SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 270, 275 and 279

[Release Nos. IA–2209, IC–26337; File No. S7–04–04]

RIN 3235–AJ08

Investment Adviser Codes of Ethics

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is proposing for comment a new rule and related rule amendments under the Investment Advisers Act of 1940 that would require registered advisers to adopt codes of ethics. The codes of ethics would set forth standards of conduct expected of advisory personnel, safeguard material nonpublic information about client transactions, and address conflicts that arise from personal trading by advisory personnel. Among other things, the rule would require advisers' supervised persons to report their personal securities transactions, including transactions in any mutual fund managed by the adviser. The rule and rule amendments are designed to promote compliance with fiduciary standards by advisers and their personnel.

DATES: Comments must be received on or before March 15, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods.

Comments sent by hardcopy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments may instead be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–04–04; if e-mail is used, this file number should be included on the subject line. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (*http://www.sec.gov*).[1]

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 requesting public comment on proposed rule 204A–1 [17 CFR 275.204A–1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (''Advisers Act'' or ''Act'') and proposed amendments to rule 204–2 [17 CFR 275.204–2] and Form ADV [17 CFR 279.1] under the Advisers Act and to rule 17j-1 [17 CFR 270.17j-1] under the Investment Company Act of 1940 [15 U.S.C. 80a] (''Company Act'').[2]

I. Background

Advisers are fiduciaries that owe their clients a duty of undivided loyalty.[3] The Commission has become concerned that the obligations attendant to this duty were lost on the growing number of advisers we see each month on our enforcement calendar. Recently, we have brought actions against advisory personnel who divulged portfolio information about their mutual funds, permitting favored clients to exploit the funds' investors,[4] and against an adviser we allege failed to take adequate steps to detect and deter its portfolio managers' short-term trading in affiliated funds.[5] There have been too many other cases in which we have had to bring enforcement actions against advisers or their personnel alleging violations of their fiduciary obligations to their clients.[6]

In order to educate their employees, protect the reputation of the firm, and guard against violating the securities laws, many advisers have adopted codes of ethics, establishing standards of conduct to which their employees must adhere. Codes of ethics often remind employees that they are in a position of trust, which requires them to act at all

[1] We do not edit personal or identifying information, such as names or e-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] 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.

[3] *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 181–82 (1963).

[4] *See, e.g., Gary L. Pilgrim, Harold J. Baxter, and Pilgrim Baxter & Associates, Ltd,* Litigation Release No. 18474 (Nov. 20, 2003) (alleged disclosure of nonpublic fund portfolio information by adviser's principal permitted certain investors to exploit mispricing of the mutual fund's net asset value); *In the Matter of Alliance Capital Management, L.P.,* Investment Advisers Act Release No. 2205 (Dec. 18, 2003) (disclosure of material nonpublic information about certain mutual fund portfolio holdings permitted favored client to profit from market timing).

[5] *In the Matter of Putnam Investment Management LLC,* Investment Advisers Act Release No. 2192 (Nov. 13, 2003).

[6] Other recent enforcement actions against advisers and advisory personnel include *In the Matter of Paul Joseph Sheehan dba Paul J. Sheehan & Associates,* Investment Advisers Act Release No. 2207 (Dec. 29, 2003) (investment adviser alleged to have ''cherry picked'' millions of dollars of profitable trades for his own accounts); *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); *SEC* v. *Heartland Advisors et al.*, Litigation Release No. 18505 (Dec. 12, 2003) (adviser and employees allegedly engaged in fraudulent pricing, misrepresentation, insider trading and other violations of fiduciary duties); *In the Matter of Zion Capital Management LLC and Ricky A. Lang,* Investment Advisers Act Release No. 2200 (Dec. 11, 2003) (in allocating securities trades, investment adviser favored an account in which its principal had a financial interest over account of 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 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 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).

times with the utmost integrity. Many impose ethical obligations that exceed those imposed by law, for example, requiring personnel to avoid even the *appearance* of a conflict with clients. Codes of ethics also establish procedures for employees to follow so that the adviser may determine whether the employee is complying with the firm's principles. In addition, the procedures laid out in a code of ethics can offer employees guidance and certainty as to whether certain actions are, or are not, permissible. Codes of ethics ultimately protect the interests of both clients *and* advisers by demanding that advisory personnel perform their duties with complete propriety and do not take advantage of their position.

Recently we adopted rules designed to deter and detect violations of the Act,[7] proposed to require better disclosures by mutual funds,[8] and proposed safeguards against late trading.[9] Today we are proposing a rule under the Investment Advisers Act of 1940 requiring each adviser registered with us to adopt and enforce a code of ethics applicable to its supervised persons. The rule is designed to prevent fraud by reinforcing fiduciary principles that must govern the conduct of advisory firms and their personnel.

II. Discussion

The Commission is proposing for comment new rule 204A–1, and related rule amendments, that would require advisers to adopt codes of ethics. Each adviser's code of ethics would be required to (i) set forth standards of conduct expected of advisory personnel (including compliance with the federal securities laws), (ii) safeguard material nonpublic information about client transactions, and (iii) require advisers' ''access persons'' to report their personal securities transactions, including transactions in any mutual fund managed by the adviser. The code of ethics would also have to require access persons to obtain the adviser's approval before investing in an initial public offering (''IPO'') or private placement. The code of ethics would have to require prompt reporting, to the adviser's chief compliance officer or another person designated in the code of ethics, of any violations of the code.[10] Finally, the code of ethics would have to require the adviser to provide each supervised person with a copy of the code and any amendments, and require the supervised persons to acknowledge, in writing, their receipt of these copies.

The rule would apply to each adviser registered with the Commission, although as we discuss below firms with only one employee would be exempt from some provisions.[11] We have drafted the rule broadly so that each adviser will be able to develop a code that takes into consideration the nature of its business, as it does when drafting its procedures under section 204A of the Act.[12]

The proposed rule, would not, of course, preclude an adviser from adopting a code of ethics covering additional matters. We encourage advisers to adopt broader codes, and request comment on whether we should require advisers to adopt them. What matters should they address?

A. Standards of Conduct and Compliance With Laws

We propose that each code of ethics set forth a standard of business conduct that the adviser requires of all its supervised persons.[13] This standard must reflect the adviser's fiduciary obligations and those of its supervised persons, and must require compliance with the federal securities laws. These obligations are imposed by law, and thus would establish a minimum requirement for a code of ethics complying with the rule. Advisers would be free, however, to require higher standards such as those we described above.

We request comment on these requirements. Is our formulation of the business conduct element of the code of ethics appropriate? Should we specify a particular standard of conduct that all codes of ethics must incorporate? What standard should we adopt? Should the code of ethics require supervised persons to comply with all applicable laws and regulations, rather than only the federal securities laws?

B. Protection of Material Nonpublic Information

Tight controls on access to sensitive client information are a first line of defense against misuse of that information.[14] Therefore, we also propose that each code of ethics include provisions reasonably designed to prevent access to material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions, unless those individuals need the information to perform their duties.[15] The proposed rule would require advisers to restrict access to client information on a ''need to know'' basis, but would not preclude the adviser from providing necessary information to persons providing services to the adviser or the account, *i.e.*, brokers, accountants, custodians, and fund transfer agents.[16]

- Are these criteria adequate? Are there alternative formulations we should use?
- Some advisers' codes of ethics require that computer files containing nonpublic information be identified and segregated. Should we require all

[7] Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (''Compliance Adopting Release'').

[8] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26287 (Dec. 11, 2003) [68 FR 70402 (Dec. 17, 2003)].

[9] Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) [68 FR 70388 (Dec. 17, 2003)].

[10] Congress recently required public companies to disclose whether (and if not, why not) they have adopted codes of ethics for their senior financial officers. ''Codes of ethics'' in section 406 of the Sarbanes-Oxley Act of 2002 are standards reasonably necessary to promote honest and ethical conduct, compliance with regulations, and full and fair disclosure. Pub. L. 107–204, 116 Stat. 745 (2002). The Commission's rules adopted under section 406 also refer to standards to promote avoidance of conflicts of interest as well as prompt reporting of any violations of the code of ethics. 17 CFR 229.406. Investment advisers that are themselves public companies are subject to the Sarbanes-Oxley Act and the Commission's rules under section 406.

[11] The rule would thus not apply to an adviser not registered with us in reliance on an exemption in section 203(b) of the Act [15 U.S.C. 80b–3(b)], nor to an adviser that is registered with state authorities and prohibited by section 203A of the Act [15 U.S.C. 80b–3a] from registering with us.

