

An Investment Company Director's Guide to

Oversight of
Codes of Ethics
and
Personal Investing

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Preface

The Investment Company Institute, the national association of the U.S. investment company industry, is pleased to present *An Investment Company Director's Guide to Oversight of Codes of Ethics and Personal Investing*. The *Guide* focuses on fund director oversight of the personal investing activities of investment company personnel. The *Guide* is intended as a general source of information and should not be viewed as a substitute for appropriate legal advice. Investment company directors and others are encouraged to consult with legal counsel for a fuller discussion of the issues described herein.

Executive Summary

Investment company directors play a critical role in protecting the interests of fund shareholders. One of their many important functions is overseeing codes of ethics designed to prevent conflicts of interest that can arise when investment company personnel trade for their own accounts. Under U.S. Securities and Exchange Commission Rule 17j-1, each fund and its investment adviser and principal underwriter generally must adopt a code of ethics, and the board of directors of the fund must approve each of these codes, as well as material changes to the codes. In addition, on an annual basis, the board must consider written reports describing, among other things, material violations of the code since the last such report. Furthermore, the directors themselves may be subject to reporting requirements with respect to certain of their own investments.

This *Guide* provides background information concerning codes of ethics and personal investing issues, summarizes applicable regulatory requirements, including directors' specific responsibilities in this area, and describes the recommendations of an industry Advisory Group as to specific code of ethics provisions that go beyond regulatory requirements.

I. Introduction

As investment company directors are aware, they are not the only persons who act as fiduciaries on behalf of investment companies and their shareholders. Other investment company personnel¹ also are charged with the rigorous duties of fiduciaries. The federal securities laws reflect congressional recognition of “the delicate fiduciary nature of an investment advisory relationship” as well as an intent to address any potential conflicts of interest that might inhibit an investment adviser’s ability to render disinterested advice to its clients.²

Congress, the U.S. Securities and Exchange Commission (SEC), and the fund industry have long recognized the need to reconcile these fiduciary obligations with personal investing practices. For over five decades, these issues have received regular and detailed review, resulting in the development of statutory and regulatory requirements and industry codes of ethics. Most significantly, the SEC’s Rule 17j-1, promulgated under Section 17(j) of the Investment Company Act of 1940, requires that all investment companies and their investment advisers and certain principal underwriters adopt codes of ethics and procedures designed to detect and prevent inappropriate personal investing.

Beginning in early 1994, personal investing became the subject of renewed focus from Congress, the SEC, and the media, and the Institute formed an Advisory Group of senior industry officials to review existing standards governing personal investing and to develop appropriate recommendations. The Advisory Group issued a report in May 1994 that concluded that existing standards—found in the federal securities laws and in fund codes of ethics—had worked well to prevent potential conflicts of interest in personal investing. Nevertheless, the report recommended that all funds voluntarily adopt thirteen specific measures beyond those required by the federal securities laws, tailored as necessary to the particular structure and operations of the fund complex.

Later that same year, the SEC's Division of Investment Management issued a detailed report on personal investing issues and fund codes of ethics. This SEC staff report also found that existing regulatory requirements generally have worked well, but suggested some ways in which the regulatory scheme could be improved. In 1995, the SEC proposed amendments to Rule 17j-1 that the industry strongly supported. The amendments were adopted in 1999.

These amendments emphasized the role of investment company directors in exercising effective oversight of personal investing by requiring for the first time that a fund's board of directors approve the codes of ethics of the fund, its investment adviser, and its principal underwriter. The board of directors also must review written reports of any problems in this area at least annually.

To assist fund directors in fulfilling their responsibilities, this *Guide* describes the relevant statutory and regulatory provisions that govern personal investing by investment company personnel, with special emphasis on the duties of fund directors with respect to fund codes of ethics. The *Guide* also describes the recommendations of the Advisory Group Report, which represent additional voluntary measures that have been adopted by a majority of the industry in whole or in part, depending on the particular circumstances of the fund complex.

