

# SPOTLIGHT ON

## Investment Adviser Code of Ethics

*The contents of this Spotlight have been prepared for informational purposes only and should not be construed as legal or compliance advice.*

### **Code of Ethics Requirements**

In 2004, the Securities and Exchange Commission (“SEC”) adopted a new code of ethics rules for investment advisers under the Investment Advisers Act of 1940 (“Advisers Act”). The adopted rule, Rule 204A-1, lays out specific requirements for an investment adviser’s Code of Ethics. At a minimum, an investment adviser’s Code of Ethics must include the following:

1. “A standard (or standards) of business conduct that you require of your supervised persons, which standard must reflect your fiduciary obligations and those of your supervised persons;
2. Provisions requiring your supervised persons to comply with applicable Federal securities laws;
3. Provisions that require all of your access persons to report, and you to review, their personal securities transactions and holdings periodically as provided below;
4. Provisions requiring supervised persons to report any violations of your code of ethics promptly to your chief compliance officer or, provided your chief compliance officer also receives reports of all violations, to other persons you designate in your code of ethics; and
5. Provisions requiring you to provide each of your supervised persons with a copy of your code of ethics and any amendments and requiring your supervised persons to provide you with a written acknowledgment of their receipt of the code and any amendments.”<sup>1</sup>

Under the Code of Ethics requirements, all investment advisers must meet the minimum requirements above but may adopt higher or additional standards. The SEC urges advisers to take great care and be very thoughtful in developing a code of ethics, such that the code represents the ideals of honesty and trust for the company.

Representing the firm’s commitment to its fiduciary duty and compliance with federal and state securities laws where applicable in the code of ethics, and then having employees review and certify the code creates an environment of compliance and accountability.

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<sup>1</sup> Doug Cornelius, *Code of Ethics for Investment Advisers*, Compliance Building (2008), <https://www.compliancebuilding.com/2008/10/24/code-of-ethics-for-investment-advisers/> (last visited October 30, 2020).

## **Reporting Requirements**

The SEC requires access persons to submit a holdings report of each access person's current personal security holdings to the firm's Chief Compliance Officer or other designated persons. The report must meet certain requirements. Each holdings report must at least contain the title of each security, the number of shares, and the principal amount of each security that the access person has direct or indirect beneficial ownership. The report must also contain the name of any broker-dealer or bank in which any of the access person's securities are held and the report submission date. The holdings report must be submitted no later than ten (10) days after an employee becomes an access person and be current with an as of date within 45 days prior. At least once every 12-months after, the holdings report must be updated.

In addition to the holdings report, an investment adviser's access persons must submit securities transactions reports. At a minimum, the transaction report must include the date of the transaction, the title and the ticker symbol of the security, the number of shares, and the principal amount of any security in which the access person has any direct or indirect beneficial ownership. The nature of the transaction, the price of the security, and the broker-dealer or bank that executed the transaction must also be reported. Also, before directly or indirectly acquiring beneficial ownership in any security in an initial public offering or a limited offering, access persons are required to obtain approval.

Certain exceptions exist for the reporting requirements. Any transaction reports for accounts in which the access person has no direct or indirect control and any transaction reports for transactions through an automatic investment plan are not required to be reported.

In the context of the Code of Ethics requirements, access persons are defined as any supervised person who has non-public information regarding any clients' purchase or sale of securities, non-public information regarding holdings of any fund. An access person is also anyone involved in making investment recommendations to clients or has access to those non-public recommendations. If providing investment advice is the primary business, then all directors, officers, and partners of the company are considered to be access persons as well.<sup>2</sup>

## **Suggestions for Personal Trading Procedures**

The above requirements have been emphasized by the SEC as minimum requirements for reporting personal securities trading. To supplement the minimum requirements, the SEC has provided some elements that are commonly included in SEC-registered investment advisers' code of ethics. Some of the suggestions are outlined below:

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<sup>2</sup> *Final Rule: Investment Adviser Code of Ethics*, US Securities and Exchange Commission (2005), <https://www.sec.gov/rules/final/ia-2256.htm> (last visited October 30, 2020).