[12] Section 204A of the Advisers Act [15 U.S.C. 80b–4a], requires that each adviser take into consideration the nature of its business when establishing and enforcing procedures reasonably designed to prevent misuse of material nonpublic information by the investment adviser or any person associated with the investment adviser. *See also* H.R. Rep. No. 100–910, at 21–22 (Sep. 9, 1988) (recognizing that policies and procedures to prevent insider trading may reasonably differ among investment advisers, depending on the firm's operations, business structure, and the nature and scope of its business); Report of the Division of Investment Management, SEC, *Personal Investment Activities of Investment Company Personnel* at 4 (Sep. 1994) (''PIA Report'') (noting that rule 17j–1 allows funds to tailor personal trading restrictions and procedures to the funds' circumstances because that flexibility puts the funds in the best position to oversee access persons' investment activities).

[13] Proposed rule 204A–1(a)(1).

[14] Section 204A of the Act both requires advisers to establish policies to prevent misuse of material nonpublic information, and gives us authority to adopt rules requiring advisers to adopt specific policies and procedures to prevent nonpublic information from being misused.

[15] Proposed rule 204A–1(a)(3). We would expect many advisers would incorporate, into their code of ethics, their written policies and procedures to guard against misuse of material nonpublic information required by section 204A.

[16] *Cf.* sections 248.13 and 248.14 of Regulation S–P [17 CFR 248.13 and 248.14] (permitting financial institutions to share, with nonaffiliated third parties, without providing the consumer an opt out, information about the consumer in order to permit the third party to provide services to the financial institution or to the consumer's account).

advisers to incorporate this safeguard into their codes of ethics?

• Advisers' required procedures under section 204A usually contain a summary of the law on insider trading and procedures for determining whether information has become public. Should we require these to be integrated into the code of ethics?

C. Personal Securities Trading

Investment advisers and their personnel face inherent conflicts of interest when they trade in securities for their own accounts. They have access to information about their clients' securities transactions, which they can exploit for their own benefit.[17] In several of our enforcement cases involving personal trading, advisers profited from ''front-running'' client trades.[18] More recently, our enforcement cases have involved advisory personnel profiting unfairly through short-term trading in funds they managed, or alerting friends to do likewise.[19]

Misuse of client information violates the adviser's fiduciary duty as well as the Act's prohibitions against fraud and other provisions of the federal securities laws that prohibit insider trading. *See, e.g.*, section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. 78j] and rule 10b–5 thereunder [17 CFR 240.10b–5], section 17(j) of the Company Act [15 U.S.C. 80a–17(j)] and rule 17j–1 thereunder, and section 206 of the Advisers Act [15 U.S.C. 80b–6]. *See also, e.g., In the Matter of Gintel Asset Management, Inc., Gintel & Co. LLC, Robert M. Gintel, and Stephen G. Stavrides,* Investment Advisers Act Release No. 2079 (Nov. 8, 2002) (adviser violated rule 17j–1 by permitting principal to make repeated personal trades in securities to be acquired by fund and other advisory clients; adviser violated section 204A and affiliated broker-dealer violated section 15(f) of Securities Exchange Act in connection with misuse of material nonpublic information about planned trades for client accounts).

To prevent the personal securities trading of advisers' personnel from harming clients, each adviser's code of ethics would have to require personal trading reports from ''access persons'' of the adviser. The rule would, however, contain an exception for an adviser with only one employee (*i.e.*, the adviser himself); the sole employee would not be required to make reports of personal securities transactions and holdings, but would be required to maintain records of his personal trades and provide them to our examiners upon request.[20] These small advisers would be subject to the other provisions of the rule, including the requirements to adopt a code of ethics and safeguard material nonpublic client information.

• Are there other advisers we should exempt from provisions of the rule?

Our proposed requirements for reporting of personal securities trading are modeled largely on rule 17j–1 under the Company Act, which we adopted in 1980.[21] Rule 17j–1 requires that advisers to investment companies 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.[22] These procedures are an important part of these advisers' efforts to deter fraudulent personal trading by their personnel.

We have, however, made a number of changes to better apply the provisions on personal securities reporting to the many smaller advisory firms registered with us that do not advise an investment company. Appendix A to this Release contains a table comparing our proposal with rule 17j–1. We request comment on whether the differences, the most significant of which we describe below, make sense. Are there provisions in rule 17j–1 that we have omitted from proposed rule 204A–1 but that should be included? Conversely, are there changes we are proposing that should be extended to rule 17j–1? Is there a significant need for rule 204A–1 and rule 17j–1 to be as uniform as possible—in the event we adopt rule 204A–1 with changes from this proposal, should we make parallel changes to rule 17j–1?

The code of ethics would have to require the adviser's ''access persons''—generally, its personnel who have access to nonpublic information regarding client securities recommendations, trading and holdings—to periodically report their personal securities transactions and holdings to the adviser's chief compliance officer.[23] As discussed in more detail below, these reports would allow advisers as well as the Commission's examination staff to identify trades or patterns of trading by access persons that may be improper.

1. Personal Trading Procedures

In order to give advisers flexibility to adopt codes appropriate for their businesses, we are not proposing specific provisions regarding personal trading, other than pre-clearance of certain investments as discussed below. Firms that have already adopted a code of ethics, however, commonly include many of the following elements, or address the following issues, which we believe all advisers should consider in crafting their own procedures for employees' personal securities trading.

• Prior written approval before access persons can place a personal securities transaction (''pre-clearance'').[24]

[17] In most cases, an advisory firm and its personnel have access to such information because they have investment discretion to effect trades on behalf of their clients, including the investment companies (''funds'') that the adviser manages. Approximately 80% of the advisers registered with the Commission manage client securities portfolios on a discretionary basis, and another 10% manage them only on a non-discretionary basis.

[18] *See, e.g., In the Matter of Roger W. Honour*, Investment Advisers Act Release No. 1527 (Sept. 29, 1995). *See also SEC* v. *Capital Gains, supra* note at 181–82 (''scalping'' operates as a fraud or deceit on advisory clients).

[19] *See supra* notes 4 and 5.

[20] Proposed rule 204A–1(d). These advisers would also be excused from pre-clearing investments in IPOs and private placements. *Id.* It would make little sense to require the sole employee to make reports to himself or to pre-clear investments with himself.

[21] Prevention of Certain Unlawful Activities With Respect to Registered Investment Companies, Investment Company Act Release No. 11421 (Oct. 31, 1980) [45 FR 73915 (Nov. 7, 1980)] (adopting rule 17j–1) (''Rule 17j–1 1980 Adopting Release'').

We have also required advisers registered with us to keep records of transactions in which the firm or certain personnel have a beneficial ownership interest. Advisers Act rule 204–2(a)(12) and (13). As discussed in more detail below, we propose to modify these recordkeeping rules.

[22] Rule 17j–1(c)(1) and (d) under the Investment Company Act. Most investment companies, and therefore most advisers to investment companies, 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. Rule 17j–1(c)(1)(i). As of December 10, 2003, approximately 1500 advisers, or 18–19% of the firms registered with us, reported that they manage portfolios for investment companies.

[23] Proposed rule 204A–1(a)(4).

[24] 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

• Maintenance of ''restricted lists'' of issuers of securities that the advisory firm is analyzing or recommending for client transactions, and prohibitions on personal trading in securities of those issuers.

• ''Blackout periods'' when client securities trades are being placed or recommendations are being made and access persons are not permitted to place personal securities transactions.[25]

• 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.[26]

• Prohibitions or restrictions on ''short-swing'' trading and market timing.[27]

• 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.[28]

We request comment on whether the rule should require that any of the above ''best practice'' procedures regarding personal securities trading be in advisers'' codes of ethics.

• Are there other common elements or procedures, in addition to the above, that all advisers should consider as best practices, and, if so, should we include these in our adopting release? Commenters favoring additional policies and procedures should give specific recommendations.

• Should advisers be required to document the factors they considered in developing their procedures?

2. Persons Subject to the Reporting Requirements

Under proposed rule 204A–1, the adviser's code must require certain supervised persons, called ''access persons,'' to report their personal securities transactions and holdings.[29] 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.[30]

Access persons would include portfolio management personnel.[31] In some organizations, they would also include 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 exploit their inside knowledge. Administrative, technical, and clerical personnel may also be access persons if their functions or duties make them privy to nonpublic information. Organizations where 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.

