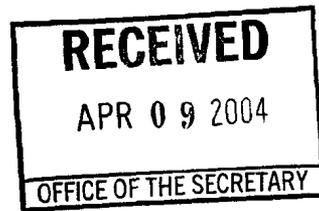


**ETHICS
RESOURCE
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**Joint Comment Letter of the Ethics Resource Center and
Thelen Reid & Priest LLP**

April 6, 2004

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*President,
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Mr. Jonathan G. Katz
Secretary
Office of the Secretary
Mail Stop 0609
United States Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Investment Advisers Act Release 2209 (January 20, 2004)
("Release"); File No. S7-04-04.

Dear Mr. Katz:

This letter is submitted jointly by the Ethics Resource Center ("ERC") and Thelen Reid & Priest LLP. We appreciate this opportunity to comment on the Commission's efforts concerning advisers codes of ethics ("Proposed Rule"). The ERC is a nonprofit, nonpartisan, educational organization based in Washington, D.C., with offices throughout the world.¹ The mission of the ERC is to be a leader and a catalyst in fostering ethical practices in individuals and institutions. The ERC has supported hundreds of business leaders, ethics officers, and nonprofit executives worldwide in designing, assessing, and improving their ethics initiatives. The ERC's clients range from leading Fortune 100 companies to nationally known nonprofit

¹ The ERC seeks to: *inspire individuals to act ethically towards one another; inspire institutions to act ethically, recognizing their role as transmitters of values; and inspire individuals and institutions to join together in fostering ethical communities.* The ERC has been active in the debate regarding the role of corporate officers and directors in the wake of recent scandals. For further information regarding the ERC, see www.ethics.org.

organizations and leading trade associations.² Thelen Reid & Priest LLP is a national law firm that regularly advises public companies, broker-dealers, and investment advisers on matters relating to compliance with the federal securities laws and on labor and employment issues.³

Based on our experience, we have four comments with respect to the code of ethics requirements under consideration by the Commission. Each of these is described more fully below. However, they can be summarized as follows:

- We believe that the current proposal by the Commission achieves the appropriate balance between operational and aspirational elements of a code of ethics. Beyond what is proposed, it is our view that advisers must be free to develop codes of ethics that meet the needs of their individual organizations. These policies may extend beyond matters relevant to the federal securities laws. The Commission should not attempt to define the full scope of advisers' codes of conduct.
- We believe that the Commission should carefully consider any requirement for employees to report codes of ethics violations in the absence of a structure designed to prevent retaliation. It is our view that this requirement may present particular problems for smaller advisers. We recommend that the Commission require advisers to develop a structure to *encourage reporting* of violations. Individual firms would still be free to require reporting of violations.
- We believe that the Commission should carefully consider a recordkeeping requirement for codes of ethics violations. Such records could undermine the goals of the Commission. There may be concern by advisers that such records will promote litigation, may be the subject of due diligence inquiries, or lead to regulatory sanctions. Rather than increasing the ardor with which a firm promotes ethics, the requirement may deny advisers the latitude to have codes that go beyond compliance, and may have a chilling effect on the reporting and resolution of potential code of ethics violations. Individual advisers should be free to develop their own recordkeeping standards.
- We recommend that the Commission encourage advisers to develop an ethics awareness and training strategy. Without ongoing training and education, codes of ethics alone may not be effective in communicating ethical values. Advisers should tailor any ethics training and communications program to the needs of their individual organizations. For smaller organizations, such programs could be less formal.

² Among the ERC's clients have been the World Bank, International Finance Corporation, Lockheed Martin, BellSouth, Merck Pharmaceuticals, United Way of America, the Department of Defense, and the International Brotherhood of Teamsters.

³ For further information regarding Thelen Reid & Priest LLP, *see*, www.thelenreid.com.

I. OVERVIEW

We believe that attention focused on adviser ethics at this time is appropriate. Provisions requiring public companies to adopt codes of ethics for directors and employees of public companies have been approved recently by the New York Stock Exchange and the Nasdaq Stock Market in connection with other changes in their listing standards. In addition, the Commission recently has implemented portions of the Sarbanes-Oxley legislation that require public companies to disclose whether or not they have adopted codes of ethics for certain senior management. Advisers play an important role in the financial markets and are expected to observe the highest standards for trust and integrity.

While we agree that it is appropriate to focus on adviser ethics at this time, it also is important to be aware that there are significant distinctions between the average advisory firm subject to regulation by the Commission, and the organizational structure of larger public companies. Advisory firms that manage significant amounts of assets generally will have far fewer employees than other organizations with comparable revenues. The Commission notes in the Release, for example, that almost 70% of investment advisers regulated by the Commission have fewer than 10 employees, and 49% have fewer than five non-clerical personnel.

