Report of the Advisory Group on Personal Investing May 9, 1994

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REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING

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EXECUTIVE SUMMARY

FORMATION OF THE ADVISORY GROUP

On February 16, 1994, the Investment Company Institute ("Institute")[1] announced the formation of a special Advisory Group to review practices and standards governing personal investing and to make any recommendations deemed necessary or desirable in the interest of investors. The Advisory Group has considered a wide variety of approaches to the issue and has consulted with an array of experts, including former senior Securities and Exchange Commission ("Commission") officials, representatives of the accounting and legal community, and noted ethicists and academicians.

REGULATION OF PERSONAL INVESTING ACTIVITIES OF INVESTMENT COMPANY INDUSTRY PERSONNEL

The federal securities laws impose certain standards upon the personal trading activities of all market participants. In particular, all investors are precluded from engaging in insider trading or tipping. Investment company personnel,[2] however, are subject to specific additional regulations that address potential conflicts arising from their personal investment activities. These other potential conflicts — and standards to address them — have been the subject of recent attention and are the focus of the Advisory Group's Report.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 4,807 open-end investment companies ("mutual funds"), 442 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.107 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders.

[2] Throughout the Report, the Advisory Group addresses itself to codes of ethics adopted by investment companies. The recommendations are in each case intended to apply equally to investment advisers and principal underwriters who also adopt codes of ethics under Rule 17j-1. Similarly, while the Report makes reference to "investment company personnel," this is intended to encompass any employees, officers and directors of investment companies, investment advisers, and principal underwriters who are subject to the requirements of Rule 17j-1. The text of Rule 17j-1 is set forth in Appendix VII.

For over five decades, Congress and the Commission have recognized that conflicts of interest may arise when investment company personnel trade for their own accounts. After careful examination, Congress enacted Section 17(j) of the Investment Company Act of 1940 and the Commission promulgated Rule 17j-1 to specifically address these potential conflicts.

Rule 17j-1 generally:

- requires that all investment companies and their investment advisers and principal underwriters adopt codes of ethics and procedures designed to detect and prevent improper personal trading;
- directs that all "access persons" (broadly defined to encompass most industry employees) file quarterly reports concerning their personal securities transactions; and
- directs the maintenance of substantial records on these transactions.

The Commission staff, in the course of its regular inspection of investment companies and their investment advisers and principal underwriters, typically examines codes of ethics and procedures under Rule 17j-1. The Commission may bring civil injunctive actions or administrative proceedings for violations of Section 17(j) and Rule 17j-1, and firms and employees who violate Section 17(j) or Rule 17j-1 may be subject to substantial criminal or civil sanctions. Despite the scrutiny that it has received, personal investing by investment company personnel has been the source of relatively few enforcement actions. In the rare cases that serious misconduct has occurred, stringent penalties have been imposed.

The Advisory Group believes that relatively few enforcement actions have been necessary because the industry has accorded high priority to developing effective codes of ethics. The Institute conducted a survey ("Institute Survey") of the codes of ethics of 96 investment company complexes, accounting for almost 90 percent of all mutual fund assets

under management. The Institute Survey demonstrated that investment companies have crafted their codes carefully to address potential conflicts most effectively in light of their particular circumstances. Most, if not all, codes contain provisions that far exceed the requirements of current law. (A summary of the results of the Institute Survey is attached as Appendix II.)

The same conflicts of interest arise when the employees of other asset managers (*e.g.*, pension plans, banks, insurance companies, commodity pool operators, and hedge fund advisers) trade for their own accounts. By comparison, however, personal trading by these other asset managers is not subject to comprehensive regulation of the kind applicable to investment companies. (A legal analysis of standards governing personal trading by investment personnel in these other industries is attached as Appendix VI.)

CONSIDERATION OF A BAN ON PERSONAL INVESTING

Some have suggested that there should be a complete ban on personal investing by portfolio managers. The personal investing activities of these employees, it has been stated, can create at least the appearance of conflicts and may involve time, resources or opportunities diverted from the management of the investment company's own portfolio on behalf of the shareholders. The Advisory Group has considered these and other arguments carefully. Nonetheless, the Advisory Group strongly opposes a complete ban on personal investing for several reasons.

First, investment management firms compete fiercely in the market place, above all on the basis of their performance for investors. No investment company will succeed unless its first priority is the interest of its shareholders. In this competitive environment, the Advisory Group believes that

investment companies will not tolerate personal investing activity of a nature or level that disserves the interest of shareholders.

Second, the Advisory Group believes that the potential conflicts arising from personal investing activities can be addressed decisively — and the public's trust fully vindicated — through effective restrictions and procedures that do not constitute a total ban. The former Commission members and senior officials with whom the Advisory Group met in the course of its work concurred unanimously in this judgment.

Third, the Advisory Group is convinced that a total ban on personal investing would arbitrarily and unfairly foreclose, potentially to many thousands of individual employees, wholly legitimate and appropriate investment opportunities. Based on the Advisory Group's review, such a ban would be unprecedented and would far exceed accepted notions of fiduciary conduct or any reasonable expectations of ethical accountability.

Finally, as senior executives in the industry, the Advisory Group notes the widespread expressions of concern — which are legitimate — that foreclosing portfolio managers from opportunities to invest directly in the markets not only would detract from the very portfolio management abilities on which shareholders rely, but would establish significant and needless disincentives to the continued service of these talented individuals in the industry. This is especially true in the absence of comparable restrictions on other types of asset managers. In the end, the Advisory Group believes that a ban would operate to the detriment of millions of individual fund shareholders and of the industry at large.

RECOMMENDATIONS

The Advisory Group recommends that the investment company industry adopt a series of additional measures to obviate conflicts, prevent and detect abusive practices, and preserve the confidence of investors. These recommendations fall into five main categories.[3]

1. Statement of General Principles.

The Advisory Group recommend that every investment company incorporate in its code of ethics a statement of general fiduciary principles that govern personal investment activities. These principles should, at a minimum, reflect the following: (1) the duty at all times to place the interests of shareholders first; (2) the requirement that all personal securities transactions be conducted consistent with the code of ethics and in such a manner as to avoid any actual or potential conflict of interest or any abuse of an individual's position of trust and responsibility; and (3) the fundamental standard that investment company personnel should not take inappropriate advantage of their positions.

2. Applicability of Restrictions and Procedures.

The Advisory Group recommends that every investment company, in promulgating its code of ethics, consider how the code's restrictions and procedures may be applied in light of its ethical obligations, the overall nature of the investment company's operations, and the issues potentially raised by transactions in different kinds of securities and by the personal investment activities of different categories of personnel. These categories of personnel include portfolio managers (who make decisions about fund investments), other investment personnel (including the analysts and traders who assist in the process) and access persons in general (including all those others who are in a position to know about fund transactions). In tailoring ethics codes, restrictions

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[3] The text of the Advisory Group's recommendations is provided separately in Appendix I.

and procedures, investment companies may consider, for example, whether to exempt certain classes of securities (*e.g.*, government securities, mutual fund shares and other securities exempt under Rule 17j-1) and certain types of transactions (*e.g., de minimis* transactions). Any such exceptions should be narrowly defined, clearly documented and strictly in keeping with the letter and spirit of the general ethical principles stated above.

3. Substantive Restrictions on Personal Investing Activities.

The Advisory Group recommends that codes of ethics include, at a minimum, the following substantive restrictions to guard against the most likely potential conflicts.

- **INITIAL PUBLIC OFFERINGS.** Codes of ethics should flatly prohibit investment personnel from acquiring any securities in an initial public offering, in order to preclude any possibility of their profiting improperly from their positions on behalf of an investment company.

- **PRIVATE PLACEMENTS.** (a) Codes of ethics should require express *prior approval* of any acquisition of securities by investment personnel in a private placement. This prior approval should take into account, among other factors, whether the investment opportunity should be reserved for an investment company and its shareholders, and whether the opportunity is being offered to an individual by virtue of his or her position with the investment company. (b) Investment personnel who have been authorized to acquire securities in a private placement should be required to *disclose* that investment when they play a part in any investment company's subsequent consideration of an investment in the issuer. (c) In such circumstances, the investment company's decision to purchase securities of the issuer should be subject to an *independent review* by investment personnel with no personal interest in the issuer.

- **BLACKOUT PERIODS.** Codes of ethics should prohibit any access person from executing a securities transaction on a day during which any investment company in his or her complex has a pending "buy" or "sell" order in that same security until that order is executed or withdrawn. In addition, codes of ethics should prohibit any portfolio manager from buying or selling a security within at least seven calendar days before and after an investment company that he or she manages trades in that security. Any profits realized on trades within the proscribed periods should be required to be disgorged.

- **BAN ON SHORT-TERM TRADING PROFITS.** In addition to the blackout periods described above, codes of ethics should prohibit all investment personnel from profiting in the purchase and sale, or sale and purchase, of the same (or equivalent) securities within 60 calendar days. Any profits realized on such short-term trades should be required to be disgorged.

- **GIFTS.** Codes of ethics should prohibit investment personnel from receiving any gift or other thing of more than *de minimis* value from any person or entity that does business with or on behalf of the investment company.

- **SERVICE AS A DIRECTOR.** Codes of ethics should prohibit investment personnel from serving on the boards of directors of publicly traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the investment company and its shareholders. In the relatively small number of instances in which board service is authorized, investment personnel serving as directors normally should be isolated from those making investment decisions through "Chinese Wall" or other procedures.

4. Compliance Procedures.

In order to implement these restrictions, the Advisory Group recommends that investment companies adopt certain compliance procedures:

- **PRECLEARANCE.** Codes of ethics should require all access persons to "preclear" personal securities investments. These preclearance requirements and associated procedures should be reasonably designed to identify any prohibition or limitation applicable to the proposed investment.

- **RECORDS OF SECURITIES TRANSACTIONS.** Codes of ethics should require all access persons to direct their brokers to supply to a designated compliance official, on a timely basis, duplicate copies of confirmations of all personal securities transactions and copies of periodic statements for all securities accounts.

- **NASD RULEMAKING — OPENING OF ACCOUNTS.** The Advisory Group recommends that the National Association of Securities Dealers, Inc. ("NASD") adopt a rule requiring all broker-dealers to notify a registered investment adviser when any of its employees opens a brokerage account.

- **POST-TRADE MONITORING.** Each investment company should implement appropriate procedures to monitor personal investment activity by access persons after preclearance has been granted.

- **DISCLOSURE OF PERSONAL HOLDINGS.** Codes of ethics should require all investment personnel to disclose all personal securities holdings upon commencement of employment and thereafter on an annual basis.

- **CERTIFICATION OF COMPLIANCE WITH CODES OF ETHICS.** All access persons should be required to certify annually that they have read and understand the code of the ethics and recognize that they are subject thereto. Further, access persons should be required to certify annually that they have complied with the requirements of the code of ethics and that they have disclosed or reported all personal securities transactions required to be disclosed or reported pursuant to the requirements of the code.

- **REVIEW BY THE BOARD OF DIRECTORS.** Each investment company's management should prepare an annual report to the investment company's board of directors that, at a minimum —

    - summarizes existing procedures concerning personal investing and any changes in the procedures made during the past year;

    - identifies any violations requiring significant remedial action during the past year; and

    - identifies any recommended changes in existing restrictions or procedures based upon the investment company's experience under its code of ethics, evolving industry practices, or developments in applicable laws or regulations.

5. Additional Disclosure.

Investment companies should include in their Prospectuses or, at a minimum, in their Statements of Additional Information, disclosures concerning whether or not access persons are permitted to engage in personal securities transactions, and, if so, subject to what general restrictions and procedures.

6. The Commission's Role.

While internal compliance initiatives can continue to address potential conflicts of interest in personal investments, the Advisory Group recommends that the Commission continue vigorous oversight and enforcement in this area to deter and punish violators. To this end, the Advisory Group strongly supports the Commission's efforts to secure adequate funding for its regulatory programs.

THE REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING

I. FORMATION AND WORK OF THE ADVISORY GROUP

Scrutiny of the personal investing activities of portfolio managers and others in the investment company industry is not new. For at least five decades, these activities have received regular and detailed reviews, resulting in the development of statutory and regulatory requirements and industry codes of ethics. Recent attention to this issue is attributable largely to three factors. First, investment company assets under management have grown dramatically in recent years, and mutual funds in particular have achieved widespread acceptance as an investment vehicle for individuals and institutional investors alike. Second, in recent years the Securities and Exchange Commission ("Commission") and Congress[1] have conducted an extensive review of the industry, its current regulations and other issues. Finally, press reports early this year related that a prominent portfolio manager had been terminated because he failed to comply with his company's internal procedures relating to securities trading practices. About the same time, several articles reported that the country's largest investment company complex had reviewed and updated its internal procedures regarding personal trading.[2]

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1 *See* U.S. SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY ACT REGULATION (1992); Hearing on H.R. 3447, the "Securities Regulatory Equality Act of 1993," before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong., 2d Sess. (1994); Hearing on Bank Mutual Funds Activities before the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance of the House Committee on Banking, Finance and Urban Affairs, 103d Congress, 2d Sess. (1994); Hearing on the Mutual Fund Industry before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 103d Cong., 1st Sess. (1993); Hearing on the Mutual Fund Industry before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee, 103d Cong., 1st Sess. (1993).

2 *See, e.g.,* Robert McGough and Sara Calian, *Invesco Funds Fires Kaweske, A Star Manager*, WALL ST. J., Jan. 6, 1994, at C1; Steve Bailey and Aaron Zitner, *New Rules For Fidelity Managers*, BOSTON GLOBE, Jan. 12, 1994, at 37; Robert McGough and Sara Calian, *SEC Focuses on Personal Trades at Funds*, WALL ST. J., Jan. 13, 1994, at C1.

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Together, these three developments precipitated renewed exploration of the potential conflicts of interest that might exist when investment company portfolio managers engage in personal securities transactions.[3] The potential conflicts identified in recent accounts include frontrunning,[4] the opportunity for lucrative side deals in the form of initial public offerings and private placements,[5] and issues that may arise when portfolio managers serve on boards of directors of public companies.[6]

In light of these developments, Representative Edward J. Markey, Chairman of the House Subcommittee on Telecommunications and Finance, wrote on January 11, 1994 to Securities and Exchange Commission Chairman Arthur Levitt to inquire about the issue of personal securities trading by investment company portfolio managers.[7] Chairman Levitt's February 9, 1994 reply included a memorandum from the Commission's Division of Investment Management stating that inspections to date "have not revealed a systematic pattern of widespread abusive personal

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These press accounts in fact depict a system that is working. Investment companies should adopt and enforce rigorous standards regarding personal investing activities. They also should periodically and voluntarily review and upgrade, as appropriate, existing strictures regarding personal trading by investment personnel. Accountability of this kind contributes to investor confidence in investment companies.

[3] *See, e.g.,* Jonathan Clements, *Personal Trading is Common Among Fund Managers*, WALL ST.J., Jan. 25, 1994, at C1; Susan Antilla, *Money Managers Who Cross the Line*, N.Y. TIMES, Jan. 6, 1994, § 3, at 13; Brett Fornson, *Fund Managers' Own Trades Termed a Potential Conflict*, WASH. POST, Jan. 11, 1994, at A1; Sara Calian, *Mutual Funds: Funds Tighten Rules For Managers*, WALL ST. J., Jan. 10, 1994, at C1.

[4] *See, e.g.*, Brett Fronson, *Fund Managers' Own Trades Termed a Potential Conflict*, WASH. POST, Jan. 11, 1994, at A1.

[5] *See, e.g.,* Sara Calian, *Mutual-Fund Managers Can Often Get Part of the Action in Privae Placements*, WALL ST. J., Jan. 28, 1994, at C1 ("[T]he potential for a conflict of interest arises [when portfolio managers invest in private placements] if the value of the company's stock increases as a result of purchases by the mutual fund.").

[6] *See, e.g.,* Robert McGough, *Mutual-Fund Managers Face Conflicts of Interest While Serving as Directors*, WALL ST. J., Jan. 21, 1994, at C1 (noting that conflicts can arise because "[a} manager might hesitate to dump a company's stock from a fund while sitting on that company's board waiting for personal options to rise in value.").

[7] *See* Letter from Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives, to Arthur Levitt, Jr., Chairman , U.S. Securities and Exchange Commission, Jan. 11, 1994.

trading by fund insiders."[8] Chairman Levitt's letter also noted that current law already enables the Commission to monitor and redress possible abuses in this area, and emphasized the Commission's continued willingness to "be vigilant in [the agency's] efforts to detect abusive trading practices by portfolio managers . . . [and] to take action against any portfolio manager whom we find to have engaged in these practices." The Chairman further announced that the Commission was undertaking to survey portfolio managers' personal trading practices in thirty fund complexes.[9] Finally, he pledged that the Commission would "take whatever measures are appropriate to correct any abuses that we discover as a result of our inquiry, including, if necessary, recommending new rules or legislation."[10]

Shortly thereafter, on February 16, 1994, the Investment Company Institute ("Institute") announced the formation of a special Advisory Group to evaluate current law, regulation and industry practices and to consider the need to revise existing standards.[11] The Advisory Group was charged with completing its analysis and reporting to the public in May 1994.

The Advisory Group held six meetings during the course of its deliberations. It drew upon the extensive experience of its members. It also sought the views of former senior Commission officials, representatives of accounting and law firms who have participated extensively in matters involving the investment company industry, respected academicians knowledgeable in

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[8] Memorandum from Division of Investment Management to Arthur Levitt, Jr., Chairman, U.S. Securities and Exchange Commission, Feb. 9, 1994, at 8.

[9] *See also* Albert B. Crenshaw, *SEC Looks at Fund Managers; Inquiry is Focusing on Personal Trading*, WASH. POST, Feb. 11, 1994, at E1.

[10] Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, Feb. 9, 1994.

[11] *See* Appendix III for the press release announcing the formation of the Advisory Group and Appendix IV for the biographies of the members of the Advisory Group.

the fields of ethics, finance and investment company regulation, and representatives of other industries.[12]

In addition, the Advisory Group canvassed the existing practices and solicited the views and suggestions of almost the entire investment company industry. As outlined in Appendix II, the Institute conducted a survey ("Institute Survey") of the compliance practices regarding personal investment practices followed by 96 investment company complexes that constitute almost 90 percent of all mutual funds assets under management.

[12] *See* Appendix V for a list of the persons with whom the Advisory Group consulted.

II. REGULATION OF PERSONAL INVESTING ACTIVITIES OF INVESTMENT COMPANY PERSONNEL

Investment company personnel are charged with the rigorous duties of fiduciaries. In the words of the Supreme Court, the federal securities laws reflect Congressional recognition "'of the delicate fiduciary nature of an investment advisory relationship,' as well as a Congressional intent to eliminate, or at least to expose, all conflicts of interest that might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested."[13] The need to reconcile these fiduciary obligations with personal investing practices is longstanding.[14] Indeed, the question of personal investing is addressed in various ways through investment company regulation.

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13 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 191-92 (1963) (footnotes omitted). Since *Capital Gains*, the Supreme Court has reiterated that Congress intended the Investment Advisers Act to set fiduciary standards to govern investment advisers. *See Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17 (1979); *Burks v. Lasker*, 441 U.S. 471, 481-82 n. 10 (1979); *Santa Fe Indus.v. Green*, 430 U.S. 462, 471 n. 11 (1977).

14 Even prior to the enactment of the Investment Company Act, the Commission considered the issue and reported on it in an analogous context. *See Report of the Securities and Exchange Commission on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*, H.R. Doc. No. 477, 76th Cong., 2d Sess. 29-30 (1939) ("According to some investment counsel representatives, trading by investment counselers for their own account in securities in which their clients are interested may adversely affect the interest of these clients, since a problem of priority of transactions is created - i.e., a question arises as to whether a block of a particular security is to be accumulated (or liquidated) first for the account of the client or the account of the investment counsel.").

See also Analysis of S. 1659 Prepared by the Securities and Exchange Commission, reprinted in Comparative Print Showing Changes in Existing Law, Senate Committee on Banking and Currency 18 (May 1, 1967):

> Although persons affiliated with investment companies cannot be expected to refrain from engaging in securities transactions for their personal accounts, the shareholders they serve are entitled to assurance that such transactions will not conflict with their companies' investment programs.

A. STATUTORY STANDARDS

The federal securities laws prohibit outright certain types of transactions by investment company personnel. Some of these restrictions apply broadly to all participants in the marketplace. For example, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder[15] have been interpreted to proscribe trading on the basis of material, nonpublic information or communicating this information in breach of a fiduciary duty ("insider trading" and "tipping"). The prohibition on insider trading applies to "any person" and not just investment company personnel.

The insider trading prohibition must be distinguished from the focus of recent media discussions and of this Report: the latter concerns personal trading activities by investment company personnel that do *not* constitute insider trading but *may* involve fraud or raise other conflict issues. The federal securities laws impose additional layers of protection to address these latter concerns. For example, investment company personnel are prohibited from:

- purchasing or selling securities for a personal account in order to profit from a subsequent purchase or sale by an investment company ("frontrunning");[16]
- placing the investment company in securities in order to receive personal investment opportunities, bribes or kickbacks;[17] or
- purchasing or selling securities from the investment company.[18]

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[15] *See* 15 U.S.C. § 78j(b) (1988); 17 C.F.R. § 240.10b-5 (1993).

[16] This activity generally is prohibited by Rule 10b-5 under the Securities Exchange Act and Section 206 of the Investment Advisers Act. *See, e.g.*, the discussion of *Griggs* in Section II (C).