Persons who are not ''supervised persons'' of the investment adviser would not be access persons under the proposed rule. Thus, employees of other organizations, including affiliated organizations such as broker-dealers, custodians, and banks that may acquire information about client securities transactions in the course of their duties, would not be subject to reporting requirements.[32] It may be impractical to apply the adviser's code of ethics to these persons, who may in any event be subject to ethical restrictions imposed by their own employers.[33] As discussed earlier, proposed rule 204A–1 would require advisers' codes of ethics to safeguard material nonpublic information, so that the number of persons outside the firm who have access should be few.[34] Moreover, advisers' fiduciary duty of care already requires them to exercise caution when disclosing client information to third parties, even those who are affiliates. Should the rule require advisers to undertake specific safeguards in this regard, and if so, what should they be?

We request comment on the scope of the definition of access person under the proposed rule:

• Is the definition too broad? Are there additional persons who should be excluded?

• Is the definition too narrow ''are there personnel at advisory firms who would not be access persons but who may be in a position to misuse nonpublic information?

confirmations against the log of pre-clearance approvals.

[25] Advisers may use blackout periods to guard against employees trading ahead of clients or on the same day as clients' trades are placed. *See Roger Honour, supra* note 18. Prohibiting personal trading at the same time as client trading can also serve as a measure to prevent personnel 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 (SDNY 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 investment companies and advisers should have policies precluding certain insiders from buying and selling securities at the same time as a fund they manage).

[26] 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).

[27] Advisers that prohibit short-term trading generally mandate disgorgement of any profits if an employee effects a short-term trade.

[28] Our proposal to have codes of ethics require initial and annual holdings reports would facilitate an adviser's assessment of whether an individual's personal securities holdings present a conflict of interest.

[29] Proposed rule 204A–1(a)(4). Section 202(a)(25) of the Advisers Act [15 U.S.C. 80b–2(a)(25)] defines the term ''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.

[30] Proposed rule 204A–1(e)(1). A supervised person who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds would also be an access person. *See* discussion *infra* at Section II.C.4 of this Release.

[31] Proposed rule 204A–1(e)(1)(i)(B).

[32] Our recordkeeping rules have required advisers to keep records of personal securities transactions of employees of companies affiliated with the adviser, if those employees have access to prior information about the adviser's clients' trades. Rule 204–2(a)(12)(iii)(A). We amended our recordkeeping rule to include personal securities transactions of these persons in 1975, in recognition that they may possess inside knowledge that could lead to ''scalping'' or front-running. Revised Definition of Term ''Advisory Representative'' and Limitation of Record-Keeping Requirements for Certain Persons, Investment Advisers Act Release No. 436 (Feb. 21, 1975) [40 FR 8548 (Feb. 28, 1975)].

[33] Advisers are currently subject to detailed rules that may require them to keep records of the personal securities transactions of some of these persons. Because we believe requiring advisers to monitor the personal securities trading of employees of other firms may not be practical, we believe it may be more effective to eliminate these recordkeeping requirements. *See* Section II.I of this Release, below. Instead, our proposed rule would encourage tighter controls on material nonpublic information by imposing a general requirement that the adviser safeguard access to such information.

[34] Proposed rule 204A–1(a)(3).

• Should access persons include employees of companies that control or are controlled by the adviser?

Whether directors and partners of an adviser have access to client securities information may vary significantly between organizations. In some large organizations with multiple lines of business, not all officers may have access to the type of information the proposed rule is designed to protect. Rule 17j–1 creates special rules for advisory firms that are ''primarily engaged'' in a business other than advising funds or advisory clients, and sets out a test based on the firm's sources of revenue.[35] In order to achieve the same result, proposed rule 204A–1 would create a legal presumption that, if the firm's primary business is providing investment advice, then all of its directors, officers and partners are access persons.[36] If the firm has another primary business, then whether a director, officer or partner is an access person would turn on whether the individual has access to nonpublic client information.

• Is there a continuing need for the rule to specify a test for the adviser's ''primary'' business? If so, should the new rule use the revenue-based test currently in rule 17j–1 or is there another measure that would be more effective?

• Should we amend rule 17j–1 to create a legal presumption rather than using the current revenue-based test?

3. Reportable Securities and Beneficial Ownership

Several types of securities would appear to present little opportunity for the type of improper trading that the access person reports are designed to uncover. Money market instruments '' bankers'' acceptances, bank certificates of deposit, commercial paper, repurchase agreements and other high quality short-term debt instruments—and direct obligations of the Government of the United States would be exempt from reporting requirements.[37] Shares of money market funds would also be exempt.[38] Transactions and holdings in shares of other types of mutual funds would not be reportable unless the adviser or a control affiliate acts as the investment adviser or principal underwriter for the fund.[39]

• Are there other types of mutual funds, in addition to money market funds, that we should exempt from access persons' holdings and transactions reporting requirements—for example, should reporting on transactions in index funds be required? Should investments in variable annuity contracts be excluded from reporting requirements?

Access persons would be required to report holdings and transactions in securities in which they have beneficial ownership. In 1999, we clarified that beneficial ownership under rule 17j–1 should be 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. [40] We are proposing to include that same provision in rule 204A–1.[41] Because it is the same as the standard under rule 17j–1, advisers to investment companies will not have to apply two different standards.[42]

4. Reporting of Investment Company Shares

Proposed rule 204A–1 would require access persons of an adviser to report their holdings and transactions in shares of investment companies managed by the adviser or a control affiliate (''reportable funds'').[43] We are proposing these reporting requirements in order to close a regulatory gap under the Company Act.

Section 17(j) of the Company Act authorizes us to adopt rules preventing fraud or deceptive practices in connection with the purchase or sale of ''any security held or to be acquired'' by an investment company. As a result, rule 17j–1 does not require access persons of investment companies to report personal securities trades in mutual funds they manage. Moreover, the exclusion of mutual funds reflects an assumption that trading in mutual fund shares posed little risk of abuse, because those shares are priced at net asset value daily.[44]

Our enforcement actions against fund managers who we allege to have engaged in market timing of their funds based upon their knowledge that portfolio securities were mispriced indicates that this assumption was false.[45] Therefore, we propose to require all advisers' codes of ethics to call for reporting of holdings and transactions in affiliated mutual funds.[46]

• Should the proposed rule require reporting of transactions and holdings in all mutual fund shares, rather than only affiliated funds? Does the proposed rule draw an appropriate line regarding which funds should be covered, and if not, where should that line be drawn?

• Proposed rule 204A–1 would include, as access persons, individuals who obtain information about the existing securities holdings in the adviser's investment companies. Should these individuals be considered access persons? Should we amend rule 17j–1 under the Investment Company Act to conform the definitions?

• Should supervised persons who have information about the holdings of non-fund clients also be included as access persons?

5. Initial and Annual Holdings Reports

Proposed rule 204A–1 would require a complete report of each access

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[35] Rule 17j–1(a)(1)(i) (A) and (B). *See also* rule 204–2(a)(13)(iii)(D).

[36] Proposed rule 204A–1(e)(1)(ii).

[37] Proposed rule 204A–1(b)(1)(i)(A) and (e)(10) (i) and (ii). The Commission interprets ''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 note 66.

[38] Proposed rule 204A–1(e)(10)(iii).

[39] Proposed rule 204A–1(e)(9) and (10)(iv). Transactions and holdings in shares of closed-end investment companies would be reportable regardless of affiliation.

[40] *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''). *See also* rule 204–2(a)(12)(iii)(B).

[41] Proposed rule 204A–1(e)(3).

[42] As under rule 17j–1, any report required under rule 204A–1 would be permitted to contain a disclaimer of beneficial ownership by the person making the report.

[43] A fund is a ''reportable fund'' under proposed rule 204A–1(e)(9) if the adviser acts as investment adviser to the fund, or if certain control affiliates of the adviser serve as either investment adviser or principal underwriter to the fund. Those control affiliates are persons who control the adviser, who are controlled by the adviser, or who are under common control with the adviser. For many advisers to investment companies, their reportable funds will be only those they manage, because these advisers have no control affiliates that are other advisers or broker-dealers. A large financial services complex with multiple advisory and brokerage firms under common control will have a greater number of reportable funds.

[44] *See* Rule 17j–1 1980 Adopting Release, *supra* note 21 (the Commission exempted shares of mutual funds from the rule's reporting requirements because they ''present very little opportunity for the type of improper trading that the rule is intended to cover'').

[45] *See supra* note 5.