II. Potential Conflicts Posed by Personal Investing

When a fund's portfolio manager invests in securities for his or her own account at the same time that he or she is trading the same securities for the fund's portfolio, several conflicts of interest may occur. First, the portfolio manager may be tempted to purchase or sell securities for his or her personal account ahead of trades for the fund in order to receive a better price than the fund obtains. This practice is called "frontrunning."

In addition, a portfolio manager might cause a fund to purchase a security already in the manager's personal account in order to protect or improve the security's market value. A manager could seek to do this, for example, in order to avoid a personal margin call. Similar practices can involve personal trading in securities related to securities held or to be purchased by the fund, such as options on common stock where the fund invests in the underlying stock. Other possible conflicts could arise when persons who wish to influence the price of a security may offer the portfolio manager an attractive investment opportunity to influence fund activity in that security.

Even if particular investment company personnel do not control a fund's trading, advance knowledge of what securities are being considered for the fund's portfolio could be used by those personnel for their own benefit and to the detriment of the fund. Furthermore, even where these kinds of misconduct do not occur, public confidence in a fund's management can be undermined if investors believe that the fund does not have in place policies and procedures to prevent improper personal investing.

III. Overview of Regulation of Personal Investing

A. General

The issues presented by personal investing by investment company personnel are addressed in a number of ways under the federal securities laws, both in statutory and regulatory provisions that apply to all market participants, and through provisions that specifically address personal investing by investment company personnel. For example, all market participants are prohibited under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder from engaging in fraudulent practices, trading on the basis of material, nonpublic information, or communicating such information in breach of a fiduciary duty. Investment company personnel, however, are subject to *additional* requirements that address the unique potential conflicts that can arise from their personal investing activities.

In addition to Section 17(j) of the Investment Company Act and related Rule 17j-1, which are discussed in greater detail below, the most important of these are Section 36(a) of the Investment Company Act, which makes unlawful breaches of fiduciary duty involving personal misconduct by fund officers or directors, and Section 206 of the Investment Advisers Act of 1940, which prohibits investment advisers from engaging in fraudulent, deceptive, or manipulative conduct. Investment company personnel also are prohibited from selling securities to or purchasing securities from the fund by Section 17(a) of the Investment Company Act. Section 17(e) of the Investment Company Act prohibits investment company personnel from investing the fund's assets in securities in order to receive compensation other than a usual or customary commission.

B. Section 17(j) of the Investment Company Act

Over a lengthy period of time beginning before the 1940 enactment of the Investment Company Act, the SEC studied, and drew public attention to, the problems that could arise as a result of personal investing by investment

company personnel. In its Report of the Commission on the Public Policy Implications of Investment Company Growth, published in 1966, the SEC recommended that Congress grant the SEC express rulemaking authority for the protection of investors in connection with securities transactions by persons affiliated with investment companies or their investment advisers or principal underwriters.

In response to the SEC's request, Congress added Section 17(j) to the Investment Company Act in 1970. Section 17(j) authorizes the SEC to adopt rules reasonably designed to prevent investment company personnel, including fund directors, from engaging in any fraudulent, deceptive, or manipulative practice in connection with the purchase or sale of any security held or to be acquired by the fund. The section specifically contemplates that the SEC may require each fund to adopt a code of ethics reasonably designed to prevent any such practice.

C. Rule 17j-1 under the Investment Company Act

The SEC implemented the authority granted to it by Section 17(j) by adopting Rule 17j-1 in 1980. The rule prohibits any affiliated person of or principal underwriter for a fund, or any affiliated person of an investment adviser of or principal underwriter for a fund, from engaging in certain enumerated forms of fraudulent or deceptive conduct. To enforce this general prohibition, the rule, as adopted in 1980, required each fund and its adviser and principal underwriter to adopt a code containing provisions reasonably necessary to prevent fund "access persons" from engaging in the prohibited conduct, and required quarterly reports from access persons concerning their personal securities transactions. In August 1999, the SEC adopted amendments to Rule 17j-1 that were designed to (1) increase the oversight role of a fund's board of directors; (2) require that access persons provide information concerning their personal securities holdings; and (3) improve disclosure to investors concerning policies on personal investment activities. The SEC has left to each fund, however, the responsibility to devise a code of ethics appropriate to the fund's investment objectives, size, and other factors.

