

**PUBLIC**

ACT 1AA  
SECTION \_\_\_\_\_  
RULE 204-2(a)(12)  
PUBLISHED 8/8/97  
AVAILABILITY \_\_\_\_\_

RESPONSE OF THE OFFICE  
OF THE CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 97-348-CC  
LNC Equity Sales  
Corporation  
File No. 801-42530

Your letter of November 1, 1996 requests our assurance that we would not recommend enforcement action to the Commission under Rule 204-2(a)(12) under the Investment Advisers Act of 1940 (the "Advisers Act") if LNC Equity Sales Corporation (the "Adviser"), an investment adviser registered with the Commission, does not make and keep books and records of personal securities transactions of advisory representatives in shares of registered open-end investment companies, variable annuities and variable life insurance products ("variable insurance products"), including those issued by affiliates of the Adviser.

You state that the Adviser is a wholly owned subsidiary of Lincoln Financial Group, Inc., which is a wholly owned subsidiary of Lincoln National Corporation. You state that the Adviser's principal business is as a broker-dealer marketing mutual funds, limited partnerships, unit investment trusts and coins/precious metals, and providing asset management and investment timing services. The Adviser is affiliated with certain entities, including The Lincoln National Life Insurance Company ("LNL"), a broker-dealer, registered investment adviser, insurance company and pension consulting firm. You state that the Adviser and/or its affiliates are investment advisers or investment sub-advisers to certain registered open-end investment companies, the shares of which are sold to separate accounts of LNL to support variable annuity and variable life insurance contracts issued by LNL.

Rule 204-2(a)(12) generally requires an investment adviser to maintain a record of every transaction in a security in which the adviser or any of its advisory representatives (as defined in the rule) has, or by reason of such transaction acquires, direct or indirect beneficial ownership. A purpose of the rule is to deter advisers and advisory representatives from engaging in certain practices, including scalping, which could result in the violation of the fiduciary obligations that advisers owe to their clients.<sup>1</sup> Scalping is a practice whereby a person who obtains

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<sup>1</sup>Paragraph (a)(12) of Rule 204-2 was adopted to help implement, among other things, the prohibitions set forth in Section 206(4) of the Advisers Act against fraudulent, deceptive or manipulative practices. See Investment Advisers Act Release No. 203 (Aug. 11, 1966) (adopting paragraph (a)(12) of Rule 204-2); and Investment Advisers Act Release No. 197

(footnote continued)

information concerning securities recommendations being made by an investment adviser, prior to the dissemination of such information, trades on the anticipated short-run market activity which may ensue from the issuance by the adviser of the securities recommendations.<sup>2</sup>

In a number of no-action letters, the staff has taken the position that it will not recommend enforcement action under Rule 204-2(a)(12) if an investment adviser does not make and keep records of transactions by the adviser and its advisory representatives in shares of unaffiliated open-end investment companies and interests in variable insurance products issued by unaffiliated separate accounts.<sup>3</sup> In *The Colonial Group, Inc.* (pub. avail. Mar. 10, 1988), the staff indicated that an adviser need not make and keep records of transactions by the adviser and its advisory representatives in shares of affiliated money market funds. Moreover, the Commission has proposed amendments to the rule that would except from the recordkeeping requirements of paragraph (a)(12) transactions in shares of open-end investment companies, without regard to whether the investment companies are affiliates of the adviser.<sup>4</sup> These positions are based primarily

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(Mar. 17, 1966) (proposing the addition of paragraph (a)(12)). "[A] person associated with an investment adviser who knows that he will have to report his transactions to the investment adviser may hesitate to effect a transaction inconsistent with the adviser's fiduciary obligations to clients . . . ." Investment Advisers Act Release No. 120 (Oct. 16, 1961) (also proposing paragraph (a)(12)).

<sup>2</sup>Investment Advisers Act Release No. 436 (Feb. 21, 1975). See also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), in which the Supreme Court held that scalping operates as a fraud or deceit upon any client or prospective client within the meaning of Section 206 of the Advisers Act.

<sup>3</sup>See, e.g., *Massachusetts Financial Services Company* (pub. avail. Oct. 6, 1992); *Lipper Analytical Services, Inc.* (pub. avail. June 5, 1990); *TransAmerica Advisors, Inc.* (pub. avail. Nov. 4, 1988) (excepting transactions in interests in variable insurance products); *Joshua, Lauren & Co. Inc.* (pub. avail. Oct. 11, 1988); and *The Boston Company, Inc.* (pub. avail. Apr. 27, 1987).