[46] In addition, we would expand the definition of ''access person'' from that in rule 17j–1. Access persons under rule 17j–1 include advisory personnel who make trading recommendations or decisions for the fund or have information about the fund's purchases and sales of securities. Access persons under rule 204A–1 would also expressly include supervised persons who have nonpublic information about a reportable fund's portfolio securities *holdings*.

person's securities holdings.[47] Holdings reports would be required at the time the person becomes an access person and at least once a year thereafter.[48] We require similar holdings reports under rule 17j–1.[49]

• Should we require holdings reports to be more frequent?

• If we require holdings reports more often than annually, should we make parallel changes to rule 17j–1?

6. Periodic Transactions Reports

Proposed rule 204A–1 would require quarterly reports of all personal securities transactions by access persons.[50] The reports would be due no later than 10 days after the close of the calendar quarter. In the event an access person had no personal securities transactions during the quarter, the report would contain a statement to that effect and would still be required.

• We request comment on the required timing of these reports.

• If we require more frequent transaction reports or a shorter deadline for reporting, should we make parallel changes to rule 17j-1?

Transactions effected pursuant to an automatic investment plan would not have to be reported.[51] Automatic investment plan participants must determine, well in advance, what their investments will be, and that pre-determined schedule does not leave the individual in a position to time their own trades against clients' trades, or to act on newly discovered confidential information. Often, however, a participant in an automatic investment plan will effect a transaction that overrides the pre-set schedule or allocations of the plan; such transactions would have to be reported in a quarterly transaction report.

• Are there other types of transactions that should be exempt from quarterly transactions reports? For example, some advisers that have overall pre-clearance requirements permit employees to purchase securities pursuant to an exercise of rights issued *pro rata,* or certain corporate actions such as stock splits, without pre-clearing the purchase. Should those transactions also be exempt from quarterly transactions reports? Commenters are requested to specify which corporate actions should qualify for any exemption.

• Should small transactions be exempt if the issuer has a large market capitalization? If so, what should be the thresholds for the size of the transaction and for the size of the issuer?

• Should transactions pursuant to automatic investment plans, or other types of transactions, also be exempt from quarterly reporting under rule 17j–1?

7. Duplicate Broker Confirms and Statements

Many advisory firms already receive copies of their employees' trade confirmations or account statements covering personal securities transactions. Proposed rule 204A–1 would not require access persons to submit transaction reports that would duplicate information contained in trade confirmations or account statements that the adviser holds in its records. A duplicate trade confirmation or account statement would be required to be received by the adviser within 10 days after the end of the quarter in which the transaction takes place.

• The proposed 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 confirm or statement, and the remainder could appear elsewhere in the adviser's records. Is this clear in the proposed rule, or should the rule contain an express provision on this point? Does this practice fragment the information such that a complete picture of the access person's securities trades is harder to obtain?

D. Initial Public Offerings and Private Placements

The code of ethics would have to require that access persons obtain the adviser's approval before investing in an initial public offering (''IPO'') or private placement.[52] We added a similar provision to rule 17j-1 in 1999.[53] Because most individuals rarely have the opportunity to invest in these types of securities, an access person's IPO or private placement purchase may, for example, raise 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.[54]

• Many advisers prohibit their employees from participating in initial public offerings and private placements.[55] Should the rule prohibit access persons from making these investments for their personal accounts?

E. Reporting of Violations

The code of ethics would have to require prompt internal reporting of any violations of the code.[56] Reports of violations would have to be made to the adviser's chief compliance officer or to another person designated in the code of

[47] In contrast, our current recordkeeping rules require only that advisers retain records of certain personal securities transactions of their employees. Rule 204–2(a)(12)(i) and (13)(i). The rules do not require reports on holdings acquired before the employee joined the adviser, nor do they require reports showing cumulative holdings in securities. Both the adviser and our examiners, however, may also need to see a complete picture of all securities held by the access person in order to identify potential or actual conflicts of interest. Without knowledge of all those securities, including securities acquired *before* the person became an access person, it would, for example, be difficult for an adviser to determine whether the access person is recommending purchases for clients based solely on the clients' best interest or based on the securities that the access person holds in his or her own portfolio.

[48] Proposed rule 204A–1(b)(1)(ii).

[49] Rule 17j–1(d)(1)(i) and (iii). We recognize that some persons may already be reporting their securities holdings and brokerage accounts to the adviser. We believe that, as under rule 17j–1, an access person would satisfy the initial holdings report requirement and would not have to submit a separate report, if the adviser maintains a composite record of the information required to be disclosed in the initial report and the access person confirms in writing (which writing may be electronic) the accuracy of the record within 10 days after becoming subject to this provision. *See* Rule 17j–1 1999 Adopting Release, *supra* note *40, at n. 34.* The proposed rule would not, however, permit an access person to avoid filing an initial 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.

[50] Proposed rule 204A–1(b)(2).

[51] Proposed rule 204A–1(b)(3)(ii).

[52] Proposed rule 204A–1(c).

[53] *See* Rule 17j–1 1999 Adopting Release, *supra* note 40.

[54] *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).

[55] Guidelines on personal investing endorsed by the Investment Counsel Association of America recommend prohibiting advisory personnel from acquiring securities in an IPO. Investment Counsel Association of America, Inc., *Guidelines on Personal Investing* (Feb. 1995). Similarly, the advisory group to the Investment Company Institute recommended prohibiting investment personnel from acquiring IPO shares. Investment Company Institute Report of the Advisory Group on Personal Investing at 32 (May 9, 1994). Of course, the proposed rule would not require an adviser that prohibited these transactions to include provisions in its code of ethics requiring their pre-clearance.

[56] Proposed rule 204A–1(a)(5).

ethics.[57] The sooner the adviser learns of a violation by a supervised person, the sooner the firm can take corrective measures.[58] But no compliance officer can be everywhere within the firm at all times. Reports may come from violators themselves, as would be likely in the case of inadvertent and some technical violations of the code of ethics, or may come from others within the firm who learn of a fellow employee's inappropriate actions.

We ask for comment on this provision of the proposals. Should advisers identify at least two persons to whom reports of violations can be submitted, in case one of the designated persons is involved in the violation?

• Should the code of ethics require reporting of apparent violations as well?

F. Acknowledged Receipt of Code of Ethics

The code of ethics would have to require the adviser to provide each supervised person with a copy of the code of ethics and any amendments, and require each supervised person to acknowledge, in writing, his receipt of those copies.[59] An investment adviser's procedures for informing its employees about its code of ethics are critical to obtaining good compliance and avoiding inadvertent violations of the code.

• Advisers' codes of ethics often contain procedures for the firm to educate employees about the code of ethics, including the reporting requirements, and to advise employees periodically of changes made to the code.[60] Should we mandate that all adviser codes of ethics contain such procedures?

• Advisers' codes also often 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. Should rule 204A–1 expressly impose these requirements?

G. Other Code of Ethics Provisions

As discussed above, advisers that have adopted codes of ethics often include a variety of provisions designed to guard against impropriety and conflict, and designed to ensure that the firm can implement the code it has adopted.[61] They may include other provisions such as:

• Limitations on acceptance of gifts.

• Limitations on the circumstances under which an access person may serve as a director of a publicly traded company.

• Detailed identification of who is considered an access person within the organization.

• Procedures for the firm and its compliance personnel to review periodically the code of ethics as well as to review reports made pursuant to it.

• Discussion of penalties for violating the code of ethics.[62]

Should any of these be required elements of an adviser's code of ethics?

H. Adviser Review and Enforcement

Proposed rule 204A–1 would require that advisers maintain and enforce the provisions of their codes of ethics.[63] Enforcement of the code would include reviewing the securities holdings and transaction reports of the adviser's access persons.[64] We expect that the responsibility for enforcing the adviser's code of ethics will lie substantially with the adviser's chief compliance officer, to whom personal trading reports must be submitted.[65]

I. Recordkeeping

We are also proposing to amend rule 204–2 under the Advisers Act to reflect the codes of ethics that advisers would adopt under rule 204A–1 and to eliminate details that rule 204A–1 would make unnecessary. As a result, advisers should find it easier to understand and meet their recordkeeping obligations.

Currently, rules 204–2(a)(12) and (13) lay out fairly complex requirements for the information that advisers must keep regarding personal securities transactions.[66] Our proposed amendments would simplify recordkeeping by, instead, relying on and referring to the adviser's required code of ethics. Advisers would have to keep copies of their code of ethics and their supervised persons' written acknowledgment of receipt of the code. They would have to keep records of violations of the code, and records of action taken as a result of violations.[67] In addition, advisers would have to keep a record of the names of their access persons under rule 204A–1, holdings and transaction reports made by access persons, and records of decisions approving access persons' acquisition of securities in IPOs and limited offerings.[68]

• We ask comment on whether the proposed recordkeeping requirements are appropriate.

