the title, and as applicable the exchange ticker symbol or CUSIP number, interest rate and maturity date, number of shares, and principal amount of each reportable security involved;

(B) The nature of the transaction (*i.e.*, purchase, sale or any other type of acquisition or disposition);

(C) The price of the security at which the transaction was effected;

(D) The name of the broker, dealer or bank with or through which the transaction was effected; and

(E) The date the access person submits the report.

(ii) *Timing of transaction reports.* Each access person must submit a transaction report no later than 30 days after the end of each calendar quarter,

which report must cover, at a minimum, all transactions during the quarter.

(3) *Exceptions from reporting requirements.* Your code of ethics need not require an access person to submit:

(i) Any report with respect to securities held in accounts over which the access person had no direct or indirect influence or control;

(ii) A transaction report with respect to transactions effected pursuant to an automatic investment plan;

(iii) A transaction report if the report would duplicate information contained in broker trade confirmations or account statements that you hold in your records so long as you receive the confirmations or statements no later than 30 days after the end of the applicable calendar quarter.

(c) *Pre-approval of certain investments.* Your code of ethics must require your access persons to obtain your approval before they directly or indirectly acquire beneficial ownership in any security in an initial public offering or in a limited offering.

(d) *Small advisers.* If you have only one access person (*i.e.*, yourself), you are not required to submit reports to yourself or to obtain your own approval for investments in any security in an initial public offering or in a limited offering, if you maintain records of all of your holdings and transactions that this section would otherwise require you to report.

(e) *Definitions.* For the purpose of this section:

(1) *Access person* means:

(i) Any of your supervised persons:

(A) Who 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

(B) Who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic.

(ii) If providing investment advice is your primary business, all of your directors, officers and partners are presumed to be access persons.

(2) *Automatic investment plan* means a program in which regular periodic purchases (or withdrawals) are made automatically in (or from) investment accounts in accordance with a predetermined schedule and allocation. An automatic investment plan includes a dividend reinvestment plan.

(3) *Beneficial ownership* is interpreted in the same manner as it would be under § 240.16a-1(a)(2) of this chapter in determining whether a person has beneficial ownership of a security for purposes of section 16 of the Securities

Exchange Act of 1934 (15 U.S.C. 78p) and the rules and regulations thereunder. Any report required by paragraph (b) of this section may contain a statement that the report will not be construed as an admission that the person making the report has any direct or indirect beneficial ownership in the security to which the report relates.

(4) *Federal securities laws* means the Securities Act of 1933 (15 U.S.C. 77a-aa), the Securities Exchange Act of 1934 (15 U.S.C. 78a-mm), the Sarbanes-Oxley Act of 2002 (Pub. L. 107-204, 116 Stat. 745 (2002)), the Investment Company Act of 1940 (15 U.S.C. 80a), the Investment Advisers Act of 1940 (15 U.S.C. 80b), title V of the Gramm-Leach-Bliley Act (Pub. L. 106-102, 113 Stat. 1338 (1999)), any rules adopted by the Commission under any of these statutes, the Bank Secrecy Act (31 U.S.C. 5311-5314; 5316-5332) as it applies to funds and investment advisers, and any rules adopted thereunder by the Commission or the Department of the Treasury.

(5) *Fund* means an investment company registered under the Investment Company Act.

(6) *Initial public offering* means an offering of securities registered under the Securities Act of 1933 (15 U.S.C. 77a), the issuer of which, immediately before the registration, was not subject to the reporting requirements of sections

13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)).

(7) *Limited offering* means an offering that is exempt from registration under the Securities Act of 1933 pursuant to section 4(2) or section 4(6) (15 U.S.C. 77d(2) or 77d(6)) or pursuant to §§ 230.504, 230.505, or 230.506 of this chapter.

(8) *Purchase or sale of a security* includes, among other things, the writing of an option to purchase or sell a security.

(9) *Reportable fund* means:

(i) Any fund for which you serve as an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(20)) (*i.e.*, in most cases you must be approved by the fund's board of directors before you can serve); or

(ii) Any fund whose investment adviser or principal underwriter controls you, is controlled by you, or is under common control with you. For purposes of this section, *control* has the same meaning as it does in section 2(a)(9) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(9)).

(10) *Reportable security* means a security as defined in section 202(a)(18) of the Act (15 U.S.C. 80b-2(a)(18)), except that it does not include:

(i) Direct obligations of the Government of the United States;

(ii) Bankers' acceptances, bank certificates of deposit, commercial paper and high quality short-term debt

instruments, including repurchase agreements;

(iii) Shares issued by money market funds;

(iv) Shares issued by open-end funds other than reportable funds; and

(v) Shares issued by unit investment trusts that are invested exclusively in one or more open-end funds, none of which are reportable funds.

#### **PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940**

■ 6. The authority citation for Part 279 continues to read as follows:

**Authority:** The Investment Advisers Act of 1940, 15 U.S.C. 80b-1, *et seq.*

■ 7. Form ADV (referenced in § 279.1) is amended by:

■ In part II, at the end of Item 9 add "Describe, on Schedule F, your code of ethics, and state that you will provide a copy of your code of ethics to any client or prospective client upon request."

**Note:** The text of Form ADV does not and this amendment will not appear in the Code of Federal Regulations.

Dated: July 2, 2004.

By the Commission.

**Margaret H. McFarland,**  
*Deputy Secretary.*

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