PERSONAL INVESTMENT ACTIVITIES OF INVESTMENT COMPANY PERSONNEL

Report of the
Division of Investment Management
United States Securities and Exchange Commission

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I. INTRODUCTION AND EXECUTIVE SUMMARY

Over the last 15 years, the investment company industry has been remarkably successful. Between 1979 and 1994, total assets under management grew from $95 billion to $2.1 trillion. Over 38 million Americans now invest in mutual funds, the most popular type of investment company, entrusting their retirement savings, funds for their childrens' education and their ready cash to mutual fund managers. By the end of last year, 27% of U.S. households owned mutual funds.

The success of the investment company industry is in no small measure the result of the industry's excellent record; the industry has generally been free of major scandal for the last two decades. The industry's continued health, however, depends on its meeting the expectation of American investors, many of whom are new to the market. The industry will continue to be trusted by investors only if it demonstrates that it maintains the highest possible ethical standards and that it operates free from abusive and fraudulent practices.

Recent press reports and Congressional inquiries have raised questions about the ethical standards of the industry by focusing on the personal investment activities of investment company personnel. In seeking to address these questions, the Division of Investment Management (the "Division") has, over the past seven months, undertaken a detailed examination of the personal investment activities of investment company personnel, particularly fund managers, and conducted an analysis of the regulatory scheme that governs those investment activities. In particular, the Division:

- examined the personal securities transactions for 1993 of 622 fund managers employed by 30 companies ("fund groups") that, in the aggregate, manage 1,053 funds with total assets of $521 billion;
- examined the restrictions and procedures placed on the personal investment activities of fund personnel by the 30 fund groups;
- analyzed the provisions of section 17(j) of the Investment Company Act of 1940 (the "1940 Act") and rule 17j-1 under the 1940 Act, the principal federal provisions regulating the investment activities of fund personnel; and
- assessed the recommendations contained in a report by a special advisory group formed by the Investment Company Institute (the "ICI") that surveyed the industry's practices and standards governing personal investing by fund personnel.

This Report describes the Division's findings and contains recommendations designed to enhance the oversight of the personal investment activities of fund personnel and improve ethical standards throughout the fund industry. The vast majority of the 30 fund groups from which the Division collected data reported moderate to infrequent investing by their fund managers, little of which was potentially abusive. A small number of fund groups, however, reported extensive personal investment activity by their fund managers, who, in several instances, purchased or sold securities shortly ahead of their funds. The Division currently is obtaining additional information about all potentially abusive transactions.

The data collected from the 30 fund groups revealed that:

- Fund managers generally appear not to invest extensively for their personal accounts. Of the fund managers whose transactions the Division examined, 75% engaged in ten or fewer transactions in 1993 (the year covered by the Division's requests for information), while 43.5% did not buy or sell securities at all. The median number of personal transactions per manager for 1993 was two.

- Potential conflict of interest situations caused by fund managers buying and selling securities ahead of their funds appear to be infrequent. The overwhelming majority of fund managers did not buy or sell securities during the ten days preceding the purchase or sale of those securities by their funds. In 0.7% of all personal transactions reported to the Division a fund manager purchased or sold securities at a better price than received by his fund during the 10 days following the manager's transaction. In addition, in 1.8% of the reported transactions a fund manager received a better price than some fund in the same fund group.

- Potential conflict of interest situations caused by a fund's purchase or sale of securities already held by the fund's manager appear to be infrequent. Less than 3% of all equity securities purchased by the funds examined were, at the time of purchase, also owned by the fund's manager. Many of these securities were issued by large capitalization companies, and therefore provide a minimal potential for conflict.

- The investment activities of a few fund managers were inconsistent with the general trends reflected in the data. Fund managers employed by four fund groups accounted for a large percentage of personal transactions generally and of transactions that mirrored fund transactions within a ten day period. Although these four fund groups collectively employed only 15.5% of the managers whose trades were examined, those managers engaged in nearly half of all personal transactions reviewed, 70% of personal transactions that matched transactions made by the manager's fund, and 50% of personal transactions that matched a transaction made by the manager's fund or any other fund in the same fund group.