• Should the rule require advisers to keep records of any code of ethics waivers or exemptions they grant to a supervised person?

We propose to require that records of access persons' personal securities reports (and duplicate brokerage confirmations or account statements in lieu of those reports) be maintained electronically in an accessible computer database.[69] In all but the smallest advisory organizations, it may be impractical for the adviser or our examiners to review paper trading reports for patterns that may indicate abuse. [70] Electronic records need not be costly or burdensome to maintain. In a small firm, a spreadsheet may be sufficient. Larger firms may monitor

[57] As we discussed in adopting a similar provision under section 406 of the Sarbanes-Oxley Act, *see supra* note 10, the person to whom violations are reported should not be a person involved in the matter giving rise to the violation, and if the person is not the adviser's chief compliance officer, should have sufficient status within the organization to engender respect for the code of ethics. *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)] at n.45.

[58] As discussed below at Section II.I of this Release, advisers would be required to keep records of violations of the code of ethics and of actions taken as a result of the violation.

[59] Proposed rule 204A–1(a)(6).

[60] Some advisers may hold orientation sessions periodically for new or existing employees to remind them of the requirements of the firm's code of ethics.

[61] *See* PPI Report, *supra* note 25 at 199 (noting that failure to adopt appropriate procedures for implementing codes to prevent insider trading, or to fix responsibility for such implementation, ''impairs the value of even the most carefully drafted code'').

[62] 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.

[63] Proposed rule 204A–1(a).

[64] Proposed rule 204A–1(a)(4).

[65] Proposed rule 204A–1(b)(1) and (2). We recently adopted rule 206(4)–7 under the Advisers Act [17 CFR 275.206(4)–7], which, among other things, requires every adviser registered with us to appoint a chief compliance officer. Compliance Adopting Release, *supra* note 7. Under our proposal, reports of violations of the code of ethics would also go to the chief compliance officer or to another person designated in the code. Proposed rule 204A–1(a)(5).

[66] Rule 204–2(a)(13) repeats virtually all of rule 204–2(a)(12), but applies specifically to investment advisers who are primarily engaged in a business other than advising funds or other advisory clients.

[67] Proposed amended rule 204–2(a)(12).

[68] Proposed amended rule 204–2(a)(13). Advisers would be required to maintain the records required under proposed amended rule 204–2(a)(12) and (13) in an easily accessible place for five years, the first two years in an appropriate office of the investment adviser. These are the standard retention requirements for books and records under rule 204–2.

[69] These records would be subject to the special safeguards and other requirements for electronic storage contained in rule 204–2(g).

[70] Under current rule 204–2(a)(12) and (13), duplicate confirmations and account statements can substitute for transaction reports otherwise required, so long as any paper copies are organized so as to allow easy access to and retrieval of any particular confirmation or statement.

employees' trading by opening up ''client'' accounts for each employee so that the firm's existing portfolio analysis programs can track the employees' trades.

• We ask comment on our understanding that requiring these records to be kept electronically would not be burdensome. Is there a need to exempt some smaller firms from the electronic recordkeeping requirement, or to modify the electronic recordkeeping requirement for these firms?

J. Amendment to Form ADV

We are proposing to amend Part II of Form ADV 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.[71] We emphasized the importance of disclosure in 1999 when we amended rule 17j–1 to require funds' codes of ethics to be filed with us electronically and thus available to the public.[72] This disclosure would help clients understand the ethical culture and standards at the advisory firm, how the adviser controls sensitive information and what steps it has taken to prevent employees from misusing their inside positions at the expense of clients. Clients would be able to select advisers whose ethical commitment meets their expectations. Disclosure should also serve to encourage advisers to implement more effective procedures.[73]

• Is a general disclosure requirement adequate? Commenters urging that more specific disclosure be required should provide sample text.

K. Investment Company Advisers

Approximately 19 percent of the advisers registered with us advise registered investment companies and are therefore also subject to rule 17j–1. We would not want those advisers to be subject to conflicting responsibilities under that rule and our new proposals.

Currently, access persons under rule 17j–1 need not make a quarterly transaction report under that rule if ''all of'' the information in the report would duplicate information required to be recorded under Advisers Act rules.[74] We are proposing to revise that to state that no report would be required under rule 17j–1 ''to the extent that'' the report would duplicate information required under the Advisers Act recordkeeping rules, because the reports we propose to require under the Advisers Act are not identical to those that rule 17j–1 would require. To avoid duplicative reports, some advisers to investment companies may require their access persons to provide reports that cover all information required under rule 17j–1 and all information required under the Advisers Act code of ethics ''for example, an access person's quarterly report might include information on new securities accounts (required under rule 17j–1) as well as on transactions in affiliated mutual funds (required under rule 204A–1).

• We ask comment on whether there are alternative approaches to better reconcile this issue.

III. General Request for Comment

The Commission requests comment on the rule and amendments proposed in this release, suggestions for other additions to the rule and amendments, and comment on other matters that might have an effect on the proposals contained in this release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed rule and amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. Proposed rule 204A–1 would require investment advisers to establish, maintain, and enforce codes of ethics for their supervised persons. These codes of ethics would establish standards of business conduct reflecting the fiduciary obligations of the adviser and its personnel and impose measures designed to prevent supervised persons from abusing their access to information about clients' securities transactions. We are also proposing related recordkeeping and client disclosure amendments.[75] We have identified certain costs and benefits, which are discussed below, that may result from these proposed rules. We request comment on the costs and benefits of the proposed rules. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

A. Benefits

We anticipate that advisory firm clients and the firms themselves would benefit from the proposed rules, though these benefits are difficult to quantify. Codes of ethics under proposed rule 204A–1 would impress upon 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 would also be an important part of advisers' efforts to prevent fraudulent personal trading by their supervised persons. As a result, these codes should increase investor protection by forestalling supervised persons from engaging in misconduct that defrauds clients. In addition, requiring advisers to describe their codes of ethics to clients and to furnish copies to clients upon request should 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 would be able to seek a different adviser whose measures he approves.

Proposed rule 204A–1 would reinforce existing measures that require investment advisers to guard against employee misconduct. It would go beyond section 204A of the Advisers Act, which focuses on policies and procedures to prevent misuse of material nonpublic information by advisory firm personnel, and expand advisers' policies to address other situations in which such personnel could potentially benefit at the expense of firm clients. It would also go 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, and expand advisers' policies to address advisory personnel's holdings and transactions in shares of investment companies managed by the adviser. Codes of ethics should also assist advisers in meeting their obligations under Advisers Act rule 206(4)–7 to adopt policies and procedures reasonably designed to prevent their

[71] We are proposing to amend 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.

[72] *See* Rule 17j–1 1999 Adopting Release, *supra* note 40.

[73] The provisions of section 206 of the Advisers Act would be applicable to an investment adviser that disclosed its policies and procedures but then materially deviated from them.

[74] Rule 17j–1(d)(2)(iv).

[75] We are proposing amendments to Advisers Act rule 204–2, the adviser recordkeeping rule, to address documentation of advisers' compliance with rule 204A–1. We are also proposing to amend 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.

supervised persons from violating the Advisers Act.

Proposed rule 204A–1 would benefit investment advisers by diminishing the likelihood 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.[76] In addition, advisers could be precluded from serving in other capacities.[77]

Our proposal to revise advisers' recordkeeping obligations for personal securities transactions should also benefit investment advisers. The proposed rules are easier to understand than the complex provisions currently contained in Advisers Act rule 204–2(a)(12) and (13). In addition, by requiring investment advisers to maintain information about their access persons' personal securities transactions electronically in an accessible database, we would make it more likely that firms could detect patterns that may indicate abuse. In all but the smallest advisory organizations, it may be impractical to try to identify such patterns by reviewing paper records. The requirement that each access person provide initial and annual holdings reports will allow 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 proposed rules would result in some additional costs for advisers, and advisers may pass these costs along to their clients in the form of advisory fees. However, since advisers are already required to maintain various policies and procedures that would constitute core elements of their codes of ethics, many of these costs are already reflected in fees clients currently pay. Advisers are required to maintain written policies and procedures reasonably designed to prevent the misuse of material nonpublic information under section 204A of the Advisers Act. 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.[78] 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 codes of ethics will impose few new costs on advisers.