The small size of advisory firms often results in an informal structure without boards of directors, in-house counsel, human resource offices, or ethics officers. Particularly in these smaller organizations, the value placed on ethical conduct is readily transparent, and frequently defined by a few individuals. Apart from what is set forth in writing, daily decisions regarding allocation of expenses, trade errors, client recommendations, and the allocation of soft dollar credits, among many other matters, can set the ethical tone of an organization. Thus, employees and partners are more attuned to “how things really work around here,” rather than what might be stated in written codes.

II. WHAT IS THE PURPOSE OF A CODE OF ETHICS?

Before proceeding into our specific comments, we believe that it is important to place in context the use of “codes of ethics” and their creation. Traditionally, a code of ethics outlines a set of fundamental principles, whether or not they are the basis for operational or legal requirements or prohibitions. A code of ethics is a value-laden document, not one designed for expedience. Further, codes of ethics often are both aspirational and operational.

Codes of ethics are aspirational, in that they set out ideals for ethical conduct that may reach higher than is practical at the moment (e.g. standards for openness, integrity, trust, teamwork, customer service which go far beyond that attainable in the current organizational culture/climate). They may be operational in such matters as are within reach (e.g. total honesty in reporting securities transactions, finite limits on gifts and gratuities, and other ethical conduct that can be specified in policy or procedure). In addition, within codes of ethics there is a realization that different individuals may apply the same principle differently, and therefore it often can be a matter of judgment regarding the appropriate application of a value or principle,

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rather than a black or white, “yes” or “no,” interpretation of whether a code provision was violated.

III. COMMENTS

A. *Scope of the Code of Ethics*

We believe that the current proposal by the Commission achieves the appropriate balance between operational and aspirational elements of a code of ethics. Investment advisers operate in a highly regulated environment, both at the federal and state level. Individual advisers already must develop appropriate procedures to assure compliance with the federal securities laws. A code of ethics, however, is more than a compliance manual and we believe that it would be a mistake for the Commission to specify the content of such codes.

Beyond requirements that are designed to prevent violations of the law, codes of ethics do not lend themselves to being created from “boilerplate.” In order to become part of the culture, or genetic DNA, of an organization the actual document should be the outcome of active participation of all parties affected, in a process in which core values, roles, responsibilities, expectations, and behavioral standards are debated and decided. In the adviser community, values stressed may include loyalty, honesty, fairness and accountability, among others.

For example, the value of loyalty embraces the avoidance of conflicts of interest.⁴ In the description of how individuals are expected to be loyal, a code of ethics would typically detail how loyalty plays out in conflicts of interest, and the need to separate personal needs from those of the organization. The proposed requirements relating to personal trading reflect obvious conflicts. Beyond this, however, advisers must contend daily with issues involving the fair allocation of investment opportunities, candor in client communications, confidentiality, fair dealing (including loyalty to the adviser) and the protection and proper use of client assets. Importantly, codes of ethics, often will go well beyond what is required by the law.

B. *Reporting of Violations*

Under the Commission’s proposal, an adviser’s code of ethics should *require* prompt internal reporting of any violations, or *apparent* violations.⁵ Reports of violations would have to be made to the adviser's chief compliance officer or to another person designated in the code of

⁴ Avoidance of conflicts of interest also often is expressed in terms of “fairness” and “trustworthiness”. The concept of “assuring full disclosure” also may be referenced in the context of “honesty.” Honesty, for example, includes being candid, open, truthful, and free from deception and deceit in all actions – telling the truth, even when doing so may be difficult, and being forthcoming with all relevant facts and information in reports filed with the Commission and in communications with clients.

⁵ Under the proposed rule, adviser’s codes of ethics would have to contain:

“Provisions requiring supervised persons to report any violations of your code of ethics promptly to your chief compliance officer or to another person you designate in your code of ethics.”

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ethics. We believe that the Commission should carefully consider this requirement in the context of most investment advisers. In our view, it is likely to present significant difficulties for employees in many instances, particularly when the violation may be only “apparent,” when the issue under consideration is complex (and based on legal rather than solely ethical considerations), and when senior management may be involved.⁶

Two organizational actions are widely recognized as necessary to encourage an employee to share sensitive information—particularly where the employee may not have all of the facts, but only suspicions, or may be unfamiliar with the law. First, there must be assurance that the process is safe. A firm must have an absolute commitment to the promise that there will be no retribution or retaliation for reporting observed or suspected wrongdoing. Second, the employee must have confidence that his or her report will be given serious attention. The firm must be committed to conducting a thorough and effective investigation of any alleged misconduct, and it must communicate the value of such reporting in ways that reinforce both the safety and effectiveness of the process.

