



ASSOCIATION FOR
INVESTMENT MANAGEMENT
AND RESEARCH[®]

CHARLOTTESVILLE • HONG KONG • LONDON

560 Ray C. Hunt Drive • P.O. Box 3668
Charlottesville, VA 22903-0668 USA
Tel: 434-951-5499 • Fax: 434-951-5262
Email: info@aimr.org • Internet: www.aimr.org

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Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20459-0609

Re: Investment Adviser Codes of Ethics – File No. S7-04-04

Dear Mr. Katz:

The Standards of Practice Council (SPC) of the Association for Investment Management and Research[®] (AIMR[®])¹ appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC) proposed rule 204A-1 to require investment advisers registered with the SEC to adopt and enforce codes of ethics. The SPC is a standing committee of AIMR responsible for developing, maintaining, and interpreting the AIMR *Code of Ethics* and *Standards of Professional Conduct* (Code and Standards). The committee responds to new regulatory, legislative, and other developments in the United States and globally relating to standards of practice that affect the investment profession, the practice of investment analysis and management, and the efficiency of financial markets.

As proposed in rule 204A-1, each investment adviser registered with the SEC would be required to adopt codes of ethics that would set forth standards of conduct expected of advisory personnel, safeguard material nonpublic information about client transactions, and address conflicts of interest that arise from personal trading by advisory personnel. The proposal would require the codes of ethics to contain provisions mandating that certain advisory personnel comply with a number of specific compliance procedures relating to personal trading. The proposal would also require that codes of ethics include provisions to ensure their effectiveness.

I. Summary of Position

The SPC supports requiring registered investment advisers to adopt a code of ethics that enumerate standards of conduct for employees of investment advisers with the following comments:

¹ With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, the Association for Investment Management and Research[®] is a non-profit professional association of more than 69,000 financial analysts, portfolio managers, and other investment professionals in 116 countries of which 56,647 are holders of the Chartered Financial Analyst[®] (CFA[®]) designation. AIMR's membership also includes 127 Member Societies and Chapters in 46 countries.

- The codes of ethics must clearly and plainly communicate to employees of investment advisers the basic fiduciary concepts that must be followed for the advisory firm and its personnel to meet high ethical standards of conduct. The SPC does not believe that a code of ethics should include specific compliance procedures. Advisory firms must also adopt appropriate compliance procedures to implement the codes' principles, but these detailed procedures should not be part of the codes themselves.
- Codes of ethics must apply to all employees of registered investment advisers. Only when the codes apply to everyone will the firm inculcate in its employees the need for ethics and integrity. When firms define who and who is not covered by a code of ethics, there is an increased opportunity for confusion and for selectivity in applying the principles of the code. It is not less important for administrative and clerical staff to understand that investing clients' needs come first, than it is for those who interact directly with clients. It would be appropriate for firms in implementing their codes to develop compliance procedures designed for specific actions by and applicable to different job functions.
- There are several ethical concepts missing from the proposed rule that should be required in the codes of ethics, especially with respect to communication with clients. These concepts include suitability, disclosure of conflicts of interest, and prohibition against misrepresentation.
- We support the SEC proposal requiring registered investment advisers to implement procedures to ensure that the codes of ethics are effective (such as reporting of violations, acknowledging receipt of the code). However, we do not believe these provisions belong in the codes of ethics themselves; rather they should be part of the compliance procedures.

We discuss these positions in more detail below.

II. Discussion

As a general matter we support the SEC's efforts to require registered investment advisers to adopt a code of ethics. AIMR has historically encouraged its members to recommend that their employers adopt the AIMR Code and Standards on a firm-wide basis. We agree with the SEC that adoption of a code of ethics is critical to establishing a strong ethical foundation for investment adviser firms and their employees. Codes of ethics formally emphasize and reinforce the fiduciary duties of investment adviser personnel, protect investing clients by deterring misconduct, and protect the firm's reputation for integrity.

Since 1962, AIMR has had a Code and Standards which apply to all AIMR members and candidates for the Chartered Financial Analyst[®] (CFA[®]) designation. We believe that the Code and Standards contains all of the necessary elements that should be adopted by an investment

adviser. We recommend that the SEC either urge investment advisory firms to adopt the AIMR Code and Standards or base their own codes of ethics on the relevant requirements found therein.

