



# ► Compliance Corner

— David J. Baum and Paul D. Hourigan\*

## Personal Securities and Proprietary Account Trading

### Overview

Investment advisers that are registered under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) have a fiduciary duty to their clients whereby they must put the interest of their clients above their own. One of the areas in which this duty comes under significant pressure is in relation to the personal and proprietary trading of investment advisers and their personnel. By their very nature, these transactions often involve potential conflicts of interest with the possibility that the adviser or its personnel may achieve personal profit at the expense of the firm’s clients. In addition to the general fiduciary duty advisers owe their clients, registered investment advisers must also comply with specific provisions under the Advisers Act. In particular, the Advisers Act and the rules promulgated thereunder require that investment advisers adopt a code of ethics and collect securities holdings and transactions reports from certain advisory personnel.

Because of the risks inherent in personal and proprietary trading by advisers and their personnel, the Securities and Exchange Commission (“SEC”), when conducting examinations, has consistently focused on the internal compliance controls that an adviser has in place with respect to its employees’ trading and trading by the firm in its own proprietary accounts. In light of recent scandals involving the conduct of investment advisers, it is likely that this scrutiny will only intensify.

### ***What are the specific code of ethics requirements under the Advisers Act with respect to personal trading and trading in proprietary accounts?***

Rule 204A-1 under the Advisers Act requires an adviser that is registered or re-

quired to be registered to establish, maintain, and enforce a written code of ethics that covers the reporting of personal securities transactions by certain advisory personnel and that requires all supervised persons of the investment adviser to comply with applicable federal securities laws. The code of ethics must set forth a standard of business conduct that the adviser requires of all its supervised persons. While this standard must reflect the fiduciary obligations of the adviser and its supervised personnel, it is not specifically addressed in detail by the rule. Instead, individual advisers must determine what standard is most appropriate in light of the nature of their business.

In the adopting release for the Rule, the SEC did, however, state that the code of ethics “should set out ideals for ethical conduct premised on fundamental principles of openness, integrity, honesty and trust. A good code of ethics should effectively convey to employees the value the advisory firm places on ethical conduct, and should challenge employees to live up not only to the letter of the law, but also to the ideals of the organization.” Accordingly, advisers are given great latitude in drafting their code of ethics to specifically tailor the level of trading restrictions to each employee’s actual involvement in the recommendation of securities. While some circumstances may require advisers to affirmatively implement information barriers to protect against the misuse of information regarding recommendations, the functions of other personnel may simply warrant them to acknowledge their fiduciary obligations and the restrictions imposed upon them regarding the misuse of certain information.

Rule 204A-1 requires that all supervised personnel of the adviser be provided with a copy of the code of ethics and any subsequent amendments and acknowledge, electronically if desired, such receipt. Although

Rule 204A-1 does not require that employees be trained on the code of ethics or certify annually that they have read, understood and complied with the code, the SEC has indicated that both activities should be considered best practices for advisers.

Rule 204A-1 also mandates that an adviser’s code of ethics requires the adviser’s “access persons” (*i.e.*, supervised persons who have access to nonpublic information regarding any clients’ purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or who are involved in making securities recommendations to clients, or have access to such recommendations that are nonpublic) to report their personal securities holdings and transactions on a periodic basis and that such reports must include:

- the title and type of security;
- number of shares;
- date purchased;
- principal amount of each reportable security in which the access person has any direct or indirect beneficial ownership; and
- the name of any broker, dealer or bank utilized to effect such transactions.

Holdings reports must be submitted initially upon becoming an access person and annually thereafter while transaction reports must be submitted quarterly.