IV. Specific Requirements of Rule 17j-1

A. Codes of Ethics

As noted above, Rule 17j-1 makes it unlawful for any affiliated person of a fund or any affiliated person of its investment adviser or principal underwriter to engage in certain enumerated types of misconduct in connection with the purchase or sale by such person of a security held or to be acquired by the fund. Each fund and its investment adviser and principal underwriter are required to adopt a written code of ethics containing provisions reasonably necessary to prevent the specified types of misconduct, and to use reasonable diligence and institute procedures reasonably necessary to prevent violations of the code. Money market funds and other funds that limit their investments to certain types of instruments are exempted from this requirement, in recognition that the types of instruments held by these funds provide little or no opportunity for abuse.

The rule applies to all “access persons” of a fund. This term includes any director, officer, or general partner of the fund, its adviser, and its principal underwriter. It also includes “advisory persons” of the fund or its adviser, who are persons who make, participate in, or obtain information regarding the fund’s portfolio transactions.

B. Role of the Board

1. Board Approval

Rule 17j-1 emphasizes the role of fund boards of directors by requiring that the board, including a majority of the independent directors, approve the fund’s code of ethics, as well as the codes of ethics of the fund’s adviser and principal underwriter. The board must base its approval of the code on a determination that the code contains provisions reasonably necessary to prevent access persons from engaging in conduct prohibited by the rule. Before approving the code, the board must receive a certification from the fund, the adviser, or the principal underwriter (as applicable) that it has adopted procedures that are reasonably necessary to prevent violations of the code. In addition, the board must approve

any material changes to these codes within six months after the adoption of the material change.

2. Reports to the Board

Boards of directors also must monitor codes of ethics on a regular basis. At least annually, a fund, its adviser, and its principal underwriter must submit to the board, and the board must consider, a written report concerning, among other things, any material violations of the code or procedures since the last report and sanctions imposed in response to the material violations. In addition, the report must certify to the board that the fund, adviser, or underwriter (as applicable) has adopted procedures reasonably necessary to prevent its access persons from violating its code of ethics.

C. Reporting by Access Persons

Rule 17j-1 requires that each access person disclose his or her personal securities holdings when he or she first becomes an access person, and, thereafter, file transaction reports at least quarterly. The initial holdings report is due within 10 days of becoming an access person; quarterly transaction reports must be filed within 10 days of the end of each calendar quarter. In addition, the rule requires annual holdings reports by access persons. The information in an annual holdings report must be current as of a date no more than 30 days before the report is submitted. All of these reports must also identify any broker, dealer, or bank with which the access person maintains a securities account. Investments in and transactions involving certain government securities, money market instruments, and shares of open-end mutual funds are excluded from these requirements.

Although the rule generally exempts independent directors from these reporting requirements, they are required to file quarterly transaction reports under certain circumstances. An independent director must file a quarterly transaction report if he or she knows, or in the ordinary course of fulfilling his or her official duties as a fund director should have known, that during the 15-day period immediately before or after the director effected a securities transaction, the fund purchased or sold the security or the fund or its adviser considered purchasing or selling the security.

Rule 17j-1 also requires that each fund, adviser, and principal underwriter identify all access persons who are required to make holdings and transaction reports and inform those access persons of their reporting obligations. In addition, each fund, adviser, and principal underwriter must institute procedures by which appropriate management or compliance personnel review these reports. Furthermore, each fund, adviser, and principal underwriter must maintain lists of the names of all persons required to file holdings and transaction reports, as well as those responsible for reviewing the reports.