AIMR is a global professional organization; its members and candidates live and work in many different countries and are subject to many different securities regulation regimes. AIMR members and candidates also serve in a wide variety of job functions within the investment profession; their work is not limited to employment as investment advisers or financial analysts. The AIMR Code and Standards, therefore, focuses on more than one aspect of the investment industry, such as providing investment advice. Its must contain requirements that cover all of the responsibilities an investment professional might have within the investment profession. Nevertheless, we believe that the Code and Standards addresses the ethical issues faced by anyone engaged in the practice of investment management or giving investment advice.

A. Codes of Ethics Should be Comprised of Broad, Principle-Based Concepts, Not Specific Compliance Procedures

As a general matter, we believe there is a distinction between codes of ethics and the necessary specific policies and procedures needed to ensure compliance with securities laws and regulations. Codes of ethics should be comprised of fundamental, principle-based, ethical and fiduciary concepts that can be applicable to all of the firm's employees. In this way, investment advisory firms can best convey to employees and clients the ethical ideals that investment advisers strive to achieve. These concepts can then be implemented by detailed, firm-wide compliance policies and procedures. Compliance procedures will assist the investment adviser's personnel in fulfilling the responsibilities enumerated in the code of ethics and ensure that the ideals expressed in the code of ethics are adhered to in the day-to-day operation of the firm.

Throughout the SEC's proposal, the same question appears in different forms: "Should the SEC mandate that adviser codes of ethics contain *such procedures*?" We believe that commingling compliance procedures in the adviser's code of ethics will diminish the goal of the Commission to reinforce with advisers and their employees their ethical obligations attendant to their fiduciary duty to clients. Standalone codes of ethics should be written in plain English and address general fiduciary concepts, unencumbered by numerous detailed procedures directed to the day-to-day operation of the firm. In this way codes will be most effective in reinforcing to employees that they are in positions of trust and must act with integrity at all times.

Separating the codes of ethics from compliance procedures will also reduce, if not eliminate, the legal terminology and boilerplate language that often make the underlying ethical principles incomprehensible to the average person. Above all, the principles in the codes of ethics must be accessible and understandable to everyone in the investment adviser firm to ensure that a culture of ethics and integrity is created rather than merely a focus on attention to the rules. We would hope that rule 204A-1 would engender decision-making and actions with an investment advisory firm that reflects a willingness to live by the spirit of the code of ethics rather than the letter of compliance procedures.

In addition, we note that the SEC is proposing to amend Part II of Form ADV to require advisers to describe their codes of ethics to clients and, upon request, to furnish clients with a copy of the code of ethics. This disclosure is aimed at helping clients understand the ethical culture and standards at the firm. We support these proposals and believe that codes of ethics should be fully disclosed to clients. However, we believe that only simple, straightforward codes of ethics will be understandable to clients and, consequently, effective in conveying the message that the firm is committed to conducting business in an ethical manner and in the best interest of the clients. We believe that the average client's eyes will glaze when presented with a code of ethics that refers to "supervised persons" and "access persons" that are subject to "pre-clearance," "restricted lists," "blackout periods," and "short-swing" limitations.

Our belief that the Codes of Ethics required by Rule 204A-1 should be general in nature does not mean that we believe investment advisers should not be subject to the compliance procedures set forth in the SEC's proposal. On the contrary, AIMR has long recommended many of the same compliance procedures set forth in the proposal, especially with regard to the conflicts of interests associated with personal transactions.

While we do not argue with the substance of the proposed compliance procedures outlined in the proposal, we believe they are more appropriate for inclusion in Rule 206(4)-7 that requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. As it currently stands, Rule 206(4)-7 does not require specific compliance procedures. However, we recommend that rule 206(4)-7 be expanded to require that investment advisers adopt and implement policies and procedures reasonably designed to prevent violations of the adviser's Code of Ethics required by 204A-1 as well as violations of federal securities laws.

As an example of the respective roles of codes of ethics and compliance procedures and the relationship between the two, we recommend the SEC consider the issue of personal trading by investment adviser personnel. We believe that all investment advisers should establish, as an operating principle, the broad concept that investment actions for clients must have priority over any investment transactions in which the investment adviser or its employees have a beneficial interest. The personal transactions of investment adviser employees must not operate adversely to clients' interests.

