

March 12, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609
Re: File No. S7-04-04 - Proposed Rules: Codes of Ethics of Investment
Advisers

Dear Secretary Katz:

The National Society of Compliance Professionals (“NSCP”) appreciates the opportunity to comment on proposed Rule 204A-1 (the “Proposed Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) proposed by the Securities and Exchange Commission (the “Commission”) that would require investment advisers registered with the Commission to adopt codes of ethics. Under the Proposed Rule, advisers’ codes of ethics would set forth standards of conduct expected of advisory personnel, safeguard material nonpublic information about client transactions, and address conflicts that arise from personal trading by advisory personnel. Among other things, the Proposed Rule would require advisers’ supervised persons to report their personal securities transactions, including transactions in shares of investment companies managed by the adviser and would require advisers’ access persons to obtain approval before investing in an initial public offering (“IPO”) or limited offering; and would impose certain reporting and recordkeeping and disclosure requirements.¹ The Proposed Rule would also make certain conforming changes to Rule 17j-1 (“Rule 17j-1”) under the Investment Company Act of 1940, as amended (the “Company Act”).²

NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, effective supervision, and oversight. The principal purpose of NSCP is to enhance compliance in the securities industry, including firms’ compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. An important mission of the NSCP is to instill in its members the importance of developing and implementing sound compliance programs across-the-board. Since its founding in 1987, NSCP has grown to over 1,250 members, and the constituency from which its membership is drawn is unique.

¹ Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2209, Investment Company Release No. 26337, File No. S7-04-04, (Jan. 20, 2004 (hereinafter “Release 2209)).

² 17 CFR 270.17j-1.

NSCP's membership is drawn principally from traditional broker-dealers, investment advisers, bank and insurance affiliated firms, as well as the law firms, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel, and the asset management members of NSCP span a wide spectrum of firms, including employees from the largest brokerage and investment advisory firms to those operations with only a handful of employees. The diversity of our membership allows the NSCP to represent a large variety of perspectives in the financial services industry.

The NSCP strongly supports the Commission's efforts to enhance and strengthen business standards and reinforce fiduciary standards associated with personal securities transactions by advisers and their employees. However, NSCP is concerned that the scope and requirements of the Proposed Rule and Rule 17j-1 be as nearly co-extensive as possible to avoid duplication, confusion, and regulatory gaps. In addition, NSCP is concerned that certain technical aspects of the Proposed Rule would interfere with legitimate business practices of advisers.

1. Standards of Conduct, Compliance with Laws, and Personal Trading Procedures

Release 2209 proposes that all advisers registered with the Commission adopt a code of ethics that, at a minimum, reflects the fiduciary obligations of the adviser and its employees, requires compliance with applicable federal securities laws, includes provisions reasonably designed to prevent inappropriate access to material nonpublic information, and imposes certain limitations on personal trading by advisers' access persons.³ The Commission has asked for comment on the elements that should be included by advisers in their standards for business conduct. The Commission has also asked for comment concerning the inclusion in the Proposed Rule of certain "best practices" relating to personal trading activities.⁴

NSCP believes that standards of business conduct are most effective as positive statements of the firm's ethical culture. As such, they should be broad, and should neither dwell on nor be limited to specific applicable legal requirements. Although laws and regulations establish minimum standards, ethical principles support a higher and different type of behavior – the "punctilio of honor" that fiduciary obligations are based upon.⁵ The experience of NSCP's members frequently shows that, to be effective, such statements must be addressed to the actual business context of individual firms. Accordingly, NSCP does not support the adoption of a specific standard of conduct for all codes. Indeed, NSCP believes that any such standard would amount to a mere formalism and lack substantive value.

On the other hand, NSCP does not believe that standards of business conduct should be narrowly confined to a specific aspect of business practice. As stated above, standards of business conduct should be broad statements of a firm's approach to doing business. As a result, NSCP supports a requirement that adviser's codes of ethics address all applicable laws and regulations.

Similarly, while it encourages advisory firms to include a broad array of controls and procedures for monitoring the personal securities transactions of employees, NSCP does not support the inclusion of any specific procedures in the Proposed Rule. Advisers should select an appropriate matrix of such controls, and should develop specific implementation requirements (such as timing, coverage areas, and any appropriate exemptions). However, both the controls

³ Release 2209, Proposed Rule § 275.204A-1(a).