D. Disclosure to Investors

The SEC's registration forms require funds to disclose information in their prospectuses or statements of additional information (SAIs) concerning their codes of ethics. The forms also require funds to file their codes of ethics (and those of the fund's adviser and principal underwriter) as exhibits to their registration statements.

E. Pre-Approval of Certain Transactions

Rule 17j-1 requires the fund or its investment adviser to review and pre-approve any direct or indirect investment by "investment personnel" in an initial public offering (IPO) or in a private placement or other limited offering. The term "investment personnel" is defined in Rule 17j-1 to include portfolio managers and other employees of the fund or its investment adviser who participate in making investment recommendations to the fund, as well as persons in a control relationship to the fund who obtain information about investment recommendations made to the fund. The rule also requires funds and investment advisers to retain a record of the approval of such investments and the reasons supporting the approval decision.

V. Advisory Group Recommendations

A. Role of Advisory Group Recommendations

Rule 17j-1 sets minimum requirements for codes of ethics. The Advisory Group Report contains a number of additional recommended provisions for codes of ethics. While Institute members should adopt codes of ethics appropriate to their circumstances, the Institute believes that each of the Advisory Group's recommendations should be considered by a fund's board of directors. A substantial majority of member funds have adopted these recommendations in whole or with modifications.

B. Specific Recommendations

1. Statement of General Principles

The Advisory Group Report recommends that each code include a statement of general fiduciary principles governing personal trading. At a minimum, these principles should reflect “(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 Report 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. The Advisory Group Report makes clear that a code should be adapted to the fund's particular situation and should take into account differences between various categories of affected personnel. In particular, it may

be appropriate to draw distinctions among the following classes of individuals: (1) portfolio managers; (2) other investment personnel, such as securities analysts and traders; and (3) other “access persons,” such as compliance or clerical personnel, who do not affect a fund’s investment decisions but have access to information about a fund’s trading. As noted in the Advisory Group Report, investment personnel generally hold positions that offer greater potential for inappropriate conduct as a result of their proximity to, knowledge of, or ability to influence investment decisionmaking.

3. Substantive Restrictions

The Advisory Group Report recommends that a code of ethics include several substantive restrictions on personal investing activities, as discussed below.

a. Initial Public Offerings (IPOs)

The Advisory Group Report 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. The demand for shares in an IPO commonly exceeds the supply. The price of the shares often rises dramatically immediately after the offering, ensuring a profit for those who have purchased in the offering. As a consequence, the opportunity to purchase shares in such “hot issues” is highly sought after, and underwriters often allocate hot issue shares to their best customers. If a portfolio manager purchases shares of a hot issue for his or her own account, the purchase may create the impression that the manager was given the opportunity to participate based upon having directed past brokerage business to the underwriting firm or upon an expectation of future business. In addition, the manager may appear to have intercepted an investment opportunity that should have been made available to the fund.

The Advisory Group concluded that eliminating these potential conflicts is in the best interests of the investment company industry. Thus, in contrast to Rule 17j-1, which requires that the fund or its investment adviser review and pre-approve IPO investments by investment personnel, the Advisory Group Report recommends that codes of ethics *flatly prohibit* investment personnel from acquiring any securities in an IPO.

b. Private Placements

The Advisory Group Report recommends that (a) codes of ethics require express prior approval of any acquisition of securities by investment personnel in a private placement; (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; and (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 matter. Although Rule 17j-1 requires pre-approval of the acquisition by investment personnel of securities in a private placement, this requirement does not address the potential conflicts of interest that may arise as a result of continued ownership of such securities by investment personnel. For example, even if a portfolio manager receives approval to acquire securities in a private placement, subsequent purchases made by the fund (especially if the purchase enables a privately held company to have a successful IPO) may have the effect of enhancing the value of the portfolio manager's privately acquired shares. Accordingly, the Advisory Group Report recommends that, where investment personnel propose to purchase on behalf of a fund securities of an issuer that they have acquired personally through a private placement, such investment personnel must disclose their position, and the fund's investment decision should be reviewed by investment personnel within the organization who have no personal interest in the issuer.

