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## **SEC Adopts New Rule 204A-1 of the Advisers Act – Registered Investment Advisers Are Required to Adopt a Code of Ethics<sup>1</sup>**

**To: Clients of Tannenbaum Helpern Syracuse Hirschtritt LLP**

**Date: July 14, 2004**

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### **Summary**

On July 2, 2004, the Securities and Exchange Commission (the “SEC”) released IA-2256 (“Release IA-2556”)<sup>2</sup> whereby the SEC adopted final rules to require registered investment advisers to adopt a code of ethics pursuant to new Rule 204A-1 of the Investment Advisers Act of 1940, as amended (the “Advisers Act”). The code of ethics must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel. The SEC is also amending Rule 204-2 of the Advisers Act to require advisers to keep certain documents relating to the code of ethics and is amending the client disclosure requirements under Part II of Form ADV to require advisers to describe their code of ethics to clients. In general, compliance with new Rule 204A-1 covers the following eight topics: (i) adopting standards of conduct that includes compliance with federal securities laws; (ii) the reporting of personal securities transactions of “access persons”; (iii) reporting violations of the code of ethics; (iv) the distribution of the code of ethics to all supervised persons and acknowledgement of receipt; (v) the review of access persons’ personal securities reports; (vi) recordkeeping of certain documents; (vii) describing an adviser’s code of ethics in Part II of Form ADV of such adviser; and (viii) insider trading. The SEC expects an adviser’s chief compliance officer or persons under his or her authority to have primary responsibility for enforcing the code of ethics.<sup>3</sup>

### **Effective Date**

New Rule 204A-1 of the Advisers Act becomes effective on August 31, 2004. The compliance date is January 7, 2005. By January 7, 2005, an adviser must have adopted a code of ethics, identified who its current access persons are, provided a copy of the code of ethics to each

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<sup>1</sup> This memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects treated here.

<sup>2</sup> Securities and Exchange Commission; “Investment Adviser Codes of Ethics”; final rule. 69 Fed. Reg. 41696-41709 (July 9, 2004).

<sup>3</sup> Rule 206(4)-7 of the Advisers Act requires a registered investment adviser to appoint a chief compliance officer. Compliance with Rule 206(4)-7 is required by October 5, 2004.

supervised person and received their acknowledgement, and received initial holding reports from its access persons.<sup>4</sup>

## **I. Standards of Conduct and Compliance with Federal Securities Laws**

The code of ethics must set forth a standard of business conduct applicable to all of the adviser's supervised persons.<sup>5</sup> The term "supervised person" refers to the adviser's partners, officer, directors (or other person occupying a similar status or performing similar functions) and employees, as well as any other persons who provide advice on behalf of the adviser and are subject to the adviser's supervision and control.<sup>6</sup> New Rule 204A-1 of the Advisers Act does not mandate the adoption of a particular standard. Rather, the SEC is leaving it up to advisers to draft their own standards of business conduct as long as such standards (i) reflect the adviser's fiduciary obligations and those of its supervised persons and (ii) require compliance with the federal securities laws.<sup>7</sup>

According to the SEC, the code of ethics should accomplish the following:

- Set out ideals for ethical conduct premised on fundamental principals of openness, integrity, honest and trust.
- Convey to employees the value the adviser places on ethical conduct.<sup>8</sup>

## **II. Personal Securities Transactions**

### A. Who Must Comply – Access Persons

Pursuant to new Rule 204A-1(a)(3) of the Advisers Act, the adviser's code of ethics must require an adviser's "access persons" to periodically report their holdings and personal securities transactions to the adviser's chief compliance officer or other designated person.<sup>9</sup> The term "access person" is a new category of employees created for purposes of compliance with the code of ethics. The term "access person" is a functional definition that refers to any supervised person that performs the following functions:

- Has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund; or

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<sup>4</sup> Until advisers begin to comply with new Rule 204A-1 and the amendments to Rule 204-2, advisers must continue to comply with the personal securities transaction recordkeeping requirements under current Rule 204-2(a)(12) and (13). Fed. Reg. at 41702.

<sup>5</sup> New Rule 204A-1(a)(1) of the Advisers Act.

<sup>6</sup> See Section 202(a)(25) of the Advisers Act.

<sup>7</sup> New Rule 204A-1(a)(1) and (2) of the Advisers Act. For the purposes of new Rule 204A-1 of the Advisers Act, the term "federal securities laws" means the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the SEC under any of these statutes, the Bank Secrecy Act as it applies to funds and investment advisers, and any rule adopted thereunder by the SEC or the Department of Treasury. Rule 204A-1(e)(4) of the Advisers Act.