[17] This activity generally is prohibited by Rule 10b-5 under the Securities Exchange Act, Section 206 of the Investment Advisers Act, Section 17(e) of the Investment Company Act, and Rule 17j-1 thereunder. *See, e.g., United States v. Deutsch*, 451 F.2d 98 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972); *Securities and Exchange Commission v. Embry*, Litig. Rel. No. 13777, 54 SEC DKT. (CCH) 2038 (Sept. 9, 1993).

B. RULE 17J-1

In addition to these statutory proscriptions, the personal investing activities of investment company personnel are subject to strict regulation by the Commission. Investment Company Act Rule 17j-1,[19] the linchpin of the Commission's regulatory authority, was the product of a lengthy gestation period. Over thirty years ago, in its landmark 1963 *Special Study of the Securities Markets*, the Commission noted that personal trades by investment company personnel in securities held by an investment company they advise may raise a conflict of interest.[20] The *Special Study* noted:

> broad industry awareness of the problem raised by the conflict of interest which may exist when an individual or entity privy to a mutual fund's investment recommendations and decisions engages in trading for his or its own account in securities purchased or sold by the fund. The almost universal existence of policies aimed at dealing with the problem and the adoption of such a policy in 1962 by the industry's principal trade organization, the Investment Company Institute, are evidence of this awareness.[21.]

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[18] This activity generally is prohibited by Section 17(a) of the Investment Company Act.

[19] The full text of Rule 17j-1 is set forth in Appendix VII.

[20] *See Report of the Special Study of the Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 4, at 235-55 (1963). In the *Special Study*, the Commission noted that the Investment Company Institute had promulgated a "*Guide to Business Standards*"that admonished officers, directors and employees of its members to take no action "which is inconsistent with such [persons'] obligations to the investment company." *Id.* at 235.

[21.] *Id.* at 252.

The issue resurfaced three years later in the Commission's report on the *Public Policy Implications of Investment Company Growth*.[22] In the *Public Policy Implications* report, the Commission requested that Congress give it specific authority to adopt rules for the protection of investors in connection with securities transactions by investment companies and by persons affiliated with investment companies, or their investment advisers or principal underwriters. With the industry's support, Congress added Section 17(j) to the Investment Company Act in 1970. Section 17(j), as enacted, expressly contemplated that investment company personnel would, and could, engage in "the purchase or sale . . . of . . . securit[ies] held or to be acquired by [a] registered investment company" with which they are employed or affiliated.[23] Consequently, Section 17(j) does not ban personal investing, but rather authorizes the Commission to adopt rules and regulations necessary to prevent any trading practices that might prove "fraudulent, deceptive or manipulative."

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[22] *See Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 195-200 (1966).

[23] The text of Section 17(j) reads:

> It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business.
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> 15 U.S.C. § 80a-17(j) (1988).

Among other things, Section 17(j) specifically authorizes the Commission, by rule, to require "the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies . . . ."[24] The Senate Report accompanying the bill enacting Section 17(j) noted that the provision gave the Commission broad authority "to draw flexible guidelines to prohibit [affiliated] persons . . . from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their companies."[25]

The Commission's subsequent rulemaking reflected a delicate balance between the appropriateness of prohibiting conduct that might disadvantage investment company shareholders and the desirability of utilizing individual compliance efforts to take account of the facts and circumstances unique to each investment company. The initial version of the rule, proposed in 1972, contained specific trading prohibitions and would have mandated that codes of ethics violations be reported to the Commission.[26] The proposed rule was withdrawn in 1976 and reproposed two years later, in an effort to provide greater flexibility to investment companies in adapting their codes of ethics to their specific operations.[27] Two years later, after further comments and revisions, Rule 17j-1 was promulgated in its current form.

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[24] *Id.*

[25] Senate Report No. 184, 91st Cong., 1st Sess. At 28-29 (1969).

[26] *See* Investment Company Act Rel. No. 7581 [1972-73 Transfer Binder] Fed. Sec. L. Rep. ¶(CCH) 79, 157 (Dec. 26, 1972).

[27] *See* Investment Company Act Rel. No. 10162, 14 SEC DKT. (CCH) 558 (Mar. 20, 1978); Investment Company Act Rel. No. 9170, 8 SEC DKT. (CCH) 1328 (Feb. 19, 1976).

In brief, the Rule:

- prohibits directors, officers and employees of investment companies (and their investment advisers and principal underwriters) from engaging in fraudulent, manipulative or deceptive conduct in connection with their personal trading of securities held or to be acquired by the investment company;

- requires investment companies (and their investment advisers and principal underwriters) to adopt codes of ethics and procedures reasonably designed to prevent trading prohibited by the rule;

- requires every "access person" to file reports with the firm concerning his or her personal securities transactions, within 10 days of the end of the quarter in which the transaction was effected;[28] and

- requires investment companies (and their investment advisers and principal underwriters) to maintain records related to the implementation of their procedures.[29]

Several features of the rule are worth particular note. First, Rule 17j-1 specifically exempts from any of its terms (and presumably *any* limitations on personal transactions by investment company personnel) transactions in "securities issued by the Government of the United States, bankers' acceptances, bank certificates of deposit, commercial paper and shares of registered open-end investment companies."[30]

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[28] These reports must disclose (1) the date of the transaction, the title and the number of shares, and the principal amount of each security involved; (2) whether the transaction was a purchase, sale, or any other type of acquisition or disposition; (3) the price; and (4) the name of the broker, dealer, or bank through which the transaction was effected.

[29] Rule 204-2(a)(12) under the Advisers Act also requires investment advisers to maintain identical records on personal securities transactions by the adviser and every advisory representative. Investment advisers who have to report under Rule 204-2(a)(12) need not report duplicate information under Rule 17j-1. *See* Rule 17j-1(c)(3)(iv), 17 C.F.R. § 270.17j-1 (c)(3)(iv) (1993).

[30] Rule 17j-1(e)(5), 17 C.F.R § 270.17j-1(e)(5) (1993).

Second, Rule 17j-1 defines the term "access person" quite broadly.[31] With respect to an investment adviser, for example, the term "access person" is defined to include any director, officer, and general partner, as well as any employee "who, in connection with his regular functions or duties, makes, participates in, or obtains information, regarding the purchase or sale of a security by a registered investment company, or whose functions relate to the making of any recommendations with respect to such purchases or sales."[32] Moreover, the filing requirement was extended to transactions involving any security in which the access person has "any direct or indirect beneficial ownership," a provision broad enough to encompass accounts held by immediate family members in the same household and certain trust accounts if the access person has influence or control over those accounts.[33] As a result, many investment companies have elected to treat all of their employees *and* their immediate family members as access persons and to require them to file the quarterly reports required under Rule 17j-1.

Finally, these procedures, particularly the reporting equipment, were designed to enable each investment company complex to detect and prevent potential conflicts of interest, including those that may not be addressed specifically by Commission regulations, in a manner deemed most effective for its particular business structure and operations. As the Commission stated when it adopted Rule 17j-1:

> [T]he variety of employment and the institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities. Moreover, as a matter of policy, the Commission believes the introduction and tailoring of ethical restraints on the behavior of

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[31] The Commission defined "access person" broadly to ensure that the Rule applies "to those persons who have an active part in the management, portfolio selection or underwriting functions of the investment companies with which they are associated." *See* Investment Company Act Rel. No. 11421, 21 SEC DKT. (CCH) 488, 493 (Oct. 31, 1980).

[32] Rule 17j-1(e)(2)(i), 17 C.F.R. § 270.17j-1(e)(2)(i) (1993).

[33] Rule 17j-1(c)(1), 17 C.F.R. § 270.17j-1(c)(1) (1993).

> persons associated with an investment company can best be left in the first instance to the directors of the investment company.[34]

Thus, the Commission purposely crafted Rule 17j-1 to be broad in its scope and flexible in its application, to permit personal investment activities but to mandate the implementation through codes of ethics of standards and procedures deemed necessary to prevent abusive practices. The Commission expressly stated its expectation "that an effective code of ethics will be designed, in part, to eliminate conflict of interest situations where access persons improperly are able to gain personal benefit through their relationship with the investment company."[35]

C. COMMISSION INSPECTION AND ENFORCEMENT PROGRAMS

Compliance with statutory and regulatory requirements in this area also is addressed through the Commission's inspection and enforcement programs. Although the Commission's examiners have paid considerable attention to the funds' personal investing procedures,[36] the agency's inspections program "has not revealed systemic problems."[37] In fact, despite the Commission's scrutiny, the personal investing of investment company personnel has been the focus of relatively few enforcement actions. While most cases have involved the failure to adopt adequate codes of ethics or to file the requisite reporting forms, there have been isolated cases

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[34] Investment Company Act Rel. No. 11421, 21 SEC DKT. (CCH) 488, 489 (Oct. 31, 1980).

[35] *Id*.

[36] *See, e.g.*, *Keeping Your Fund Manager Honest*, KIPLINGER PERSONAL FINANCE MAGAZINE, Apr. 1994, at 57 ("[The Commission] always looks at personal trading [during the inspection process]") (statement of Barry Barbash, Director, Division of Investment Management, U.S. Securities and Exchange Commission.

[37] *See, e.g.*, Rob Wells, *Stock Market Regulators Examining Fund Dealings*, THE ASSOCIATED PRESS, Mar. 7, 1994 (quoting Barry Barbash, Director, Division of Investment Management, U.S. Securities and Exchange Commission).

involving frontrunning violations or personal gratuities to investment company personnel — and these have been dealt with forcefully and effectively.

Two recent cases bear special mention. In *United States v. Ostrander*,[38] a high-yield corporate bond fund manager was convicted of illegally accepting warrants, unknown to the fund complex, for investing fund assets in certain securities. Upon sentencing Ms. Ostrander to prison and a substantial fine, Federal District Court Judge Richard Owen emphasized the seriousness of her offense and the intended deterrent effect of the applicable criminal statutes:

> We are in a situation where people turn to people like you with incredible amounts of American dollars and they are entitled to have the exercise of your unaffected faithfulness in investing those. And if one can't be trusted in doing that, you shouldn't be in the business, and people in the business should know that if there is an abuse of trust, it is costly.[39]

Similarly, in *United States v. Griggs*,[40] the government alleged that an investment adviser's analyst secretly provided an outside investor with confidential information about the analyst's recommendations regarding high-yield debt securities and the probable timing of fund purchases based on these recommendations. The investor allegedly generated approximately $3 million in illegal profits by purchasing a substantial portion of the bonds available in the market in advance if the fund's purchase and directing sales of the bonds at the time that the

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[38] 792 F. Supp. 241 (S.D.N.Y. 1992), *aff'd*, 999 F.2d (2d Cir. 1993).

[39] *Ex-Fidelity Manager Sentenced for Accepting Illegal Drexel Payoff*, SEC. & INSIDER TRADING LITIG. REP., Dec. 7, 1992, 792, at 793. The Fidelity funds also sued Ms. Ostrander to recover her profits from the warrants. *See also Securities and Exchange Commission v. Bayse*, Litig. Rel. No. 13145, 50 SEC DKT. (CCH) 1170 (Jan. 24, 1992) (investment company portfolio manager agreed to disgorge proceeds from limited partnership investment and profits from unreported personal securities transactions).

[40] Crim. No. 445 (S.D.N.Y. May 21, 1992).

fund entered the market. The government responded with civil and criminal actions against the participants in the alleged scheme.[41]

When one considers the number of registered investment companies and related access persons subject to Rule 17j-1, there have been remarkably few administrative or civil proceedings. Nonetheless, even in instances involving no improper trading or harm to shareholders, the Commission has brought enforcement actions for the failure to adopt adequate codes of ethics as mandated by Rule 17j-1,[42] or the failure to maintain the quarterly reports mandated by the Rule.[43]

D. INDUSTRY COMPLIANCE PROGRAMS

The paucity of enforcement actions against investment company personnel is neither fortuitous nor solely due to the Commission's careful regulation. The Advisory Group believes that this record reflects the priority accorded compliance issues throughout the industry. In this regard, the Institute Survey compels three major conclusions:

First, most codes of ethics incorporate standards that far exceed legal requirements. For example, while Rule 17j-1 does not require the investment company to review, or "preclear," every personal trade before it is executed, the Institute Survey indicates that the practice has become standard in the industry. *All* 96 of the investment company complexes responding to

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[41] In May 1992, Griggs entered a guilty plea to criminal violations of the Investment Company Act and the Advisers Act. Early this year, the investor was convicted on multiple criminal counts after a six-week trial. *See* Donna B. Henriques, *Cooper's Ex-Chairman Convicted in Fraud Case*, N.Y. TIMES, Jan. 14, 1994, at D3.

[42] *See, e.g., In re Cummings*, Investment Company Act Rel. No. 18624, 51 SEC DKT. (CCH) 118 (Mar. 23, 1992); *In re Rapholz*, Investment Advisers Act Rel. No. 1293, 50 SEC DKT. (CCH) 116 (Oct. 31, 1991); *In re Leibowitz*, Investment Company Act Rel. No. 14310, 32 SEC DKT. (CCH) 359 (Jan. 10, 1985).

[43] *See, e.g., In re VIC Management Inc.*, Investment Advisers Act Rel. No. 1210, 44 SEC DKT. (CCH) 1566 (Nov. 6, 1989); *In re Bench*, Investment Advisers Act Rel. No. 1202, 44 SEC DKT. (CCH) 1075 (Sept. 19, 1989); *In re Frantzman*, Investment Company Act Rel. No. 16349, 40 SEC DKT. (CCH) 859 (Apr. 5, 1988); *In re Guilden*, Investment Company Act Rel. No. 15578, 37 SEC DKT. (CCH) 909 (Feb. 13, 1987); *In re Lubart*, Investment Company Rel. No. 15577, 37 SEC DKT. (CCH) 908 (Feb. 13, 1987); *In re Flusfeder*.;Investment Company Act Rel. No. 15575, 37 SEC DKT. (CCH) 823 (Feb. 12, 1987); *In re Farrer*, Investment Company Act Rel. No. 13131, 27 SEC DKT. (CCH) 705 (Mar. 31, 1983).

the Institute Survey include a preclearance requirement in their codes. Similarly, many investment companies have applied their personal trading procedures to personnel who are not necessarily "access persons" under Rule 17j-1. For example, one complex sets varying restrictions for access persons, non-access trustees, portfolio managers and other employees. Another complex's code notes:

> The following procedures are general procedures applicable to all employees regardless of their activities at [the complex]. In addition to the procedures described below, certain employees engaged in activities that give rise to specific compliance concerns may be required to comply with [additional] procedures designed to address those concerns.

Second, investment companies have structured codes to foster a corporate culture that places a premium on high ethical standards. Codes of ethics often begin with a statement of the firm's own principles regarding the conduct of its business and its relationship with clients or customers. These principles typically are far broader than the regulatory structure implicit in Rule 17j-1. As with all aspects of the codes, these principles are designed to address the unique needs of each firm. One firm has developed a statement of principles in the form of a firm "credo" which reads in part: "We will at all times conduct ourselves with integrity an distinction, putting first the interests of our clients." Another firm's principles state, in part:

> The code is based on the principle that the officers, directors and employees of the [Company] owe a fiduciary duty to, among others, the shareholders of the [Company's] Funds, to conduct their personal securities transactions in a manner which does not interfere with Fund portfolio transactions or otherwise take unfair advantage of their relationship to the Funds. Persons covered by this Code must adhere to this general principle as well as comply with the Code's specific provisions.

Third, the considerable variety of approaches in the codes of ethics reflects an industry-wide effort to tailor compliance programs that are most effective given the unique circumstances of each investment company. Codes of ethics are not unique to the investment company industry, although the industry is notable for its development of sophisticated compliance codes. Those familiar with the most effective forms of corporate codes consistently counsel that codes should be crafted to deal with the specific needs and circumstances of the organization to which they apply.

The diversity of approaches indicates that investment companies are taking seriously their obligation to develop and implement effective codes. It also indicates they recognize that the provisions adopted in their codes must work in practice within their organizations, must satisfy the general guidelines set forth in Section 17(j) of the Investment Company Act and Rule 17j-1, and must fulfill their obligations to investment company shareholders.

E. COMPARISON WITH STANDARDS OF OTHER ASSET MANAGERS

Today, there are numerous vehicles other than investment companies through which investors obtain professional money management. These include, for example, employee benefit plans, bank common trust funds and collective investment funds, insurance company separate accounts, commodity pools, and hedge funds. *All* of these vehicles present identical opportunities for conflicts of interest and other abuses in connection with personal trading. In considering what additional safeguards might be appropriate for investment companies, the Advisory Group therefore reviewed the approaches taken by other asset management vehicles and those who regulate them.[44]

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[44] At the Advisory Group's request, counsel to the Institute prepared an analysis of the different levels and types of regulation for each of the pooled investment vehicles identified in the text. The results of that analysis are summarized in Appendix VI.

The Advisory Group finds that the close scrutiny of personal investing in the investment company industry contrasts starkly with the regulatory framework for personal investing in other industries. The personal investing of no other category of investment manager is subject to a regulatory regime as strict, comprehensive or detailed as that governing investment company personnel. Although each of the other pooled investment vehicles is subject to some form of regulation, there is nothing comparable to the specific mandates in Rule 17j-1 (*i.e.*, those concerning codes of ethics, quarterly reporting by a broad category of employees, and detailed recordkeeping), or the Commission's active inspection and enforcement in this area.

F. SUMMARY

There is a longstanding and historic recognition of the conflicts of interest that potentially arise in connection with personal trading activities by investment company personnel. Since the adoption of the key federal statutes in 1940, the Commission, Congress and the industry have embarked on a process of finding ways to address and prevent such conflicts. Over the intervening years, there has emerged a consensus — clearly reflected in Rule 17j-1 — that these conflicts are addressed best through ethical strictures and intense compliance efforts developed by and tailored to the circumstances of individual investment companies.

History teaches that no regulatory or corporate regime is foolproof. Even the best program can be circumvented by the willful misconduct of a single lawless employee.[45] The occasional "bad apple" is and will continue to be inevitable. Nonetheless, the investment company industry's success in preventing such misconduct justifies continued reliance on the industry to

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[45] *See, e.g.,* Barbara Bradley, *Brokers Sweeping Clean or Under the Rug?* CHRISTIAN SCI. MON., Feb. 23, 1987, at 18 ("When you use a pay phone, set up a bank account in the Bahamas, meet someone in Grand Central Station with a suitcase of money — there's no procedure that's going to protect against that.") (statement of unidentified investment bank counsel).

develop detailed standards on issues of personal investing, subject to ongoing scrutiny and vigilant oversight by the Commission.

III. CONSIDERATION OF A BAN ON PERSONAL INVESTING

In formulating its recommendations, the Advisory Group has entertained a broad array of options. Although carefully considered, one option — a ban on personal investing by portfolio managers — was rejected by the Advisory Group. It merits special discussion.

Some commentators have suggested a complete ban on personal investing by portfolio managers, because of their direct role in decisions about fund transactions.[46] Three rationales have been advanced in support of such a ban. First, it has been suggested that personal investing activities may give rise to the possibility of an impropriety, even when the transactions themselves are entirely appropriate and beyond reproach. Second, it has been argued that portfolio managers should be confined to participating personally in the markets in exactly the same manner as the fund shareholders whom they serve — in essence, by requiring them to "eat their own cooking."[47] Finally, it has been contended that a complete ban would eliminate the possibility of time and attention being devoted by portfolio managers to their personal investments, at the expense of time that should be devoted to management of fund assets. On this view, it is thought unrealistic to expect that personal investments can be

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[46] *See, e.g.,* B.J. Phillips, *Mutual Funds, Mutual Conflicts*, PHILA. INQUIRER, Mar. 9, 1994 ("As absolutist as it seems, abolishing personal trading entirely may be the only approach the investment industry can afford."); *Mutual Funds Need Tighter Rules*, BUS. WK., Feb. 14, 1994, at 134 ("One way for the mutual-fund industry to retain its squeaky clean image is to forbid its managers from trading themselves.").

[47] *See* Remarks of Richard Y. Roberts, Commissioner, U.S. Securities and Exchange Commission, D.C. Bar and George Washington University Merging Financial Markets Conference, Washington, D.C., Mar. 25, 1994, at 2 ("Some will argue that fund managers should be restricted to investing in the funds they manage and thus 'eat their own cooking.'"). *See also* Henry Dubroff, *A Mutual Fund Pro Responds to One of His Inquisitive Investors*, DENVER POST, Feb. 13, 1994.

managed on personal time — for example, "at home after [the] kids are in bed."[48]

Commission Chairman Levitt noted in a recent address — and the Advisory Group agrees — that "we can ill afford even the perception of conflict [in the mutual fund industry]."[49] On this basis, he has observed that, were he a mutual fund director, he "would have reservations about [personal] trading by managers . . . ." In conducting its review, the Advisory Group has taken to heart Chairman Levitt's injunction to fund directors to ask the "hard and sometimes impolite questions" about personal trading practices — "to take, as a starting question, whether to bar altogether trading by fund insiders? What purpose does it serve? How does it benefit shareholders?"[50]

From the outset of its work, and to all those inside and outside the industry with whom the Advisory Group has consulted these last three months, these are precisely the questions that have been posed. For some investment companies, a ban on personal investing indeed may recommend itself as a clear standard to follow. Such a ban may be relatively easy to implement and administer and less burdensome and costly than the alternatives. Any investment company is, and should be, at liberty to adopt such a standard if it sees fit. Nonetheless, it is unnecessary, and it would be unfair and contrary to the interests of shareholders, to impose such a ban on investment companies at large. The Advisory Group has reached this conclusion for a number of reasons.