⁴ Such practices include, for example, pre-clearance of transactions, blackout periods, holding periods and receipt of duplicate brokerage confirmations. Cite to text accompanying notes 23-27.

⁵ Cardozo, J., *Meinhard v. Salmon*, 249 N.Y. 458 at 464, 164 N.E. 545 at 546 (1928).

and their implementation should be carefully crafted to meet the risks presented by individual advisory businesses. Because of the great diversity among investment advisers⁶ NSCP does not believe that a single rule can be crafted that adequately addresses the potential conflicts of interests faced by this diverse group, while providing appropriate flexibility where the risk of a conflict is diminished by a firm's business model.⁷

Accordingly, NSCP suggests that, in crafting personal trading policies, advisers should consider the use of each of the best practices discussed in Release 2209 as well as the types of securities and transactions to which those controls should be applied.⁸ In this way, the legitimate interests of clients, firms and regulators in addressing potential conflicts of interest can be balanced with the legitimate interests of employees in making personal investment decisions. The Commission has taken a similar approach in rulemakings in a number of other areas, including proxy voting and compliance procedures generally.⁹

2. Protection of Material Nonpublic Information

NSCP strongly agrees that advisers should have strong policies and procedures addressing material nonpublic information as well as other confidential or client-sensitive information.¹⁰ Further, NSCP believes such policies and procedures are most effective when they are in writing and regularly distributed and explained to an adviser's staff.

The Proposed Rule imposes a "need to know" standard as the appropriate control over confidential client information. NSCP agrees that access to and distribution of confidential information must be controlled if confidentiality is to be respected and protected. In this context, "need to know" is a valuable principle that all advisers consider when developing policies and procedures. However, a "need to know" standard is not the only possible control, and in some

⁶ See H.R. Rep. No. 100-910, at 21-22 (Sep. 9, 1988) (recognizing that policies and procedures to prevent insider trading may reasonably differ among investment advisers, depending on the firm's operations, business structure, and the nature and scope of its business); Report of the Division of Investment Management, SEC, *Personal Investment Activities of Investment Company Personnel* at 4 (Sep. 1994) (noting that rule 17j-1 allows funds to tailor personal trading restrictions and procedures to the funds' circumstances because that flexibility puts the funds in the best position to oversee access persons' investment activities).

⁷ For example, advisers that invest in small capitalization equity securities should be expected to have strong procedures for employee transactions involving such securities, including pre-clearance and even a ban on investing in IPOs. NSCP does not believe, however, that such robust procedures would represent an appropriate balancing of interests for employees of advisers that invest exclusively in fixed-income securities.

⁸ See, Release 2209 at text accompanying notes 23-27.

⁹ See, Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Release No. 33-8188, 34-47304, IC-25922, Jan. 31, 2003.; and Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA – 2204; IC – 26299; File No. S7-03-03, Dec. 17, 2003.

¹⁰ NSCP believes that all clients of advisers (whether individuals, institutions or investment companies) are owed the same duty of confidentiality. Accordingly, NSCP believes that the same standards for maintaining confidentiality should apply under the Advisers Act and the Company Act. Moreover, NSCP believes that the obligation to respect and protect confidential and nonpublic information should extend to *both* transactional and holdings information.

circumstances may not be the most desirable approach.¹¹ Instead of establishing a single standard for all advisers and all contexts, NSCP believes that advisers should adopt safeguards that adequately prevent inappropriate dissemination of confidential client information. This approach would allow advisers to take into account their specific business context without undergoing the difficult and, perhaps, hollow process of determining whether a specific employee “needs” to know specific information.

This approach would have several advantages over the approach of the Proposed Rule. First, it would allow advisers to adopt processes that are tailored to their particular situations.¹² Second, by focusing on the efficacy of controls, it would avoid confusion and unproductive disputes over the meaning of “need to know.” Third, and important from a review and monitoring perspective, it would provide a focused and objective basis for evaluating an adviser’s practices.