Similarly, our proposals 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 rule 204–2(a)(12) and (13). The additional reporting required of access persons under our proposed rules ''routine quarterly reports indicating that no transactions were effected, and an annual report of securities holdings '' should impose only minor additional costs. 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.[79] 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.

Our proposal to require advisers to maintain information about their access persons' personal securities transactions electronically in an accessible database would be new. However, we do not expect advisers would be required to acquire new computer equipment or software to implement this approach. We understand that all but the smallest firms currently use client portfolio management software platforms that could easily be used by access persons to report their holdings and transactions under proposed rule 204A–1. Smaller firms could also easily require access persons to submit their reports in common electronic spreadsheet formats.[80]

We expect only minor cost increases from our proposals to require access persons to obtain their advisers' approval before investing in an initial public offering or private placement. Our experience administering the same requirement under Company Act rule 17j–1 has been that such proposals are infrequent, even at larger advisory firms.

Finally, we expect only minor cost increases from our proposal to require advisers to describe their codes of ethics to clients and provide copies on request. Advisers would include the description in the disclosure brochure they are already required to provide to clients. The description should be sufficient for most clients, and it should not impose substantial costs to provide a copy of the code of ethics to the few clients that request it.

C. Request for Comment

We request comment on the potential costs and benefits identified in the proposal and any other costs or benefits that may result from the proposed rules. Commenters are requested to identify, discuss, analyze, and supply relevant data to support their views.

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, the proposed rule would require investment advisers to

[76] 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.

[77] *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)]).

[78] 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.

[79] 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.

[80] Firms could also require access persons to conduct their personal securities activities through the same broker-dealers from which the firm obtains electronic reporting of client transactions, and obtain access persons' information electronically from the broker-dealers.

adopt codes of ethics applicable to their supervised persons. These codes of ethics would establish standards of business conduct reflecting the fiduciary obligations of the adviser and its personnel and impose measures designed to prevent supervised persons from abusing their access to information about clients' securities transactions. We expect that the proposed rule may indirectly increase efficiency. These codes of ethics should 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 proposed rule would apply equally to all registered advisers, we do not anticipate that it would introduce any competitive disadvantages. We expect that the proposed 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 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

The proposed rule and amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[81] One of the collections of information is new. The Commission has submitted this new collection 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 title of this new collection is ''Rule 204A–1;'' OMB has not yet assigned it a control number. The other collection of information takes the form of amendments to two currently-approved collections titled ''Rule 204–2'' under OMB control number 3235–0278, and ''Form ADV'' under OMB control number 3235–0049. The Commission has also 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. 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.[82] The records that an adviser must keep in accordance with rule 204–2 must generally be retained for not less than five years.[83]

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 their clients' interests. Responses to the disclosure requirements are not kept confidential.

A. Rule 204A–1

Rule 204A–1 would require SEC-registered investment advisers to establish a written code of ethics for their supervised persons. These codes of ethics would establish standards of business conduct reflecting the fiduciary obligations of the adviser and its personnel and impose measures designed to prevent supervised persons from abusing their access to information about clients' securities transactions.[84] We estimate that each adviser would be required to spend six hours annually, on average, documenting its code of ethics. In preparing this estimate, we have taken into account that investment advisers currently maintain certain policies and procedures that could serve as the core of their codes of ethics. Advisers are required to maintain written policies and procedures reasonably designed to prevent the misuse of material nonpublic information, and to keep records of their advisory representatives' personal securities transactions.[85] Also, the approximately 1,500 advisers who advise investment companies currently have codes of ethics pursuant to Investment Company Act rule 17j–1.[86] In addition, investment advisers are required to adopt policies and procedures reasonably designed to prevent their supervised persons from violating the Advisers Act.[87] We further estimate that 8,019 investment advisers will incur this burden, for a total of 48,114 hours.[88]

Rule 204A–1 would also require 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.[89] ''Access persons'' are supervised persons of the adviser who have access to certain client securities information or recommendations.[90] For purposes of estimating the paperwork burden for access persons under proposed rule 204A–1, we assume that advisers will treat all their non-clerical

[81] 44 U.S.C. 3501 to 3520.

[82] *See* section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

[83] *See* rule 204–2(e) [17 CFR 275.204–2(e)].

[84] Proposed rule 204A–1(a). Some firms have already adopted a code of ethics. These codes typically remind employees that they occupy positions of trust requiring them to act with the utmost integrity and include measures to restrict personal trading in securities being recommended to or traded for clients and to limit access to material nonpublic information. They also include reporting and other measures for the firm to monitor employees' personal securities transactions.

[85] *See* section 204A of the Advisers Act and Advisers Act rule 204–2(a)(12)–(13).

[86] Based on our records of information submitted to us by investment advisers in Part 1A of Form ADV through December 10, 2003, approximately 1,500 advisers report that they manage portfolios for investment companies. Under Investment Company Act rule 17j–1, advisers to investment companies generally must have a code of ethics to prevent their ''access persons'' from abusing their access to information about the fund's securities trading. Access persons must also submit reports containing information about their personal securities transactions and holding.

[87] Rule 206(4)–7 under the Advisers Act.

[88] As of December 9, 2003, there were 8,019 investment advisers registered with the Commission. 8,019 advisers × 6 hours = 48,114 total annual hours.

[89] Proposed rule 204A–1(a)(4).

[90] Proposed rule 204A–1(e)(1). *See* notes 29–30, *supra,* and accompanying text.

employees as access persons.[91] We estimate that investment advisers have 84 non-clerical employees on average, although this estimate overstates the number of such employees at the majority of advisory firms.[92] Based on this average, we estimate that 673,596 access persons would be subject to the collection of information under the proposed rule.[93]

These access persons would be required to file an initial report of their personal securities holdings upon becoming access persons, and an annual holdings report at least once a year thereafter.[94] We estimate access persons would spend 0.7 hours on average completing each such report. These access persons would also be required to file transaction reports once each quarter stating whether the access person had any personal securities transactions that quarter and giving basic information about any such transactions.[95] We estimate access persons would spend 0.6 hours on average completing such reports each year.[96] Thus, the total annual burden hours for all access persons under the proposed would be 875,675 hours.[97]

Rule 204A–1 would also require 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. We estimate that each investment adviser has 100 supervised persons on average, although this estimate overstates the number of supervised persons at the majority of advisory firms.[98] We further estimate that each adviser will be required to provide a copy and obtain an acknowledgment 55 times each year, on average. This is based on our estimate that advisers will amend their codes every other year and hire five new supervised persons each year.[99] We further estimate each iteration will take an investment adviser 0.05 hours on average, for an annual burden of 2.75 hours per adviser and a total burden increase of 22,052.25 hours for all advisers.[100]

Based on these estimates, the total annual burden for advisers and access persons under proposed rule 204A–1 would be 945,841.25 hours.[101]

B. Rule 204–2

In addition, the proposal would amend rule 204–2, the adviser recordkeeping rule. The currently-approved annual aggregate information collection burden under rule 204–2 is 1,651,324.2 hours. This approved annual aggregate burden was based on estimates that 7,790 advisers were subject to the rule, and each of these advisers spends an average of 211.98 hours preparing and preserving records in accordance with the rule. Based upon the most recently available data, there are 8,019 registered investment advisers. The increase in the number of registered investment advisers increases the total burden hours of current rule 204–2 from 1,651,324.2 to 1,699,867.6 hours.[102]

The proposed amendments would reduce the burden of collection under rule 204–2. The 211.98 hour burden estimate for the currently-approved collection includes a requirement that investment advisers retain records relating to the personal securities transactions of ''advisory representatives.''[103] Advisers must record the personal securities transactions of their advisory representatives no later than ten days after the close of the quarter in which the transactions takes place. The proposed amendments to rule 204–2 would eliminate this requirement and instead require the adviser to retain the personal securities transaction information reported to it by its access persons under proposed rule 204A–1. We estimate this will reduce the burden on investment advisers under rule 204–2 by an average of 0.3 hours for each of the 84 access persons we estimate are at each firm.[104] The annual hour burden estimate for rule 204–2 would correspondingly be reduced to 186.78 hours .[105]

The proposed amendments to rule 204–2 would also increase the types of information collected under the rule. We estimate these new collections would increase the annual burden by 5 hours on average, to 191.78 hours. Advisers would be required to retain the personal securities holdings and transaction information submitted by their access persons under proposed rule 204A–1 and maintain it electronically in an accessible

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[91] This may overestimate the number of access persons to the extent investment advisers prevent some of their employees from having access to client securities information, or may underestimate the number of access persons to the extent clerical employees of some advisers have access to such information. On the basis of data submitted to us by SEC-registered investment advisers in Part 1 of Form ADV, it is difficult to estimate how many supervised persons of an investment adviser would be access persons; in addition, the internal controls on sensitive information will vary among advisers. We are aware that many investment advisers currently elect to treat all employees as ''advisory representatives'' or ''access persons'' for purposes of personal securities reporting under Advisers Act rule 204–2(a)(12) and Company Act rule 17j–1, respectively.