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[48] *See* Susan Antilla, *Fund Managers Testing the Rules*, N.Y. TIMES, Jan. 23, 1994 ("They are spending time analyzing stocks that aren't benefiting the fund. . . . They can all say, 'I do it at home after my kids are in bed,' but well, give me a break.") (Statement of Andrew Cox, Trustee, Montgomery Funds.)

[49] *See* Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Funds and Investment Management Conference, Scottsdale, Ariz., Mar. 21, 1994, at 6.

[50] *Id.*

First is the importance of one very stark truth about the industry: Investment managers compete fiercely in the marketplace, and their competition is waged first and foremost on the basis of proven performance.[51] Today, there are over 5,200 investment companies registered with the Commission and thousands of other pooled investment vehicles. While there always has been a healthy level of competition in the industry, this is especially so today, when there are so many alternative funds whose performance is widely publicized.[52] No investment management firm will succeed in this environment unless it consistently serves the interests of the customer first.[53] No firm is likely to tolerate a portfolio manager becoming preoccupied with personal investments at the expense of a fund and its shareholders.[54] Nor is a portfolio

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[51] Rankings of investment companies by performance are a staple of the financial press. *See, e.g.*, John Wyatt, *The Best Mutual Funds*, FORTUNE, Mar. 21, 1994, at 167 (ranking mutual funds on annual rates of return after allowing for appropriate taxes and fund expenses).

[52] *Id*.

[53] As one firm's code of ethics states, "our own long-term business interests are best served by strict adherence to [the principle that clients' interests come first]." In addition to such statements in codes of ethics, members also expressed such a philosophy in their comment letters to the Institute. For example, one letter noted:

> Nothing is more important . . . than maintaining and enhancing the hard-earned reputation of our company and the industry in general for fulfilling fiduciary obligations to shareholders.
>
> Another letter articulated the philosophy as follows:
>
> It is the view of [the company] that high ethical standards are an essential ingredient not only for the success of our business but to maintain the confidence of investors.

[54] Some codes expressly prohibit preoccupation with personal investing. For example, one code of ethics notes, "[a]ctivity should not be excessive . . . in terms of time spent on [the employee's] own investments." Based upon the Advisory Group's personal experience and the information available to it, it appears that portfolio managers typically conduct a limited number of personal securities transactions over the course of a year. *See*

Footnote continued on next page

manager, whose personal compensation frequently is linked to the performance of the fund, likely to be motivated to engage in trading activities that benefit him at the expense of fund performance.[55]

Second, while the Advisory Group is most mindful of the potential conflicts of interest in this area, it is convinced that the industry can continue to address these concerns in a decisive manner — and maintain the investing public's confidence in the industry — through the imposition of various restrictions and the implementation of related compliance procedures short of a total ban. Those many former Commission members and senior officials with whom the Advisory Group met in the course of its work concurred unanimously in this judgment.

Third, an outright prohibition on personal investing would heavily — and unfairly — penalize many portfolio managers. As has been noted, the language of Section 17(j) of the Investment Company Act and of Rule 17j-1 reflects both Congress' and the Commission's express contemplation that a portfolio manager, and other investment company personnel and their families, would not be precluded altogether from personally investing. This approach is

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Footnote continued from previous page

Jonathan Clements, *Personal Trading is Common Among Fund Managers*, WALL ST. J., Jan. 25, 1994 (among portfolio managers at six major fund groups, the most active traders reported to have from a low of 6 to a high of 48 purchases and sales over the course of a full year). While some individuals may trade more actively, they appear to be the exception to the rule, and, in any event, there is no basis to believe that the level of personal investing activity industry-wide has compromised the diligence and loyalty shareholders rightly expect of portfolio managers.

[55] In most professions, employees do not devote 100 percent of their time at the office to the performance of their official duties. Conversely, most professionals recognize the necessity, and desirability, of "taking aspects of their job home with them." As a result, many professionals use their time to read professional journals, consider local, national and world developments that might affect the market for various investment instruments, and catch up on other critical reading. Through job performance evaluations, careful supervision, and other techniques, employers ensure that the predominant portion of an employee's time at work is spent on the employer's business. No system, other than professional pride, has been devised to ensure that appropriate amounts of personal time are spent in furtherance of employment-related job obligations. The Advisory Group considered , and believes that it is not possible to achieve, the development of specific rules governing the amount of time an investment company portfolio manager must spend on job-related activities both at the office and at home. These are functions best left to investment companies, and the results of each portfolio manager's efforts.

true to our long experience under the common law of trusts. The courts traditionally have applied the fiduciary's duty of loyalty with "[u]ncompromising rigidity."[56] But they have never done so by completely foreclosing a trustee from entering into an entire category of personal transactions unrelated to the administration of the trust or to the trust assets.

In these and other respects, the issue of personal investment and trading activities does not arise on a clean slate. The Advisory Group is aware of no circumstances that would argue for such a drastic change in standards, and does not believe that the case for such a change has been made. Moreover, the unfairness to those numerous professionals who entered the industry with one set of rules, only to find those rules radically changed, is not something the Advisory Group would regard lightly.

Moreover, although concerns about personal investments typically are associated with trading in common stocks, equity investment companies comprise only about 35 percent of the assets of the investment company industry. The clear majority of investment company assets are invested in bond and money market funds. It is not apparent what legitimate purpose would be served, for example, by precluding the young manager of a money market fund, whose professional activities are limited to markets in short-term, high-quality debt instruments, from investing in growth stocks for his retirement account or in blue-chip stocks as gifts to his minor children.[57] As one ethicist noted in the course of the Advisory Group's work, rules adopted in an area such as this should vindicate the "reasonable expectations" of

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[56] *Meinhard v. Salmon*, 246 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, J.)

[57] It often may be inappropriate for a portfolio manager to invest personal assets in his or her own fund, because the fund's objective may be altogether inconsistent with quite legitimate investment objectives of the manager. "An older person managing an aggressive growth fund," for example, "might prefer an equity income fund for his own money, and vice versa." *Invesco Fires a Star Manager*, NO-LOAD FUND INVESTOR, Feb. 1994. In short, investment company personnel should be free to observe for their own accounts the same principles of investing that they preach to others.

the American public. Applying this standard, an across-the-board ban is inappropriate, because its consequences in many cases would be illogical and unfair.

Fourth, such a ban could — and, in the Advisory Group's judgment, clearly would — operate to the detriment of investment companies and millions of fund shareholders. As senior executives in the investment company industry, the Advisory Group is keenly aware that the industry's performance for shareholders is still dependent upon highly talented investment professionals. For many of the best of these — the ones with a passion and a sixth sense for the market[58] — a ban on personal investing would detract from the very portfolio management abilities on which shareholders depend. For example, Peter Lynch, the renowned manager of the Magellan Fund, has stated that his personal equity investing was critically important in developing his skills as an equity manager.[59] The Advisory Group believes he speaks for many others whose skillful performance has been of immense value to fund shareholders.

Finally, as has been noted, investment company portfolio managers (and other access persons) already are subject to more detailed accountability for their personal investing activities than are the employees of other investment managers. Historically, the energies and skills of these investment experts have been available exclusively to institutions and the wealthiest individuals. Today, they are at the disposal of millions of ordinary

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[58] *See* Jonathan Clements, *Personal Trading is Common Among Fund Managers*, WALL ST. J., Jan. 25, 1994 ("[The best portfolio managers] love the markets. That love is what separates the really good managers from the rest.") (statement of Steven Somes, fund manager, State Street Research and Management).

[59] *See also* Brett D. Fromson, *Fund Managers' Own Trades Termed a Potential Conflict*, WASH. POST, Jan., 11, 1994, at A1 ("We know that Peter Lynch was a great portfolio manager . . . . We know that Peter Lynch did some personal trading and felt it sharpened his skills. We know that if we had said to Peter Lynch, 'You can do no trading when you are at Fidelity,' that would have been a major problem for him.") (Statement of Robert C. Pozen, General Counsel, FMR Corporation).

investors. In the course of the Advisory Group's review, there have been widespread expressions of concern — which are legitimate — that foreclosing these experts from any opportunity to invest in the markets directly would establish significant and needless disincentives to their entering or continuing to serve in the investment company industry.[60]

In sum, the Advisory Group is persuaded that an across-the-board prohibition on personal investing is unnecessary, unfair and, in the final analysis, contrary to the interests of investors. Notwithstanding this conclusion, the Advisory Group recommends additional standards, short of a total ban, in order to address recognized potential for abuse.

[60] *See* James M. Pethokoukis, *Controversy Has Yet to Sully Funds' Image*, INVESTOR BUS. DAILY, Mar. 4, 1994 ("And what I think would happen [with a ban on personal trading] is that the good money managers would leave for hedge funds. I don't want to drive the good people out.") (statement of A. Michael Lipper, President, Lipper Analytical Services, Inc.).

IV. RECOMMENDATIONS

In crafting these recommendations, the Advisory Group has been guided by three principles. First, certain substantive standards should apply across the industry. Individual investment companies, of course, may elect to implement more rigorous standards should these be deemed more appropriate in a specific case. Second, flexibility to allow investment companies to tailor restrictions to unique or exceptional circumstances is critical to successful implementation of these standards. Finally, while no set of compliance standards is foolproof, and an employee intent upon deliberate misconduct can foil the most elaborate system, additional compliance procedures are desirable and should be implemented.

The recommendations that follow are in five principal parts: (1) a statement of general ethical principles; (2) a discussion of the applicability of the recommended restrictions and procedures; (3) recommended restrictions on personal investing activities; (4) recommended compliance procedures to implement these restrictions; and (5) recommended disclosure to investors.

As noted above, the Advisory Group addresses itself throughout these recommendations to codes of ethics adopted by "investment companies." The recommendations in each case are intended to apply equally to investment advisers and principal underwriters who must adopt codes of ethics under Rule 17j-1.[61]

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[61] Similarly, when the recommendations refer to "investment company personnel" (or more specifically to portfolio managers, investment personnel or access persons), this is intended to encompass any such employee subject to Rule 17j-1, whether employed by an investment company or its investment adviser or principal underwriter.

A. STATEMENT OF GENERAL PRINCIPLES

The Advisory Group recommends that every investment company incorporate in its code of ethics a statement of general fiduciary principles that govern personal investment activities. These principles should, at a minimum, reflect the following: (1) the duty at all times to place the interests of shareholders first; (2) the requirement that all personal securities transactions be conducted consistent with the code of ethics and in such a manner as to avoid any actual or potential conflict of interest or any abuse of an individual's position of trust and responsibility; and (3) the fundamental standard that investment company personnel should not take inappropriate advantage of their positions.

Investment company codes of ethics are intended to be flexible, living documents, designed to communicate broad principles and aspirational goals. The area of personal investment activities demands no less. Although a number of specific standards and procedures are recommended below, the Advisory Group believes that there is no substitute for a thoughtful statement of general principles by which all investment company personnel should conduct their activities. The precise formulation of these broad standards should be developed by each investment company complex, taking into account its particular activities, culture and personnel. The Advisory Group recommends that three bedrock principles be articulated.

First, the interests of the shareholders must come first. A code of ethics must implement the threshold legal principle that investment company personnel — at all levels — act as fiduciaries. In common sense terms, this principle can be distilled to a single core precept: the shareholders' interests must and will come first. Although this principle is relatively simple to

state, it is of paramount importance. Investment company personnel must recognize and respect, at all times, the interests of the shareholders. In any decision relating to their personal investments, they must scrupulously avoid serving their own personal interests ahead of the shareholders'. In most cases, difficult decisions can be resolved quickly and fairly — by asking what an employee would expect or demand if he or she were a fund shareholder and the shoe were on the other foot.

Second, personal investment should comport with the code of ethics and should avoid any actual or potential conflicts of interest. An important corollary to this proposition is the commitment to avoid situations involving any real or possible impropriety. The ethicists with whom the Advisory Group met, as well as the industry practitioners and former Commissioners and senior Commission staff officials, all stressed the importance of avoiding conduct that creates a potential conflict of interest. In this regard, it is not enough for investment company personnel to follow the letter of the code. They also should abide by the spirit of the code and the principles articulated therein.[62]

Third, investment company personnel should not take inappropriate advantage of their position. Consistent with the notion that the shareholders' interests must come first is the corollary that investment company personnel should not take inappropriate advantage of their position with or on behalf of the fund. Troublesome questions can arise whenever investment company personnel receive unusual investment opportunities, perquisites, or gifts of more than

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[62] As one Institute member's code states:

> The Code is based on the principle that the officers, directors and employees of the [Company] owe a fiduciary duty to, among others, the shareholders of the Funds, to conduct their personal securities transactions in a manner which does not interfere with Fund portfolio transactions or otherwise take unfair advantage of their relationship to the Funds. Persons covered by this Code must adhere to this general principle as well as comply with the Code's specific provisions. It bears emphasis that technical compliance with the Code's procedures will not automatically insulate from scrutiny trades which show a pattern of abuse of the individual's fiduciary duties to the [Company's] Funds or a portfolio within the group.

de minimis value from persons doing or seeking business with the investment company. As a general principle, it is imperative that those who work for or on behalf of an investment company avoid any such situation that might compromise, or call into question, their exercise of fully independent judgment in the interests of shareholders.

B. APPLICABILITY OF RESTRICTIONS AND PROCEDURES

The Advisory Group recommends that every investment company, in promulgating its code of ethics, consider how the code's restrictions and procedures may be applied in light of its ethical obligations, the overall nature of the investment company's operations, and the issues potentially raised by transactions in different kinds of securities and by the personal investment activities of different categories of personnel — including portfolio managers, other investment personnel and access persons in general.

Based on its review of existing codes and prevailing industry practices, it is clear to the Advisory Group that investment companies have achieved substantial success in integrating codes of ethics into their business operations, and appropriately have relied on them both to restrict behavior and to shape the judgment of individual employees. This is an on-going process, and it is essential if any set of ethical standards is to be more than a formality. In the Advisory Group's judgment, this process should be encouraged. The Advisory Group has two recommendations.

1. Consideration of Different Categories of Personnel.

It is imperative that an investment company, in delineating restrictions applicable to personal securities transactions, carefully consider how and to whom such restrictions should

be applied. In general, this process should take into account the position and responsibilities of several sets of employees.

The first set includes *portfolio managers* — those employees entrusted with the direct responsibility and authority to make investment decisions affecting an investment company, and who, therefore, are the persons best informed about an investment company's investment plans and interests. The second set includes portfolio managers as well as other *investment personnel*, such as the securities analysts and traders who provide information and advice to a portfolio manager or who help execute the portfolio manager's decisions. The third and largest set of employees includes all *access persons*, as that term is used in Rule 17j-1 and has been applied in the industry. In addition to all portfolio managers and other investment personnel, access persons include all individuals who, in the course of their normal workplace duties, obtain information about an investment company's purchase or sale of securities. In keeping with the spirit of Rule 17j-1, investment companies typically have construed this category of access persons very broadly.

In the Advisory Group's experience, the portfolio managers and other investment personnel in the industry are highly conscientious and talented men and women who serve their shareholders with the utmost dedication and integrity. Nevertheless, the formulation of tiered restrictions recognizes that the positions they hold are of a nature that offers greater potential for inappropriate conduct as a result of an individual's proximity to, knowledge of or ability to influence investment decisionmaking for an investment company.

2. Consideration of Different Circumstances.

It is not possible to develop a single detailed code of ethics that will address the highly diverse settings to which Rule 17j-1 applies. Investment company complexes today vary

dramatically in terms of the number of funds and amount of assets they have under management, the portfolio securities in which they invest, the individual and institutional shareholders that they serve, the structure and geographical dispersion of their investment company operations, other investment management activities in which they engage, and numerous other factors. Thus, it is important to recognize that the general ethical principles set forth above must be applied in highly differentiated settings.

As has been discussed, Rule 17j-1 clearly recognizes this need. For example, the Rule excludes personal transactions involving certain types of securities that do not implicate the policies of the Rule — *e.g.*, money market instruments, government securities, and shares of mutual funds. Some codes of ethics likewise may provide certain exceptions for personal transactions involving small amounts of securities that have very high market capitalization and high average daily trading volume. This exception is based on the notion that neither the individual nor fund transactions will materially affect the price of such securities. The Advisory Group also recognizes, for example, that tiered restrictions may be more appropriate for larger complexes than for smaller ones, where the relatively few individuals employed may have substantially the same access to information about fund investments.

The Advisory Group, in developing the substantive and procedural recommendations that follow, has been mindful of these and other practical concerns. The Advisory Group urges that its recommendations be adopted broadly within the industry, and that they be applied as uniformly as possible. Any *de minimis* standard of other exception should be narrowly defined, clearly documented under the code of ethics, and in keeping with the letter and the spirit of the broad ethical principles set forth earlier.

C. SUBSTANTIVE RESTRICTIONS ON PERSONAL INVESTING ACTIVITIES

1. INITIAL PUBLIC OFFERINGS

The Advisory Group recommends that codes of ethics flatly prohibit investment personnel from acquiring any securities in an initial public offering, in order to preclude any possibility of their profiting improperly from their positions on behalf of an investment company.

From time-to-time, brokerage firms are part of underwriting syndicates that bring new issues of securities to market. For companies that are not then public, these are known as initial public offerings ("IPOs"). In some cases, the opportunity to invest in an IPO is highly attractive and sought-after: some eagerly anticipated new issues may trade above their original offering price shortly after the initial offering is complete, and the opportunity to participate in that IPO may be available to only a limited number of investors.[63] If the opportunity to participate in an IPO is bestowed upon an individual affiliated with an investment company and active in the management of its portfolio securities, there is a clear potential for conflict between the interests of the individual and of the fund.[64]

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[63] *See* James K. Glassman, *For an Exclusive Few, Quick Profits in IPOs*, WASH. POST, July 23, 1993, at B1 (ten IPOs in June 1993 produced one-day trading profits of more than 40 percent; another 11 companies produced one-day trading profits of 21 percent to 37 percent). *See also* William Power, *In IPOs, if You're Not in on Day One, It's Usually Going to Be a Losing Play*, WALL ST. J., Mar. 17, 1994, at C1 ("It's usually fruitless to buy an IPO if - like most of us - you can't get it at the offering price.").

[64] Securities and Exchange Commission Chairman Levitt has indicated that, were he an investment company director, he "would have reservations about trading by managers and would be greatly troubled by their buying and selling IPOs." *Levitt Remarks, supra* note 49, at 6. While the issues discussed above may arise in connection with any IPO purchase, the Advisory Group recognizes that the NASD has addressed these issues with regard to "hot issues." *See* National Association of Securities Dealers, Inc., Interpretation of the Board of Governors, *Freeriding and Withholding*, June, 1993 (stating that purchases of "hot issues" are in violation of Article III, Section 1 of the Rules of Fair Practice).

Purchases of IPOs by investment personnel pose two potential conflicts of interest. First, these purchases may suggest that such personnel have taken inappropriate advantage of their positions for personal profit. An opportunity for investment personnel to participate in a "hot issue" or other attractive IPO is not likely to be viewed as a random event. At a minimum, it may create the impression that future investment decisions for the investment company were not pursued solely because they were in the best interest of the fund's shareholders. Second, realization of any short-term profits also may create at least the appearance that an investment opportunity that should have been available to the fund was diverted to the personal benefit of an individual employee. Eliminating these potential conflicts is in the best interests of the investment company industry. In fact, twenty-five complexes responding to the Institute Survey currently forbid or restrict personal purchases of IPOs. The Advisory Group recommends that a prohibition in this area be adopted throughout the investment company industry.

2. PRIVATE PLACEMENTS

The Advisory Group recommends that (a) codes of ethics require express *prior approval* of any acquisition of securities by investment personnel in a private placement. This prior approval should take into account, among other factors, whether the investment opportunity should be reserved for an investment company and its shareholders, and whether the opportunity is being offered to an individual by virtue of his or her position with the investment company. (b) Investment personnel who have been authorized to acquire securities in a private placement should be required to *disclose* that investment when they play a part in any investment company's subsequent consideration of an investment in the issuer. (c) In such circumstances, the investment company's decision to purchase securities of the issuer should be subject to an *independent review* by investment personnel with no personal interest in the issuer.

Personal investments in securities distributed in a private placement can create a conflict of interest but, unlike the situation with IPOs, the conflict typically will not manifest itself immediately. Some press accounts have alleged that emerging companies court portfolio managers through private placements in order to encourage the portfolio managers to have their funds invest in the company when it later undertakes an initial public offering.[65] The portfolio manager's investment of the fund's assets in such a situation can pose a direct conflict of interest, because the fund's investment may produce an increase in the value of the

[65] *See, e.g.,* John Accola, *Firms, Fund Exec Ties 'Normal,'* ROCKY MOUNTAIN NEWS, Jan. 18, 1994, at 38A ("Normally, where fund companies have invested in the Vancouver Stock Exchange at high prices, you will find that the funds' advisers or managers, and sometimes, both, invested at the lower prices.") (statement of James Woods, publisher, *Canada Stockwatch*).

company's securities and thus an increase in the value of the portfolio manager's personal holdings. In public remarks, Commissioner Richard Roberts has emphasized that he is "troubled by such reports."[66]

Regulation of personal investments in private placements is more problematic than investments in IPOs because many, if not most, private placements will not raise any potential conflict of interest. Indeed, many involve a situation in which there is neither much possibility that the issuer would become a publicly-traded company nor that its securities (*e.g.*, shares in a local restaurant or sports team) would be appropriate for fund investment.[67] A complete ban on such investments would restrict many wholly legitimate investment opportunities without providing any benefit to the investment company involved.