This approach seems to have been partially anticipated in the Proposed Rule’s discussion of the definition of “access person”:

Organizations where employees have broad responsibilities, and where information barriers are few, may see a larger percentage of their staff subject to the reporting requirements. In contrast, organizations that keep strict controls on sensitive information may have fewer access persons.¹³

For these reasons, NSCP also does not support specific requirements concerning either the handling of material nonpublic information or the specific placement of a firm’s insider trading procedures within overall firm procedures, including a requirement that computer and other files containing nonpublic information be specifically identified and segregated. Such a practice may be appropriate in some advisory businesses, but would prove to be unworkable in other businesses. Rather than prescribing specific one-size fits all practices, the Commission and advisers should focus on the broad fiduciary duty of advisers to protect all confidential client information. As there is a multitude of advisory contexts, so advisers must be free to adopt and adapt procedures that fit their risks and business. As with the adoption of codes of ethics, NSCP

¹¹ For example, “need to know” could be construed narrowly to mean that an individual employee could not be given access to information unless the information is required for that employee to direct (portfolio managers), effect (trading) or monitor (legal and compliance) a transaction for a client portfolio. If an employee were not responsible for directing, evaluating or monitoring a portfolio decision, she would not have, therefore, a “need to know” information related to a securities recommendation or client holding. However, such an interpretation would be difficult to implement for firms that have separated the portfolio management function from the securities research function. It would also be difficult to reconcile this interpretation with the legitimate business interest of advisers in developing and enhancing the skills and responsibilities of employees, and for supervising employees. On the other hand, it is easy to see how a broad interpretation of “need to know” would undermine the standard and render it meaningless. Differences between an adviser and the staff of the Commission over the correct scope of this standard would, predictably, lead to protracted and unproductive use of both the adviser’s and the staff’s time and resources. Seen in practice, a “need to know” rule is either overly broad or overly narrow.

¹² Compliance Programs of Investment Companies and Investment Advisers, SEC, Investment Company Act Release No. 26299, Feb. 5, 2003; and Compliance Programs of Investment Companies and Investment Advisers, SEC, Investment Company Act Release No. 25925, Feb. 5, 2003.

¹³ Release 2209 at text accompanying Note 30.

believes that the emphasis should be on the seriousness with which risks are addressed and on the appropriateness of the practices employed, not on ritualistic formulations.

3. Coordination with Section 17j-1 of the Company Act

As noted above, NSCP believes that the requirements of advisers under the Proposed Rule and Rule 17j-1 under the Company Act should be, as nearly as practical, identical. Accordingly, NSCP urges the Commission to make parallel changes to Rule 17j-1 in the event that it should adopt Rule 204A-1 with changes from the Proposed Rule. For example, the types of securities subject to Rule 17j-1 (a “Covered Security”) and the Proposed Rule (a “Reportable Security”) should be co-extensive.¹⁴ Similarly, the standards for determining whether a specific individual is covered by the Proposed Rule (an “Access Person”) and Rule 17j-1 (“Advisory Person”) should be determined by reference to the same factors.¹⁵

4. Definition of Access Persons

NSCP supports the definition of Access Persons as set forth in (e)(1)(i) of the Proposed Rule, and does not support the extension of the definition to include persons who are not supervised persons as defined in Section 202(a)(25) of the Advisers Act. By definition, these individuals are not under the supervision and control of the adviser, and the adviser will not, consequently, be in a position to require such persons to adhere to the requirements of its code of ethics or enforce compliance. Moreover, non-supervised persons who have access to confidential client information, such as broker-dealers and custodian banks, are already subject to similar requirements. Requiring advisers to provide additional supervision of such persons would, therefore, add little protection, but would be unduly burdensome to advisers and unnecessarily increase clients’ costs.

5. Application to Directors, Officers and Partners

With respect to that portion of the definition of Access Person contained in Section (e)(1)(ii) of the Proposed Rule, NSCP believes that there is a continuing need to provide an exemption from both Rule 17j-1 and the Proposed Rule for officers and directors who, due to the nature of the business of the adviser do not, in fact, have access to the type of information that both rules protect. The current exemption from Rule 17j-1 excludes those whose primary business is not advising funds or clients. NSCP believes that this exemption works well for large or integrated financial services companies, such as banks and insurance companies that happen to provide investment advice as an adjunct to their main business. However, such a test does not work well for groups of advisers organized as subsidiaries of financial holding companies, especially when a financial holding company holds advisory subsidiaries (or participates in joint ventures) formed under the laws of multiple nations.

NSCP believes that the concerns of both types of businesses could be more adequately addressed through the creation of a legal presumption that directors, officers and partners are

¹⁴ The Proposed Rule would exclude money market funds from the definition of Reportable Security, while no such exemption currently exists under Rule 17j-1. *See*, Rule 17j-1(a)(4).