<sup>8</sup> Fed. Reg. at 41697.

<sup>9</sup> New Rule 204A-1(a)(3) of the Advisers Act. Currently, registered investment advisers are required to maintain certain records regarding the personal securities transactions of its advisory representatives pursuant to Rule 204-2(a)(12)(i) of the Advisers Act.

- Is involved in making securities recommendations to clients, or has access to such recommendations that are nonpublic.<sup>10</sup>

In addition, access persons include portfolio management personnel, and, in some advisers, their client service representatives who communicate investment advice to clients since the SEC believes that they are in a position to take advantage of their inside knowledge.<sup>11</sup> Also, administrative, technical, and clerical personnel may also be access persons if their functions or duties give them access to nonpublic information.<sup>12</sup>

Furthermore, if an adviser's primary business is to provide investment advice, then all of the adviser's directors, officers and partners are presumed to be access persons.<sup>13</sup> Accordingly, anyone who is senior management of a registered investment adviser will be required to submit holdings reports and transaction reports pursuant to Rule 204A-1(b) of the Advisers Act. Given the broad scope of the definition (in essence, any employee that has access to the investment adviser's trading information), it might be simpler from an administrative perspective to apply this rule to all of an adviser's employees.

Note that in instances when the chief compliance officer is also an access person and therefore must submit reports, the SEC expects advisers to designate another individual to review the personal securities reports submitted by the chief compliance officer.<sup>14</sup>

#### B. "Reportable Securities"

The reporting requirements under new Rule 204A-1 require access persons to disclose their holdings and transactions with respect to certain securities referred to as "reportable securities." The term "reportable security" refers to a security as defined in Section 202(a)(18) of the Advisers Act.<sup>15</sup>

Excluded from the definition of "reportable security" are the following types of financial products:

- Direct obligations of the government of the United States;
- Bankers' acceptances, bank certificates of deposit, commercial paper and high quality short-term debt instruments, including repurchase agreements;
- Shares issued by money market funds;

<sup>10</sup> New Rule 204A-1(e)(1)(i)(A) and (B) of the Advisers Act.

<sup>11</sup> Fed. Reg. at 41698.

<sup>12</sup> Fed. Reg. at 41698.

<sup>13</sup> New Rule 204A-1(e)(1)(ii) of the Advisers Act.

<sup>14</sup> Fed. Reg. at 41697, note 13.

<sup>15</sup> New Rule 204A-1(e)(10) of the Advisers Act. "Security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call straddle, option or privilege entered into on a national securities exchange relating to foreign currency, or in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subject to or purchase any of the foregoing. See Section 202(a)(18) of the Advisers Act.

- Shares issued by open-end funds other than reportable funds<sup>16</sup>; and
- Shares issued by unit investment trusts that are invested exclusively in one or more open-end funds, none of which are reportable funds.<sup>17</sup>

As such, an adviser's access person is not required to disclose his or her purchase of U.S. Treasury bonds or open-ended mutual funds. However, an access person must still report his or her securities holdings if it includes closed-end mutual funds regardless of affiliation or non-U.S. investment companies.<sup>18</sup> Also, if the access person owns interests in a mutual fund whereby the access person's employer is the adviser to the fund or has common control with respect to the fund, then such an access person must report his or her interests in the mutual fund.

### C. Personal Trading Procedures

Although the code of ethics must address personal trading of an adviser's access persons, new Rule 204A-1 of the Advisers Act does not impose specific measures as to how to implement and monitor an access person's personal trading. Again, the SEC is leaving it up to the adviser how to craft and to implement its own policies and procedures with respect to personal securities trading. Nevertheless, the SEC has listed measures common to many codes of ethics that the SEC believes that all advisers *should consider* when drafting their personal securities trading procedures:

- Prior written approval before access persons can place a personal securities transaction ("pre-clearance").
- Maintenance of lists of issuers of securities that the adviser is analyzing or recommending for client transactions, and prohibitions on personal trading in securities of those issuers.
- Maintenance of "restricted lists" of issuers about which the advisory firm has inside information, and prohibitions on any trading (personal or for clients) in securities of those issuers.
- "Blackout periods" when client securities trades are being placed or recommendations are being made and access persons are not permitted to place personal securities transactions.
- Reminders that investment opportunities must be offered first to clients before the adviser or its employees may act on them, and procedures to implement this principle.
- Prohibitions or restrictions on "short-swing" trading and market timing.
- Requirements to trade only through certain brokers, or limitations on the number of brokerage accounts permitted.
- Requirements to provide the adviser with duplicate trade confirmations and account statements.
- Procedures for assigning new securities analyses to employees whose personal holdings do not present apparent conflicts of interest.<sup>19</sup>