Instead, the Advisory Group recommends a three-step process. First, all acquisitions of securities by investment personnel in private placements should be subject to a process of prior review and approval by some designated senior official. Second, any employee who has taken a personal position through a private placement should be under an affirmative obligation to disclose that position if he or she plays a material role in an investment company's subsequent investment decision regarding the same issuer. Finally, once such disclosure has been made, the code of ethics should provide for an independent review of the fund's investment decision by investment personnel with no personal interest in the company. This process will

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[66] *See Roberts Remarks, supra* note 47, at 2 (noting that he is troubled by "recent press accounts which depict fund managers as receiving free or deeply discounted stock and options in companies prior to fund investment in that company . . . . At a minimum, this type of conduct is troublesome, particularly in an IPO situation.").

[67] *See* Sara Calian, *Mutual Fund Managers Can Often Get Part of the Action in Private Placements*, WALL ST. J., Jan. 28, 1994, at C-1 ("Early investors [in private placements] are taking a big risk because there's no guarantee the stock will ever reach the public market.").

accommodate personal investments in private placements, but assure close scrutiny of those instances in which there is a potential conflict.

3. BLACKOUT PERIODS

The Advisory Group recommends that codes of ethics prohibit any access person from executing a securities transaction on a day during which any investment company in his or her complex has a pending "buy" or "sell" order in that same security until that order is executed or withdrawn. In addition, codes of ethics should prohibit any portfolio manager from buying or selling a security within at least seven calendar days before and after an investment company that he or she manages trades in that security. Any profits realized on trades within the proscribed periods should be required to be disgorged.

A blackout policy should be implemented in two forms. The first, which should apply to all access persons, would consist of a blackout period when the complex has an open order to purchase or sell a particular security. Employee trading in the security should be restricted while an order for that security remains open for any investment company in the complex until the investment company's order is completed (*i.e.*, until the order is executed or withdrawn). The requirement provides a tangible implementation of the principle that shareholder interests always are primary.[68] The second, applicable to all portfolio managers, would consist of a blackout period of at least seven calendar days, during which portfolio managers are strictly

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[68] The Advisory Group recognizes the *de minimis* exceptions, (*e.g.*, for transactions involving a small number of shares of a company with very large market capitalization and high average daily trading volume) might be developed in respect of this first blackout provision. Nonetheless, the Advisory Group recommends that all personal trades by access persons, including those that might qualify for such an exception, be precleared.

prohibited from purchasing or selling a particular security traded by their investment company. This second blackout period serves to protect against frontrunning and various activities that create conflicts.[69] At a minimum, the Advisory Group recommends that this second blackout period be adopted for portfolio managers who have decisionmaking authority over fund investments.

These types of blackout periods are common in the investment company industry. Sixty-three of those responding to the Institute Survey — about two-thirds of the sample — include some form of blackout period in their codes of ethics. Nonetheless, there is little uniformity in the duration of blackout periods presently applied — the time periods vary from two to thirty days. The Advisory Group recommends that the second blackout period described above consist of no fewer than seven calendar days running before and after the date on which the investment company trades a particular survey. This time period is a sensible minimum period because it diminishes considerably the ability of a portfolio manager to capitalize improperly upon the market impact of the investment company's trades. It should be noted that a longer period increases the potential for hardship in individual cases unrelated to any principle of shareholder protection.[70]

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[69] The blackout period *before* an investment company trades addresses frontrunning violations that are typified by personal trades conducted shortly before an investment company's transaction and calculated to capitalize on the market effect of the investment company's trading. Similar patterns of quick "in-and-out" trading have been the subject of the government's successful prosecution of violations based on advance knowledge of market-sensitive publications in the financial press. *See Carpenter v. United States*, 484 U.S. 19 (1987) (Over a four-month period, the brokers made prepublication trades on the basis of information given to them by Winans about 27 *Herald* columns.); *United States v. Libera,* 989 F.2d 596 (2d Cir. 1993) (defendent executed a total of 64 trades between October 1986 and February 1987 based on advance information about the contents of BUSINESS WEEK'S *Inside Wall Street* column).

A blackout period *after* an investment company trades is designed to allow dissipation of the market effect of the investment company's trade before the portfolio manager trades. It also is designed to prevent the portfolio manager from benefiting from a trade that is *opposite* the investment company's trade (*e.g.,* the sale of a security shortly after the investment company purchased the security and boosted its price).

[70] Studies of trading impacts suggest that the effect of the dissemination of significant nonpublic market information is generally dissipated within a few days. *See, generally*, Robert W. Holthausen, Richard W. Loftwich,

The implementation of a blackout period before and after a trade date poses certain procedural difficulties. Even a portfolio manager will not always be aware of all investment company trades seven days before they are executed. Inevitably, there will arise circumstances in which an employee trades within a proscribed period. The Advisory Group recommends that such trades generally be unwound or, if that is impractical, all profits from the trading should be disgorged to the appropriate investment company (or, alternatively, to a charitable organization).

4. BAN ON SHORT-TERM TRADING PROFITS

In addition to the blackout periods described above, the Advisory Group recommends that codes of ethics prohibit all investment personnel from profiting in the purchase and sale, or sale and purchase, of the same (or equivalent) securities within 60 calendar days. Any profits realized on such short-term trades should be required to be disgorged.

While the Advisory Group recognizes that short-term trading securities can be pursued by investment personnel well within the parameters of existing legal requirements, a prohibition on short-term trading profits can serve as an important prophylactic device against potential frontrunning transactions. As noted above, frontrunning typically involves a quick trading pattern to capitalize on a short-lived market impact of an investment company's trade. The prohibition against short-term trading profits by investment personnel is designed to minimize the possibility that they will capitalize inappropriately on the market impact of trades involving another investment company in the complex to which they possibly could be privy.

David Maryers, *The Effect of Large Block Transactions on Security Prices*, 19. J. OF FIN. ECON. 237, 240 (1987) ("Transaction prices subsequent to the block [trade] quickly revert to the former equilibrium price unless the intermediary sells large blocks of stock to reduce inventory.")

The Advisory Group recommends that trades made in violation of this prohibition be unwound or, if that is not practical, all profits from the trading should be disgorged to the appropriate investment company (or, alternatively, to a charitable organization).

This recommendation imposes a standard more onerous than those presently common throughout the industry. While fifteen of the complexes responding to the Institute Survey discourage short-term trading, only four impose express restrictions on such trading.[71] The Advisory Group recognizes that its recommendation embraces a prophylactic rule that, by its very nature, would prohibit many legitimate personal investments in order to prevent *potential* conflicts of interest. Given the historically low incidence of *actual* conflicts of interest involving personal investments in the investment company industry, as well as the Advisory Group's recommended blackout periods, such a prophylactic rule could be viewed as "overkill." Indeed, an investment company's management may wish to allow exceptions on a case-by-case basis when no abuse is involved and the equities of the situation strongly support an exemption. For example, although a portfolio manager may buy a stock as a long-term investment, that stock may have to be sold involuntarily due to unforeseen corporate activity such as a merger. As a general principle, however, the Advisory Group recommends this prohibition in order to address the risk, real or perceived, of frontrunning or other abusive practices involving short-term personal trading by investment personnel.[72]

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[71] Two complexes responding to the Institute Survey require that securities be held for 30 days. One imposes a 60-day holding period and another imposes a 91-day holding period.

[72] This prohibition also would effectively limit the utility of options trading and short sales of securities. Only about a dozen respondents to the Institute Survey prohibit or restrict such investment techniques. By crafting the recommendation to encompass a sale followed by a purchase, the Advisory Group is extending its recommendation to the format typically followed in short sales. A 60-day profit ban, for most investors, will pose too great a risk of being frozen in an unviable position. The Advisory Group acknowledges that, as a result of this profit ban, certain legitimate hedging activities may become less available to the investment personnel of investment companies. The Advisory Group nevertheless accepts these implications of the profit ban because options trading and short sales can be utilized to effect speculative, short-term trading, as well as hedging.

5. GIFTS

The Advisory Group recommends that codes of ethics prohibit investment personnel from receiving any gift or other thing of more than *de minimis* value from any person or entity that does business with or on behalf of the investment company.

A standard component of most corporate ethics statements is a general proscription against any payment or gratuity that could pose a potential conflict of interest. The Advisory Group intends that its recommendation parallel the NASD Rules of Fair Practice, which preclude any member from giving (or permitting to be given) anything of value in excess of a *de minimis* amount to any person or an employee or another entity "where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity."[73] About one-third of the codes of ethics reviewed in the Institute Survey include a specific restriction on the receipt of gifts[74] and the Advisory Group recommends such a restriction for all codes.

[73] NASD, *Rules of Fair Practice* § 10(a).

[74] Twenty-seven complexes have restrictions on the receipt of gifts, favors, preferenatial treatment or valuable consideration from anyone involved in the securities industry, with only *de minimis* exceptions.

6. SERVICE AS A DIRECTOR

The Advisory Group recommends that codes of ethics prohibit investment personnel from serving on the boards of directors of publicly traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the investment company and its shareholders. In the relatively small number of instances in which board service is authorized, investment personnel serving as directors normally should be isolated from those making investment decisions through "Chinese Wall" or other procedures.

Certain investment company personnel, such as prominent portfolio managers, occasionally are asked to serve on a portfolio company's board of directors.[75] Such service poses three forms of potential conflicts for the employee. First, board service may raise conflicting fiduciary duties to the company on the one hand, and to the shareholders of an investment company that has invested in that company on the other hand. Second, investment personnel who serve as directors may receive options or other rights to purchase the company's securities at a discounted price.[76] The availability of these special options or rights may bring into question trading decisions made for the investment company that could increase the value of those special options or rights.[77] Third, service on the board of directors places the employee in the fulcrum of material, nonpublic information involving the company. The case in which the Commission launched its modern regulation of insider trading involved the use of information

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[75] *See* McGough, *supra* note 6.

[76] A director's position also may involve fees, attractive perquisites and other benefits.

[77] *See* McGough, *supra* note 6.

obtained at a board of directors meeting.[78] If the investment company is invested in the company in which one of its investment personnel serves as a director, the investment company's ability to trade that company's securities may be limited.

Few of the respondents to the Institute Survey restrict service on corporate boards. In the Advisory Group's experience, this is because the issue of directorships for investment company personnel arises infrequently. The issue, however, has been raised in some of the articles addressing potential conflicts confronting portfolio managers.[79] The Advisory Group recognizes that resolving these issues involves considerations beyond the realm of personal investing by investment company personnel. Mindful of the important service provided by independent directors generally (and of the heavy reliance on independent directors in the corporate governance structure of the investment company industry), the Advisory Group is reluctant to recommend a complete ban on such positions.[80] As investment companies increasingly are exhorted to exercise their ownership rights as investors in public companies,[81] there may be circumstances in which an investment company determines it is appropriate to obtain representation upon a portfolio company's board. Moreover, an outright ban may be impractical for funds whose investments are concentrated in financially distressed companies.

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[78] *See In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

[79] *See, e.g.*, McGough, *supra* note 6.

[80] *Id.* ("The advantage of continuing to have this exposure [to the board of directors] is we never forget how difficult it is for small venture companies and small companies in general to succeed.") (statement of Lawrence Auriana, Co-manager, Kaufmann Fund).

[81] *See* Levitt Remarks, *supra* note 49, at 5 ("[Investment company] [d]irectors should look carefully at whether it is in investors' interest that a fund exercise its franchise in matters as critical as anti-takeover measures, proxy fights for control of a portfolio company, elections.").

Therefore, the Advisory Group recommends that service on corporate boards be subject to prior approval and that safeguards be implemented — either through a Chinese Wall policy or investment restrictions — to address the potential conflicts of interest. The distressed debt markets provide a precedent for such an arrangement, which has been structured with the Commission's support.[82]

D. COMPLIANCE PROCEDURES

Establishing substantive restrictions represents only half of the task in formulating a policy to address personal investing by investment company personnel. Each fund also must implement its restrictions effectively. The investment company industry has extensive experience in this area. The Advisory Group therefore looked to the experience of its individual members and of those responding to the Institute Survey to identify procedures that, on a day-to-day basis, have proven to be effective. Based on this review, the Advisory Group recommends that the following measures be taken by all investment companies.

1. PRECLEARANCE

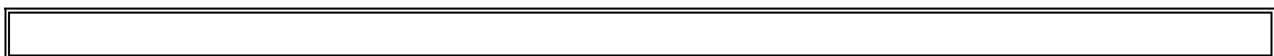
The Advisory Group recommends that codes of ethics require all access persons to "preclear" personal securities investments. These preclearance requirements and associated procedures should be reasonably designed to identify any prohibition or limitation applicable to the proposed investment.

Preclearance is a staple of investment company industry compliance efforts: 96 investment company complexes responding to the Institute Survey — 100 percent of the Institute Survey

[82] *See* Memorandum of the Securities and Exchange Commission in Support of Motion of Fidelity Management & Research Co., *In re Federated Department Stores, Inc.*, No. 1-90-00130, 1991 Bankr. LEXIS 288 (S.D. Ohio Mar. 7, 1991).

sample — employ some form of preclearance. As its name suggests, preclearance involves a process by which personal investments are reviewed prior to their execution. The universal use of this technique reflects a pragmatic recognition that it is always better to address a "problem" trade *before* it is executed. Consequently, the preclearance procedure allows a complex to prevent a trade in which, for example, an access person of one fund intends to purchase securities for his or her own account, unaware that another fund in the same complex has an open order to purchase a significant block of the same securities. For both the investment company and the access person involved, the preclearance process creates a record of their good faith effort to meet (and exceed) legal requirements.

The Institute Survey revealed considerable differences in the actual process by which preclearance is implemented. For example, 62 of those responding mandate preclearance for all securities transactions (with certain limited exceptions, such as transactions in government securities), while 34 mandate preclearance for a defined set of assets. Variances extend also to the period for which preclearance remains valid. Of the codes of ethics that specifically address the issue, eleven indicated that preclearance remains valid for one day and eleven specify time periods ranging from two to fifteen days. The Advisory Group deliberately has crafted a flexible recommendation that funds adopt a preclearance process reasonably designed to identify any prohibition or limitation applicable to the proposed investment. Given the wide range of investment companies subject to Rule 17j-1, the Advisory Group recognizes that no one procedure will be appropriate across the board. Instead, investment companies should have considerable latitude in adopting a preclearance process appropriate to their individual circumstances.



2. RECORDS OF SECURITIES TRANSACTIONS

The Advisory Group recommends that codes of ethics require all access persons to direct their brokers to supply to a designated compliance official, on a timely basis, duplicate copies of confirmations of all personal securities transactions and copies of periodic statements for all securities accounts.

Under Rule 17j-1, investment company access persons are required to report securities transactions on a quarterly basis to the investment company (or the relevant adviser or principal underwriter). Twenty-seven complexes responding to the Institute Survey exceed this requirement, and require that access persons supply copies of monthly brokerage statements, while 22 require that access persons supply brokerage confirmations. The Advisory Group recommends that all access persons be required to direct their brokers to supply a designated compliance official with duplicate copies of trade confirmations and copies of periodic account statements. Timely brokerage records allow an investment company to conduct "spot checks" to ensure the effectiveness of its compliance efforts. For example, these records can be compared against the investment company's internal preclearance records to ensure that the process is being followed in each instance.

3. NASD RULEMAKING — OPENING OF ACCOUNTS

The Advisory Group recommends that the National Association of Securities Dealers, Inc. ("NASD") adopt a rule requiring all broker-dealers to notify a registered investment adviser when any of its employees opens a brokerage account.

Current NASD rules require all broker-dealers to notify any other registered broker-dealer if any of its employees opens a brokerage account.[83] The Advisory Group recommends the extension of this NASD rule to cover employees of any registered investment adviser, in order to help investment companies police the opening of brokerage accounts by their personnel and ascertain that they are receiving confirmations and account statements for all of the employee's accounts.

4. POST-TRADE MONITORING

The Advisory Group recommends that each investment company implement appropriate procedures to monitor personal investment activity by access persons after preclearance has been granted.

The Advisory Group recommends that investment companies implement a system to monitor the trading patterns of their access persons. Such a system accords an investment company a means by which to identify patterns of instances of possible infractions. For example, such a system might seek to identify patterns of personal securities trading occurring before fund trades. Similarly, it might involve some sampling and comparison of the trading activities of various funds and individuals within a complex. No single system of post-trade monitoring will be right for each investment company. Consequently, each investment company must develop post-trade monitoring procedures that would be most effective given such factors as the structure and size of the complex.

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[83] NASD, *Rules of Fair Practice* § 28(b).

5. DISCLOSURE OF PERSONAL HOLDINGS

The Advisory Group recommends that codes of ethics require all investment personnel to disclose all personal securities holdings upon commencement of employment and thereafter on an annual basis.

A requirement that investment personnel annually disclose all personal securities holdings — irrespective of trading activity — exceeds considerably the reporting requirements of Rule 17j-1. The Institute Survey indicates that such reporting is already common in the industry: 54 complexes responding to the Survey require all employees to disclose their personal holdings. The Advisory Group recommends that, at a minimum, the personnel most active in the investment process list all securities holdings on an annual basis. This disclosure will serve two purposes. First, it provides a mechanism for funds to ensure that account statements are being received for each brokerage account. Second, a comprehensive list will capture certain investments (*e.g.*, private placements) that are not reflected in traditional broker-dealer accounts.

6. CERTIFICATION OF COMPLIANCE WITH CODES OF ETHICS

The Advisory Group recommends that all access persons be required to certify annually that they have read and understand the code of ethics and recognize that they are subject thereto. Further, access persons should be required to certify annually that they have complied with the requirements of the code of ethics and that they have disclosed or reported all personal securities transactions required to be disclosed or reported pursuant to the requirements of the code.

An investment company's compliance efforts should be reinforced with a requirement that each access person certify his or her compliance with the code of ethics. The certification should form part of a broader effort to implement codes of ethics through orientation and training programs and ongoing reminders. For investment companies, such certifications

provide an important measure of additional assurance that its personnel understand the importance of these standards and of their scrupulous compliance therewith.

7. REVIEW BY THE BOARD OF DIRECTORS

The Advisory Group recommends that each investment company's management prepare an annual report to the investment company's board of directors that, at a minimum —

- **summarizes existing procedures concerning personal investing and any changes in the procedures made during the past year;**
- **identifies any violations requiring significant remedial action during the past year; and**
- **identifies any recommended changes in existing restrictions or procedures based upon the investment company's experience under its code of ethics, evolving industry practices, or developments in applicable laws or regulations**

By statute, at least 40 percent of an investment company's board of directors must be composed of independent directors or, more specifically, persons who are not "interested persons" as defined in Section 2(a)(19) of the Investment Company Act. In its comprehensive review of the Investment Company Act, the Commission's Division of Investment Management concluded "[t]he oversight function performed by investment company boards of directors, especially the 'watchdog' function performed by the independent directors, has served investors well . . . . The role of directors in policing conflicts of interest is central to the Act."[84]

[84] *See* PROTECTING INVESTORS, *supra* note 1, at 253, 255 (footnote omitted). Indeed, one of the Division's recommendations suggested increasing the representation of independent directors to more than 50 percent of the board. *Id.* at 253.

It should come as little surprise, therefore, that board oversight of personal investment issues already is common among investment companies. Most codes of ethics reviewed in the Institute Survey specifically require that investment company management report to the board on the operation of the code of ethics.[85] Board involvement is essential because it subjects the code of ethics to independent, objective analysis by the "watchdog" for the investment company shareholders. At the same time, it is important to articulate for the board an appropriate oversight role; it would be both counterproductive and atypical for directors of any enterprise to become personally involved in day-to-day compliance efforts.

This balance is struck best with two requirements. First, investment company management should be required to report annually to the board of directors regarding compliance efforts on personal investing activities. This report would outline the operation of the compliance efforts over the last twelve months and would identify, for the board's approval, any amendments to the code of ethics that had been prompted by changes in the law or the investment company's experience in administering its compliance program. This report could constitute part of a broader report to the board, or an appropriate committee, addressing other compliance issues as well. Second, the directors should be informed, on a timely basis, of significant remedial action taken by management in response to violations of the code of ethics. As a general guideline, significant remedial action could be construed as any action that has a material financial effect upon the employee, such as firing, suspending or demoting the employee, imposing a substantial fine or requiring the disgorgement of profits.

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[85] A total of 52 complexes require that a compliance officer, or an employee in a comparable position, report to the board:

- 24 require reporting in cases of violations
- 15 require annual reporting
- 10 require reports in other instances (*i.e.*, every six months)
- 3 require quarterly reporting.

E. ADDITIONAL DISCLOSURE

The Advisory Group recommends that investment companies include in their Prospectuses or, at a minimum, in their Statements of Additional Information, disclosures concerning whether or not access persons are permitted to engage in personal securities transactions, and, if so, subject to what general restrictions and procedures.