¹⁵ The Proposed Rule focuses on whether a supervised person, in fact, has or has access to confidential information (*see*, Proposed Rule 204A-1(e)(1)(i)(A) contained in Release 2209), while Rule 17j-1 relates only to supervised persons “who, in connection with his or her regular functions or duties, makes or participates in making recommendations regarding the purchase or sale of securities by the Fund.” Rule 17j-1(a)(7)(i).

access persons subject to a showing that they, in fact do not have access to the type of information that Rule 17j-1 and the Proposed Rule seek to protect. In any case, NSCP believes that it is imperative that the same approach be used under both rules to avoid conflicting obligations.

6. Reporting of Investment Company Shares

The Commission has asked for comment on whether personal transactions in shares of unaffiliated investment companies should be exempt from the requirements of the Proposed Rule. NSCP shares the Commission's view that transactions in such securities do not generally pose the types of risks associated with transactions in shares of affiliated investment companies. Accordingly, NSCP does not believe that transactions in shares of unaffiliated investment companies should be subject to the Proposed Rule. However, NSCP does believe that the business models of certain types of investment advisers may create a risk of conflict with respect to transactions in shares of unaffiliated investment companies.¹⁶ As a result, NSCP believes that firms should consider whether their business models involve a potential conflict of interest with respect to unaffiliated investment companies and adopt controls appropriate to any such risks.

NSCP also agrees that certain types of investment companies, such as money market funds, funds whose holdings track well-established market indices¹⁷ and exchange traded funds pose little risk of abuse. Accordingly, NSCP supports the exemption of such funds from the reporting requirements of the Proposed Rule.

NSCP also believes that a risk of misusing information exists whenever a supervised person has access to transactional *or* holdings information concerning a portfolio. Accordingly, NSCP also supports the Proposed Rule's inclusion of individuals who obtain information about existing securities holdings in the definition of Access Person and supports the amendment of Rule 17j-1 to include such individuals.¹⁸

7. Initial Public Offerings and Limited Offerings

NSCP agrees that, in some circumstances, investment in an IPO or limited offering may involve a conflict of interest between an adviser (including its employees) and its clients. Thus, clients have a legitimate interest in restricting the investment activities of advisers and their employees. NSCP also recognizes that IPOs and limited offerings are legitimate investment opportunities for advisers and their employees. NSCP believes that where a conflict exists between the legitimate interests of an adviser and its clients, the interests of the client are

¹⁶ For example, NSCP understands that some advisers recommend investment by their clients in shares of investment companies managed by other, unaffiliated, advisers. In the process of conducting research and developing recommendations with respect to such investments, such advisers may receive access to material nonpublic information about an investment company. In some circumstances, such adviser's recommendations may result in transactions of a magnitude sufficient to affect the performance of a subject investment company.

¹⁷ Such investment companies are generally referred to as "index funds." Index funds pose little risk of abuse because their holdings are known or readily available to the public, and because pricing and valuation information is standardized. However, index funds may also include funds that (i) track small, or "constructed," indices; and (ii) track the performance of an index, but not its holdings. NSCP does not believe that such investment companies provide sufficient structural protection from abuse to warrant an exception from the Proposed Rule.

¹⁸ NSCP recognizes that such a requirement will result in the vast majority of most advisers' employees being deemed to be access persons.

primary. Nonetheless, NSCP does not believe that employees of all advisers should be prohibited from investing in IPOs or limited offerings.

The Commission has noted that the businesses of advisers are varied and the types and degrees of risk presented by those businesses are equally varied. For example, some advisers give advice exclusively with respect to fixed-income instruments, while others emphasize equity securities of small capitalization or emerging companies. The potential for conflict between these two types of businesses and their respective clients with respect to both IPOs and limited offerings is of different magnitudes. NSCP believes that an appropriate balancing of the interests of clients of these two types of businesses and the interests of the businesses themselves would and should result in different types of controls. For example, NSCP believes that advisers that give investment advice exclusively with respect to fixed-income instruments present a low risk of conflict with the interests of their clients and that a ban on personal investing in IPOs or limited offerings would be inappropriate. NSCP believes that other business models (e.g., advisers that advise clients to invest exclusively in investment companies managed by other advisers) present a similar low level of risk.