- The data collected from the 30 fund groups may overstate the extent of personal investing and the number of potentially abusive transactions in the fund industry generally. The Division intentionally included in its examination three fund groups whose managers, in the past, traded actively for their personal accounts. All three groups were among the four fund groups whose managers engaged in the most personal transactions and the most transactions ahead of their funds. By contrast, most of the fund managers employed by 26 of the 27 fund groups that were selected for examination without regard to the suspected frequency of personal trading by their managers engaged in few personal transactions generally and very few potentially abusive personal transactions.

The Division has concluded that the data collected, taken as a whole, suggests that the existing regulatory framework governing the personal investment activities of fund personnel has generally worked well, but can be improved. The data, in any event, does not reveal abusive trading patterns that the Division believes could be remedied only by a total prohibition on personal investing by fund personnel.

To improve the regulatory scheme, the Division is making six recommendations. The Division's recommendations are designed to further protect fund shareholders by making available to the public additional information about fund policies on personal investment; enhancing the oversight of personal investment policies by fund boards of directors or trustees; making it easier for both funds and the Commission's staff to monitor the personal transactions of fund personnel; and clarifying the scope of prohibited activities by fund personnel. The Division believes that its recommendations, together with the industry's general acceptance of the principles reflected in the report of the ICI's special advisory group, would enhance ethical standards throughout the fund industry which, in turn, should bolster investor confidence. The Division's recommendations are as follows:

- The Commission should require every fund to publicly disclose its policies regarding personal investing by fund personnel;

- The Commission should require each fund's board of directors or trustees to review the fund's code of ethics and compliance matters relating to the code at least annually;

- The Commission should require fund personnel to disclose to their employers their personal securities holdings at the commencement of employment;

- The National Association of Securities Dealers, Inc. (the "NASD") should be asked to consider adopting a rule requiring its member broker-dealers to notify a fund's investment adviser when one of the adviser's employees opens a brokerage account and, upon request, to transmit duplicate trade confirmations and account statements to the adviser;

- The NASD should be asked to consider prohibiting the participation by certain fund personnel in "hot issue" public offerings; and

- Section 17(j) of the 1940 Act should be amended to include purchases and sales of property other than securities, and to clarify the section's scope.

The Division's recommendations are discussed more fully in Part V of this Report.

II. BACKGROUND

A. Regulation of Personal Investing

Investment advisers owe their customers the highest duty of trust and fair dealing and must place the customers' interests ahead of their own.[1] Thus, although federal law does not specifically prohibit a fund manager from buying or selling the same securities as the

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[1] *SEC v. Capital Gains Bureau, Inc.*, 375 U.S. 180 (1963).

funds with which he[2] is associated, he may not, when making investment decisions for himself or the funds, place his personal interests ahead of the funds' interests.[3]

In performing their day-to-day responsibilities, fund personnel, such as managers, analysts, and traders, may have access to information about impending fund transactions. Under current law, these "access persons," like other "insiders," may not use material nonpublic information to benefit themselves or others. Access persons of a fund may not, for example, engage in "front-running," which occurs when an access person engages in a securities transaction ahead of a fund with the expectation that the fund's transaction will favorably affect the price of the securities. Front-running is most likely to benefit an unscrupulous access person when it involves a security that is thinly traded.

Conflicts of interest can arise whenever access persons buy and sell securities for their personal accounts. Beginning in the early 1960s, Congress and the Commission attempted to devise a regulatory scheme that would effectively address these potential conflicts. Their efforts culminated in the addition of section 17(j) to the 1940 Act in 1970 and the adoption of rule 17j-1 under the Act by the Commission in 1980.

Three themes run through the extensive legislative and administrative history of section 17(j) and rule 17j-1. First, both Congress and the Commission consistently have recognized that effective regulation of the investment activities of access persons requires that funds themselves provide a strong first line of oversight. Second, both Congress and the Commission have indicated that funds can best provide effective oversight if they are given the flexibility to adopt restrictions on personal investment activities, and procedures implementing those restrictions, that are tailored to the funds' individual circumstances; indeed, the Commission on occasion has rejected staff recommendations to formulate uniform standards that would apply to all funds. Third, Congress and the Commission consistently have recognized that not all personal securities transactions by access persons involve conflicts of interest or are inconsistent with the responsibilities of access persons toward their funds. As a result, both Congress and the Commission have to date declined to impose an outright ban on personal investment by fund personnel.