The present controversy over personal investing by access persons is in some significant part a product of insufficient information regarding current practices and standards. The Advisory Group recommends that investment companies incorporate into their Prospectuses or Statements of Additional Information appropriate general disclosure concerning whether access persons engage in personal securities transactions and, if so, what restrictions and procedures apply. The disclosure document should provide a brief overview of the procedures followed by the investment company to address any conflict of interest that might arise. At their own discretion, investment companies also may elect to attach a copy of their codes of ethics as an exhibit to their registration statements.

F. THE COMMISSION'S ROLE

While internal compliance initiatives can continue to address potential conflicts of interest in personal investments, the Advisory Group recommends that the Securities and Exchange Commission continue vigorous oversight and enforcement in this area to deter and punish violators. To this end, the Advisory Group strongly supports the Commission's efforts to secure adequate funding for its regulatory programs.

The Advisory Group is proud of the investment company industry's reputation for integrity. More than anything else, the industry's good record has been due to the day-to-day efforts of countless supervisors and managers who share a commitment to the good name of their investment companies and of the industry. The Advisory Group's recommendations reflect a preference for internal compliance.

None of this, however, diminishes two key points. First, as in any industry, an employee who evades internal controls in order to violate the federal securities laws should bear the brunt of the Commission's enforcement power. Strict enforcement will emphasize to every employee in the industry that violations of their fiduciary duty to shareholders will carry a heavy price. Second, the Commission must have adequate funding to continue its examination efforts. Both individually and collectively through the Institute, all members of the Advisory Group strongly support the Commission's efforts to secure adequate funding for its important work.

V. CONCLUSION

The Advisory Group is pleased to have had the opportunity to review existing standards and practices governing personal investing by investment company personnel and to make this Report. The recommendations of the Advisory Group are intended to assist the Institute's members and Board of Governors as they consider what measures may be appropriate in this area. The Advisory Group also hopes that its Report and recommendations will prove responsive to the Commission and Congress as they consider the issue of personal investing in the context of both investment companies and other pooled investment vehicles. Most importantly, the Advisory Group hopes that its recommendations will provide even greater assurance of the industry's unwavering commitment to the interests of investors.

APPENDIX I

TEXT OF THE ADVISORY GROUP'S RECOMMENDATIONS

STATEMENT OF GENERAL PRINCIPLES

The Advisory Group recommends that every investment company incorporate in its code of ethics a statement of general fiduciary principles that govern personal investment activities. These principles should, at a minimum, reflect the following: (1) the duty at all times to place the interests of the shareholders first; (2) the requirement that all personal securities transactions be conducted consistent with the code of ethics and in such a manner as to avoid any actual or potential conflict of interest or any abuse of an individual's position of trust and responsibility; and (3) the fundamental standard that investment company personnel should not take inappropriate advantage of their positions.

APPLICABILITY OF RESTRICTIONS AND PROCEDURES

The Advisory Group recommends that every investment company, in promulgating its code of ethics, consider how the code's restrictions and procedures may be applied in light of its ethical obligations, the overall nature of the investment company's operations, and the issues potentially raised by transactions in different kinds of securities and by the personal investment activities of different categories of personnel — including portfolio managers, other investment personnel and access persons in general.

SUBSTANTIVE RESTRICTIONS ON PERSONAL INVESTING ACTIVITIES

1. Initial Public Offerings

The Advisory Group recommends that codes of ethics flatly prohibit investment personnel from acquiring any securities in an initial public offering, in order to preclude any possibility of their profiting improperly from their positions on behalf of an investment company.

2. Private Placements

The Advisory Group recommends that (a) codes of ethics require express *prior approval* of any acquisition of securities by investment personnel in a private placement. This prior approval should take into account, among other factors, whether the investment opportunity should be reserved for an investment company and its shareholders, and whether the opportunity is being offered to an individual by virtue of his or her position with the

investment company. (b) Investment personnel who have been authorized to acquire securities in a private placement should be required to *disclose* that investment when they play a part in any investment company's subsequent consideration of an investment in the issuer. (c) In such circumstances, the investment company's decision to purchase securities of the issuer should be subject to an *independent review* by investment personnel with no personal interest in the issuer.

3. Blackout Periods

The Advisory Group recommends that codes of ethics prohibit any access person from executing a securities transaction on a day during which any investment company in his or her complex has a pending "buy" or "sell" order in that same security until that order is executed or withdrawn. In addition, codes of ethics should prohibit any portfolio manager from buying or selling a security within at least seven calendar days before and after an investment company that he or she manages trades in that security. Any profits realized on trades within the proscribed periods should be required to be disgorged.

4. Ban On Short-Term Trading Profits

In addition to the blackout periods described above, the Advisory Group recommends that codes of ethics prohibit all investment personnel from profiting in the purchase and sale, or sale and purchase, of the same (or equivalent) securities within 60 calendar days. Any profits realized on such short-term trades should be required to be disgorged.

5. Gifts

The Advisory Group recommends that codes of ethics prohibit investment personnel from receiving any gift or other thing of more than *de minimis* value from any person or entity that does business with or on behalf of the investment company.

6. Service as a Director

The Advisory Group recommends that codes of ethics prohibit investment personnel from serving on the boards of directors of publicly traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the investment company and its shareholders. In the relatively small number of instances in which board service is authorized, investment personnel serving as directors normally should be isolated from those making investment decisions through "Chinese Wall" or other procedures.

COMPLIANCE PROCEDURES

1. Preclearance

The Advisory Group recommends that codes of ethics require all access persons to "preclear" personal securities investments. These preclearance requirements and associated procedures should be reasonably designed to identify any prohibition or limitation applicable to the proposed investment.

2. Records of Securities Transactions

The Advisory Group recommends that codes of ethics require all access persons to direct their brokers to supply to a designated official, on a timely basis, duplicate copies of confirmations of all personal securities transactions and copies of periodic statements for all securities accounts.

3. NASD Rulemaking — Opening of Accounts

The Advisory Group recommends that the National Association of Securities Dealers, Inc. ("NASD") adopt a rule requiring all broker-dealers to notify a registered investment adviser when any of its employees opens a brokerage account.

4. Post-Trade Monitoring

The Advisory Group recommends that each investment company implement appropriate procedures to monitor personal investment activity by access persons after preclearance has been granted.

5. Disclosure of Personal Holdings

The Advisory Group recommends that codes of ethics require all investment personnel to disclose all personal securities holdings upon commencement of employment and thereafter on an annual basis.

6. Certification of Compliance With Codes of Ethics

The Advisory Group recommends that all access persons be required to certify annually that they have read and understand the code of ethics and recognize that they are subject thereto. Further, access persons should be required to certify annually that they have complied with the requirements of the code of ethics and that they have disclosed or reported all personal securities transactions required to be disclosed or reported pursuant to the requirements of the code.

7. Review by the Board of Directors

The Advisory Group recommends that each investment company's management prepare an annual report to the investment company's board of directors that, at a minimum —

- summarizes existing procedures concerning personal investing and any changes in the procedures made during the past year;
- identifies any violations requiring significant remedial action during the past year; and
- identifies any recommended changes in existing restrictions or procedures based upon the investment company's experience under its codes of ethics, evolving industry practices, or developments in applicable laws or regulations.

ADDITIONAL DISCLOSURE

The Advisory Group recommends that investment companies include in their Prospectuses or, at a minimum, in their Statements of Additional Information, disclosures concerning whether or not access persons are permitted to engage in personal securities transactions, and, if so, subject to what general restrictions and procedures.

THE COMMISSION'S ROLE

While internal compliance initiatives can continue to address potential conflicts of interest in personal investments, the Advisory Group recommends that the Securities and Exchange Commission continue vigorous oversight and enforcement in this area to deter and punish violators. To this end, the Advisory Group strongly supports the Commission's efforts to secure adequate funding for its regulatory programs.

APPENDIX II

INSTITUTE SURVEY OF CODES OF ETHICS GOVERNING PERSONAL INVESTING ACTIVITIES

Rule 17j-1 of the Investment Company Act of 1940 requires investment companies (and their investment advisers and principal underwriters) to adopt written codes of ethics and procedures reasonably designed to prevent fraudulent trading. The Securities and Exchange Commission (the "Commission") expressly designed the Rule to permit each investment company to craft procedures that are most effective for its particular business structure and operations. As the Commission stated when it adopted Rule 17j-1:

> [T]he variety of employment and the institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities. Moreover, as a matter of policy, the Commission believes the introduction and tailoring of ethical restraints on the behavior of persons associated with an investment company can best be left in the first instance to the directors of the investment company.[1]

In practice, most investment companies have adopted standards that far exceed the minimum requirements prescribed under Rule 17j-1.

In February, 1994, the Investment Company Institute (the "Institute") requested that its members voluntarily submit their codes to the Institute so that the Institute could survey current industry practices with respect to personal investing by investment company personnel.[2] Ninety-six investment company complexes, representing almost 90 percent of the mutual fund assets under management, responded to the Institute's request.[3]

These complexes, which are comprised of all types of funds, vary widely in size and organizational structure.[4] For example, some of the firms responding to the Institute's survey manage over 100 mutual funds and have numerous employees with specific, well-defined responsibilities, while other respondents manage only a limited number of funds and have a small number of employees with broader duties. Those responding also constitute a broad cross-section in that they are affiliated with broker-dealers, insurance companies, financial

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[1] Investment Company Act Rel. No. 11421, 21 SEC DKT. (CCH) 488, 489 (Oct. 31, 1980).

[2] The Institute advised its members that it would maintain the confidentiality of their codes.

[3] In the aggregate, these 96 complexes are associated with over 2,150 mutual funds.

[4] The overwhelming majority of complexes responding to the Institute's request include *both* equity funds and bond and income funds.

planners, banks or other financial institutions, and offer shares through a variety of distribution channels.[5]

As the following chart illustrates, many mutual fund complexes already have implemented on a voluntary basis some or all of the procedures recommended by the Advisory Group in its Report on Personal Investing. The chart summarizes the codes of ethics of the 96 mutual fund complexes that responded to the Institute's request.

[5] In addition, the majority of the investment company complexes that received the Commission's February 9, 1994 survey request regarding personal trading also participated in the Institute Survey.

INSTITUTE SURVEY OF CODES OF ETHICS GOVERNING PERSONAL INVESTING ACTIVITIES

To Whom Does the Code Apply	Of the **96** Complexes providing their Codes to the Institute: • **65** specify restrictions for "Access Persons: as defined in the codes • **37** Complexes expressly include families in application
IPO Purchases Restricted	• **25** Complexes explicitly restrict **IPO** purchases
Private Placement Purchases Restricted	• **7** Complexes explicitly restrict **Private Placement** purchases

Mandatory Blackout Period for Security Transactions	• **63** Complexes restrict trading by specified personnel concurrent with the trading of their fund(s)
	    ◦ **17** restrict trading for **15** days both *before* and *after* a trade by the fund
	    ◦ **16** restrict trading until the fund's trading program is complete
	    ◦ **15** restrict trading for **15** days *after* a trade by the fund
	    ◦ **9** restrict trading for **5** days *after* a trade by the fund
	    ◦ **1** restricts trading for **30** days *after* a trade by the fund
	    ◦ **1** restricts trading for **14** days *after* a trade by the fund
	    ◦ **1** restricts trading for **3** days *after* a trade by the fund
	    ◦ **1** restricts trading for **2** days *after* a trade by the fund
	    ◦ **1** restricts trading for **10** days both *before* and *after* a trade by the fund
	    ◦ **1** restricts trading for **5** days both *before* and *after* a trade by the fund
	    ◦
	• **6** Complexes have multiple blackout periods for different types of security transactions

Short-Term Trading	• **15** Complexes expressly discourage or prohibit short-term trading
	    ◦ **2** Complexes require securities to be held for **30** days
	    ◦ **1** Complex requires securities to be held for **60** days
	    ◦ **1** Complex requires securities to be held for **91** days

Restrictions on Receiving Gifts, Favors or Preferential Treatment from Participants in the Securities Industry	• **37** Complexes have restrictions
	    ◦ **18** prohibit the receipt of gifts, with *de minimis* exceptions
	    ◦ **8** allow gifts of less than $50 annually
	    ◦ **7** allow gifts of less than $100 annually
	    ◦ **4** allow gifts of other *de minimis* amounts

Service as a Director	• **10** Complexes expressly restrict service as a director or trustee on the board of another company

Preclearance for Personal Securities Transactions	• **96** Complexes require preclearance for personal securities transactions
	    • **62** mandate preclearance for all personal securites transactions (with defined exceptions)
	    • **34** mandate preclearance for certain, defined personal securities transactions)
	
	• **21** Complexes are structured to permit compilation of specific lists of prohibited securities
	
	• **13** Complexes utilize standard forms for requesting preclearance
	
	• **5** forms include certifications that purchase/sale does not conflict with fund/client interests

Length of Preclearance	Where specified, time limits for the validity of preclearance (*i.e.*, authorization to trade in a security) are: • pre-clearance good for **1** day in **11** Complexes • pre-clearance good for **2** days in **2** Complexes • pre-clearance good for **3** days in **2** Complexes • pre-clearance good for **5** days in **4** Complexes • pre-clearance good for **7** days in **2** Complexes • pre-clearance good for **15** days in **1** Complex.

Exemptions from Trading Restrictions for Companies with Large Market Capitalization	• **15** Complexes exempt from the trading restrictions certain **large capitalization** stocks
	    • **10** have a **$1 billion** capitalization exemption
	    • **1** has a **$5 billion** capitalization exemption
	    • **1** has a **$500 million** capitalization exemption
	    • **3** have exemptions for ***de minimis*** purchases of large capitalization stock
	
	• **1** Complex exempts from trading restrictions **small capitalization** stocks (*i.e.*, for companies with fewer than 500 employees or less than $1 million in total assets)

Periodic Reports for Securities Transactions	• All **96** Complexes have reporting requirements for access persons
	    • **78** require reporting on a **quarterly** basis
	    • **13** require reporting on a **monthly** basis
	    • **5** require reporting on a **transactional** basis
	
	• **13** Complexes require reports for periods in which no transactions were effected

	• **27** Complexes require that **monthly brokerage statements** be supplied • **22** Complexes require that **brokerage confirmations** be supplied • **23** Complexes permit **monthly brokerage statements** to be supplied in lieu of other periodic reports • **10** Complexes require employees to conduct trading through the firm
Disclosure of Personal Holdings	• **54** Complexes require disclosure of all holdings and accounts for all employees • **5** Complexes specifically require portfolio managers and analysts to report all holdings

Participation by the Board of Directors	• **52** Complexes require a Compliance Officer or other employee with similar responsibilities to report to Board
	  ◦ **24** require reporting in cases of violations
	  ◦ **15** require annual reporting
	  ◦ **10** require reports in other instances (*i.e.,* every six months)
	  ◦ **3** require quarterly reporting
	• **12** Complexes require periodic Board review of the code of ethics
	• **41** Complexes require sanctions to be reported to and enforced by the Board
	  ◦ **12** require trade reversals where necessary
	  ◦ **11** require forfeiture of profit where necessary
	• **9** Complexes require the Audit Committee or other entity with similar responsibilities to determine sanctions for violations of the code of ethics

MEMORANDUM
INVESTMENT COMPANY INSTITUTE

APPENDIX III

INSTITUTE SURVEY OF CODES OF ETHICS GOVERNING PERSONAL INVESTING ACTIVITIES

For Immediate Release

Contacts: Erick Kanter 202/326-5860
John Collins 202/326-5864
Malin Jennings 202/326-5865

INVESTMENT COMPANY INSTITUTE ORGANIZES BLUE-RIBBON PANEL TO EXAMINE PERSONAL TRADING ISSUES IN MUTUAL FUND INDUSTRY

WASHINGTON, D.C. Feb 16--The Investment Company Institute announced today the formation of a special Advisory Group, composed of mutual fund industry leaders, to review and evaluate the adequacy of current codes of conduct and develop recommendations concerning standards governing the personal trading activities of portfolio managers and other personnel. "With this initiative we are taking a fresh look and making an in-depth examination of existing requirements. We will assess the adequacy of current standards, with an eye toward any needed changes in mutual funds' codes of ethics and other requirements," said Ronald P. Lynch, Managing Partner of Lord, Abbett & Co., Chairman of the Institute, and a member of the new Advisory Group.

In addition to the six mutual fund industry leaders on the panel, outside experts on legal and ethical issues will be called upon to provide advice and suggestions and to assist in the work of the Advisory Group, Mr. Lynch explained.

May 13th has been established as the target date for completion of the Advisory Group's work. Its findings and recommendations will be reported to the Securities and Exchange Commission, to Congress and to the public, according to Institute President Matthew P. Fink.

"The 90-day time frame allows for a comprehensive analysis of the stringent standards that already apply to mutual funds and their investment advisers and principal underwriters," Mr. Fink said. "We continue to believe that these high standards, which are far more stringent than those governing other money managers and financial institutions, are integral to the mutual fund industry's success. We remain committed to any enhancement of those standards that seems advisable. Moreover, the mutual fund industry and the Investment Company Institute continue to support vigorous enforcement of those standards by the Securities and Exchange Commission."

The Advisory Group's review of personal trading is part of a broader Institute study of possible enhancement of mutual fund internal compliance mechanisms, he added. "In addition to supporting strict rules and vigorous enforcement, the industry is well aware that there is no substitute for corporate and personal commitment to integrity and adherence to the highest ethical standards. The vitality and continued success of the mutual fund industry surely rest on public trust and confidence."

In a letter to Chairman Levitt and to the chairs of the House and Senate Committees of relevant jurisdiction, Mr. Fink said: "The mutual fund industry has a long history of addressing swiftly and directly issues that may be of concern to shareholders, regulators and legislators. The Institute and its members are committed to a thorough review of the issues raised by personal trading of portfolio managers, and importantly, to any changes in the current standards that may be advisable. You have my personal assurance that we will work together to achieve what is the best outcome for this industry's most valued asset -- its shareholder."

In addition to Mr. Lynch, the five other members of the advisory group are: Charles A. Fiumefreddo, Chairman and Ceo, Dean Witter InterCapital Inc.; Jon S. Fossel, President and

CEO, Oppenheimer Management Corp.; Robert H. Graham, President, AIM Advisors, Inc.; Robert C. Pozen, Managing Director and General Counsel, FMR Corp.; and James S. Riepe, Managing Director, T. Rowe Price Associates, Inc.

# # #

ICI-94-03

Attachments: Letter dated Feb. 10, 1994 from Matthew P. Fink to Arthur J. Levitt, Jr.; Letters dated Feb. 16, 1994 from Matthew P. Fink to Arthur J. Levitt, Jr. and to Chairman Edward J. Markey, U.S. House Energy and Commerce Subcommittee on Telecommunications and Finance.

MATTHEW P. FINK
PRESIDENT

February 16, 1994

The Honorable Arthur J. Levitt, Jr.
Chairman
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Chairman:

Thank you for meeting with me on February 11th to discuss the very complicated issue of personal trading of portfolio managers. As I indicated, the Institute's Board of Governors has appointed a blue-ribbon Advisory Group to review codes of conduct for mutual funds and other money managers and develop recommendations concerning standards governing personal trading activities of mutual fund managers, including any needed changes in fund codes of ethics adopted pursuant to Rule 17j-1. The Advisory Group's findings and recommendations will be reported to you, to the Congress and to the public. The Advisory Group includes the following members:

Charles A. Fiumefreddo
Chairman and Chief Executive Officer
Dean Witter InterCapital, Inc.

Jon S. Fossel
President and Chief Executive Officer
Oppenheimer Management Corp.

Robert H. Graham
President
AIM Advisors, Inc.

Ronald P. Lynch
Managing Partner
Lord, Abbett & Co.

Robert C. Pozen
Managing Director and General Counsel
FMR Corporation

James S. Riepe
Managing Director
T. Rowe Price Associates, Inc.

As we discussed at our meeting, the Advisory Group's work will be completed within 90 days. This will allow time for a comprehensive analysis of industry standards and a thorough formulation of appropriate recommendations. As such, we anticipate that the Advisory Group will complete its report by May 13, 1994.

We expect to work closely with the Commission, the Congress and respective staff on this important issue and will keep you apprised of the panel's progress in the coming months. I would hope that the Commission would consider the Advisory Group's report before formulating its own regulatory and/or legislative recommendations.

The mutual fund industry has a long history of addressing swiftly and directly issues that may be of concern to shareholders, regulators and legislators. The Institute and its members are committed to a thorough review of the issues raised by personal trading of portfolio managers, and importantly, to any changes in the current standards that may be advisable. You have my personal assurance that we will work to achieve what is the best outcome for this industry's most valued asset -- its shareholders.

Very truly yours,

Matthew P. Fink

cc: Chairs and Ranking
Members of Committees of Jurisdiction

Barry P. Barbash
Colleen P. Mahoney
Kathryn Fulton

MATTHEW P. FINK
PRESIDENT

February 16, 1994

The Honorable Edward J. Markey
Chairman
Subcommittee on Telecommunications
and Finance
316 Ford House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

As you are aware, in recent weeks attention has been focused on the very complicated issue of personal trading by portfolio managers. This is an area in which the Congress, the Securities and Exchange Commission and the mutual fund industry long have recognized, and sought diligently to address, the potential for conflicts of interest. As a result of such diligence, mutual fund portfolio managers today are subject to the greatest existing regulation in the exercise of their fiduciary responsibilities. This highly effective collaboration has produced an unprecedented level of success in protecting the interests of fund shareholders.

In view of the growth of the mutual fund industry, we commend the SEC's recently announced intention to take a fresh look at the standards currently in effect. We pledge our support and cooperation to the Commission in order to assure that the public's trust continues to be well placed and well protected.