In summary, an investment adviser’s code of ethics must incorporate the following provisions:

- an overview of the standard of business conduct that the adviser requires of its supervised persons and which reflects their fiduciary obligations;
- a requirement that the adviser’s supervised persons comply with applicable federal securities laws;

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- the personal securities holding and transaction reporting requirements described in Rule 204A-1;
- a requirement that supervised persons report violations of the code of ethics to the chief compliance office or other designated persons; and
- a provision that each supervised person be provided with the code of ethics and acknowledge receipt of it

While Rule 204A-1 also mandates that codes of ethics require the pre-approval of purchases in IPOs and other limited offerings, it does not otherwise expressly set forth specific requirements or prohibitions regarding the oversight of personal trading. However, the SEC noted in the adopting release to Rule 204A-1 and again in its July 2008 *ComplianceAlert* letter to chief compliance officers, that there are certain elements or “best practices” that advisers should consider for inclusion in their code of ethics if appropriate in light of their business activities. Those elements or best practices include:

- requiring the pre-clearance of personal securities transactions;
- imposing “blackout periods” that prohibit employees from trading in securities in which client transactions are being contemplated or executed;
- prohibiting access persons from engaging in short term trading or market timing;
- prohibiting access persons from participating in IPOs and private placements (or a requirement that access persons receive approval prior to making such purchases);
- requiring that personal securities transactions be executed through the adviser’s trading desk with approved broker-dealers; and
- requiring access persons to direct their broker-dealers to provide duplicate trade confirmations and copies of monthly brokerage statements to the adviser.

***What else should advisers keep in mind when crafting, implementing and enforcing their code of ethics and other policies and procedures related to***

### ***personal trading and trading in proprietary accounts?***

Investment advisers must ensure that they have in place, in addition to the code of ethics required by Rule 204A-1, compliance policies and procedures and internal controls relating to personal trading and trading in propriety accounts that are reasonably designed to prevent violations of the Advisers Act and breaches of their fiduciary duty to their clients.

Recently, the SEC has focused on the adequacy of such policies, procedures and internal controls during examinations. In its July 2008 *ComplianceAlert* letter, the SEC staff listed several recurring deficiencies regarding personal securities trading by access persons and proprietary trading by investment advisers that had been observed by its examiners. These deficiencies included:

- *Incomplete Codes of Ethics*— codes of ethics were not addressing all regulatory requirements. For instance, advisers were often not requiring access persons to seek pre-approval before engaging in IPOs, private placements and certain other transactions;
- *Failure to Adhere to the Code of Ethics*— advisers or their employees were engaging in practices that deviate from the code of ethics or the advisers had weak control procedures regarding the oversight of supervised personnel. These deficiencies were particularly evident with respect to the pre-clearance of securities trades and the use and control of material non-public information;
- *Failure to Report or Monitor Personal Trades*— access persons were failing to submit reports of their personal securities transactions and some advisers are failing to review personal trading reports; and
- *Inaccurate Public Disclosures*— the adviser’s public disclosures did not accurately reflect the firm’s internal policies and procedures over personal trading. Form ADV inquires whether an adviser or “related person” may invest in the same securities that the adviser recommends

to clients and they must update that disclosure promptly in such disclosure becomes inaccurate.

Accordingly, advisers should ensure that their codes of ethics address all regulatory requirements, that they and their employees adhere to the requirements of their code, that access persons report their personal trades as required, that compliance personnel review those reports, and that public disclosures accurately reflect the firm’s policies on personal and proprietary account trading.

While noting what many firms have been doing wrong, the SEC also identified areas in which advisers have implemented successful programs with respect to personal securities transactions and proprietary account trading. In addition to the code of ethics “best practices” discussed above, the SEC’s *ComplianceAlert* identified other common practices that the SEC staff considered to be generally effective in preventing violations of the Advisers Act. Advisers should consider incorporating some of these best practices which include:

- Having policies and procedures that address conflicts of interest with respect to trading in personal and proprietary accounts.
- Maintaining restricted and watch lists and ensuring that such lists are accurate and up to date.
- Using time-stamped order tickets.
- Bundling trades in client accounts with, or executing prior to, trades in personal or proprietary accounts on a consistent basis.
- Ensuring that, if any exceptions from the policies stated in the adviser’s code of ethics are granted to supervised persons, such exceptions are reasonable and documented.
- Determining trade allocations prior to or soon after a trade is executed. Documenting any post-execution changes to trade allocation and having any such change reviewed by an appropriate individual to ensure that the allocation is

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consistent with the adviser's policies and procedures.