1. Section 17(j)

In 1961, Congress directed the Commission to undertake a study of the securities markets, which resulted in the issuance in 1963 of a Commission staff report known as the Special Study Report.[4] Although the Special Study Report was concerned primarily with the securities markets in general, the Report addressed certain investment company issues, including "insider transactions in portfolio securities." As part of its analysis, the staff examined the nature and extent of trading by a representative sample of mutual funds and

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[2] For ease of reading we have used the masculine form throughout this Report in referring to fund personnel.

[3] *Capital Gains*, *supra* note 1.

[4] Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

their insiders,[5] and concluded that personal trading by insiders ahead of their funds was "fairly extensive" and "significant."[6] Despite these findings, the staff did not recommend a ban on personal investment by fund insiders, but concluded that "each mutual fund, its investment adviser, and principal underwriter should be required to adopt written policies covering insider trading and provisions for their implementation which meet minimum standards established by the Commission."[7]

In 1966, the Commission published a report dealing with the public policy implications of investment company growth (the "PPI Report") that analyzed the need to update the regulation of mutual funds in light of the fund industry's significant growth since the passage of the 1940 Act.[8] The PPI Report dealt with, among other things, the issue of personal investing by fund personnel and identified three areas of particular concern. First, a fund's insiders can profit by buying or selling securities ahead of the fund's transactions in the same securities if the fund's transactions affect the price of the securities. Second, a fund can be harmed if an insider's securities transactions adversely affect the transaction prices received by the fund. Third, a fund can be harmed if an insider causes the fund to purchase or hold securities to protect or strengthen the insider's investment in those securities.[9]

The Commission, in the PPI Report, noted that the Special Study Report had found "widespread" buying and selling by fund insiders before their funds.[10] Nevertheless, the Commission did not recommend a ban on investing by fund insiders, concluding that "persons affiliated with investment companies cannot be expected to refrain from engaging in securities transactions for their personal accounts."[11]

The Commission acknowledged in the PPI Report that it had authority under the broad antifraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Advisers Act of 1940 (the "Advisers Act") to adopt rules against insider trading abuses by persons affiliated with investment companies.[12] The Commission noted, for instance, that those provisions would have allowed it to establish uniform minimum standards governing personal investing by fund insiders. The Commission, however, stated

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[5] The Special Study Report looked initially at 51 funds with total net assets of $14.9 billion, then looked more closely at 28 funds with total net assets of $5.2 billion. For this Report, the Division collected data with respect to 1,053 funds with net assets of $521 billion.

[6] Special Study Report, *supra* note 4, at 254, 255.

[7] *Id.* at 254. The staff further recommended that "[t]he standards which are called for should be common to the entire industry, and their adoption and implementation should not be left to the individual companies themselves." *Id.* The Commission consistently has declined to follow this particular recommendation.

[8] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966).

[9] *Id.* at 195.

[10] *Id.* at 196 (citing the Special Study Report).

[11] PPI Report, *supra* note 8, at 199.

[12] *Id.* at 200.

its preference "to deal with problems of insider trading in investment company portfolio securities in a more flexible manner," by requiring every fund subject to the 1940 Act to adopt its own code of ethics.[13] Thus, the Commission asked Congress for authority under the 1940 Act to adopt rules for the protection of investors in connection with "insider trading in portfolio securities by persons affiliated with investment companies."[14]

In response to the Commission's request for rulemaking authority in the PPI Report, Congress in 1970 added section 17(j) to the 1940 Act. Section 17(j) makes it unlawful for persons affiliated with a registered investment company or with the company's investment adviser or principal underwriter, in connection with the purchase or sale of securities held or to be acquired by the company, to engage in any fraudulent, deceptive, or manipulative act or practice in contravention of rules adopted by the Commission. Section 17(j) expressly states that "such rules and regulations may include requirements for the adoption of codes of ethics" by funds and their affiliated persons.

