ROPES & GRAY

ALERT

Asset Management

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SEC Releases Guidance on Code of Ethics Personal Securities Reporting

On June 26, 2015, the SEC's Division of Investment Management released a Guidance Update titled, "Personal Securities Transactions Reports by Registered Investment Advisers: Securities Held in Accounts Over Which Reporting Persons Had No Influence or Control" (the "Guidance," available here). The Guidance increases the compliance obligations for an adviser administering its code of ethics – required under the Investment Advisers Act (Rule 204A-1) – with respect to certain personal transactions of the adviser's "access persons" (a defined term). Specifically, with respect to a securities account belonging to an adviser's access person, an adviser will no longer be able simply to rely on the access person's assertion that he/she cannot influence or control securities transactions within the account. Instead, the Guidance provides a compliance framework for the adviser to establish a reasonable belief that transactions within the access person's securities account, in fact, are not subject to the access person's influence or control. Separately, the Guidance also may have implications for advisers to registered investment companies in administering a code of ethics required under the 1940 Act (Rule 17j-1).

Background

Section 204A of the Advisers Act requires registered investment advisers to maintain and enforce written policies and procedures reasonably designed to prevent the firm or its employees from misusing material nonpublic information. Rule 204A-1, promulgated under Section 204A, provides that a registered investment adviser must establish and enforce a written code of ethics that requires the adviser's directors, officers and partners and its supervised persons who have access to nonpublic information regarding securities transactions (collectively, "access persons") to report their personal securities holdings and transactions. Rule 204A-1(b)(3)(i) provides an exemption (the "Reporting Exemption") to these reporting requirements with respect to an access person's "securities that are held in accounts over which the access person had no direct or indirect influence or control."

The Guidance

In the Guidance, the SEC staff clarified the circumstances in which the Reporting Exemption is available. The staff contrasted a "blind trust" – an arrangement in which a trustee manages a securities account for an access person who has no knowledge of the trustee's actions and no power to interfere with the trustee's actions – with other types of trusts and discretionary accounts. According to the staff, a blind trust would be within the Reporting Exemption. However, the staff noted, the fact that an access person provides a trustee or a third-party manager discretionary investment authority over a personal account "*by itself*, is insufficient for an adviser to reasonably believe that the access person had no direct or indirect influence or control over the trust or account for purposes of relying on the [Reporting Exemption]" (emphasis in original). For example, according to the staff, notwithstanding the fact that an access person provides a trustee or a third-party manager with discretionary investment authority over the access person's account, the access person retains "direct or indirect influence or control" if the access person can (i) suggest purchases or sales of investments in the account to the trustee or third-party manager; (ii) direct transactions within the account; or (iii) consult with the trustee or third-party manager regarding allocation of investments in the account.

The staff stated that reasonably designed policies and procedures should focus on whether an access person actually has direct or indirect influence or control over the trust or account, instead of whether the trustee or third-party manager has discretionary or nondiscretionary investment authority. The staff provided the following examples of controls that an adviser could implement in order to establish that an access person had no direct or indirect influence or control over a trust or account and, therefore, may rely on the Reporting Exemption:

- Procure information about the access person's relationship to the trustee or third-party manager (e.g., an independent professional versus friend or relative, an unaffiliated firm versus an affiliated firm);
- Using a sampling basis, request holdings and/or transactions reports of access persons' trust or discretionary accounts to identify any transactions that would have been prohibited by the adviser's code of ethics (i.e., absent reliance on the Reporting Exemption); and
- Procure regular certifications by the access person and the access person's trustee or third-party manager concerning the access person's lack of influence or control over the trusts or accounts.

With respect to certifications, the staff stated that a "general" certification, by itself, from an access person – to the effect that the access person did not exercise direct or indirect influence or control over a trust or discretionary account – would likely be inadequate. Instead, the staff stated, advisers may consider obtaining more specific certifications from each access person (e.g., certifications that an access person did not suggest or direct any particular transactions in the account to the trustee or third-party manager, or consult with the trustee or third-party manager regarding allocation of investments in the account).

Discussion

It appears that the staff wants to impose a heightened level of diligence for advisers with respect to access persons seeking to rely on the Reporting Exemption. While access persons' use of blind trusts permits bright-line testing for an adviser and its CCO, other types of trusts and discretionary accounts, according to the Guidance, seem to require a nuanced analysis of facts and circumstances (which could lead to second guessing of the adviser and CCO). The Guidance suggests that each adviser now should consider the additional controls and enhanced certifications suggested in the Guidance, as well as other methods to enhance the adviser's scrutiny of access persons' reliance on the Reporting Exemption. Based on such a review, amendments to the adviser's code of ethics and related written policies and procedures may be called for.

While the Guidance is limited to the Reporting Exemption within Rule 204A-1, the Guidance also may have implications for an adviser to a registered investment company in administering the code of ethics required by Rule 17j-1 under the 1940 Act. Rule 17j-1 requires "access persons," as defined within Rule 17j-1, to report personal securities holdings and transactions. Rule 17j-1(d)(2)(i), like Rule 204A-1, contains a reporting exemption for "any account over which the person has no direct or indirect influence or control." Therefore, the heightened diligence called for in the Guidance with respect to persons seeking to rely on the Reporting Exemption may logically apply to Rule 17j-1 "access persons" seeking to rely on the analogous reporting exemption in Rule 17j-1(d)(2)(i).

Many advisers to registered investment companies maintain a single code of ethics that is designed to satisfy the requirements of both Rule 17j-1 and Rule 204A-1. For such advisers, the heightened diligence called for in the Guidance is likely to apply to any access person (as defined within the single code of ethics) seeking to avoid reporting personal securities holdings and transactions in accounts over which the access person claims to have no direct or indirect influence or control.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.