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<sup>16</sup> The term "reportable fund" means (i) any fund which an adviser serves as an investment adviser as defined in Section 2(a)(2) of the Investment Company Act of 1940, as amended; or (ii) any fund whose investment adviser or principal underwriter controls the adviser, is controlled by the adviser, or is under common control with the adviser. See new Rule 204A-1(e)(9) of the Advisers Act.

<sup>17</sup> New Rule 204A-1(e)(1)(i)-(v) of the Advisers Act.

<sup>18</sup> Fed. Reg. at 41699, note 46.

<sup>19</sup> Fed. Reg. at 41698.

Other provisions that the SEC has identified as being included by advisers in their code of ethics are:

- Limitations on acceptance of gifts.
- Limitations on the circumstances under which an access person may serve as a director of a publicly traded company.
- Procedures to review periodically the code of ethics as well as to review reports made pursuant to the code of ethics.<sup>20</sup>

#### D. Access Persons to Submit Initial Reports, Annual Reports, and Quarterly Transactions Reports

##### 1. Initial Holdings Reports

An access person must complete an initial report of his or her reportable securities holdings at the time the person becomes an access person. The initial report must be submitted no later than ten (10) days after the person becomes an access person of an adviser.<sup>21</sup> Also, the initial holdings report must be current as of a date not more than forty-five (45) days prior to the individual becoming an access person.<sup>22</sup>

The initial holdings report must contain, at a minimum, the following information:

- The title and type of security, and as applicable the exchange ticker symbol or CUSIP number, the number of shares, and principal amount of each reportable security in which the access person has any direct or indirect beneficial ownership;
- The name of any broker, dealer or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit; and
- The date the access person submits the report.<sup>23</sup>

Registered investment advisers should start identifying who their access persons are so that there is sufficient time for their access persons to complete and to submit the initial holdings reports by January 7, 2005.

##### 2. Annual Holdings Reports

On an annual basis, an adviser's access person must complete a report of his or her reportable securities. The annual holdings report must be current as of a date no more than forty-five (45) days prior to the date the annual report was submitted.<sup>24</sup>

The annual holdings report must contain, at a minimum, the following information:

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<sup>20</sup> Fed. Reg. at 41698, note 17

<sup>21</sup> New Rule 204A-1(b)(ii)(A) of the Advisers Act.

<sup>22</sup> New Rule 204A-1(b)(ii)(A) of the Advisers Act.

<sup>23</sup> New Rule 204A-1(b)(i)(A)-(C) of the Advisers Act.

<sup>24</sup> New Rule 204A-1(b)(ii)(B) of the Advisers Act.

- The title and type of security, and as applicable the exchange ticker symbol or CUSIP number, the number of shares, and principal amount of each reportable security in which the access person has any direct or indirect beneficial ownership;
- The name of any broker, dealer or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit; and
- The date the access person submits the report.<sup>25</sup>

### 3. Quarterly Transaction Reports

An adviser's code of ethics must require access person to submit transaction reports of all personal securities transactions on a quarterly basis.<sup>26</sup> Such quarterly transaction reports must be due no later than thirty (30) days after the close of the calendar quarter.<sup>27</sup>

The transaction report must contain, at a minimum, the following information about each transaction that results in any direct or indirect beneficial ownership:

- The date of the transaction, the title and as applicable the exchange ticker symbol or CUSIP number, interest rate and maturity date, number of shares, and principal amount of each reportable security involved;
- The nature of the transaction, i.e., purchase, sale or any other type of acquisition or disposition;
- The price of the security at which the transaction was effected;
- The name of the broker, dealer or bank with or through which the transaction was effected; and
- The date the access person submits the transaction report.<sup>28</sup>

As an alternative, advisers may continue to require persons who are access persons to submit brokerage statements or trade confirmations as long as such documents contain the information required under new Rule 204A-1(b)(2)(i)(A)-(E) of the Advisers Act. Moreover, such statements or confirmations must be received by the adviser no later than thirty (30) days after the close of the calendar quarter in which the transaction takes place.<sup>29</sup> Note that it is permissible for some of the required information to appear in the statements or confirmations and for the remainder of the required information to be reported in the quarterly transaction report.<sup>30</sup>

Finally, note that any access person that does not engage in any personal securities transactions during a calendar quarter is not required to submit a quarterly transaction report.<sup>31</sup>

### 4. Exceptions to the Reporting Requirements

An access person is not required to submit a report with respect to certain securities under the following three (3) circumstances:

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<sup>25</sup> New Rule 204A-1(b)(i)(A)-(C) of the Advisers Act.