In explaining its decision to provide for Commission rulemaking in section 17(j), Congress noted that:

> The ability to deal with [personal securities] transactions by rule is intended to permit the Commission to draw flexible guidelines to prohibit persons affiliated with investment companies, their advisers and principal underwriters, from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their companies.[15]

Thus, the express language and legislative history of section 17(j) make clear that Congress was not seeking, and was not authorizing the Commission, to ban all personal investment activity by fund insiders. Section 17(j) contemplates that the insiders of a fund could not only buy and sell securities, but also that they could buy and sell securities held or to be acquired by the fund. The legislative history of section 17(j) suggests a concern on the part of Congress about insider transactions involving conflicts of interest and not about insider transactions generally.

2. Rule 17j-1

In 1972, the Commission first proposed rule 17j-1 under the rulemaking authority provided by section 17(j).[16] The proposed rule differed from the rule now in effect primarily in two ways. First, the proposed rule expressly would have permitted (but did not require) funds to pre-clear personal trades by access persons. Second, it would have prohibited an access person from trading for his personal account any securities that he knew were being purchased or sold, or were being considered or recommended for purchase or sale, by the fund. Commenters heavily criticized the proposed rule, particularly the

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[13] *Id.*

[14] *Id.*

[15] H.R. Rep. No. 1382, 91st Cong., 2d Sess., at 28 (1970) ("House Report"); S. Rep. No. 184, 91st Cong., 1st Sess., at 29 (1969) ("Senate Report").

[16] Investment Company Act Release No. 7581 (Dec. 26, 1972).

personal trading prohibition, which they described as "nebulous," "difficult to apply," "extremely vague and impossible of application in specific situations," and "dangerously ambiguous."[17] In response to the negative comments, the Commission withdrew proposed rule 17j-1 in 1976.[18]

In 1978, the Commission reproposed rule 17j-1 with several significant changes.[19] Among other things, the reproposed rule did not contain any specific trading prohibitions. The Commission explained that this revision was made "in view of the arguments made by public commentators that the trading prohibitions set forth in the previous proposed rule could lead to difficulties of interpretation and administration."[20] Moreover, the Commission declined to include *suggested* personal trading restrictions in the release that accompanied reproposed rule 17j-1.

In 1980, the Commission adopted rule 17j-1.[21] The rule, which has not been amended since its adoption, has four primary components:

▸ Paragraph (a) prohibits fraudulent, deceptive or manipulative acts by any affiliated person (which includes an investment adviser) or principal underwriter of an investment company, or any affiliated person of the company's investment adviser or principal underwriter, in connection with their personal transactions in securities[22] held or to be acquired by the investment company.

▸ Paragraph (b) requires investment companies and their investment advisers and principal underwriters to adopt codes of ethics containing provisions reasonably necessary to prevent access persons[23] from engaging in the fraudulent, deceptive, or manipulative acts prohibited by the rule.

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[17] Commenters also criticized nearly every other aspect of the proposed rule, including the types of transactions proposed to be covered by the rule, the rule's application to non-interested directors, the definition of the term "access person," and the proposed requirement that violations of a firm's code of ethics be reported to the Commission.

[18] Investment Company Act Release No. 9169 (Feb. 19, 1976).

[19] Investment Company Act Release No. 10162 (Mar. 20, 1978).

[20] *Id.*

[21] Investment Company Act Release No. 11421 (Oct. 31, 1980).

[22] The definition of "securities" in rule 17j-1 excludes, among other things, United States government securities, commercial paper, and shares of open-end funds. United States government securities are excluded because "the value of such securities held by an individual could not be substantially affected by purchases or sales by an investment company." Release No. 10162, *supra* note 19. Commercial paper and shares of open-end funds are excluded because they "present very little opportunity for the type of improper trading that the Rule is intended to cover." Release No. 11421, *supra* note 21.

[23] As defined in rule 17j-1(e), "access persons" of an entity generally include officers, directors, and any employees who participate in the selection of a fund's portfolio securities or who have access to information regarding a fund's impending purchases and sales of portfolio securities.

▸ Paragraph (c) requires access persons of investment companies and of their investment advisers and principal underwriters to report their personal securities transactions to their employers on a quarterly basis.