Toward that end, I am pleased to report to you that the Institute's Board of Governors has appointed a blue-ribbon Advisory Group to review current codes of conduct for mutual funds and other money managers and to develop recommendations concerning standards governing personal trading activities of mutual fund managers, including any needed changes in fund codes of ethics adopted pursuant to Rule 17j-1. While we envision that the Advisory Group will focus primarily on the adequacy and effectiveness of the current codes of conduct in place at all mutual funds, it is my hope that the work of the Advisory Group also will assist in the formulation of recommendations regarding other, unregulated or less regulated, money managers who perform functions akin to those performed by mutual fund portfolio managers.

The Advisory Group's findings and recommendations will be reported to the Congress and the SEC and be made public. The Advisory Group includes the following members:

Charles A. Fiumefreddo
Chairman and Chief Executive Officer
Dean Witter InterCapital, Inc.

Jon. S. Fossel
President and Chief Executive Officer
Oppenheimer Management Corp.

Robert H. Graham
President
AIM Advisors, Inc.

Ronald P. Lynch
Managing Partner
Lord, Abbett & Co.

Robert C. Pozen
Managing Director and General Counsel
FMR Corporation

James S. Riepe
Managing Director
T. Rowe Price Associates, Inc.

The Advisory Group's work will be completed within 90 days. This will allow time for a comprehensive analysis of industry standards and a thorough formulation of appropriate recommendations. As such, we anticipate that the Advisory Group will complete its report by May 13, 1994.

We expect to work closely with the Commission, the Congress and respective staff on this important issue and will keep you apprised of the panel's progress. I would hope that you would consider the Advisory Group's report before formulating your own recommendations in this area.

The mutual fund industry has a long history of addressing swiftly and directly issues that may be of concern to shareholders, regulators and legislators. The Institute and its members are committed to a thorough review of the issues raised by personal trading of portfolio managers, and importantly, to any changes in the current standards that may be advisable. You have my personal assurance that we will work to achieve what is the best outcome for this industry's most valued assets -- its shareholders.

Very truly yours,

Matthew P.Fink

cc: The Honorable John D. Dingell
The Honorable Carlos J. Moorhead
The Honorable Jack Fields
The Honorable Donald W. Riegle, Jr.
The Honorable Alfonse M. D'Amato
The Honorable Christopher J. Dodd

The Honorable Arthur J. Levitt, Jr.
Barry P. Barbash
Colleen P. Mahoney
Kathryn Fulton

APPENDIX IV

Members of the Advisory Group on Personal Investing

Biographies

Charles A. Fiumefreddo

Charles Fiumefreddo is Chairman and Chief Executive Officer of Dean Witter InterCapital Inc. and Dean Witter Distributors Inc. Mr. Fiumefreddo also serves in various leadership capacities for the Dean Witter Funds, TCW/DW Funds, Dean Witter Trust Company, Dean Witter Reynolds Inc. and for various Dean Witter, Discover & Co. subsidiaries.

Mr. Fiumefreddo's career in investment management spans 35 years. He served formerly as a Founder, Officer and Director of Standard and Poor's InterCapital, Inc. (1969-1977) and as an Officer of Anchor Corporation (1965-1977) and First Jersey National Bank (1955-1977).

Mr. Fiumefreddo is a member of the Executive Committee and Board of Governors of the Investment Company Institute.

Mr. Fiumefreddo received his B.S. degree from St. Peter's College in 1955 and attended the New York University Graduate School of Business Administration from 1955 to 1957.

Jon S. Fossel

Jon Fossel is responsible for overall management of Oppenheimer Management Corporation (OMC). The Company manages over 50 mutual funds with assets in excess for $27 billion; the company also services more than 1.8 million shareholder accounts.

Mr. Fossel joined OMC in 1987 as president and chief operating officer. From 1983 to 1987, he was chairman and director of the distribution company for Alliance Capital Management Corporation, where he built that company's mutual fund business to $4 billion in domestic and international assets.

Mr. Fossel also is a member of the Board of Governors and the Executive Committee of the Investment Company Institute.

Mr. Fossel started his investment career in 1964 as a securities analyst. He also has served as portfolio manager, research director, and chief investment officer with several large investment management organizations.

Mr. Fossel is consulted by the media regularly for his views on the financial markets, investment opportunities and the mutual fund industry.

In 1977, Mr. Fossel was elected to the New York State Legislature, where he served as an assemblyman for two terms. During this period, he was the first freshman legislator to be appointed to the prestigious Ways & Means Committee and was the ranking member of the Government Operations Committee. He also served as Co-Chairman of the freshman caucus and initiated "Waste Watchers Alerts," a program which identified areas of wasteful state spending. In 1982, Mr. Fossel ran unsuccessfully for the U.S. House of Representatives.

He received his B.A. in Economics from Tufts University in 1964 and is a Chartered Financial Analysts (C.F.A.).

Robert H. Graham

Bob Graham is President and Chief Operating Officer of AIM Management Group Inc. and President of AIM Advisors, Inc. Prior to being one of the founders of AIM in 1976, Mr. Graham had been a portfolio manager and assistant to the president of another investment management firm.

Mr. Graham is a member of the Board of Governors and the Executive Committee of the Investment Company Institute. He is currently serving as Chairman of the Contractual Plans Committee of the Investment Company Institute. Mr. Graham also serves as a member of the Board of Directors, a member of the Investment Committee and Chairman of the Audit Committee of ICI Mutual Insurance Company.

Mr. Graham received a B.S. degree in Electrical Engineering from The University of Texas at Austin in 1968. He also received an M.S. in Electrical Engineering in 1972 and an M.B.A. in Finance in 1973, both from The University of Texas at Austin.

Mr. Graham was born and raised in Houston, where he now resides with his wife and two children.

Ronald P. Lynch

Ronald P. Lynch is the Managing Partner of Lord, Abbett & Co. He is also Chairman of the Lord Abbett family of funds.

He began his career with Lord, Abbett & Co. in 1965, representing the firm as a regional manager in New York. In 1973 he was appointed western manager based in San Francisco. He was named a partner in 1977, and returned to New York in 1980 to become a senior partner and chief marketing and operating officer. In 1983 he became Managing Partner.

Mr. Lynch has been active in industry associations. He is presently Chairman of the Board of Governors and a member of the Executive Committee of the Investment Company Institute. He is the former Vice Chairman of the Board of Governors of the National Association of Securities Dealers. He is also a Director of the Bond Club of New York.

His activities outside the securities industry include being the Vice Chair of the Board of Trustees of Cornell University, serving as Chair of the Major Gifts Committee and Chair of the Investment Committee. He is a member of the Joint Board and the Board of Overseers of Cornell University Medical Center. In addition, he is a member of the S.C. Johnson Graduate School of Management Advisory Council, and past Chairman of the Cornell University Council.

Mr. Lynch is a graduate of Cornell University, where he majored in agricultural economics. He is married and has three sons.

Robert C. Pozen

Robert C. Pozen is a Managing Director and General Counsel of FMR Corporation, the parent company of Fidelity Investments. He is responsible for Fidelity's government relations, legislation and litigation worldwide as well as the regulatory and tax aspects of Fidelity's acquisitions and new products.

He serves as a director of Fidelity's credit card bank, its life insurance company, and its Canadian investment management business. He also is responsible for voting the proxies of the Fidelity funds and representing Fidelity in international trade negotiations.

Prior to joining Fidelity, Mr. Pozen had a varied and distinguished career in business, government and academia, most recently serving as an adjunct lecturer at Harvard Law School. In addition, he has been a law professor at New York University and Georgetown University.

His many publications include the textbook *Financial Institutions, Investment Management*, two other books, guest editorials in leading newspapers as well as numerous articles on domestic and international finance. He has been a speaker at a broad variety of conferences and conventions in the United States and abroad.

From 1978 to 1980 Mr. Pozen served as Associate General Counsel to the Securities and Exchange Commission. Following that, he was in charge of the banking/securities department at the Washington law firm of Caplin & Drysdale.

Mr. Pozen serves on numerous boards and committees in the financial area, including the Executive Committee of the Investment Company Institute, the Board of Trustees of the Wharton Financial Institutions Center, and the International Services Advisory Committee of the U.S. Commerce Department.

He serves the metropolitan Boston community as a trustee of the New England Medical Center, a trustee of the Pro Arte Chamber Music Orchestra, and a director of the Boston Chamber of Commerce.

Mr. Pozen graduated *summa cum laude* and Phi Beta Kappa in 1968 from Harvard College, which awarded him a Knox Traveling Fellowship. Mr. Pozen received his J.D. in 1972 from Yale Law School, where he served on the editorial board of the Yale Law Journal.

Mr. Pozen lives with his wife and two teenage children in Newton, Massachusetts.

James S. Riepe

James S. Riepe is Managing Director, member of the Management Committee, and Director of T. Rowe Price Associates, Inc. The Firm manages $53 billion in assets, serving as investment adviser to 57 no-load mutual funds with three million investor account and to institutional and individual clients. Mr. Riepe also serves as Chairman of the firm's retail and institutional service subsidiaries and President of T. Rowe Price Investment Services, the firm's marketing subsidiary. In addition, he serves as director and/or officer of all the T. Rowe Price mutual funds.

Mr. Riepe is recognized as one of the leading executives in the mutual fund industry and has played an active role in industry affairs. He is currently a member of the Executive Committee and past-chairman of the Board of Governors of the Investment Company Institute, the national trade association of the mutual fund industry. Previously, he has been a member of the NASD's Investment Companies Committee, a member of the Securities and Exchange Commission's Market Oversight and Financial Services Advisory Committee, and various other industry committees.

Mr. Riepe has been in the investment management business since 1969, and earned a B.S. and an M.B.A. from the University of Pennsylvania's Wharton School.

APPENDIX V

PERSONS CONSULTED BY THE ADVISORY GROUP ON PERSONAL INVESTING

The Advisory Group on Personal Investing was formed on February 16, 1994 and convened six meetings through May 9, 1994. The work of the Advisory Group was assisted by the staff of the Investment Company Institute, in particular by Paul Schott Stevens, General Counsel of the Institute, and Thomas M. Selman, Assistant Counsel, and by the law firm of Fried, Frank, Harris, Silver & Jacobson.

In developing its findings and recommendations, the Advisory Group consulted with a broad array of experts, both within and outside the investment company industry. Listed below are persons with whom the Advisory Group consulted. While the findings and recommendations contained in the Report are solely those of the Advisory Group, the valuable time and assistance provided by each of these persons is most gratefully acknowledged.

Michael S. Caccese — Senior Vice President and General Counsel, Association for Investment Management and Research, Charlottesville, VA

Thomas J. Donaldson — John F. Connelly Professor of Business Ethics, Georgetown Business School, Georgetown University, Washington, D.C.

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APPENDIX VI

SUMMARY OF STANDARDS APPLICABLE TO OTHER MANAGERS OF POOLED INVESTMENT VEHICLES

INTRODUCTION

The vehicles through which individuals and institutional investors can obtain access to the securities markets and professional money management are quite varied. In addition to investment companies, these investment vehicles include hedge funds, bank common trust and collective investment funds, commodity pools, insurance company separate accounts and employee benefit plans. In considering what, if any, additional safeguards might be appropriate for investment company shareholders with respect to personal investing by investment company personnel, the Advisory Group on Personal Investing has requested that we review the different regulatory approaches taken by other asset management vehicles and those who regulate them.

Based on this review, it appears that the close scrutiny directed to the personal investing of investment company industry personnel[1] contrasts sharply with the experience of other asset managers. While other pooled asset managers are also subject to general anitfraud provisions and general common law fiduciary duties, no other category of asset manager is subject to a federal regulatory regime as strict, comprehensive or detailed as that governing the investment company industry, *especially* with respect to personal investing activities. The text and charts that follow briefly summarize our review.

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[1] In this summary, references to "investment company industry personnel" are intended to include employees of affiliated advisers and principal underwriters.

DISCUSSION

A. GENERAL PATTERNS OF REGULATIONS

Personal investing by investment company industry personnel is subject to a scheme of comprehensive regulation that is not replicated for those managing *any* of the other major pooled investment vehicles. As a general principle, all investors in securities are subject to the general antifraud proscriptions of the federal securities laws. Investment company industry personnel, however, are subject to an additional regulatory regimen with respect to their personal investments.

In particular, Section 17(j) of the Investment Company Act of 1940 ("ICA")[2] and ICA Rule 17j-1[3] specifically proscribe fraudulent conduct in connection with personal investments by investment company industry personnel in securities held (or to be acquired) by an investment company. To further limit the potential abuse, Rule 17j-1 sets standards that include: (i) an obligation to adopt and enforce written codes of ethics relating to personal investments; (ii) a requirement that "access persons," a broadly defined category of investment company personnel, file quarterly reports on *all* personal securities transactions; (iii) the extension of this reporting requirement to all securities *beneficially held* by access persons, thus subjecting many accounts of family members to reporting obligations; (iv) a requirement that investment companies maintain records related to the implementation of their procedures; (v) oversight of these procedures by independent directors (who might compromise at least forty percent of an investment company's board of directors under the ICA); and (vi) close scrutiny under the

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[2] 15 U.S.C. § 80a-17(j) (1988).

[3] 17 C.F.R. § 270.17j-1 (1993).

inspection and enforcement programs of the Securities and Exchange Commission (the "Commission"), pursuant to which Commission examiners review investment companies' oversight of personal investing by asset managers.

In addition, investment advisers are under an express statutory obligation to develop and implement written procedures to prevent the illegal use of material, nonpublic information by investment company industry personnel.[4] This direct regulation is complemented by investment company compliance programs, under which most investment companies adopt individualized codes of ethics that far exceed minimum legal requirements in order to foster a corporate culture that places a premium on high ethical standards.

Although the other pooled investment vehicles reviewed are subject to varying levels of regulation, there are not specific requirements governing personal investing activities by their employees or affiliates comparable to the standards imposed on investment company industry personnel under ICA Section 17(j) and Rule 17j-1. Indeed, despite the fact that managers of *each* of these pooled investment vehicles are faced with issues relating to personal securities investing similar to those faced by investment company personnel, *only* the investment company industry is fully and extensively regulated by the Commission, the sole federal agency whose exclusive mandate is investor protection. The absence of uniform regulations administered by the same regulator leaves investors in other pooled investment vehicles with substantially fewer protections that those afforded by Congress and the Commission to investment company shareholders.[5]

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[4] *See* 15 U.S.C. § 80b-4a (Supp. 1989).

[5] The benefits of functional regulation, whereby different entities engaged in similar activities are subject to oversight and supervision by the same regulator, are well-documented. *See Blueprint for Reform: The Report of the Task Group of Regulation of Financial Services*, July 1984 at 91; Testimony of Arthur Levitt, Jr., Chairman, U.S. Securities and

B. HEDGE FUNDS

The term "hedge fund" was originated in the 1960s to refer to speculative investment vehicles whose principal investment techniques included the contemporaneous purchase and sale of related equity securities and the employment of other investment strategies such as arbitrage. In the 1970s and 1980s, hedge funds expanded their activities to include transactions in futures, options, foreign currencies and government securities.[6] While hedge funds have seen "explosive growth" in recent years, there are no "precise figures available regarding the number of hedge funds that are active in the U.S. markets or the total of assets under their management."[7]

Exchange Commission, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Apr. 14, 1994); Testimony of Arthur Levitt, Jr., Chairman, U.S. Securities and Exchange Commission, before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (Nov. 10, 1993); Testimony of David Ruder, Chairman, U.S. Securities and Exchange

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Commission, before the Senate Committee on Banking, Housing and Urban Affairs (Dec. 3, 1987); Testimony of John S.F., Shad, Chairman, U.S. Securities and Exchange Commission, before the Senate Committee on Banking, Housing and Urban Affairs (Mar. 28, 1984).

[6] Testimony of Barbara Pedersen Holum, Acting Chairman, Commodity Futures Trading Commission, before the House Committe on Banking, Finance and Urban Affairs, Apr. 13, 1994.

[7] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the House Committee on Banking, Finance and Urban Affairs, Apr. 13, 1994. Estimates vary as to the number of hedge funds and the total assets under their control. *See e.g., Burnt Fingers on Passing the Buck in the Hedge Fund Thicket*, THE DAILY TELEGRAPH, Mar. 5, 1994, at C1 (reporting that there are 800 hedge funds with $75 billion in assets under management);Sara Webb & Tracy Corrigan, *Hedge Funds Hog the Limelight*, FINANCIAL TIMES, Mar. 5, 1994, at 10 (reporting that there are hundreds of hedge funds, many of which have $2 million or less in assets under management); Earl Gottshalk, *Look Before Taking Leap Into Hedge Funds*, WALL ST. J., Jan. 7, 1994, at C1 (reporting that there are 800-1,000 hedge funds with $40 billion in assets under management).

Hedge funds typically are investment companies that are structured to be exempt from the registration and reporting requirements of the Securities Act of 1933[8] and the ICA.[9] While these private investment companies *often* sell their securities to institutions or individuals with high net worths, that is not *always* the case.[10+] In addition, most hedge funds are structured to permit their investment advisers to avoid registration with, or ongoing supervision by, the Commission under the Investment Advisers Act of 1940.[11] In the absence of regulation by the Commission or a qualified self-regulatory organization, hedge funds are not required to adopt codes of ethics, mandate reports or personal investments, maintain records relating to such procedures or take *any* of the other measures mandated by Rule 17j-1 to monitor the personal investing activities of their portfolio managers.

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[8] 15 U.S.C. § 77a *et seq.* (The "Securities Act"). Sales of interest in hedge funds generally are structured to take advantage of the "private offering" exemption under Section 4(2) of the Securities Act or the related safe harbors under Regulation D.

[9] Most hedge funds rely on the so-called "private" investment company exception in Section 3(c)(1) of the ICA, 15 U.S. C. § 80a-3(c)(1) (1988). Section 3(c)(1) exempts from the definition of "investment company" (and from substantive regulation under the ICA) a fund with no more than 100 investors that does not make, and does not plan to make, a public offering of its securities.

[10+] For example, in connection with a Regulation D offering, hedge funds may sell limited partnership interests to up to thirty-five individuals who do *not* meet a minimal net worth requirement. *See* 17 C.F.R. §§ 230.505 and 230.506.

[11] 15 U.S.C. § 80b-1 *et seq*. (the "Advisers Act"). Hedge fund managers may be exempt from registration under Section 203(b)(3) of the Advisers Act, 15 U.S.C. 80b-3(b)(3) (1988). Section 203(b)(3) provides that any adviser who during the preceding twelve months has had fewer than 15 clients, does not hold itself out generally to the public as an investment adviser and does not advise a registered investment company need not register with the Commission. For purposes of computing the number of clients under Section 203(b), Advisers Act Rule 203(b)(3)-1 conditionally permits a limited partnership to count as only one client of the general partner or any other person acting as investment adviser to the partnership.

C. BANK COMMON TRUST AND COLLECTIVE INVESTMENT FUNDS

Bank common trust and collective investment funds[12] generally rely upon exemptions from the ICA's registration and reporting requirements.[13] In addition, units of participation in both types of bank funds are exempt from the registration requirements of the Securities Act[14] and banks managing common trust or collective investment funds are exempt from registration as investment advisers under the Advisers Act.[15]

The fiduciary activities of banks are governed by both state and federal laws, although the OCC has adopted Regulation 9 expressly to regulate the administration of common trust and collective investment funds by national banks.[16] Regulation 9 does not establish regulatory standards or restrictions for managers of common trust and collective investment funds, however, comparable to the requirements imposed under ICA Section 17(j) and Rule 17j-1 thereunder.

Thus, Regulation 9 does not directly address fraudulent conduct in personal investing activities by officers or employees of bank trust departments or require that banks adopt codes

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[12] Collective investment funds pool the funds of two or more accounts held by a bank in a fiduciary capacity. The Office of the Comptroller of the Currency's ("OCC") Regulation 9 defines collective investment funds to include both common trust funds "maintained by a bank exclusively for the collective investment and reinvestment of money contributed thereto by the bank in its capacity as trustee, executee, administrator, guardian or custodian under a uniform gifts to minors act" and funds "consisting solely of assets of retirement, pensions, profit sharing, stock bonus or other trusts" that are exempt from federal income taxation under the Internal Revenue Code. 12 C.F.R. § 9.18(a) (1993).

[13] 15 U.S.C. §§ 80a-3(c)(3) and 80a-3(c)(11) (1988).

[14] 15 U.S.C. § 77(a)(2) (1988).

[15] 15 U.S.C. § 80b-2(a)(11)(a) (1998). The Commission has construed these exemptions, however, to apply only where the common trust or collective investment funds are created for "bona fide fiduciary purposes," rather than as general investment vehicles.

[16] 12 C.F.R. Part 9 (1993). State banks must comply with the OCC's regulations in the administration of their collective investment funds in order for such funds to qualify for tax-exempt status under Section 584 of the Internal Revenue Code, 26 U.S.C. § 584 (1988).

of ethics specifically relating to personal investments as is required under Rule 17j-1. While the OCC had adopted quarterly recordkeeping requirements for personal securities transactions by bank officers or employees who make investment recommendations or decisions for the accounts of customers (including participants in common trust and collective investment funds), these standards are less stringent with respect to both reportable transactions and reporting persons than the requirements established under Rule 17j-1.[17] In addition, there is no requirement, as exists under the ICA, that independent directors scrutinize the activities of collective investment funds or bank employees involved in their administration. Furthermore, OCC bank examiners currently are not directed to review potential conflicts of interest that may arise when bank employees managing collective investment funds engage in personal securities transactions.[18] In comparison, as noted previously, the review of investment companies' oversight of personal investing by asset managers is an integral part of the Commission's inspection program.

