IM Guidance Update

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PERSONAL SECURITIES TRANSACTIONS REPORTS BY REGISTERED INVESTMENT ADVISERS: SECURITIES HELD IN ACCOUNTS OVER WHICH REPORTING PERSONS HAD NO INFLUENCE OR CONTROL

Advisers are required, under section 204A of the Investment Advisers Act of 1940, 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 thereunder provides that an adviser's Code of Ethics must include requirements that certain advisory personnel report personal securities trading to provide a mechanism for the adviser and examiners to identify improper trades or patterns of trading. The rule was designed, in part, to prevent the misuse of material nonpublic information, including the misuse of material nonpublic information about a registered adviser's securities recommendations, and client securities holdings and transactions. The staff receives questions from time to time about the rule's application in certain scenarios. Through this guidance, the staff expresses its views on the application of the rule in the context of certain advisory personnel's trusts and third-party discretionary accounts.

Rule 204A-1 specifically provides that a registered investment adviser must establish, maintain, and enforce a written code of ethics that requires, among other things, its directors, officers and partners and its supervised persons who have access to nonpublic information regarding securities transactions (together "access persons") to report their personal securities holdings and transactions. Subsection (b)(3)(i) of the rule (the "reporting exception"), however, provides an exception to these reporting requirements when an access person's securities are held in accounts over which he or she had "no direct or indirect influence or control."

The staff believes that blind trusts, for example, can be established such that an access person would have no direct or indirect influence or control. A blind trust is typically a legal arrangement in which a trustee manages funds for the benefit of somebody (*e.g.*, an access person) who has no knowledge of the specific management actions taken by the trustee and no right to intervene in the trustee's management.

The staff has received questions regarding the application of the rule in certain scenarios, and the Office of Compliance Inspections and Examinations has encountered situations in which advisers have asserted that other types of access persons' trusts qualify for the reporting exception when the access person (a) is a grantor or beneficiary of a trust managed by a third-party trustee and (b) has limited involvement in trust affairs. Similarly, advisers have asserted that access persons' personal accounts qualify for the reporting exception when a third-party manager has discretionary investment authority over those access persons' personal accounts. These advisers assert that these types of trusts and discretionary accounts are akin to a blind trust in terms of an access person's influence or control.

The staff believes that the fact that an access person provides a trustee with management authority over a trust for which he or she is grantor or beneficiary, or providing a third-party manager discretionary investment authority over his or her 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 exception.

With respect to determining whether an access person had direct or indirect influence or control, the staff notes that an access person providing a trustee with management authority or a third-party manager with discretionary investment authority over an account would not prevent the access person from, for example:

- suggesting purchases or sales of investments to the trustee or third-party discretionary manager;
- directing purchases or sales of investments; or
- consulting with the trustee or third-party discretionary manager as to the particular allocation of investments to be made in the account.

The staff believes that an access person's discussions with the trustee or third-party discretionary manager concerning account holdings may also, in certain circumstances, reflect direct or indirect control or influence. However, the staff also believes that discussions in which a trustee or third-party manager simply summarizes, describes, or explains account activity to an access person, without receiving directions or suggestions from the access person, would not implicate influence or control by the access person over that account.

Although the fact that a trustee or a third-party manager has management or discretionary investment authority over an access person's trust or personal account would not, by itself, enable an adviser to rely on the reporting exception, the staff also believes that the adviser may be able to implement additional controls to establish a reasonable belief that an access person had no direct or indirect influence or control over the trust or account and could accordingly rely on the exception. In the staff's view, such policies and procedures should be reasonably designed to determine whether the access person actually had direct or indirect influence or control over the trust or account, rather than whether the third-party manager had discretionary or non-discretionary investment authority. Advisers may consider, for example:

- obtaining information about a trustee or third-party manager's relationship to the access person (*i.e.*, independent professional versus friend or relative; unaffiliated versus affiliated firm);
- obtaining periodic certifications by access persons and their trustees or discretionary third-party managers regarding the access persons' influence or control over trusts or accounts;
- providing access persons with the exact wording of the reporting exception and a clear definition of "no direct or indirect influence or control" that the adviser consistently applies to all access persons; and
- on a sample basis, requesting reports on holdings and/or transactions made in the trust or discretionary account to identify transactions that would have been prohibited pursuant to the adviser's code of ethics, absent reliance on the reporting exception.

Moreover, with respect to certifications, the staff believes that obtaining general certifications, alone, would likely be insufficient to establish that an access person did not exercise direct or indirect influence or control over a trust or discretionary account. For example, a general certification from an access person may not be reasonably designed to establish that the access person indeed did not *exercise* direct or indirect influence or control over that trust or account. Advisers may consider obtaining more specific certifications from the access person by asking such questions as:

- "Did you suggest that the trustee or third-party discretionary manager make any particular purchases or sales of securities for account X during time period Y?"
- "Did you direct the trustee or third-party discretionary manager to make any particular purchases or sales of securities for account X during time period Y?"

- "Did you consult with the trustee or third-party discretionary manager as to the particular allocation of investments to be made in account X during time period Y?"

The staff encourages advisers to consider this guidance when determining whether an access person had direct or indirect influence or control over a trust or account for purposes of relying on the reporting exception.

IM Guidance Updates are recurring publications that summarize the staff's views regarding various requirements of the federal securities laws. The Division generally issues *IM Guidance Updates* as a result of emerging asset management industry trends, discussions with industry participants, reviews of registrant disclosures, and no-action and interpretive requests.

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- ▲ promote informed investment decisions and
- ▲ facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

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