<sup>26</sup> New Rule 204A-1(b)(2) of the Advisers Act.

<sup>27</sup> New Rule 204A-1(b)(2)(ii) of the Advisers Act.

<sup>28</sup> New Rule 204A-1(b)(2)(i)(A)-(E) of the Advisers Act.

<sup>29</sup> Fed. Reg. at 41699; new Rule 204A-1(b)(3)(iii) of the Advisers Act.

<sup>30</sup> Fed. Reg. at 41699, note 35.

<sup>31</sup> Fed. Reg. at 41699

- Neither a holdings report nor a transaction report is required with respect to securities held in accounts over which the access person had no direct or indirect influence or control; or
- A transaction report is not required with respect to transactions effected pursuant to an automatic investment plan;<sup>32</sup> or
- In the case of an advisory firm that has only one access person, a transaction report is not required so long as such firm maintains records, i.e., broker trade confirmations or account statements, that Rule 204A-1 of the Advisers Act would otherwise require to be reported.<sup>33</sup>

#### E. Access Persons Required to Obtain Clearance Prior to Investing in Initial Public Offerings or Limited Offerings

The code of ethics must contain provisions to require access persons to obtain an adviser's approval before investing in initial public offerings ("IPOs") or limited offerings (i.e., private placements).<sup>34</sup> The SEC's rationale for this requirement is that since most individuals rarely have the opportunity to invest in IPOs or limited offerings, when an access person invests in such securities, such a purchase invites scrutiny. The SEC believes that an access person's IPO or limited offerings purchase raises questions as to whether the access person is misappropriating an investment opportunity that should first be offered to eligible clients, or whether a portfolio manager is receiving a personal benefit for directing client business or brokerage.<sup>35</sup>

An exception to obtain pre-approval for the acquisition of IPOs or limited offerings is available to small advisers where there is only one access person. In such instances, the lone access person is not required to submit reports to himself or herself or to obtain his or her approval for investment in an IPO or a limited offering as long as the adviser maintains records of all of the access person's holdings and transactions that such a person would be required to report.<sup>36</sup>

### **III. Reporting Violations of the Code of Ethics**

The registered investment adviser's code of ethics must contain a provision that requires supervised persons to report any violations of the code of ethics.<sup>37</sup> Violations must be reported to the adviser's chief compliance officer or its designee.<sup>38</sup>

To encourage internal reporting of violations of the code of ethics, the SEC is not requiring advisers to retain records of "whistleblower reports."<sup>39</sup>

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<sup>32</sup> An "automatic investment plan" is defined to mean a program in which regular periodic purchases (or withdrawals) are made automatically in (or from) investment accounts in accordance with a predetermined schedule and allocation. An automatic investment plan includes a dividend reinvestment plan. See New Rule 204A-1(e)(2) of the Advisers Act.

<sup>33</sup> New Rule 204A-1(b)(3)(i)-(iii) of the Advisers Act.

<sup>34</sup> New Rule 204A-1(c) of the Advisers Act. For the purposes of new Rule 204A-1, the term "limited offering" means an offering that is exempt from registration under the Securities Act of 1933, as amended, pursuant to Section 4(2) or Section 4(6) of the Securities Act commonly referred to as private placements.

<sup>35</sup> Fed. Reg. at 41700.

<sup>36</sup> New Rule 204A-1(d) of the Advisers Act.

<sup>37</sup> New rule 204A-1(a)(4) of the Advisers Act.

<sup>38</sup> If an adviser chooses to require its supervised persons to report violations of the code of ethics to a designated person other than the chief compliance officer, the adviser must have procedures that would require the chief compliance officer to receive reports of all violations periodically as well. Fed. Reg. at 41700. See new Rule 204A-1(a)(4) of the Advisers Act.