[92] This average is based on Form ADV data (under Item 5.A of Part 1A) submitted to us by 8,019 advisers through December 9, 2003. If we exclude the top 100 advisers who reported the greatest number of nonclerical employees, the average for the remaining 7,919 advisers (who report their employees by range) is only 31 employees. Moreover, half of these advisers reported that they had five or fewer nonclerical employees.

[93] 84 access persons x 8,019 investment advisers = 673,596. Access persons of a firm with only one supervised person would generally be exempted from submitting personal securities activity reports. Proposed rule 204A–1(d). We have not attempted to exclude these access persons in preparing this estimate. On the basis of information submitted to us by SEC-registered investment advisers in Part 1A of Form ADV, it is difficult to estimate how many of the 8,019 advisers registered with us have only one supervised person.

[94] Proposed rule 204A–1(b)(1). These reports require basic information about securities in which the access person has a beneficial ownership interest (subject to exceptions for certain categories of securities) and the name of any broker, dealer or bank with which the access person maintains accounts to hold interests in securities.

[95] Proposed rule 204A–1(b)(2).

[96] In preparing this 0.6 hour annual estimate, we assumed advisory persons would have no transactions to report for three quarters each year (at 0.1 hours to complete each report affirming no activity) and one transaction to report one quarter each year (at 0.3 hours to complete such report listing the transaction). Although some access persons make frequent personal securities transactions, we are aware that many trade infrequently. *See* PIA Report, *supra* note 12, at 2 (noting that 43.5% of fund managers whose 1993 personal securities transactions the Commission examined in the study did not buy or sell securities at all).

[97] (0.7 hours holdings report + 0.6 hours transactions report) x 673,596 access persons = 875,675 hours.

[98] This estimate is based on the same Form ADV data we use to estimate the average number of non-clerical employees, as discussed in notes 91–92, *supra.* Since Form ADV does not require advisers to submit data about their clerical employees, we assume advisers have 16 clerical employees on average (or approximately one clerical employee for every 5 non-clerical employees). 16 clerical employees + 84 non-clerical employees = 100 employees.

[99] 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.

[100] 0.05 hours per copy x 55 copies per year = 2.75 hours. 2.75 hours x 8,019 investment advisers = 22,052.25 hours total.

[101] 48,114 hours by advisers to record their codes of ethics + 875,675 hours for reporting by access persons + 22,052.25 hours for advisers to deliver copies of codes and amendments = 945,841.25.

[102] 8,019 advisers x 211.98 hours = 1,699,867.6 aggregate hours.

[103] Rule 204–2(a)(12)–(13).

[104] As we discuss in note 96, *supra,* we estimate that access persons would make an average of one personal securities transaction each year. We estimate that it would take the adviser the same time to record the transaction as we estimate it would take the access person to report it under proposed rule 204A–1, *i.e.* 0.3 hours. As we discuss in notes 91–92, *supra,* we estimate advisers registered with the Commission have an average of 84 access persons.

[105] 0.3 hours per access person x 84 access persons per firm = 25.2 hours—per firm. 211.98 hours—25.2 hours = 186.78 hours.

database.[106] Advisers would also be required to retain copies of their codes of ethics required under proposed rule 204A–1, and copies of the written acknowledgments they receive from supervised persons confirming their receipt of the code of ethics or amendments. In addition, advisers would be required to maintain a record of the names of their access persons, make a record of any violation of their codes of ethics and any action taken, and make a record of any decision under proposed rule 204A–1 to permit an access person to invest in an initial public offering or private placement.

Accordingly, we estimate the proposed changes to rule 204–2 would decrease the annual aggregate information collection burden under the rule by 161,983.8 hours, from 1,699,867.6 hours to 1,537,883.8 hours.[107]

C. Form ADV

The proposal would also amend Part II of Form ADV, which specifies certain information investment advisers must disclose to their clients.[108] The amendment would require advisers to describe their codes of ethics to clients and, upon request, furnish clients with a copy of their code of ethics. The currently-approved burden of the collection of information in Form ADV is 46,921 hours. We estimate that each investment adviser would spend 0.25 hours preparing a description of its code of ethics for Form ADV. We further estimate that each investment adviser has 670 clients on average,[109] and 90 percent of such clients will find this description sufficiently informative, so at most 10 percent, or 67 clients on average, would request a copy of the adviser's code of ethics. We estimate it would take advisers 0.1 hour per client to deliver copies of their codes of ethics, or 6.7 hours on average per adviser. Accordingly, we estimate the proposed amendments would increase the annual aggregate information collection burden under Form ADV to 102,653 hours.[110]

D. Request for Comment

We request comment whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

- evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information;
- determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609 with reference to File No. S7–04–04. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–04–04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

VII. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with section 3(a) of the Regulatory Flexibility Act.[111] It relates to proposed rule 204A–1 and proposed amendments to rule 204–2 and Form ADV under the Advisers Act and to proposed amendments to rule 17j–1 under the Company Act.

A. Reasons for Proposed Action

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

B. Objectives and Legal Basis

Section II of this Release discusses the objectives of the proposed new rule and rule amendments. As we discuss in detail above, these objectives include requiring SEC-registered investment advisers to adopt codes of ethics for their supervised persons, requiring advisers to retain certain records relating to their codes of ethics, and requiring advisers to disclose information about their codes of ethics to clients. Section VIII of this Release lists the statutory authority for the proposed new rule and rule amendments.

C. Small Entities Subject to Rule

The proposed new rules and rule amendments under the Advisers Act would govern all advisers registered with the Commission, (and the amendments to rule 17j–1 would govern all investment companies,) including 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.[112] The Commission estimates that as of December 10, 2003, there were approximately 545 investment advisers registered with us that were small entities that might potentially be affected by the proposed new rules and

[106] We do not expect advisory firms would incur costs for computer hardware or software under this requirement. Although some larger firms have developed special software to obtain and review personal securities transactions data, we understand that all but the smallest firms currently use client portfolio management software platforms that could easily be used by firm access persons to report their holdings and transactions under proposed rule 204A–1. Smaller firms could also easily require access persons to submit their reports in common electronic spreadsheet formats. Firms could also require access persons to conduct their personal securities activities through the same broker-dealers from which the firm obtains electronic reporting of client transactions, and obtain access persons' information electronically from the broker-dealers.

[107] 191.78 hours per adviser x 8,019 advisers = 1,537,883.8 hours.

[108] Form ADV and Advisers Act rule 204–3 [17 CFR 275.204–3].

[109] *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2044 (July 18, 2002) [67 FR 48579 (July 25, 2002)].

[110] (0.25 hours + 6.7 hours) x 8,019 advisers = 55,732 hours. 46,921 hours (existing total) + 55,732 hour increase = 102,653 hours.

[111] 5 U.S.C. 603(a).

[112] 17 CFR 275.0–7(a).

rule amendments.[113] We request comment on the effect and costs of the proposed new rules and rule amendments on small entities.

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.[114] Of approximately 5,124 registered investment companies, we estimate that approximately 204 are small entities.[115] As discussed above, the proposed amendment to rule 17j–1 would allow advisers to rely on a reporting exception in the rule if the adviser already maintains duplicate information under records required by certain Advisers Act rules. Whether this proposed amendment to rule 17j–1 would affect small entities would depend on whether the small entities rely on the reporting exception in rule 17j–1. We request comment on the effect and costs of this proposed amendment on small entities.

D. Reporting, Recordkeeping, and other Compliance Requirements

The proposed amendment to Form ADV would impose 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 the proposed rule and rule amendments would impose no other new reporting requirements on registered advisers themselves, proposed rule 204A–1 would require that advisers' codes of ethics impose a new reporting requirement on advisers' access persons by requiring certain new personal securities holdings and transaction reports. The proposed rule and rule amendments would also create certain new recordkeeping and compliance requirements. The proposed rule amendments would 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).[116] The proposed rule would impose 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.