▸ Paragraph (d) requires investment companies and their investment advisers and principal underwriters to maintain certain records, including their codes of ethics and the quarterly reports filed by access persons, and to make those records available for inspection by the Commission.

Rule 17j-1 does not mandate any specific restrictions on personal investing by access persons, or any procedures to implement those restrictions. Instead, the rule requires registered investment companies and their investment advisers and principal underwriters[24] to serve as a first line of oversight with respect to the investment activities of access persons by determining for themselves which trading restrictions and procedures are "reasonably necessary" to prevent access persons from engaging in the fraudulent, deceptive, or manipulative acts and practices prohibited by the rule. In explaining its reason for adopting this approach, the Commission said:

> [T]he variety of employment and institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities. Moreover, as a matter of policy the Commission believes the introduction and tailoring of ethical restraints on the behavior of persons associated with an investment company can best be left in the first instance to the directors of the investment company.[25]

3. <u>Other Provisions of the Federal Securities Laws</u>

Abusive personal investment activities by fund access persons are prohibited not only by section 17(j) and rule 17j-1, but also by other provisions of the federal securities laws. A fund manager who engages in front-running or makes investment decisions for the fund with the intent to benefit personally, for example, would, in addition to violating section 17(j) and rule 17j-1, violate the antifraud provisions of section 17(a) of the Securities Act of 1933 (the "Securities Act") and section 10(b) of the Exchange Act and rule 10b-5 under the Exchange Act. If a fund and its portfolio manager purchase or sell securities in the same company, the portfolio manager may have engaged in a "joint transaction" with the fund in violation of section 17(d) of the 1940 Act and rule 17d-1 under the Act. If a portfolio manager causes a fund to purchase particular securities in exchange for any compensation (in the form of securities, private investment opportunities, favorable trading terms, or other similar benefits), the manager would violate section 17(e) of the 1940 Act, which prohibits any portfolio manager or other fund insider, acting as agent, from receiving compensation from outside sources in exchange for the purchase or sale of any property to or from an investment company.

Like the provisions of the 1940 Act, the Exchange Act, and the Securities Act, described above, certain provisions of the Advisers Act apply to portfolio managers'

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[24] As explained in the text, rule 17j-1 applies to registered investment companies and their investment advisers and principal underwriters. Unless the context requires otherwise, the term "fund" as used in this Report includes any entity subject to rule 17j-1.

[25] Release No. 11421, *supra* note 21.

personal investment activities. An investment adviser whose portfolio manager or other employees engage in abusive investing, for instance, would violate section 206 of the Advisers Act, which prohibits investment advisers from engaging in certain fraudulent conduct and imposes a strict fiduciary duty on all advisers.

B. Personal Investing and the Division's Inspection Program

The Division's investment company inspection staff has played an integral role in the implementation of rule 17j-1 since the rule's adoption.[26] Through its inspection program, the Division regularly monitors the fund industry's compliance with the rule, as well as with the Commission's other rules governing investing by fund access persons. The review of access persons' securities transactions records is an essential component of all inspections.

During every fund inspection, Division examiners review a sampling of access persons' securities transactions. In addition, examiners typically: review the fund's code of ethics to determine whether it is adequate given the fund's investment operations; evaluate the adequacy of personal transaction reporting procedures; verify that an appropriate person has reviewed the personal trading reports submitted by access persons; and analyze the sample of personal transactions to check compliance with the fund's code and, more generally, to detect unlawful trading activities.

To date, the Division's inspection program has not revealed a significant number of abusive transactions by fund access persons. Although, as explained in detail below, this conclusion is supported by the data collected by the Division in its special examination of the 30 fund groups, the Division notes that inspections conducted prior to September 1993 may not accurately indicate the extent of abusive trading by fund access persons. During the three-year period prior to September 1993, the Division's inspection program focused a significant part of its efforts on money market funds, which typically would not be expected to raise issues of abusive personal trading.[27] In addition, for many years the Division's inspection program has been hampered by a lack of resources, which in turn has limited the number of personal transactions that the Division's inspectors could examine. The Division anticipates that its decision to change the emphasis of the inspection program from money market funds to all types of funds, together with the Commission's recent decision to allocate greater resources to the program, will enhance the program's ability to ensure compliance with rule 17j-1.[28]

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[26] The inspection program served as an impetus to the Commission's adoption of rule 17j-1 in 1980. The Commission said that it had determined to adopt the rule because "[t]hrough its examination program, the Commission has become aware of an increasing number of situations involving parallel trading by individuals with knowledge regarding transactions anticipated or engaged in by registered investment companies." Release No. 11421, *supra* note 21.