c. Blackout Periods

*The Advisory Group Report recommends that codes of ethics prohibit an 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 for that security until the fund's order is executed or withdrawn. The Report further recommends that the "blackout period" for **portfolio managers** include at least seven days before and after a fund that he or she manages trades in that security.* The blackout period **before** the fund trade would protect against frontrunning, and the blackout period **after** the fund trade would allow dissipation of the market effect of the fund's trade before the portfolio manager trades. Any trades within the blackout period generally should be unwound or, in the alternative, all profits disgorged to the affected fund or to a designated charity.

d. Short-Term Trading Profits

The Advisory Group Report recommends that codes of ethics prohibit all investment personnel from profiting in the purchase and sale, or sale and purchase, of any security within 60 calendar days, whether or not the security is also held by the fund. This recommended prohibition is designed as a prophylactic device against potential frontrunning and to minimize the possibility that investment personnel will capitalize inappropriately on the market impact of trades involving other funds within the complex. Any profits realized on such short-term trades should be disgorged.

e. Gifts from Persons Doing Business with the Fund

The Advisory Group Report 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 fund. This recommendation was intended to parallel the National Association of Securities Dealers, Inc. Conduct Rules, and to avoid potential conflicts of interest.

f. Service on the Boards of Publicly Traded Companies

The Advisory Group Report recommends that codes of ethics prohibit investment personnel from serving on the boards of directors of publicly traded companies, absent prior authorization based on a determination that the board service would be consistent with the interests of the fund and its shareholders. The Advisory Group Report cites three forms of potential conflicts of interest regarding such service: (1) conflicting fiduciary duties to the company and to the shareholders of a fund that has invested in the company; (2) the receipt of options or other rights with respect to securities of the company that might influence investment decisions concerning the fund; and (3) the receipt of material, nonpublic information about the company. When investment personnel are authorized to serve as directors of public companies, they should be isolated, through “Chinese Wall” or other procedures, from other investment personnel making investment decisions relating to those public companies.

4. Compliance Procedures

In order for a code to be effective, it must be enforced through adequate compliance procedures. The Advisory Group Report therefore recommends that codes include a series of compliance provisions, some of which have been incorporated into Rule 17j-1 (e.g., the filing of initial holdings reports). Recommended compliance procedures that go beyond the requirements of Rule 17j-1 include:

- ▶ All access persons should be required to pre-clear all of their personal securities transactions, under procedures designed to identify any prohibitions or restrictions applicable to the proposed investment.
- ▶ All access persons should be required to direct their brokers to supply to a designated compliance officer, on a timely basis, duplicate copies of confirmations of, and account statements concerning, all personal securities transactions.
- ▶ Each fund should implement appropriate procedures to monitor personal investment activity by access persons after pre-clearance has been granted.
- ▶ All access persons should certify annually that they have read and understand the code of ethics and have complied with its requirements.

VI. Conclusion

As discussed above, fund directors play a vital role in approving, and overseeing compliance with, codes of ethics for investment company personnel. Fund directors should recognize that codes of ethics are not static documents, and must be continually updated in order to respond to potential abuses. In this regard, directors must keep abreast of changes in the financial markets and adapt their funds' codes to respond to these changes.

Endnotes

¹For the purposes of this *Guide*, the term “investment company personnel” 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 under the Investment Company Act of 1940, which is discussed in detail later in the *Guide*.

Requirements relating to the adoption and maintenance of codes of ethics do not apply to an underwriter if it is not an affiliated person of the investment company or its investment adviser and none of the officers, directors, or general partners of the underwriter serves as an officer, director, or general partner of the fund or its adviser. Unless otherwise specified, references in the *Guide* to a “principal underwriter” include only those principal underwriters that are required to adopt and maintain codes of ethics under SEC Rule 17j-1.

²*SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963).



1401 H Street, NW
Suite 1200
Washington, DC 20005-2148

202/326-5800

www.ici.org