Small entities registered with the Commission as investment advisers would for the most part be subject to these new reporting, recordkeeping and compliance requirements to the same extent larger advisers would be. 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, would not be subject to the new requirements. Additionally, we anticipate that most advisers would 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 would 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 proposed 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 proposed rule and amendments may actually alleviate reporting, recordkeeping, or compliance burdens on advisers, including those that are small entities.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate or conflict with the proposed rule. Proposed rule 204A–1 and the proposed amendments to rule 204–2 overlap with provisions of rule 17j–1 under the Company Act to some extent. Rule 17j–1 requires certain investment advisers to adopt codes of ethics, review personal securities holdings and transaction reports of certain access persons, and pre-approve certain investments by access persons. The provisions of rule 17j–1 do not apply to all investment advisers registered with us, but only to those investment advisers that advise registered investment companies. Furthermore, our proposed rule and rule amendments are designed to coordinate with, rather than duplicate or conflict with, the obligations of an investment adviser subject to both rules.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any adverse impact on small entities. In connection with the proposed rule, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for such small entities.

The Commission has drafted proposed rule 204A–1 to permit each firm subject to the rule to design and structure its own code of ethics in light of the firm's operational structure and the particular types of conflicts encountered by the firm in connection with its business and clients. In the same way, the proposed amendments to rule 204–2 would permit each firm to develop its own system for capturing and retaining the requisite information. In connection with considering whether to establish differing reporting, compliance or recordkeeping requirements or timetables for small entities, as well as whether to use performance rather than design standards, the Commission believes at this time that the flexibility already built into the proposal adequately addresses these alternatives.

In considering whether to attempt to further clarify, consolidate, or simplify the reporting, compliance and recordkeeping requirements under the rule for small entities, the Commission believes at this time that the proposal achieves the appropriate balance between simplicity and investor protection. The compliance requirements, which are integral to the effectiveness of the rule, are not

[113] This estimate is based on the information submitted by SEC-registered advisers in Part 1A of Form ADV.

[114] 17 CFR 270.0–10.

[115] This estimate, which is current as of June 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.

[116] 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.

technical or complex in any sense. The minimum criteria specified for codes of ethics (including provisions for establishment of standards of business conduct, protection of information, personal securities reporting and review of such reporting, and pre-approval of certain transactions) under proposed rule 204A–1 are designed to further adherence by advisers and their personnel to their fiduciary obligations and to prevent misuse of material nonpublic information. At this time, we believe elimination of some or all of these criteria, which are designed to ensure that advisers address these issues in a systematic fashion and actively oversee supervised persons' conduct, would potentially impede achievement of that objective. The proposed disclosure requirements would provide advisory clients with information about the adviser's code of ethics. Different disclosure requirements would leave some advisory clients without the requisite information to assess their adviser's ethical practices. Similarly, in establishing the categories of records to be retained under the proposed amendments to rule 204–2, the records described by the rule are designed to provide the Commission with sufficient information to be able to evaluate advisers' compliance with proposed rule 204A–1 as part of its inspection program.

The proposed rule would, to the greatest extent possible, incorporate performance rather than 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.

Finally, the Commission believes at this time that it would be inconsistent with the purposes of the Advisers Act to entirely exempt small entities from the proposed rule and rule amendments. The proposed codes of ethics are designed to promote advisers' fulfillment of their fiduciary duty to clients and to guard against personal securities trading by advisers' access persons that may be contrary to clients' interests. Since 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 Act to specify different requirements for small entities. To the extent we were able, however, the Commission has excepted certain small advisers, potentially including some small entities, from the requirements that access persons make personal securities reports and that access persons obtain pre-approval before making certain investments.

G. Solicitation of Comment

We encourage written comments on matters discussed in the IRFA. In particular the Commission seeks comment on:

- the number of small entities that would be affected by the proposed rule and rule amendments; and
- whether the effects of the proposed rule and rule amendments on small entities would be economically significant.

Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect.

VIII. Statutory Authority

We are proposing 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 proposing 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 proposing new 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 proposing 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 Proposed 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 proposed to be 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 revising paragraph (d)(2)(iv) to read as follows:

§ 270.17j–1 Personal investment activities of investment company personnel.

* * * * *

(d) * * *

(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.

* * * * *

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)(6) 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, all such information, whether from a report made by an access person or from information provided in lieu of

a report, to be maintained electronically in an accessible computer database;

(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 reasonably designed to prevent access to material nonpublic information about your securities recommendations and your clients' securities holdings and transactions, by persons who do not need such information to perform their duties;

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

(5) Provisions requiring supervised persons to report any violations of your code of ethics promptly to your chief compliance officer or to another person you designate in your code of ethics; and

(6) 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 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 exchange ticker symbol or CUSIP number, type of security, number of shares and principal amount (if applicable) 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 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 30 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 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 exchange ticker symbol or CUSIP number, the interest rate and maturity date (if applicable), the number of shares and the principal amount (if applicable) 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 10 days after the end of each calendar quarter, which report must cover, at a minimum, all transactions during the quarter. A report must be submitted even if the access person had no securities transactions during the period.

(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 10 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 supervised 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 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. No. 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; and

(iv) Shares issued by open-end funds other than 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: January 20, 2004.

By the Commission.

Jill M. Peterson,

Assistant Secretary.

Note: Appendix A to the preamble will not appear in the Code of Federal Regulations.

Appendix A

KEY DISTINCTIONS BETWEEN EXISTING AND PROPOSED RULES

Advisers Act Proposed Rule 204A–1	Investment Company Act Rule 17j–1
• Code of Ethics Required for each investment adviser registered with the Commission..	• Code of Ethics Required for each investment adviser of a registered investment company.
• Standards of Conduct Required element of code of ethics.	• Standards of Conduct Not required.
• Compliance with Laws Required element of code of ethics.	• Compliance with Laws Not required in code of ethics.
• Limited Access to Material Nonpublic Information Required element of code of ethics.	• Limited Access to Material Nonpublic Information Not required.
• Internal Reporting of Code Violations Required element of code of ethics.	• Internal Reporting of Code Violations Not required in code of ethics.
• Employee Acknowledgment Employee must receive copy of code of ethics and acknowledge in writing..	• Employee Acknowledgment Not required.
• Personal Securities Trading Reports Required element of code of ethics.	• Personal Securities Trading Reports Required by rule.
• Reporting Personnel	• Reporting Personnel

KEY DISTINCTIONS BETWEEN EXISTING AND PROPOSED RULES—Continued

Advisers Act Proposed Rule 204A–1	Investment Company Act Rule 17j–1
''Access Persons''—partners, officers, directors, employees, and certain controlled persons of adviser, who have access to non-public information about client securities transactions or recommendations, or holdings of affiliated mutual funds.. For advisers primarily in the business of providing advice, *all* of an adviser's directors, officers and partners *are presumed* to be Access Persons..	''Access Persons''—*any* directors, Officers, general partners of the adviser. ''Advisory persons''—employees and certain control persons (and their employees) who obtain information regarding fund securities transactions or recommendations. For advisers not primarily in the business of advising funds or advisory clients, access persons *only* include directors, officers, general partners, or advisory persons, *who make* or *who obtain information concerning, recommendations* made to fund.
• Reportable securities exclude: ■ Direct obligations of the U.S. government; ..... ■ Money market instruments; ..... ■ Shares issued by unaffiliated open-end funds and money market funds..	• Reportable Securities exclude: ■ Direct obligations of the U.S. government; ■ Money market instruments; ■ Shares issued by open-end funds.
• Personal Securities Reports ■ Initial and Annual Holdings Reports ..... ■ Quarterly Transaction Reports	• Personal Securities Reports ■ Initial and Annual Holdings Reports ■ Quarterly Transaction and New Account Reports
• Pre-Approval of Trades Required for IPO and Limited Offering.	• Pre-Approval of Trades Required for IPO and Limited Offering.
• Recordkeeping ■ Copies of codes of ethics; ..... ■ Employee acknowledgments; ..... ■ Records of violations of code and responses to violations; ..... ■ List of access persons; ..... ■ Holdings and transactions reports (electronically) ..... ■ Record of adviser's approval of investments in IPOs and limited offerings..	• Recordkeeping ■ Copies of codes of ethics; ■ Records of violations of code and responses to violations; ■ Record of all persons required to make or review reports; ■ Holdings and transactions reports; ■ Record of adviser's approval of investments in IPOs and limited offerings.

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