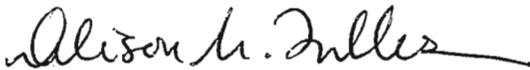
<sup>4</sup>Investment Advisers Act Release No. 1581 (Sept. 8, 1995) (the "release"). Footnote 70 to the release indicates that the staff currently takes the position that transactions in shares of affiliated open-end funds are exempt from the recordkeeping requirements. This position is consistent with the treatment of shares of registered open-end investment companies under Rule

(footnote continued)

on a determination that it is unlikely that scalping or any other improper trading practice would occur with respect to transactions in shares of open-end investment companies because there is no trading market for those shares.

We agree that, for purposes of the recordkeeping requirements of paragraph (a)(12) of Rule 204-2, there is no distinction between shares of an affiliated open-end investment company and an interest in a variable insurance product issued by an affiliated insurance company separate account.<sup>5</sup> A separate account is organized either as a managed open-end investment company or as a unit investment trust that invests in a managed open-end investment company.

On the basis of the facts and representations in your letter, we would not recommend any enforcement action to the Commission under Section 204 of the Advisers Act or Rule 204-2(a)(12) thereunder if the Adviser does not make and keep records regarding personal securities transactions of the Adviser or its advisory representatives in shares of registered open-end investment companies and interests in variable insurance products, including those issued by affiliates of the Adviser. You should note that any different facts or representations may require a different conclusion.



Alison M. Fuller  
Attorney

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17j-1 under the Investment Company Act of 1940 (the "1940 Act"). Rule 17j-1 requires, among other things, an investment company and its investment adviser to adopt a code of ethics that imposes certain reporting obligations with respect to transactions by their access persons (as defined in the rule) in securities in which the access persons have any direct or indirect beneficial ownership. Paragraph (e)(5) of the rule sets forth the definition of security for purposes of the reporting obligations of the rule, and excludes shares of open-end investment companies. Access persons are not required, therefore, to report transactions in shares of registered open-end investment companies.

<sup>5</sup>We note that, for purposes of the exclusion from the definition of security set forth in paragraph (e)(5) of Rule 17j-1 under the 1940 Act, there is no distinction between shares of open-end investment companies and interests in variable insurance products issued by insurance company separate accounts.

**STAMP AND RETURN**

**Sutherland, Asbill & Brennan, L.L.P.**  
ATLANTA • AUSTIN • NEW YORK • WASHINGTON

1275 PENNSYLVANIA AVENUE, N.W.  
WASHINGTON, D.C. 20004-2404

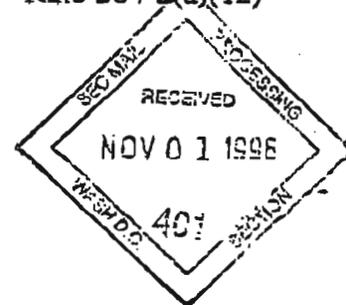
FREDERICK R. BELLAMY  
DIRECT LINE: (202) 383-0126  
Internet: fbellamy@sablaw.com

TEL: (202) 383-0100  
FAX: (202) 637-3593

November 1, 1996

Jack W. Murphy, Esq.  
Office of the Associate Director (Chief Counsel)  
Division of Investment Management  
Securities and Exchange Commission  
Room 10070, Mail Stop 10-6  
450 Fifth Street, N.W.  
Washington, DC 20549

ADVISERS ACT  
Rule 204-2(a)(12)



Dear Mr. Murphy:

On behalf of LNC Equity Sales Corporation (the "Adviser"), we respectfully request that the Division of Investment Management not recommend enforcement action to the Commission pursuant to Rule 204-2(a)(12) of the Investment Advisers Act of 1940, as amended (the "Act") if the Adviser does not make and keep books and records of personal securities transactions of advisory representatives in open-end mutual funds, variable annuities and variable life insurance products, including those issued by affiliates of the Adviser.

**Background**

The Adviser is an investment adviser registered under the Act. The Adviser is a wholly-owned subsidiary of Lincoln Financial Group, Inc., ("LFG"), Fort Wayne, Indiana. LFG is a wholly-owned subsidiary of Lincoln National Corporation ("LNC"), Fort Wayne, Indiana. Approximately 80% of the Adviser's business is providing investment advice through consultations. Only 5% of the Adviser's business involves providing investment supervisory services. The other 15% of the Adviser's business is furnishing advice to clients on matters not involving securities.

The Adviser's principal business is as a broker-dealer marketing mutual funds, limited partnerships, unit investment trusts, and coins/precious metals, and providing asset management and investment timing services. The Adviser also offers investments available through security brokerage including common and preferred stock, mutual funds, U.S. Government securities, mortgage-backed securities, corporate and municipal bonds, zero coupon bonds, certificates of deposit, and options.