D. COMMODITY POOLS

Employees of commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") may personally invest in commodities or futures contracts, and many CPOs and CTAs expressly authorize their employees to trade for their own accounts.[19] Personal

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[17] Unlike Rule 17j-1, the OCC's rule excludes from the reporting requirement "all transactions involving in the aggregate $10,000 or less during the calendar quarter" and does not specifically cover shares benefically owned by bank officers or employees. *See* 12 C.F.R. § 12.6 (1993). The Board of Governors of the Federal Reserve System (the "FRB") and the Federal Deposit Insurance Corporation (the "FDIC") have adopted similar reporting requirements for state member banks and state nonmember banks, respectively. *See* 12 C.F.R. § 208.8 (1993) (FRB rule); 12 C.F.R. § 344.6 (1993) (FDIC rule).

[18] Although the *Comptroller's Handbook for Fiduciary Activities* states that bank fiduciaries should not receive financial benefits for investing trust assets in particular investment funds, no specific restrictions on personal securities transactions are set forth, nor are examiners instructed to review such transactions for potential conflicts of interest. *See Comptroller's Handbook for Fiduciary Activties* (1990) at §§ 9.3000-9.3920.

[19] *See e.g.*, Howard Schneider & Mary L. Schapiro, *Regulation of Commodity Futures and Options Trading*, 662 PLI/Corp. 497, at 31 (1989).

investments by employees of CPOs and CTAs, however, are not subject to safeguards comparable to those crafted under the ICA. For example, there is no specific provision under the Commodity Exchange Act ("CEA") analogous to ICA. Rule 17j-1 that addresses personal investing by employees of CPOs and CTAs. As a result, the investing activities of such persons are limited primarily by general antifraud prohibitions and the common law fiduciary duties of CPOs and CTAs and their employees to clients.

Thus, in comparison with ICA Rule 17j-1, neither the CEA nor regulations adopted by the CFTC thereunder require CPOs and CTAs to adopt a code of ethics with respect to personal investment by their principals and employees. In addition, the Commodity Futures Trading Commission ("CFTC") has exempted registered CPOs and CTAs from any obligation to disclose their personal market positions to their investors.[20] Instead, rules adopted by the CFTC provide only that, if personal investing by principals of CPOs and CTAs is permitted, this fact

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[20] While the CEA requires CPOs and CTAs to disclose their personal market positions and those of their principals "[u]nless otherwise authorized by the [CFTC] by rule or regulation," 7 U.S.C. § 6n(3)(B) (1988), the CFTC has adopted a rule exempting principals of CPOs and CTAs from this requirement. *See* 17 C.F.R. § 4.11 (1993).

must be disclosed to prospective participants in the commodity pool in the offering documents.[21] CPOs also must maintain records reflecting personal investing by a CPO or its principals.[22]

Although at least forty percent of the board of directors of an investment company must be independent directors, similar requirements do not exist with respect to commodity pools. In addition, while the CFTC has active inspection and enforcement programs, as does the Commission, the CFTC has not adopted rules such as Rule 17j-1 that require CPOs and CTAs to devote substantial attention to compliance issues raised by personal investing by their principals and employees.

E. INSURANCE COMPANY SEPARATE ACCOUNTS

According to industry figures, sales of insurance company separate accounts have increased substantially in recent years.[23] Insurance company separate accounts are not uniformly subject to comprehensive regulation under the ICA and Rule 17j-1 thereunder. In particular, separate accounts holding corporate tax-qualified retirement plan assets are exempt from registration under both the Securities Act and the ICA.[24] These products were exempted

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[21] The CPO, any principal of the CPO, the CTA and any principal of the CTA must disclose whether trading of commodity interests will take place or is contemplated for its own account. If any of the foregoing persons will trade or intends to trade for its own account, the CPO also must disclose for each such person whether pool participants will be permitted to inspecct the records of such person's trades. In addition, if any of the foregoing persons will not trade or does not intend to trade its own account, the CPO must make an affirmative statement to that effect with respect to each such person. 17 C.F.R. § 4.21(a)(15) (1993). *See also* 17 C.F.R. § 4.31(a)(6) (1993) (imposing similar disclosure requirements on CTAs).

[22] In particular, 17 C.F.R. § 4.23(b)(2) (1993) requires the CPO to maintain records of each comfirmation of a commodity transaction, purchase and sale statement and monthly statement furnished by a futures commission merchant to (i) the CPO relating to the CPO's personal account and (ii) to each principal of the pool operator relating to a personal account of such principal.

[23] For example, it has been reported that sales of insurance company separate accounts increased to $4.5 billion for the first half of 1993 compared with sales of $6.8 billion for all of 1992. *See, e.g.*, Cynthia Crosson, *Synthetic GIC Sales Spurted in First Half of 1993*, NATIONAL UNDERWRITER — LIFE & HEALTH, Nov. 15, 1993, at 5.

[24] 15 U.S.C. § 77c(a)(2) (1988) (exemption under the Securities Act); 15 U.S.C. § 80a-3(c)(11) (1988) (exemption under the ICA).

from regulation under the ICA because Congress perceived that insurance company separate accounts competed with bank collective trust funds (which, as noted previously, are *not* subject to regulation as investment companies) as vehicles for the investment of pension and profit-sharing assets.

In comparison, insurance company separate accounts used to fund variable life insurance and variable annuity products generally must register as investment companies under the ICA. In addition, variable life insurance and variable annuity products are treated as "securities" under the Securities Act, and insurance companies and other persons who advise these separate accounts must register as investment advisers under the Advisers Act.[25] Furthermore, insurance agents who sell these products must be registered representatives of registered broker-dealers under the Securities Exchange Act of 1934.[26]

Thus, under current law, many separate accounts are not subject to the range of federal requirements imposed under Rule 17j-1 with respect to personal investments by investment company industry personnel. They are not required to adopt formal procedures relating to personal trading nor are their primary investment personnel subject to any federal regulatory obligation to disclose their personal investments. Indeed, both the National Association of Life Underwriters and the National Association of Insurance Commissioners have advised us informally that there are no restrictions on the ability of an investment officer of an insurance company to make personal trades in securities held in a insurance company separate account's

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25 *See, e.g., SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959). *See also Otto Variable Annuity* Life *Ins. Co.*, 814 F.2d 1127, 1132-33 (7th Cir. 1986) (fixed annuity insurance product could be subject to registration requirements if the minimum guaranteed return was "so low as to place the investment risk on the investor rather than on the insurance company").

26 15 U.S.C. § 78a *et seq.*

portfolio that he or she manages, other than those prohibitions that exist generally under the federal securities laws.

F. EMPLOYEE BENEFIT PLANS

Total assets under management by employee benefit plans have recently been estimated by the Federal Reserve Board at $4.78 trillion.[27] Nevertheless, employee benefit plans generally are exempt from regulation under the ICA,[28] and interests in employee benefit plans frequently are exempt from registration under the Securities Act.[29]

Accordingly, fiduciaries of employee benefit plans are not subject under the Employee Retirement Income Security Act of 1974 ("ERISA") to specific antifraud provisions such as ICA Section 17(j) or prohibitions or guidelines comparable to Rule 17j-1 regarding personal investing in the same securities held by the plan. ERISA does not require that plan fiduciaries comply with codes of ethics that address their personal investments, as mandated under Rule 17j-1, although ERISA generally prohibits an employee benefit plan fiduciary from dealing with plan assets for his or her own interest or for his or her own account.[30] In addition, despite the fact that employee benefit plan fiduciaries investing for their own account face potential conflicts of interest comparable to those confronted by investment company industry

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[27] *See* Patricia B. Limbacher, *Pension Assets Up 9.6%*, Pensions & Investments, April 1994, at 1.

[28] 15 U.S.C. § 80a-3(c)(11) (1988).

[29] 15 U.S.C. § 77c(a)(2) (1988).

[30] Sections 406(b)(1) and (2) of ERISA, 29 U.S.C. §§ 1106(b)(1) and (2) (1988), are construed by the Department of Labor to prohibit fiduciaries from engaging in transactions where they have interests in the transactions that may affect the exercise of their best judgment as fiduciaries and to require the avoidance of any conflicts of interest that exist or may arise in the future between the plan and the fiduciaries. *See* 29 C.F.R. § 2550.408b-2(e) (1993). As noted, however, ERISA does *not* contain any specific provisions that impose requirements on plan fiduciaries comparable to the standards established under Rule 17j-1. Moreover, ERISA Sections 406(b)(1) and (2) apply to private employee benefit plans, but not to governmental or church-sponsored plans. *See* Section 4(b) of ERISA, 29 U.S.C. § 1003(b) (1988).

personnel, such fiduciaries are not required to report their personal investments on a quarterly basis. Furthermore, ERISA does not contain a requirement similar to the ICA's requirement that an investment company have a board of directors, at least forty percent of which is composed of independent directors.

Violations of ERISA by plan fiduciaries may result in enforcement actions by the Department of Labor and the imposition of both civil and criminal penalties.[31] Since ERISA does not impose a statutory requirement on employee benefit plans to monitor personal investing by plan fiduciaries, however, it would not appear that the Department of Labor routinely reviews such investing activities as part of its oversight functions.

CONCLUSION

A potential conflict of interest may arise whenever a manager of pooled investments assets also invests in securities for his or her own account. Investment company industry personnel are subject to rigorous requirements specifically aimed at addressing these potential conflicts. The salient elements of these requirements, however, generally are not replicated in the regulatory schemes applicable to other asset managers. As illustrated by the following charts, the regimen that governs the investment company industry, particularly with respect to the personal investing activities of investment company personnel, is uniquely comprehensive in both its breadth and detail.

In at least one context, the Department of Labor has stated that a party in interest does not necessarily violate ERISA Section 406 "merely because he derives some incidental benefit from a transaction involving plan assets," where the investments are "made simultaneously with investments by a fiduciary for its own account on identical terms and in the same relative proportions." *See* Proposed Prohibited Transaction Exemption, Aplplication No. D-3629, 52 Fed. Reg. 30,965, 30,973 (1987) (Exemption granted, 88-92, Fed. Reg. 38,798 (1988)); Proposed Prohibited Transaction Exemption, Application No. D-4950A, 52 Fed. Reg. 30,977, 30,979 (1987) (Exemption granted, 88-92, 53 Fed. Reg. 38,803 (1988)).

[31] *See* 29 U.S.C. §§ 1131 (criminal penalties) and 1132 (civil penalties). In addition, plan participants and beneficiaries are authorized to bring a civil suit under ERISA for breach of fiduciary duty under 29 U.S.C. § 1132.

OVERVIEW OF REGULATION OF VARIOUS POOLED INVESTMENT VEHICLES UNDER FEDERAL SECURITIES LAWS	
INVESTMENT COMPANIES	Investment companies must be registered with the Securities and Exchange Commission ("SEC") as investment companies under the Investment Company Act of 1940 ("ICA").[1] Investment companies must register their shares under the Securities Act of 1933 ("Securities Act").[2] Investment advisers to investment companies (except for banks) must be registered with the SEC under the Investment Advisers Act of 1940 ("Advisers Act").[3] Distributors of mutual funds must be registered as broker-dealers under the Exchange Act of 1934 ("Exchange Act")[4].
HEDGE FUNDS[5]	In general, hedge funds are exempt from the registration requirements of the ICA.[6] In general, interests in hedge funds are exempt from the registration requirements under the Securities Act[7] but are subject to the antifraud provisions of the Securities Act and the Exchange Act. Under certain circumstances, hedge fund managers are not required to register with the SEC as investment advisers but are subject to the antifraud provisions of the Advisers Act.[8] Hedge funds may also qualify for an exemption from registration as securities dealers under Section 15(a) of the Exchange Act based on the "trader" exception to the definition of "dealer." In general, a trader is an entity that trades securities for its own investment account and does not carry on a public securities business and is, therefore, exempted from the Exchange Act registration requirements.
BANK COMMON TRUST AND COLLECTIVE INVESTMENT FUNDS	Common trust and collective investment funds are generally exempt from the registration requirements of the ICA.[9] Units of interest in both types of bank funds are exempt from the registration requirements under the Securities Act. Bank common and collective funds exempt from registration remain subject to the antifraud provisions of the Securities Act and the Exchange Act.[10] Banks managing common trust funds and/or collective investment funds are exempt from registration as investment advisers under the Advisers Act.[11] Banks are exempt from broker-dealer registration requirements under the Exchange Act.[12]

COMMODITY POOLS	Commodity pools generally are regulated by the Commodity Futures Trading Commission ("CFTC") rather than by the SEC under the ICA. Units of participation in a commodity pool are securities, and public offerings of participation in such pools must be registered under the Securities Act. To the extent commodity pools invest in commodity figures or options transactions, and absent exemption, they are subject to regulation under the Commodity Exchange Act (the"CEA"), as amended by the Commodity Futures Trading Commission Act of 1974.[13] In addition, the CPO[14] and the CTA[15] must register with the CFTC and the National Futures Association ("NFA").[16] CPOs and CTAs are subject to the CEA's antifraud provisions.[17]
INSURANCE COMPANY SEPARATE ACCOUNTS	Other than separate accounts *holding qualified employee retirement plan assets*, which are exempt from registration under the federal securities laws,[18] separate accounts generally must be registered as investment companies under the ICA.[19] Variable life insurance and variable annuity products are treated as securities under the Securities Act.[20] Separate accounts exempt from registration are subject to the antifraud provisions of the Securities Act and Exchange Act. Insurance companies and others who advise these separate accounts must be registered as investment advisers under the Advisers Act.[21] Insurance agents who sell these products must also register as representatives of registered broker-dealers under the Exchange Act.[22]
EMPLOYEE BENEFIT PLANS UNDER ERISA	Employee benefit plans generally are exempt from registration under the ICA.[23] Interests in employee benefit plans often are exempt from registration under the Securities Act.[24] Effectively, fiduciaries of employee benefit plans' pooled asset accounts are either bank, insurance companies *or* registered under the Advisers Act.

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1 ICA § 7(a), 15 U.S.C. § 80a-7(a) (1988).

2 Securities Act § 5, 15 U.S.C. § 77e (1988).

3 Advisers Act § 203(a), 15 U.S.C. § 80b-3(a) (1988).

4 Exchange Act § 15(a), 15 U.S.C. § 78o(a) (1988).

[5] The term "hedge fund" was originated in the 1960s to refer to speculative investment vehicles where principal investment techniques included the contemporaneous purchase and sale of related equity securities. In the 1970s and 1980s, hedge funds expanded their activities to include transactions in futures, options, foreign currency and government securities. *Testimony of Barbara Pedersen Holum*, Acting Chairman, Commodity Futures Trading Commission, Before the Committee on Banking, Finance and Urban Affairs, Apr. 13, 1994.

[6] Most hedge funds rely on the so-called "private" investment company exception in Section 3(c)(1) of the ICA. Section 3(c)(1) exempts from the definition of "investment company" and from substantive regulation under the ICA a fund having no more than 100 investors that does not make, and does not plan to make, a public offering of its securities. 15 U.S.C. § 80a-3(c)(1) (1988).

[7] Sales of interests in hedge funds typically are structured to take advantage of the "private offering" exemption under Section 4(2) of the Securities Act or the safe harbor provisions set forth in Regulation D thereunder. *See* 17 C.F.R. §§ 230.504, 230.505 and 230.506 (1993).

[8] Hedge fund managers may be exempted from investment adviser registration under Section 203(b)(3) of the Advisers Act, which exempts from registration any adviser who during the preceding 12 months has had fewer than 15 clients and does not hold itself out generally to the public as an investment adviser. For purposes of computing the number of clients under Section 203(b), a limited partnership generally counts as one client of the person acting as investment adviser to the partnership. *See* Advisers Act Rule 203(b)(3)-1, 17 C.F.R. § 275.203(b)(3)-1 (1993).

[9] ICA §§ 3(c)(3) and 3(c)(11), 15 U.S.C.§§ 80a-3(c)(3) and 80a-3(c)(11) (1988). In general, common trust funds consist solely of assets contributed by the bank in its fiduciary capacity as trustee, executor, administrator or guardian, whereas collective investment funds consist solely of assets contributed by corporate sponsored tax-qualified retirement plans.

[10] Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1988).

[11] Advisers Act § 202(a)(11)(A), 15 U.S.C. §§80b-2(a)(11)(A)(1988).

[12] Exchange Act §§ 3(a)(4) and 3(a)(5), 15 U.S.C. §§ 78c(a)(4) and 78c(a)(5) (1988).

[13] 7 U.S.C. § 1 *et seq*. The CFTCA amended the CEA to provide for CTFC regulation of commodity pool operators ("CPOs") and commodity trading advisors ("CTAs").

[14] A "commodity pool operator" is defined as "any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons as the Commission may specify by rule or regulation or order." 7 U.S.C. § 2.

[15] A "commodity trading adviser" is defined as "any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities." 7 U.S.C. § 2 (Supp. IV 1992). A CTA is most closely analogous to an investment adviser in the

securities industry. A CTA may be required to register as an investment adviser under the Advisers Act in some instances. *See* Howard Schneider & Hon. Mary L. Schapiro, *Regulation of Commodity Futures and Options Trading* 662 PLI/Corp. 497, note 8, at 517 (1989).

[16] The NFA is a self-regulatory organization similar to the NASD. *Id*. at 540.

[17] 7 U.S.C. § 2 (Supp. IV 1992) (similar to Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1988).

[18] Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1988).

[19] *Id*.

[20] *SEC v. Variable Annuity Life Ins. Co. of Am*., 359 U.S. 65 (1959). Section 3(a)(8) of the Securities Act may provide an exemption for certain insurance products for which the insurance company bears the investment risk. *See Otto v. Variable Annuity Life Ins. Co*., 814 F.2d 1127 (7th Cir. 1986), *cert. denied* 486 U.S. 1026 (1988).

[21] *See, e.g.,* Investment Advisers Act Rel. No. 359, 1 SEC DKT. (CCH) 1 (Jan. 31, 1973).

[22] *Id*.

[23] ICA § 3(c)(11), 15 U.S.C. § 80a-3(c)(11) (1988).

[24] Securities Act § 3(a)(2), 15 U.S.C. § 77(c)(2) (1988). Where a plan is voluntary and contributory and involves the purchase of employee stock, however, the interests in the plan generally must be registered. *See* Securities Act Rel. No. 6188, 19 SEC DKT. (CCH) (Feb. 1, 1980).

FIDUCIARY DUTIES	
INVESTMENT COMPANIES	**STATE OR COMMON LAW**
	General common law principles regarding fiduciary duties apply to investment company personnel.[1]
	FEDERAL LAW
	The ICA imposes specific fiduciary duties on a variety of persons in connection with their investment company activities. In particular, the SEC may bring an action for injunctive or other judicial relief against any officer, director, investment adviser or principal underwriter of an investment company for breach of fiduciary duty involving personal misconduct.[2]
	In addition, the ICA specifically provides that the investment adviser of a registered investment company shall be deemed to have fiduciary duty with respect to the respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of the investment adviser. The SEC or any shareholder of an investment company may bring an actin for breach of fiduciary duty in respect of such compensation or payments against the investment adviser, any affiliated person of the investment adviser or other persons who have fiduciary duties concerning such compensation or payments.[3]
	The antifraud provision of the Advisers Act also protects investment companies and their shareholders against fraudulent, deceptive and manipulative conduct by investment advisers.[4] There is no private right of action, however, for breach of fiduciary duties under the Advisers Act.[5]
	Any person (including a fund manager) who buys or sells securities is prohibited from using material, non-public information in breach of his or her fiduciary duties under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.
HEDGE FUNDS	**STATE OR COMMON LAW**
	Managers of hedge funds, often general partners of a limited partnership, may owe a fiduciary duty to the partnership under state partnership law or common law principles.
	FEDERAL LAW
	There are no federal laws that specifically address the fiduciary duties of hedge fund managers analogous to Section 36 of the ICA.