To translate this concept into specific action that will ensure that the employees of the investment adviser adhere to this principle, the firm must adopt compliance procedures such as those proposed by the SEC; e.g., pre-clearance of trades, restricted lists, blackout periods, investment opportunities, short term trading, limiting brokerage accounts, duplicate trade confirmations, etc. However, the procedures themselves would not be included in the code of ethics so as not to dilute or veil the fundamental principle that the client interests come first when dealing with conflicts related to personal investing. The procedures proposed in Rule 204A-1 that the SEC deems fundamental and universally applicable should be incorporated into 206(4)-

7. In addition, advisers should be required to adopt whatever additional compliance procedures would be most effective for the firm in ensuring compliance with its code of ethics.

B. Codes of Ethics Should Apply to All Employees of Investment Advisers

Under the SEC proposal, codes of ethics would apply to “supervised persons” of registered investment advisers and certain other provisions would apply only to a subcategory of “access persons.” The SEC seeks comments regarding whether the definition of access persons is too broad or too restrictive and whether it should include “related persons” outside the employment of the adviser.

We recommend that the SEC significantly simplify the requirements of the codes of ethics and broaden their applicability to all employees of the investment adviser. We believe all employees of investment advisers should be made aware of and adhere to the fundamental ethical principles governing investment advisers and found in codes of ethics.

While we agree that investment advisers must make clear who is covered by that firm’s code of ethics, we believe the use of defined terms is cumbersome and will defeat the purpose of codes of ethics – to remind employees of the fiduciary obligations. Determining who is a “supervised person,” who is in the subset of “access persons,” will confuse employees seeking guidance regarding their ethical responsibilities. We are concerned that at best, users will be bogged down in broad, complicated, and overlapping definitions; at worst, users will find ways to exclude themselves from coverage. We believe that if the principles in the code of ethics are appropriately crafted it would be in a firm’s best interests for all employees to abide by the code.

As the SEC proposal points out, the definition of an “access person” is not limited to investment professionals, and that “administrative, technical, and clerical personnel may also be “access persons” if their functions or duties make them privy to information about investment recommendations or actions whose effect may not yet be felt by the marketplace.” Depending on the adviser’s size, organization, and procedures, it is very likely that the SEC proposal would define most, if not all employees as access persons.

Broad application of the Code to all employees of an investment adviser will facilitate understanding by employees, enforcement by the firm, and maximize client protection. The firm can define “access person,” “securities,” “beneficial ownership” and other terms in the compliance procedures but the overarching concepts should cover everyone so that they are put on notice that they have responsibility for achieving concepts in code. Firms may then consider extending compliance procedures to some group of employees defined as “access persons,” or to all employees.

C. Codes of Ethics Should Contain Required Elements in Addition to Those Proposed by the SEC.

We support the SEC's effort to draft rule 204A-1 broadly so that each adviser will be able to develop a code of ethics compatible to the nature of its business. We agree that investment advisers are too varied in their operations for rules to impose a single set of required procedures to protect client interests. However, we believe that all investment advisers are subject to universally applicable fiduciary principles that can be enumerated in a Code of Ethics. The SEC's proposal identifies several business conduct standards that reflect the fiduciary obligation of advisers and their employees including: mandatory compliance with the law, and protecting the confidentiality of client information, subordinating personal transactions to client interests.

However, we recommend that, so long as the Codes of Ethics are not required to include procedural detail (See Section II(A) of this letter), Rule 204A-1 should include more required elements.

For instance, while the proposal addresses safeguarding of client information, nothing in the SEC proposal requires inclusion of ethical principles addressing communication or disclosure of information to clients. Establishing clear, adequate communication with clients is fundamental to the investment management profession. The majority of enforcement proceedings brought by the SEC result from a firm's failure to disclose information or adequately communicate with clients. Codes of ethics should set forth business conduct standards relating to client communication. Required topics should include:

Misrepresentation: Codes of ethics should state that investment adviser employees must not knowingly make any statement that misrepresents facts relating to investment analysis, recommendations, actions, or other professional activities.

Suitability: Codes of Ethics should require that investment advisers a) make a reasonable inquiry into clients and prospective clients' investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly; b) determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action; c) judge the suitability of investments in the context of the client's total portfolio.

Explaining the Investment Process: Codes of ethics should require that investment advisers a) disclose to clients and prospective clients the basic format and general principles of the investment processes by which investments are analyzed, securities are selected, and portfolios are constructed and must promptly disclose any changes that might materially affect those processes; and, b) distinguish between facts and opinions in the presentation of investment analysis and recommendations.