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The Adviser is an affiliate of the following companies:

Professional Financial Planning, Inc. ("PFP"), a wholly-owned subsidiary of LFG. PFP is a registered investment adviser and financial planning firm;

The Lincoln National Life Insurance Company ("LNL"), a wholly-owned subsidiary of LNC. LNL is a broker/ dealer, registered investment adviser, insurance company and pension consulting firm;

Lincoln National Investment Management, Inc., a wholly-owned subsidiary of LNC. Lincoln National Investment Management, Inc. is a registered investment adviser and also creates limited partnerships;

Vantage Global Advisers, Inc., a wholly-owned subsidiary of LNC. Vantage Global Advisers, Inc. is a registered investment adviser;

Lynch & Mayer, Inc. ("L&M"), a wholly-owned subsidiary of LNC. L&M is a registered investment adviser.

The Adviser and/or its affiliates are investment advisers (or sub-advisers) to the following mutual funds, whose shares are sold to separate accounts of LNL to support variable annuity and variable life insurance contracts issued by LNL:

Lincoln National Aggressive Growth Fund, Inc.;  
Lincoln National Bond Fund, Inc.;  
Lincoln National Capital Appreciation Fund, Inc.;  
Lincoln National Equity-Income Fund, Inc.;  
Lincoln National Growth and Income Fund, Inc.;  
Lincoln National International Fund, Inc.;  
Lincoln National Managed Fund, Inc.;  
Lincoln National Money Market Fund, Inc.;  
Lincoln National Global Asset Allocation Fund, Inc.;  
Lincoln National Social Awareness Fund, Inc.; and  
Lincoln National Special Opportunity Fund, Inc.

The Adviser is also affiliated with Delaware Management Holdings, Inc., a wholly-owned subsidiary of LNC. Delaware Management Holdings, Inc. is the sole owner of Delaware Management Company, Inc., a registered investment adviser (manager of the Delaware Group of mutual funds) and Delaware Distributors, Inc., a broker-dealer.

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### Discussion

Rule 204-2(a)(12) specifically requires that all registered advisers maintain "[a] record of every transaction in a security in which the investment adviser or any advisory representative ... of such investment adviser has, or by reason of such transaction acquires, any direct or indirect beneficial ownership, except (A) transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and (B) transactions in securities which are direct obligations of the United States." Rule 204-2(a)(12)(i)(A) defines "advisory representative" to include (1) any partner, officer or director of the investment adviser; (2) any employee who makes any recommendation, who participates in the determination of which recommendation shall be made, or whose functions or duties relate to the determination of which recommendation shall be made; (3) any employee who, in connection with his duties, obtains any information concerning which securities are being recommended prior to the effective dissemination of such recommendations or of the information concerning such recommendations; and (4) any affiliated person who obtains information concerning securities recommendations being made by such investment adviser prior to the effective dissemination of such recommendations or of the information concerning such recommendations.

Rule 204-2(a)(12) was adopted to "assist the Commission in determining whether a further rule to prohibit scalping is necessary...."<sup>1/</sup> The Commission defined scalping to mean a "practice whereby an investment adviser, or any person who obtains information concerning a securities recommendation being made by such investment adviser prior to the dissemination of such information, trades on the anticipated short-run market activity which may ensue from the issuance by the adviser of the securities recommendations."<sup>2/</sup> In S.E.C. v. Capital Gains Research Bureau, Inc.,<sup>3/</sup> the U. S. Supreme Court found 'scalping' to be a fraudulent and deceptive practice within the meaning of Section 206 of the Act.

In Connecticut General Pension Services, Inc.,<sup>4/</sup> the Division found that "Rule 204-2 was intended to apply only to those instances where a trading market exists for

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<sup>1/</sup> See Investment Advisers Act Release No. 203 (August 11, 1966) (1966-67 Transfer Binder) FED SEC. L. (CCH) P77,401.

<sup>2/</sup> See Investment Advisers Act Release No. 436 (February 21, 1975) (1974-75 Transfer Binder) FED. SEC. L. REP. (CCH) P80,113.

<sup>3/</sup> 375 U.S. 180 (1963).

<sup>4/</sup> SEC No-Action Letter, [1982 SEC No-Act. LEXIS 2572] (June 21, 1982).

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securities recommended by an investment adviser, such that scalping by the adviser or it[s] employees is at least a possibility. Where there is not a trading market for the securities recommended by the adviser and the possibility of 'scalping' by an 'advisory representative' does not exist, the purpose of Rule 204-2(a)(12) is not served by requiring the advisory representative to maintain a record of his or her personal securities transactions."<sup>5/</sup>

Based on this principle, three types of investment company securities currently are exempt from the Rule 204-2 reporting requirements: (1) shares of "unaffiliated" mutual funds, (2) shares of "affiliated" mutual funds and (3) variable annuity and variable life insurance policies issued by "unaffiliated" insurance companies. This letter seeks the staff's concurrence that variable annuity and life insurance policies issued by "affiliated" insurance companies are also exempt. There is no trading market in these securities regardless of whether they are issued by affiliates, so scalping is not a possibility.