	STATE OR COMMON LAW
BANK COMMON TRUST AND COLLECTIVE INVESTMENT FUNDS	In general, a bank's fiduciary activities must comply with local law, the instrument creating the trust relationship or court order. Consequently, trust activities are governed primarily by state statutory and common law. While there is no uniform law of trusts, many states have adopted fiduciary standards that provide generally that, in investing trust assets, a fiduciary must exercise the judgment and care, under the circumstances then prevailing, that persons of prudence, discretion and intelligence exercise in the management of their own affairs.[6]
	FEDERAL LAW
	Regulation 9 of the Office of the Comptroller of the Currency ("OCC")[7] characterizes national banks as fiduciaries in connection with their trust activities[8] but, unlike the ICA and the Employee Retirement Income Security Act of 1974 ("ERISA"), does not enumerate specific fiduciary duties.[9]
	Regulation 9 does not provide investors with specific remedies for breach of fiduciary duty with respect to their investments in bank common trust and collective investment funds. The OCC, however, may fine a national bank or an affiliated party for violating the banking laws or regulations in breach of its fiduciary duty[10] or revoke a bank's franchise if it exercises its fiduciary powers in an unlawful or unsound manner.[11]
COMMODITY POOLS	**STATE OR COMMON LAW**
	General common law principles regarding fiduciary duties may apply to CPOs and CTAs.[12]
	FEDERAL LAW
	A fiduciary relationship generally is deemed to exist between a commodities broker and its customer if the customer's account is discretionary.[13] Customers have an implied private right of action under the CEA.[14]
	CPOs and CTAs, however, generally are not treated as fiduciaries to the same extent as commodities brokers, although they are expressly subject to a CEA provision, similar to Exchange Act Rule 10b-5, that generally proscribes fraudulent conduct that defrauds investors.[15]
	STATE OR COMMON LAW
INSURANCE COMPANY SEPARATE ACCOUNTS	An insurance broker owes his or her customer "a duty to exercise the care that a reasonably prudent businessman in the brokerage field would exercise under similar circumstances . . . ."[16]

	FEDERAL LAW
	Insurance agents for variable life insurance products are deemed broker-dealers or agents or registered representatives of broker-dealers and as such, are subject to the same fiduciary duties as broker-dealers under the Exchange Act. Whether a broker-dealer assumes fiduciary obligations "depend[s] on all the circumstances, including the degree of sophistication of the parties and the course of conduct between them."[17]
EMPLOYEE BENEFIT PLANS UNDER ERISA	**STATE OR COMMON LAW**
	ERISA preempts state civil law with respect to employee benefit plans.[18] Therefore, participants cannot bring a common law action for breach of fiduciary duty against a plan fiduciary.
	FEDERAL LAW
	The primary provisions governing the conduct of ERISA fiduciaries are found in ERISA Sections 404, 406 and 408. Under ERISA Section 404, plan fiduciaries[19] must discharge their duties with respect to a plan "solely in the interest of the participants and beneficiaries" and with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[20]
	Under ERISA Section 406, a fiduciary is prohibited from causing the plan to engage in a transaction if the fiduciary knows or should know that such transaction constitutes a direct or indirect (i)sale or exchange of any property between the plan and a party in interest; (ii) lending of money or other extension of credit between the plan and a party in interest; (iii) furnishing or goods, services or facilities between the plan and a party in interest (subject to certain exemptions);[21] (iv) transfer to, or use by or for the benefit of, a party in interest of any assets of the plan; or (v) acquisition on behalf of the plan of any employer security or employer real property in excess of statutorily permitted amounts.[22] A fiduciary also is prohibited from (i) dealing with the assets of the plan in his or her own interest or for his or her own account; (ii) acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of the plan participants or beneficiaries; or (iii) receiving any consideration for his or her own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.[23] ERISA Section 408 provides for certain exemptions to ERISA Section 406 prohibited transactions where all of the requirements of the exemption are shown to be met.[24] Participants, beneficiaries and the Department of Labor may bring civil actions under ERISA for any breach of fiduciary duty.[25] The Department of Labor is required to assess (but may reduce or waive) a civil penalty against a fiduciary for breaching a fiduciary duty.[26]

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[1] *See e.g., SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191-92 (1963).

[2] ICA § 36(a), 15 U.S.C. § 80a-35(a) (1988).

[3] ICA § 36(b), 15 U.S.C. § 80a-35(b) (1988).

[4] Advisers Act § 206, 15 U.S.C. § 80b-6 (1988).

[5] *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 24 (1979). Advisory clients have a limited private right of action to void a contract with an investment adviser and obtain restitution of the consideration paid to the adviser. *Id.* at 24-25.

[6] *See* A. Scott, LAW OF TRUSTS at § 227.1 (3d ed. 1967).

[7] 12. C.F.R. Part 9 (1993).

[8] See, e.g., 12 C.F.R § 9.18 (1993).

[9] Regulation 9 does, however, establish certain general duties including a prohibition against self-dealing and duties with respect to investments of funds, custody of assets and compensation for services. *See*, e.g., 12 C.F.R. §§ 9.10, 9.11, 9.12 and 9.13 (1993).

[10] 12 U.S.C. § 93(b) (Supp.III 1991).

[11] 12 C.F.R. § 9.17(b) (1993).

[12] *See First National Monetary Corp. v. A.J. Weinberger*, 819 F.2d 1334, 1342 (6th Cir. 1987). *See also Heritage Capital Advisory Serv., Ltd*., 823 F.2d 171, 173 (7th Cir. 1987) (considering, without deciding, the argument that CPOs be treated as fiduciaries owing duties to plan participants).

[13] *See Heritage Capital Advisory Serv., Ltd*., 823 F.2d 171, 173 (7th Cir. 1987); *Martin v. Heinhold Commodities*, *Inc.*, 487 N.E.2d 1098, 1101 (Ill. 1985), *aff'd in part and rev'd in part*, 510 N.E.2d 840 (Ill 1987).

[14] *Merrill, Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 388 (1992).

[15] *See* 7 U.S.C. § 60 (1988).

[16] *Industrial Valley Bank and Trust Co. v. Dilks Agency*, 751 F.2d 637, 640 (3rd Cir. 1985) (*quoting Consolidated Sun Ray, Inc. v. Lea*, 401 F.2d 650, 656 (3d Cir. 1968), *cert. denied*, 393 U.S. 1050 (1969)).

[17] VIII Louis Loss & Joel Seligman, *Securities Regulation* 3829 (3d ed. 1991).

[18] ERISA § 514(a), 29 U.S.C. § 1144(a) (1988).

[19] A person is a fiduciary of an employee benefit plan if he or she (i) exercises discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of the plan's assets; (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other

property of such plan or has any authority or responsibility to do so; (iii) has any discretionary authority or discretionary responsibility in the administration plan. ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A) (1988). A person is also a fiduciary of an employee benefit plan if he is a fiduciary named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan of (B) by such employer and such employee organization acting jointly. ERISA § 402(a)(2), 29 U.S.C. § 1102(a)(2) (1988).

A plan fiduciary is permitted to delegate investment responsibility to an "investment manager" defined as a fiduciary (other than a trustee or named fiduciary, as defined in ERISA § 402(a)(2), 29 U.S.C. § 1102(a)(2) (1988)): (A) who has the power to manage, acquire or dispose of any asset of a plan; (B) who is (i) registered as an investment adviser under the Advisers Act; (ii) is a bank, as defined in the Advisers Act; or (iii) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one state; and (C) has acknowledged in writing that he is a fiduciary with respect to the plan. ERISA § 3(38), 29 U.S.C. § 1002(38) (1988).

[20] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1988 & Supp. IV 1992). A fiduciary will be deemed to have acted with necessary care, skill, prudence and diligence if he has given appropriate consideration to those facts and circumstances which, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role of the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties, and which has acted accordingly. 29 C.F.R. §§ 2550.404a-1(b)(1)(i) and (ii) 1993).

[21] ERISA § 406, 29 U.S.C. § 1108 (1988 & Supp. IV 1992).

[22] ERISA § 406(a), 29 U.S.C. § 1106(a) (1988); 29 U.S.C. § 1107 (1988 & Supp. IV 1992).

[23] ERISA § 408, 29 U.S.C.A. § 1106(b) (1988).

[24] ERISA § 408, 29 U.S.C. § 1108 (1988 & Supp. IV 1992).

[25] ERISA §§ 502(a)(2) and (3), 29 U.S.C. §§ 1132(a)(2) and (3) (1988 & Supp. IV 1992).

[26] ERISA §§ 502(1), 29 U.S.C. § 1132(1) (Supp. IV 1992). In addition, the Department of Labor may assess an additional penalty against a party-in-interest who participates in a prohibited transaction under ERISA § 406, 29 U.S.C. § 1106 (1988). See ERISA § 502(i), 29 U.S.C. § 1132(i) (1988).

APPENDIX VI

CODES OF ETHICS AND PERSONAL INVESTING	
INVESTMENT COMPANIES	Under Rule 17j-1 of the ICA, investment companies and their investment advisers and principal underwriters must adopt written codes of ethics and procedures reasonably designed to detect and prevent any improper investing activity.[1] Rule 17j-1 also requires every portfolio manager and other key employees to file reports with their firm concerning any personal securities transactions[2] and requires the firm to maintain records related to the implementation of the procedures. Section 204A of the Advisers Act requires investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information in violation of the Advisers Act, the Exchange Act or the rules and regulations promulgated under those Acts.[3]
HEDGE FUNDS	No statutory requirements exist with respect to codes of ethics or personal investing
BANK COMMON TRUST AND COLLECTIVE INVESTMENT FUNDS	Bank trust departments and their employees are not *required* to adopt and comply with codes of ethics as extensive as mandated under ICA Rule 17j-1.[4] Pursuant to 12 C.F.R. § 9.5, a national bank that exercises investment discretion with respect to trust accounts must adopt and follow written policies and procedures "intended to ensure that its brokerage placement practices comply with all applicable laws and regulations." Moreover, every national bank effecting securities transactions for customers must establish written policies and procedures imposing, among other things, a quarterly reporting requirement for personal transactions of bank employees. However, "all transactions involving in the aggregate $10,000 or less during the calendar quarter" are excluded from the reporting requirement.[5]
COMMODITY POOLS	Many CTAs and CPOs expressly permit their employees to trade for their own account; others do not.[6] CPOs and CTAs must disclose any intention to engage in personal trading. They also must disclose whether personal trading of commodity interests will take place or is contemplated. If the trade takes place, additional disclosure is required by the CPO. If it does not, disclosure to that effect is also required by the CPO.[7]
INSURANCE COMPANY SEPARATE ACCOUNTS	According to the National Association of Life Underwriters and the National Association of Insurance Commissioners, there are no restrictions on an investment officer making personal trades in securities held in a life insurance portfolio that he or she manages, other than those prohibitions contained generally in the securities laws.

EMPLOYEE BENEFIT PLANS UNDER ERISA	ERISA does not contain specific prohibitions or guidelines analogous to those required under Rule 17j-1 (i.e., a code of ethics or transaction reporting requirements) regarding personal trading in the same securities held by the plan. ERISA prohibits a plan fiduciary, however, from causing "the transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan," "deal[ing] with the assets of the plan in his or her own interest or for his or her own account" or "in his individual or in any other capacity act[ing] in any transaction involving the plan on behalf of a party (or represent[ing] a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries."[8] The Department of Labor construes the foregoing provisions as prohibiting fiduciaries from engaging in a transaction where they have interests that may affect the exercise of their best judgment as fiduciaries and requiring fiduciaries to avoid any conflicts of interests with the plan that currently exist or may arise in the future.[9] In at least one context, the Department of Labor has stated that a party in interest does not necessarily violate ERISA Section 406 "merely because he derives some incidental benefit from a transaction involving plan assets" where the investments are "made simultaneously with investments by a fiduciary for its own account on identical terms and in the same relative proportions."[10]

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[1] 17 C.F.R. § 270.17j-1(b) (1993).

[2] Such reports must be filed within ten days of the end of the quarter in which the transaction was effected and must disclose (i) the date of the transaction, the title number of shares and the principal amount of each security involved; (ii) whether the transaction was a purchase, sale or other type of acquisition or disposition; (iii) the price; and (iv) the name of the broker, dealer or bank through which the transaction was effected.

[3] Advisers Act § 204A, 15 U.S.C. § 80b-4a (Supp. 1994).

[4] The American Bankers Association has published guidelines for its members (commercial banks representing approximately ninety-five percent of the industry's assets) to follow in developing codes of ethics designed to "minimize the risks that may arise from the way [personal] investments are selected and financed." These standards, which are not grounded in statute or regulation, emphasize (1) adherence to appropriate investment policies; (2) caution with respect to short-term and speculative trading; (3) minimal contacts with personal brokers during regular business hours; (4) prohibitions on margin accounts; (5) prohibitions on the use of material, nonpublic information in personal investment decisions; and (6) prohibitions on the payment of commissions to brokers to obtain special concessions from brokerage firms. *See* American Bankers Association Safety and Soundness Commission, *Developing or Revising a Bank Code of Ethics* (July 1986), in GORLIN, RENA, CODES OF PROFESSIONAL RESPONSIBILITY (BNA 1990).

[5] 12 C.F.R. § 12.6 (1993).

[6] *See* Howard Schneider & Hon. Mary L. Schapiro, *Regulation of Commodity Futures and Options Trading* PLI/Corp. 497, at 589-90 (1989).

[7] In particular, 17 C.F.R. § 4.21(a)(15) (1993) requires the CPO, any principal of the CPO, the CTA and any principal of the CTA to disclose whether trading of commodity interests will take place or is contemplated for its own account. If any of the foregoing persons will trade or intends to trade for its own account, the CPO must further disclose for each such person whether participants will be permitted to inspect the records of such person's trades. In addition, if any of the foregoing persons will not trade or does not intend to trade for its own account, the CPO must make a statement to that effect with respect to each such person. *See also* 17 C.F.R. § 4.31(a)(6) (1993).

[8] ERISA §§ 406(a)(1)(D), 406(b)(1) and 406(b)(2), 29 U.S.C. §§ 1106(a)(1)(D) (1988), 1106(b)(1) (1988) and 1106(b)(2) (1988). The term "parties in interest" with respect to a particular plan includes the sponsors, fiduciaries and service providers of the plan and all officers, directors, employees and ten percent shareholders. *See* ERISA § 3(14), 29 U.S.C. § 1002(14) (1988).

[9] Regulations promulgated under ERISA provide that the provisions of ERISA § 406(b) are imposed on fiduciaries to deter them from exercising authority, control or responsibility in transactions where they may have conflicting interests and which may affect their best judgment as fiduciaries. *See* 29 C.F.R. § 2550.408(b)-2(e) (1993); Proposed Prohibited Transaction Exemption, Application No. D-3629, 52 Fed. Reg. 30,965, 30,973 (1987) (Exemption granted, 88-92, 53 Fed. Reg. 38,798 (1988)); Proposed Prohibited Transaction Exemption, Application No. D-4950A, 52 Fed. Reg. 30,977, 30,979 (1987) (Exemption granted, 88-93, 53 Fed. Reg. 38,803 (1988)).

[10] See Proposed Prohibited Transaction Exemption, Application No. D-3629, 52 Fed. Reg. 30,965, 30,973 (1987) (Exemption granted, 88-92, 53 Fed. Reg. 38,798 (1988)); Proposed Prohibited Transaction Exemption, Application No. D-4950A, 52 Fed. Reg. 30,977, 30,979 (1987) (Exemption granted, 88-93, 53 Fed. Reg. 38,803 (1988)).

APPENDIX VII

FULL TEXT OF INVESTMENT COMPANY ACT RULE 17j-1 17 C.F.R. 270.17j-1

Certain Unlawful Acts, Practices or Courses of Business and Requirements Relating to Codes of Ethics with Respect to Registered Investment Companies

Reg. § 270.17j-1. (a) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company, or any affiliated person of an investment adviser of or principal underwriter for a registered investment company in connection with the purchase or sale, directly or indirectly, by such person of a security held or to be acquired, as defined in this section, by such registered investment company —

(1) To employ any device, scheme or artifice to defraud such registered investment company;

(2) To make to such registered investment company any untrue statement of a material fact or omit to state to such registered investment company a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading;

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any such registered investment company; or

(4) To engage in any manipulative practice with respect to such registered investment company.

(b)(1) Every registered investment company, and each investment adviser of or principal underwriter for such investment company, shall adopt a written code of ethics containing provisions reasonably necessary to prevent its access persons form engaging in any act, practice, or course of business prohibited by paragraph (a) of this section and shall use reasonable diligence, and institute procedures reasonably necessary, to prevent violations of such code.

(2) The requirements of paragraph (b)(1) shall not apply to any underwriter (i) which is not an affiliate person of the registered investment company or its investment adviser, and (ii) none of whose officers, directors or general partners serves as an officer, director or general partner of such registered investment company or investment adviser.

(c)(1) Every access person of a registered investment company or of an investment adviser of or principal underwriter for such investment company shall report to such investment company, investment adviser or principal underwriter of which he or she is an access person the information described in paragraph (c)(2) with respect to transactions in any

security in which such access person has, or by reason of such transactions acquires, any direct or indirect beneficial ownership in the security: *Provided, however*, that any such report may contain a statement that the report shall not be construed as an admission by the person making such report that he or she has any direct or indirect beneficial ownership in the security to which the report relates. For purposes of this section, beneficial ownership shall be interpreted in the same manner as it would be in determining whether a person is subject of the provisions of section 16 of the Securities Exchange Act of 1934 [15 U.S.C. 78p] and the rules and regulations thereunder, except that the determination of direct or indirect beneficial ownership shall apply to all securities which the access person has or acquires.

(2) Every report required to be made pursuant to paragraph (c)(1) shall be made no later than 10 days after the end of the calendar quarter in which the transaction to which the report relates was effected, and shall contain the following information:

(i) The date of the transaction, the title and the number of shares, and the principal amount of each security involved;

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

(iii) The price at which the transaction was effected; and

(iv) The name of the broker, dealer or bank with or through whom the transaction was effected.

(3) Notwithstanding the provision of paragraph (c)(1), no person shall be required to make a report:

(i) With respect to transactions effected for any account over which such person does not have any direct or indirect influence or control;

(ii) If such person is not an “interested person” of a registered investment company within the meaning of section 2(a)(19) of the Act [15 U.S.C. 80a2(a)(19)], and would be required to make such a report solely by reason of being a director of such investment company, except where such director knew or, in the ordinary course of fulfilling his official duties as a director of the registered investment company, should have known that during the 15-day period immediately preceding or after the date of the transaction in a security by the director such security is or was purchased or sold by such investment company or such purchase or sale by such investment company is or was considered by the investment company or its investment adviser;

(iii) Where the principal underwriter, as to which such person is an access person, (A) is not an affiliated person of the registered investment company or any investment adviser of such investment company, and (B) has no officers, directors, or general partners who serve as officers, directors or general partners of such investment company or any such investment adviser;

(iv) Where a report made to an investment adviser would duplicate information recorded pursuant to Rules 204-2(a)(12) or 204-2(a)(13) [17 C.F.R. 275.204(a)(12) and 275.204-2(a)(13)] under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1, *et seq*.].

(4) Each registered investment company, investment adviser and principal underwriter to which reports are required to be made pursuant to this section shall identify all access persons who are under a duty to make such reports to it and shall inform such persons of such duty.

(D) Each registered investment company, investment adviser and principal underwriter which is required to adopt a code of ethics or to which reports are required to be made by access persons shall, at its principal place of business, maintain records in the manner and to the extent set forth below, and make such records available to the Commission or any representative thereof at any time and from time to time for reasonable periodic, special or other examination.

(1) A copy of each such code of ethics which is, or at any time within the past five years has been, in effect shall be preserved in an easily accessible place;

(2) A record of any violation of such code of ethics, and of any action taken as a result of such violation, shall be preserved in an easily accessible place for a period of not less than five years following the end of the fiscal year in which the violation occurs;

(3) A copy of each report made by an access person pursuant to this rule shall be preserved for a period of not less than five years from the end of the fiscal year in which it is made, the first two years in an easily accessible place; and

(4) A list of all persons who are, or within the past five years have been, required to make reports pursuant to this section shall be maintained in an easily accessible place.

(e) As used in this rule.

(1) "Access person" means:

(i) With respect to a registered investment company or an investment adviser thereof, any director, officer, general partner, or advisory person, as defined in this section, of such investment company or investment adviser;

(ii) With respect to a principal underwriter, any director, officer, or general partner of such a principal underwriter who in the ordinary course of his business makes, participates in or obtains information regarding the purchase or sale of securities for the registered investment companies for which the principal underwriter so acts or whose functions or duties as part of the ordinary course of his business relate to the making of any recommendation to such investment company regarding the purchase or sale of securities.

(iii) Notwithstanding the provisions of paragraph (e)(1)(i), where the investment adviser is primarily engaged in a business or businesses other than advising registered investment companies or other advisory clients, the term "access person" shall mean: any

director, officer, general partner or advisory person of the investment adviser who, with respect to any registered investment company, makes any recommendation, participates in the determination of which recommendation shall be made, or whose principal function or duties relate to the determination of which recommendation shall be made to any registered investment company; or who, in connection with his duties, obtains any information concerning securities recommendations being made by such investment adviser to any registered investment company; or who, in connection with his duties, obtains any information concerning securities recommendations being made by such investment adviser to any registered investment company.

(iv) An investment adviser is "primarily engaged in a business or businesses other than advising registered investment companies or other advisory clients" when, for each of its most recent three fiscal years or for the period of time since its organization, whichever is lesser, the investment adviser derived, on an unconsolidated basis, more than 50 percent of (A) its total sales and revenues, and (B) its income (or loss) before income taxes and extraordinary items from such other business or businesses.

(2) "Advisory person" of a registered investment company or an investment adviser thereof means:

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

(ii) Any natural person in a control relationship to such company or investment adviser who obtains information concerning recommendations made to such company with regard to the purchase or sale of a security.

(3) "Control" shall have the same meaning as that set forth in section 2(a)(9) of the Act [15 U.S.C. 80a-2(a)(9)].

(4) "Purchase or sale of a security" includes, *inter alia*, the writing of an option to purchase or sell a security.

(5) "Security" shall have the meaning set forth in section 2(a)(36) of the Act [15 U.S.C. 80a-2(a)(36)], except that it shall not include securities issued by the Government of the United States, bankers' acceptances, bank certificates of deposit, commercial paper and shares of registered open-end companies.

(6) "Security held or to be acquired" by a registered investment company means any security as defined in this rule which, within the most recent 15 days, (i) is or has been held by such company, or (ii) is being or has been considered by such company or its investment adviser for purchase by such company.