Note that the SEC has not adopted a system of fines or other penalties of violations of a code of ethics.<sup>40</sup> Rather, it is up to an adviser to decide how to internally punish violators of its code of ethics. The SEC notes that pursuant to some policies in place at advisory firms, employees may be required to cancel trades, disgorge profits or sells positions at a loss, and may face internal reprimands fines, or firing.<sup>41</sup>

#### **IV. Distribution of Code of Ethics to All Supervised Persons and Acknowledgement of Receipt**

Registered investment advisers are required to provide each supervised person with a copy of the code of ethics and any amendments thereto.<sup>42</sup> Moreover, each supervised person must acknowledge in writing his or her receipt of the copy.<sup>43</sup>

Note that new Rule 204A-1 of the Advisers Act does not mandate that an adviser conduct employee education sessions to inform their employees of the adviser's code of ethics. Nevertheless, the SEC stated that it "expect[s] most advisory firms [to] ensure that their employees have received adequate training on the principles and procedures of their codes."<sup>44</sup> Furthermore, the SEC notes that many firms that have already implemented codes of ethics hold periodic orientation or training sessions with new and existing employees to remind their employees of their obligations under the adviser's code of ethics.<sup>45</sup> Additionally, some firms require employees to certify that they have read and understood the codes of ethics and require an annual certification that the employee has re-read, understands and has complied with the code of ethics.<sup>46</sup> Accordingly, advisers should strongly consider implementing periodic educational sessions that include annual re-certification as part of its compliance with new Rule 204A-1 of the Advisers Act.

#### **V. Review of Access Persons' Personal Securities Reports**

A registered investment adviser must review their access persons' personal securities transaction reports as part of the adviser's duty to maintain and enforce its code of ethics.<sup>47</sup> When conducting a review of its access persons personal securities reports, the assessment should cover the following:

- Whether the access person followed any required internal procedures, e.g. pre-clearance;
- A comparison of the personal trading to any restricted lists;

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<sup>39</sup> Fed. Reg. at 41701. According to the SEC, commenters to the proposed rules persuaded the SEC that requiring whistleblower records could have a chilling effect on employees' willingness to report violations, particularly in smaller organizations.

<sup>40</sup> Fed. Reg. at 41700.

<sup>41</sup> Fed. Reg. at 41700, note 54.

<sup>42</sup> Fed. Reg. at 41700; New Rule 204A-1(a)(5) of the Advisers Act.

<sup>43</sup> Fed. Reg. at 41700.

<sup>44</sup> Fed. Reg. at 41700.

<sup>45</sup> Fed. Reg. at 41700.

<sup>46</sup> Fed. Reg. at 41700.

<sup>47</sup> New Rule 204A-1(a)(3) of the Advisers Act.

- An assessment of whether the access person is trading for his or her own account in the same securities that he or she is trading for clients, and if so whether the clients are receiving terms as favorable as the access person takes for himself or herself;
- Periodically analyzing the access person's trading for patterns that may indicate abuse, including market timing;
- Investigating any substantial disparities between the quality of performance the access person achieves for his or her own account and that he or she achieves for clients; and
- Investigating any substantial disparities between the percentage of trades that are profitable when the access person trades for his or her own account and the percentage that are profitable when he or she places trades for clients.<sup>48</sup>

## VI. Recordkeeping

Rule 204-2 of the Advisers Act (the recordkeeping rules) is amended to reflect the retention of certain documents required pursuant to new Rule 204A-1 of the Advisers Act. As amended, Rule 204-2(a)(12)(i)-(iii) requires advisers to keep the following:

- Copies of their code of ethics;<sup>49</sup>
- Records of violations of the code of ethics and actions taken as a result of the violations;<sup>50</sup> and
- Copies of their supervised persons' written acknowledgement of receipt of the code of ethics.<sup>51</sup>

As amended, Rule 204-2(a)(13)(i)-(iii) requires advisers to keep the following:

- Records of access persons' personal trading – initial, annual, and quarterly, including any information provided under Rule 204A-1(b)(3)(iii) in lieu of such reports;
- A record of the names of the adviser's access persons;<sup>52</sup> and
- Records of decisions, and the reasons supporting the decision to approve an access persons' acquisition of securities in IPOs or limited offerings.<sup>53</sup>

Such documents retained pursuant to new Rule 204A-1 of the Advisers Act must be maintained for five (5) years, in an easily accessible place, the first two years in an appropriate office of the adviser.