- Documenting pre-approval of personal securities transactions at the time of the approval and maintaining those records. Comparing pre-clearance forms prepared by access persons to the actual trading in those persons' accounts.
- Adopting procedures to ensure that trading does not occur in client accounts, employee personal accounts, or proprietary accounts while the adviser or its employees are in possession of material, non-public information pertaining to a particular security.
- Comparing performance of client accounts to the performance of personal and firm proprietary accounts employing

similar investment strategies for any indications of preferential treatment.

- Maintaining personal and proprietary securities transaction records electronically so that they may be analyzed more efficiently.
- Adjusting prices if, on the same day, trades in related accounts were executed at a better price than client accounts.
- Having another officer or control person of the adviser review the personal securities transactions of the person normally responsible for reviewing personal securities transactions.

Finally, advisers should ensure that their compliance personnel are actively involved

in implementing their compliance programs. The SEC staff has noted that many of the advisory firms that appeared to have effective compliance programs had compliance personnel that were proactively engaged in implementing those programs and ensuring continued compliance.

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## 2009 IAA Compliance Workshops – Register Today!

The Investment Adviser Association is pleased to announce the schedule for our 2009 compliance workshops. The workshops will address a variety of important topics, including the SEC's recent proposal to amend the custody rule, risk management, code of ethics, investment adviser regulatory reform, and other regulatory developments. To attend, please complete the enclosed registration form and fax it to IAA, or register online at the IAA website.

Speakers will include IAA legal staff and attorneys from prominent law firms with expertise in investment management. The IAA Compliance Workshops provide an excellent opportunity to network with other compliance professionals and gain insights on challenging legal and regulatory issues. Each workshop will be held from 9:15 a.m. to 2:00 p.m. and includes a networking luncheon, where firms will be seated based on AUM to share ideas about compliance issues. After lunch, members of the SEC examination staff from the Office of Compliance Inspections and Examinations will discuss current inspection priorities and issues for advisers.

Registration forms and payments should be received at least 14 days before the workshop. There will be no refunds for cancellations received within 7 days of the

workshop. For more information, please contact IAA Director of Meetings & Events,

Lisa Gillette at (307) 733-3332 or [lisa.gillette@investmentadviser.org](mailto:lisa.gillette@investmentadviser.org). ■

### The workshop dates and locations are:

#### Thursday, October 8 Washington, DC

The Army Navy Club  
901 17th Street, N.W.  
Washington, DC 20006  
(202) 628-8400

#### Wednesday, October 14 New York, NY

The Yale Club  
50 Vanderbilt Avenue  
New York, NY 10017  
(212) 716-2100

#### Thursday, October 15 Boston, MA

Hyatt Regency Boston  
One Avenue Lafayette  
Boston, MA 02111  
(617) 451-0054

#### Thursday, November 5 Chicago, IL

The Standard Club  
320 South Plymouth Court  
Chicago, IL 60604  
(312) 427-9100

#### Wednesday, November 18 Atlanta, GA

Crowne Plaza Ravinia  
4355 Ashford Dunwoody  
Atlanta GA 30346  
(404) 577-1234

#### Thursday, November 19 Dallas, TX

Magnolia Hotel Dallas  
1401 Commerce St.  
Dallas, TX 75201  
(214) 915-6500

#### Tuesday, December 1 Los Angeles, CA

Millennium Biltmore Hotel  
506 South Grand Ave.  
Los Angeles, CA 90071  
(213) 624-1011

#### Thursday, December 3 San Francisco, CA

San Francisco Marriott  
Union Square  
480 Sutter St  
San Francisco, CA 90071  
(415) 398-8900