Because the risk of conflict between clients and advisers varies greatly and because of the great variation of business models among advisers, NSCP does not believe that the Proposed Rule should prohibit all advisers and their Access Persons from participating in initial public offerings or limited offerings. Instead, NSCP believes that advisers should assess the nature and level of the risk of conflict that is presented by such investments and should craft procedures that are appropriate to that risk.

8. Reporting of Violations

NSCP believes that all employees should be encouraged, as part of an adviser's business environment, to report actual and apparent violations of firm policies and procedures, especially those that may involve a breach of fiduciary duty. However, NSCP strongly opposes the mandatory reporting of "apparent" violations. Such a requirement could lead to liability for violation of firm policy and federal law in the absence of any underlying behavior that was inappropriate. Moreover, it may be difficult for experts to determine whether a particular set of facts constitutes a violation or the appearance of a violation. For non-expert employees, this burden would be so great as to render compliance impractical. For example, the proposed Rule provides that advisers' codes of ethics contain provisions requiring the firms' supervised persons to comply with applicable federal securities laws. If a requirement mandating the reporting of apparent violations of a firm's code of ethics were included within the Proposed Rule, it would be unreasonable to expect a supervised person who is not an attorney practicing in the securities area to be able to determine whether an apparent violation of the federal securities laws has occurred. NSCP believes that creating liability in such circumstances is fundamentally unfair and that the Proposed Rule should not require the reporting of apparent violations.

9. Other Code of Ethics Provisions

The Commission has requested comment on whether codes of ethics should include procedures dealing with receipt of gifts, service as a director of a public company, penalties for violating and adviser's code. NSCP believes that many of these provisions have merit, but that the decision whether to include them in a code of ethics (or another firm policy) and what their

content might be is best left to individual advisers to address in the context of their own businesses. Including such provisions in the Proposed Rule would also be inconsistent with the approach taken by the Commission in Rule 17j-1 Accordingly, NSCP does not support their inclusion in the Proposed Rule.

10. Recordkeeping

The Commission has requested comment on its understanding that requiring records to be kept in electronic format would not be burdensome.

Contrary to the Commission's assertion, the experience of NSCP members is that the development and maintenance of electronic systems for tracking personal securities transactions by employees is difficult, time consuming and expensive. Many NSCP members that have attempted to implement electronic recordkeeping systems report that significant manual intervention is required in order to create useful records and maintain the systems. While electronic recordkeeping is desirable, the technology is not so sufficiently developed that it should be imposed by regulatory fiat.

Moreover, this aspect of the Proposed Rule that could have a potentially disparate impact on smaller investment advisers registered with the Commission. NSCP understands that a majority of the more than 8,000 federally registered investment advisers are relatively small. Imposing on them the requirement of maintaining electronically in accessible computer database records of access persons' personal securities reports as well as duplicate brokerage confirmations or account statements in lieu of those reports will disproportionately affect such smaller advisers with limited resources or expertise to implement such systems.

In the absence of any assertion by the Commission that current recordkeeping systems are impractical or themselves subject to abuse, NSCP strongly opposes the inclusion in the Proposed Rule of any requirement concerning the form in which records should be kept.

11. Content of Holding Reports

Section (b)(1)(i)(A) of the Proposed Rule specifies holdings reports by Access Persons include the CUSIP number of each reportable security in which the access person has any direct or indirect beneficial ownership. Security identification codes significantly assist in monitoring and review compliance with transactions subject to a code of ethics, and NSCP supports their inclusion in the Proposed Rule. However, certain securities (especially securities of companies issued and traded outside the United States) do not have a CUSIP number but instead use a SEDOL, ISIN or similar identifier. In addition, certain markets do not utilize individualized alphanumeric securities codes. In recognition of this fact, NSCP suggests that the Proposed Rule be amended to require the recordation of an alphanumeric code (such as a CUSIP, SEDOL or ISIN) where available.

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Mr. Jonathan G. Katz
Securities and Exchange Commission
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The Commission's proposals on investment adviser code of ethics contain many positive elements, and we are pleased to support them. Questions regarding our comments or requests for additional information should be directed to the undersigned at (860) 672-0843.

Sincerely yours,

Joan Hinchman
Executive Director, President and CEO

cc via postal mail:

The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
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