Furthermore, the SEC *strongly expects* most advisers to maintain records of access persons' personal securities reports (and duplicate brokerage confirmation or account statement in lieu of

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<sup>48</sup> Fed. Reg. at 41700-41701.

<sup>49</sup> The code of ethics must be kept for five (5) years after the last date the code was in effect.

<sup>50</sup> The SEC suggests that an adviser record the facts and circumstances surrounding a violation of the code of ethics but omit mention of the employee who brought the problem to the adviser's attention. Fed. Reg. at 41701, note 62.

<sup>51</sup> Supervised person acknowledgements of the code of ethics must be kept for five (5) years after an individual ceases to be a supervised person. Fed. Reg. at 41701.

<sup>52</sup> The list of access persons must include every persons who was an access person at any time within the past five (5) years, even if some of them are no longer access persons of the adviser. Fed. Reg. at 41701.

<sup>53</sup> Records related to the decision approving an access persons' acquisition of IPOs or limited offerings must be kept for at least five (5) years after the end of the fiscal year in which the approval is granted. See amended Rule 204-2(a)(13)(iii) of the Advisers Act. Fed. Reg. at 41701, note 65.

such reports) to be maintained electronically in an accessible computer database.<sup>54</sup> The SEC believes that by maintaining the records of personal securities transactions in an electronic database, the adviser will be able to meet its responsibility to review such records and to monitor compliance with its code of ethics.

## **VII. Disclosure of Code of Ethics in Part II of Form ADV**

The SEC is amending Part II of Form ADV to require registered investment advisers to describe their codes of ethics to clients and, upon request, to furnish clients with a copy of the code of ethics.<sup>55</sup> The SEC's rationale for this new requirement is two-fold: first, the disclosure in Part II of Form ADV will help clients understand the adviser's ethical culture and standards, how the adviser controls sensitive information and what steps it has taken to prevent employees from misusing their inside positions at its clients' expense.<sup>56</sup> Second, the disclosure will act as "sunlight" which will have the effect of encouraging advisers to implement more effective procedures by exposing them to view and by encouraging advisers to adhere strictly to the procedures they disclose.<sup>57</sup>

## **VIII. Insider Trading**

The SEC is not requiring advisers to adopt specific provisions to address the dissemination of material nonpublic information. Although a code of ethics is not required by statute to contain a section covering insider trading, in Release IA-2256, the SEC explicitly stated that it "remind[s] advisers that they must maintain and enforce policies and procedures to prevent the misuse of material nonpublic information, which we believe includes misuse of material nonpublic information about the advisers securities recommendations, and client securities holdings and transactions."<sup>58</sup> Furthermore, the SEC stated that an adviser's duty of care requires advisers to safeguard material nonpublic information.<sup>59</sup> Accordingly, an adviser's code of ethics must address what constitutes material nonpublic information and how the adviser intends to control the dissemination of material nonpublic information by its employees with respect to client recommendations, trading, and holdings.

Note that Section 204A of the Advisers Act already requires advisers to maintain procedures reasonably designed to prevent the misuse of material nonpublic information. Procedures prepared pursuant to Section 204A generally contain a summary of insider trading law and procedures for determining whether information has become public. According to the SEC, an adviser may choose to integrate its Section 204A procedures into the code of ethics.<sup>60</sup>

## **Impact on Hedge Fund Managers**

Hedge fund managers that are currently registered as investment advisers with the SEC already must comply with Rule 204-2(a)(12) and with Section 204A of the Advisers Act. Accordingly registered hedge fund managers presumably have already implemented policies and procedures to require their advisory representatives to submit personal securities transaction reports on a

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<sup>54</sup> Fed. Reg. at 41701.

<sup>55</sup> Fed. Reg. at 41701.

<sup>56</sup> Fed. Reg. at 41701.

<sup>57</sup> Fed. Reg. at 41701.

<sup>58</sup> Fed. Reg. at 41697.

<sup>59</sup> Fed. Reg. at 41697.

<sup>60</sup> Fed. Reg. at 41697, note 10.

quarterly basis and have adopted policies and procedures addressing insider trading. As such, compliance with new Rule 204A-1 should not be burdensome to them since the code of ethics is essentially an extension and an enhancement of current obligations. Registered hedge fund managers will only have to tailor their pre-existing policies and procedures to reflect the requirements under new Rule 204A-1.

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If you have any questions or comments regarding compliance with new rule 204A-1 of the Advisers Act or with drafting a code of ethics, please feel free to contact:

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