Diligence and Reasonable Basis: Codes of ethics should require that investment adviser personnel a) exercise diligence, independence and thoroughness in conducting investment analysis, making investment recommendations, and taking investment actions; and, b) have a

reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, and action.

Disclosure of Conflicts of Interest: To the extent that conflicts of interest cannot reasonably be avoided, the codes of ethics should require that investment adviser personnel make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their respective duties to their employer, clients, and prospective clients. Codes should require that firms ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively. It is insufficient to disclose conflicts to “designated persons” at the firm to determine if a conflict exists and, if so, how it affects the employees’ duty to clients. Such a disclosure should be made directly to the client so that the client can assess what effect, if any, the conflict has on the investment advice or recommended course of action. Such disclosures would include any fee or compensation arrangement that has the potential to bias investment advice towards a particular investment.

Performance Presentation: Codes should require that when communicating investment performance information, investment adviser employees must make reasonable efforts to ensure that it is fair, accurate, and complete.

Other fundamental concepts that should be in a firm’s code of ethics but are not related to client communication include:

Loyalty, Prudence, and Care: Codes should require that investment adviser employees act for the benefit of their clients and place their investing clients’ interests before their employer’s or own interests. Investment advisers and their employees have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment when acting on behalf of their clients.

Independence and Objectivity: Codes should require employees to use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Employees must not offer, solicit, or accept any gift, benefit, compensation or consideration that could be reasonably expected to compromise their own or another’s independence and objectivity.

Fair Dealing: Codes should require that employees deal fairly and objectively with all clients and prospective clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities

Material Nonpublic Information: Investment advisers should include in their codes that employees who possess material nonpublic information that could affect the value of an investment must not act, or cause others to act, on the information.

Market Manipulation: Codes should prohibit investment advisers employees from engaging in practices that distort security prices or artificially inflate trading volume with the intent to mislead market participants.

We believe these concepts are fundamental to providing ethical investment advice and are universally applicable to all investment adviser firms. Although many of these requirements are covered elsewhere in securities regulation, proposed rule 206(4)-7 requiring firms to adopt codes of ethics containing these elements will go a long way to conveying ethical responsibilities to investment adviser employees and establishing baseline standards of conduct. The SEC should require that investment advisers separately adopt compliance procedures that will implement these principles.

D. The SEC Should Require Provisions to Increase Effectiveness of Codes of Ethic, Separate from the Codes Themselves

We agree with the SEC that additional requirements are needed to enhance the effectiveness of the codes of ethics. These should include:

- Requiring employees to promptly report violations or apparent violations to appropriate designated persons within the firm.
- Requiring firms to provide copies of their code of ethics to employees.
- Requiring firms to adopt policies and procedures that educate employees about the code of ethics and to advise employees of any changes.
- Requiring employees to certify in writing that they have received, read, and understand a copy of the code of ethics.

However, we do not believe these administrative provisions should be included in the codes of ethics themselves. As stated in Part II(A) of this comment letter, codes of ethics should contain broad-based ethical principles. Procedures designed to implement the principles of the code and increase effectiveness are necessary but should be separate from the code of ethics so as not to detract from the code's basic message. This will allow employees and clients the review the code and easily comprehend and appreciate the ethical culture of the firm.

III. Conclusion

In summary, the SPC fully supports the SEC's efforts to require registered investment advisers to adopt and enforce a code of ethics that set forth standards of conduct. We hope the SEC takes this opportunity lead investment advisers "back to basics" of their fiduciary responsibility by requiring codes of ethics, that are applicable to all investment adviser employees and that enumerate universally applicable ethical principles. We also support the SEC's effort to require that firms establish compliance procedures and other requirements that put teeth behind principles. However, we believe that compliance procedures themselves should not be included

in the firm's code of ethics. The SEC should separately mandate compliance procedures, perhaps as part of Rule 206(4)-7 requiring the establishment of a compliance program.

AIMR and the Standards of Practice Council appreciate the opportunity to comment on the SEC's proposal. If you or your staff have questions or seek amplification of our views, please feel free to contact Ray DeAngelo by phone at 1.434.951.5340 or by e-mail at ray.deangelo@aimr.org.

Sincerely,

/s/ Lee N. Price

Lee N. Price, Ph.D., CFA
Chair, Standards of Practice Council

/s/ Raymond DeAngelo

Raymond DeAngelo
Executive Vice President, AIM