- Prior written approval before access persons can place a personal securities transaction (for all transactions, as opposed to only in situations of initial public offerings or limited offerings);
- Maintaining a list of issuers that the advisory firm is analyzing or recommending for transactions and prohibiting access persons from personally trading in those securities;
- Maintaining “blackout periods” in which access persons are prohibited from placing personal securities transactions while client securities trades are being placed or recommendations are being made; and
- Requirements to trade through certain brokers or limits on the number of brokerage accounts allowed.<sup>3</sup>

Whichever steps are taken, the systems that account for personal trading transactions should seek to mitigate any potential conflicts of interest. It may be advisable for an adviser to make explicit in its code of ethics that supervised persons should actively identify and respond to potential or apparent conflicts of interest, whether in trading securities or some other area of importance.<sup>4</sup>

### **Reporting Violations**

The Code of Ethics requirements calls for prompt internal reporting of any violations of the company’s code of ethics. Violations must be reported to the investment adviser’s chief compliance officer or another person designated by the code of ethics. When another person is designated, there should be a system to ensure the chief compliance officer is periodically updated with the reports of violations. The SEC also encourages advisers to create an environment conducive to reporting violations by protecting those supervised persons that report the violations. Some controls against retaliation against the supervised person reporting the violation would help provide the necessary environment. The SEC has also denied that they support adopting a system of penalties for violations but note that many advisers have implemented such systems to enforce their code of ethics with consequences.<sup>5</sup>

### **Educating Employees about the Code of Ethics**

The SEC does not require employee education as an element of the code of ethics but expects advisers to have appropriate systems and training in place to inform supervised persons of their

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<sup>3</sup> Burton Leibert, *SEC Adopts a Rule to Require Registered Investment Adviser to Establish Code of Ethics and Amends Investment Company Code of Ethics Rule*, Willkie Farr & Gallagher (2004), [https://www.willkie.com/~media/Files/Publications/2004/07/SEC%20Adopts%20a%20Rule%20to%20Require%20Registered%20Investme\\_\\_\\_/Files/SECAdoptsCodesofEthicspdf/FileAttachment/SEC\\_Adopts\\_Codes\\_of\\_Ethics.pdf](https://www.willkie.com/~media/Files/Publications/2004/07/SEC%20Adopts%20a%20Rule%20to%20Require%20Registered%20Investme___/Files/SECAdoptsCodesofEthicspdf/FileAttachment/SEC_Adopts_Codes_of_Ethics.pdf) (last visited October 30, 2020).

<sup>4</sup> Adam Stutz, *Identifying and Mitigating Advisory Conflicts of Interest*, Core Compliance & Legal Services, Inc. (2020), <https://www.corecls.com/news-events/identifying-and-mitigating-advisory-conflicts-of-interest> (last visited October 30, 2020).

<sup>5</sup> *Final Rule: Investment Adviser Code of Ethics*, US Securities and Exchange Commission (2005), <https://www.sec.gov/rules/final/ia-2256.htm> (last visited October 30, 2020).

code of ethics and compliance responsibilities. The processes for educating supervised persons on the code of ethics is vital to creating good compliance and avoiding violations. The SEC has noted that many firms hold sessions for new employees and periodic sessions for existing employees to ensure all supervised persons are consistently aware of their obligations. Some advisers also require supervised persons to review the code of ethics and recertify annually that they understand and will comply with the code. The SEC does not require these practices but considers them best practices.<sup>6</sup>

### SEC Enforcement Actions

The SEC's Office of Compliance and Examinations ("OCIE") has noted that Code of Ethics violations are one of the five most frequent topics identified in examinations of Investment Advisers. In a 2017 Risk Alert from the OCIE, the office highlights specific examples of code of ethics deficiencies identified by examination staff. The OCIE outlines the following:

- *Access persons not identified.* Certain advisers failed to identify all of their access persons for purposes of reviewing personal securities transactions.
- *Code of Ethics missing required information.* Certain advisers' code of ethics failed to specify the review of holdings and transactions reports and the timing of submitting the reports.
- *Untimely submission of transactions and holdings.* Certain access persons failed to submit or submitted less frequently the holdings and transactions reports required by the adviser's code of ethics.
- *No description of code of ethics in Form ADV filings.* Certain advisers failed to describe their codes of ethics in the Form ADV Part 2A and did not indicate that their codes of ethics are available to any client or prospective client upon request.<sup>7</sup>

Oftentimes when the OCIE has discovered violations of the code of ethics rules, the SEC has followed up with enforcement actions and fines. In a specific case involving a Kansas-based Investment adviser, the SEC found that the adviser's president and majority owner had violated the firm's code of ethics. The president failed to report to the chief compliance officer the securities holdings and transactions from multiple brokerage accounts for his family, in which the president had control. A settlement was reached between the SEC and the adviser for these code of ethics violations.<sup>8</sup>

In another case involving a Houston-based investment adviser, the adviser was charged with failing to establish and maintain a code of ethics as required by Rule 204A-1. This same adviser

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<sup>6</sup> Ibid.

<sup>7</sup> *Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers*, US Securities and Exchange Commission (2017), <https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf> (last visited November 7, 2020).

<sup>8</sup> *Investment Adviser and Its President Settle Charges for Testimonial Rule and Code of Ethics Violations*, US Securities and Exchange Commission (2018), <https://www.sec.gov/enforce/ia-5035-s> (last visited November 7, 2020).

also failed to establish a tailored compliance manual and to conduct the required annual compliance review. The SEC ordered charges against the firm and a cease-and-desist proceeding.<sup>9</sup>

In 2011, the SEC charged an investment adviser and its chief compliance officer with violating the code of ethics. The adviser's code of ethics stated that it would place certain securities on a "restricted list" if an employee possessed material non-public information about the company. Additionally, the code of ethics specified that if any employee served on the board of directors of a public company, that employee would be isolated from making decisions related to that company's securities. The chief compliance officer, also an investment adviser representative, sat on the board of directors of a public company and thus had non-public information about the securities of that company. The chief compliance officer was not sufficiently isolated from decisions about this company, and the company's securities were not on a restricted list. The parties involved were charged substantial fees, and the investment adviser's registration was revoked.<sup>10</sup>

One last case to note had the SEC charging an investment adviser to fail to make copies of and retain employee acknowledgements of receipt of the firm's code of ethics. This violation continued after two warnings from the SEC in deficiency letters. The investment adviser was then censured and charged with civil money penalties.<sup>11</sup>

The enforcement actions presented above establish how seriously the SEC takes violations of the Code of Ethics Rule of the Investment Adviser Act. Therefore, the code of ethics should be taken seriously and crafted carefully by investment advisers, both to promote compliance with laws and regulation and to avoid legal issues and penalties from the SEC. It would be prudent for investment advisers to understand the common deficiencies outlined by the SEC and the specific deficiencies of some advisers in order to establish a code of ethics and procedures that ensure compliance with the code of ethics rules.

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<sup>9</sup> Allesia Bell, *SEC Charges Two Houston-Based Advisory Firms, Including Hedge Fund Manager, with Principal Transaction, Custody Rule, Compliance Rule and Code of Ethics Violations*, Hedge Fund Law Report (2014), <https://www.hflawreport.com/2546951/sec-charges-two-houstonbased-advisory-firms-including-a-hedge-fund-manager-with-principal-transaction-custody-rule-compliance-rule-and-code-of-ethics-violations.shtml> (last visited November 7, 2020).

<sup>10</sup> Jennifer L. Klass, *Code of Ethics and Personal Trading*, Morgan Lewis & Bockius LLP (2013), [https://www.morganlewis.com/-/media/files/publication/presentation/speech/outline-codeofethics\\_personaltrading\\_march2013.pdf](https://www.morganlewis.com/-/media/files/publication/presentation/speech/outline-codeofethics_personaltrading_march2013.pdf) (last visited November 7, 2020).

<sup>11</sup> *Ibid.*