Sarbanes-Oxley, Item 406 of Regulation S-K, and the listing standards of the NYSE and Nasdaq effectively require public companies to encourage prompt internal reporting of violations of a code. In the context of Item 406, the Commission noted that the appropriate person to whom violations should be reported should not be involved in the matter giving rise to the conflict of interest and “should have sufficient status within the company to engender respect for the code and the authority to adequately deal with the persons subject to the code regardless of their stature in the company.” Moreover, a related provision of Sarbanes-Oxley requires a company’s audit committee to establish procedures for the receipt, treatment, and retention of complaints regarding the company with respect to any accounting, internal accounting controls, or auditing matters and “the confidential, anonymous submission by employees.”⁷ In effect, there must be an employee “hot line” to the audit committee.⁸ In addition, there are express protections under federal law afforded employees that report on suspected violations by public companies.

As we have noted earlier, in contrast to public companies advisory firms often have relatively few employees and operate in an informal fashion, despite what may be reflected in formal documents. The chief compliance officer of a firm that advises mutual funds must report

⁶ We also are not aware of any similar requirement with respect to the employees of brokers or dealers.

⁷ See, Section 10A(4)(m) of the Securities Exchange Act of 1934.

⁸ Section 806 of Sarbanes-Oxley also provides an express cause of action to an employee of a public company who is discharged, demoted, suspended, threatened, or harassed for providing information about violations of the federal securities laws or fraud to any law enforcement body, supervisor, or any person who has authority to investigate misconduct. In addition, Section 1107 of Sarbanes-Oxley makes it a crime for any person, with intent to retaliate, to knowingly take any actions harmful to any person (including interference with lawful employment or his/her livelihood) just because that person provided truthful information to a law enforcement officer relating to the commission or possible commission of a federal offense.

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directly to the fund's board of directors, and therefore has a greater degree of autonomy.⁹ At the same time, however, he or she may not have responsibility for the oversight of activities covered by a code of ethics that extend beyond the Advisers Act. Moreover, as the Commission indicates in its Release, only 19% of advisers manage mutual fund assets and will have chief compliance officers with the same protections.

In many cases, it is our belief that the chief compliance officer of a small advisory firm, as opposed to a public company, will not have sufficient stature to assure independence, and may not have familiarity with matters that involve more sophisticated application of the laws under the Advisers Act. Measured against current standards reflected in Sarbanes-Oxley or the Federal Sentencing Guidelines ("Guidelines"),¹⁰ the *requirement* for reporting, without an appropriate structure for reporting may be a potential source of problems.¹¹ Unless appropriate structures are in place, we believe that reporting requirements will present challenges for most smaller advisers and their employees.

It is our view that the Commission could achieve a similar result, in a manner that more closely reflects the individual circumstances of each organization. Instead of simply requiring the reporting of violations by individual employees, we believe that more could be achieved by a requirement that each adviser strongly *encourage* the reporting of violations of the code. This language is more consistent with the Federal Sentencing Guidelines, as well as the listing standards applicable to public companies, and we believe places a greater obligation on the organization to establish an appropriate structure for reporting both actual and apparent violations.

⁹ We also note that Rule 38a-1 prohibits advisers and others from using undue influence to affect the chief compliance officer.

¹⁰ The Guidelines, which define an effective ethics and compliance program include: establishing ethics and compliance standards and procedures; assigning specific, high level person(s) to oversee ethics and compliance; Taking due care in delegation of substantial discretionary authority to individuals; effectively communicating standards and procedures to all employees and agents through training and also through printed and electronic materials; monitoring and auditing the operation of the ethics and compliance program and establishing a retribution-free means (e.g., a helpline) for employees to obtain information about standards and procedures and to report possible wrongdoing; consistently enforcing discipline of employee violations; and responding promptly to any wrongdoing and remedy any program deficiencies.

¹¹ For example, as noted in note 10, *supra*, the Guidelines describe an effective ethics program as one in which, among other things, there is established a retribution-free means (e.g., a helpline) for employees to obtain information about standards and procedures and to report possible wrongdoing. The new listing requirements of the New York Stock Exchange and Nasdaq require similar elements as part of their codes of ethics (e.g. NYSE – "The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith"; Nasdaq – "reporting of questionable behavior is protected and encouraged."