In a series of no-action letters, the Division has excepted the reporting of securities transactions by advisory representatives in unaffiliated open-end mutual funds. The Division's position in these letters was based on the determination that since there "is no trading market for open-end fund shares, it is unlikely that scalping or any other improper trading practice would occur."<sup>6/</sup>

The Division has proposed amendments to Rule 204-2(a)(12) to formally except from the recordkeeping requirement transactions in shares of registered open-end investment companies, without regard to whether they are issued by affiliates.<sup>7/</sup> The proposing release (No. IA-1518) states in footnote 70 that "...the Division staff also currently takes the position

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<sup>5/</sup> See also Pioneering Managements Corporation (1984-1985 Transfer Binder) FED. SEC. L. REP. (CCH) P77,899 and Prudential Insurance Company of America (1977-1978 Transfer Binder) FED. SEC. L. REP. (CCH) P81,414.

<sup>6/</sup> Massachusetts Financial Services Company, SEC No-Action Letter, [1992 SEC No-Act. LEXIS 1043] note 4 (October 6, 1992). See e.g., Lipper Analytical Services, Inc., SEC No-Action Letter, [1990 SEC No-Act. LEXIS 882] (June 5, 1990); TransAmerica Advisors, Inc., SEC No-Action Letter, [1988 SEC No-Act. LEXIS 1492] (Nov. 4, 1988); The Colonial Group, Inc., SEC No-Action Letter, [1988 SEC No-Act. LEXIS 406] (Mar. 10, 1988); The Boston Company, SEC No-Action Letter, [1987 SEC No-Act. LEXIS 2027].

<sup>7/</sup> See Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and their Investment Advisers and Principal Underwriters, Securities and Exchange Commission Release No. 33-7212; IC-21341; IA-1518 [1995 SEC LEXIS 2400] (September 8, 1995).

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that transactions in shares of **affiliated open-end funds** are exempt from the recordkeeping requirements."<sup>8/</sup>

Neither the proposed amendments nor Release IA-1518 address whether variable annuities and variable life insurance products are exempt from the reporting requirements. However, in a no-action letter to TransAmerica Advisors, Inc., the Division stated that it "has taken the position that an investment adviser need not maintain records of advisory representatives' personal securities transactions in shares of "unaffiliated" open-end funds."<sup>9/</sup> The Division continued by stating that "because a contractholder's interest in a separate account represents, in effect, an interest in an open-end fund, we believe your request regarding variable insurance products is **directly analogous** to your request regarding open-end funds. Thus, we would not recommend any enforcement action if Advisors does not maintain records of its advisory representatives' personal transactions in variable insurance products issued by **unaffiliated** separate accounts."<sup>10/</sup>

Accordingly, for purposes of Rule 204-2(a)(12) there is no distinction between shares of affiliated and unaffiliated mutual funds - both are exempt from those recordkeeping requirements. Since investments in variable annuity and variable life insurance policies are "directly analogous" to investments in mutual funds, logically there should be no distinction between variable insurance products issued by affiliated and unaffiliated insurance company separate accounts. Indeed, variable insurance products are by their very nature tailored to one specific situation, since by their terms the benefits depend on the life or death of a specific named individual. For both mutual funds and variable insurance products there is no trading market for such securities.

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<sup>8/</sup> See supra note 7 (emphasis added). Previously, the Division had expressed a concern that "advisory representatives of an adviser managing a fund's portfolio securities, or of an investment adviser affiliated with that adviser who have the ability to gain access to information about impending portfolio transactions involving securities for which there is an active secondary market could misuse confidential information...." Massachusetts Financial Services Company, SEC No-Action Letter [1992 SEC No-Act. LEXIS 1043] (October 6, 1992) referring to TransAmerica Advisors, Inc., supra note 6.

<sup>9/</sup> See supra note 6, TransAmerica Advisors, Inc. at 2. Footnote 3 states that "generally speaking, insurance companies may establish separate accounts organized as open-end funds, or separate accounts organized as UITs that invest exclusively in open-end funds, that issue variable annuity or life insurance contracts, which are linked to the performance of the account."

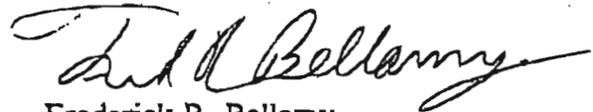
<sup>10/</sup> Id. at 3-4 (emphasis added).

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Conclusion

In light of the foregoing, we respectfully request that the Division advise us that it will recommend no action by the Commission if the Adviser does not maintain records pursuant to Rule 204-2(a)(12) with respect to transactions in affiliated or unaffiliated open-end mutual funds, variable annuities and variable life insurance products.

Sincerely,



Frederick R. Bellamy

FRB/pn