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Firms of all sizes can develop structures suited to their needs to encourage reporting. Elements might include annual conduct surveys, as well as the creation of structures to allow anonymous reporting to senior executives, outside shareholders, ethics hotlines, or boards of directors. Regardless of the approach taken, we believe that this amendment to the Commission's proposal would account for the individual circumstances of each adviser and would enhance instances in which potential problems or violations are reported. Moreover, individual firms would still be free to require reporting of violations in the context of their particular organizations.

C. Records of Violations of the Code

As proposed, the Commission would require advisers to keep records of any violations of the code of ethics, and the actions taken as a result of the violations. We believe that potential violations of an adviser's code may not be reported or addressed by the organization if there is a concern that such issues are likely to result in records that will promote litigation, may be subject to due diligence inquiries, or lead to regulatory sanctions. In our view, this requirement would undermine the goals of the Commission in requiring a code of ethics for advisors. Rather than increasing the ardor with which a firm promotes ethics, it may have the unintended consequence of denying advisers the latitude to develop codes that go beyond compliance, and have a chilling effect on the reporting and resolution of potential code of ethics violations.

Once such a recordkeeping requirement exists, we anticipate that the files would routinely be examined by regulators and may be requested by fiduciaries in the course of their due diligence in the manager selection process. Although we are certain that this issue will be addressed by others, it is our belief that such records may deny a company and its employees the opportunity to address matters that may or may not be violations of the law or the company's code, or have any bearing on the Advisers Act.¹²

In addition, it is our strong feeling that such a requirement would reduce monitoring, and make it far less likely that a firm would find violations of its code. We suggest that instead of the current recordkeeping requirement, the Commission consider language that requires consistently enforced discipline, and that would require specific recordkeeping only with respect to personal trading restrictions. Beyond what is required, however, advisers would still have the

¹² We believe that a formal recordkeeping requirement could have the opposite effect of the Commission's desired goal, as articulated in the Release:

Proposed rule 204A-1 would benefit investment advisers by diminishing the likelihood their firms will be embroiled in securities violations, Commission enforcement actions, and private litigation. For an adviser, the potential costs associated with a securities law violation may consist of much more than merely the fines or other penalties levied by the Commission or civil liability. The reputation of an adviser may be significantly tarnished, resulting in lost clients. Advisers may be denied eligibility to advise funds. In addition, advisers could be precluded from serving in other capacities. (footnotes omitted).

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latitude to develop their own policies with respect to resolving and recording ethics code violations.

D. The Commission Encourage Ethics Communication and Training Strategies.

In addition to a code of ethics, there typically are numerous written and unwritten support mechanisms that will determine the effectiveness of the company's ethical compliance. Central among these is a program to communicate core values to all persons within the company. Depending upon the size of the organization, these programs may have more or less formality. However, in all cases, these programs, as well as the implicit message communicated by the senior management of the organization, are far more important than the words of the actual code. The conduct and involvement of senior management of a company in transmitting the values of the organization is paramount.

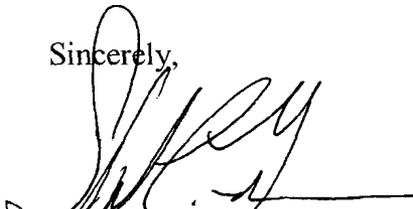
In order to be effective, the values defined in the codes of ethics must be regularly communicated. Ethics awareness programs often may take the form of comprehensive yearly professional conduct and compliance training for all employees, a periodic evaluation, and a mechanism for enhancing and strengthening the system. These mechanisms are important in assuring the effectiveness of any code of ethics. For this reason, we recommend that the Commission encourage advisers to develop an ethics awareness and training strategy, in addition to adopting codes of ethics. In our view, this training should be specifically tailored to the needs of the individual organization and its employees, but for smaller organizations could be less formal.¹³

V. CONCLUSION

We appreciate the opportunity to comment on the Release. The recent events suggest that even where there are express prohibitions, people are capable of seeking and finding ways to pervert ethical and legal standards. An effective ethics program requires continual reinforcement of strong values by management – in the same way that a strong compliance program requires regular training. Neither a code of ethics nor detailed compliance procedures, however, are a substitute for good and honorable management and employees.

We would be pleased to discuss our views further with the Staff or the Commission. Please feel free to contact either the ERC or Thelen Reid & Priest LLP at (202) 737-2258 or (202) 508-4000, respectively, if we can answer any further questions.

Sincerely,



Stuart C. Gilman, Ph.D.
President
Ethics Resource Center



Edward L. Pittman, Esq.
Thelen Reid & Priest LLP

¹³ We note that similar training requirements are imposed on broker-dealers.

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and Thelen Reid & Priest LLP**

cc: The Securities and Exchange Commission

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

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