[27] Under existing Commission rules, money market funds must limit their investments to high quality, short-term debt instruments. These instruments generally do not present opportunities for front-running or other abusive transactions by access persons.

[28] *See* U.S. Securities and Exchange Commission Budget Estimate Fiscal 1995, at IV-6 (Feb. 1994) (stating that the focus of the Division's investment company inspection program would shift to small and medium fund complexes and that the inspection staff would increase by 54 staff years over 1993); *see also* Ellyn Spragins, *Much Ado About . . .*, Newsweek, Sept. 5, 1994, at 48 ("If corruption were rampant, it would likely show up among smaller, newer fund companies -- the focus of this year's SEC inspections.").

C. Personal Investing and the Commission's Enforcement Program

Like the Division's investment company inspection program, the Commission's enforcement program serves as a means of ensuring compliance with the Commission's rules on personal investing. As Chairman Levitt has said of the program: "[W]e will be, as we have always been, vigilant in our efforts to detect abusive trading practices by portfolio managers [and] we will not hesitate to take action against any portfolio manager whom we find to have engaged in these practices."[29]

The activities of fund access persons have been the subject of a number of recent Commission actions. These actions generally have involved abusive practices other than front-running. Three recent cases -- *In re Strong/Corneliuson Capital Management*,[30] *In re Kemper Financial Services*,[31] and *In re Embry*[32] -- highlight the Commission's efforts to deter investment advisers and their employees from engaging in abusive personal investment activities.

In *Strong/Corneliuson*, the Commission alleged that an investment adviser and two of its principals violated certain affiliated transaction provisions of the 1940 Act in connection with a number of securities transactions between registered funds managed by the adviser and an unregistered offshore investment company managed by the adviser in which the principals had a substantial undisclosed ownership interest. The Commission also alleged that the adviser and its principals had violated the antifraud provisions of the Advisers Act by acting inconsistently with the stated policy in the adviser's disclosure brochure provided to clients that the adviser and its principals would not invest in securities that it recommended to clients. In settling the action, the adviser and its two principals consented to censures and were subjected to cease and desist orders, and the adviser agreed to adopt and maintain comprehensive procedures to review and authorize all personal securities transactions in which the adviser or any of its access persons engage. The adviser also agreed to reimburse the funds almost $450,000 for pricing errors in certain of the securities transactions at issue. Finally, the adviser agreed to an unprecedented condition under which it may not serve as investment manager of a registered investment company unless a specified percentage, exceeding the percentage otherwise required under the 1940 Act, of the company's directors or trustees are non-interested persons of the adviser.[33]

Kemper involved an alleged misallocation of transactions in financial futures contracts between two registered investment companies managed by a Kemper employee and an account partially managed by the same employee and in which the employee had a financial interest. In *Kemper*, the Commission alleged that the investment adviser of two registered

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[29] Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Feb. 9, 1994).

[30] Investment Advisers Act Release No. 1425 (July 12, 1994).

[31] Investment Advisers Act Release No. 1387 (Oct. 20, 1993).

[32] Investment Advisers Act Release No. 1382 (Sept. 16, 1993).

[33] Sections 10(a) and 2(a)(19) of the 1940 Act, read together, require that at least 40% of an investment company's directors be non-interested persons of the company's investment adviser. The Commission increased this figure to 60% for Strong/Corneliuson.

investment companies caused violations of the provisions of the 1940 Act prohibiting self-dealing,[34] and failed to supervise one of its fund managers with a view to preventing his violations of those provisions. In particular, the Commission alleged that the fund manager placed the two investment companies that he managed at a disadvantage by allocating favorable transactions in futures contracts to an employee benefit plan account in which he had an interest and less favorable transactions to the two investment companies. In settling the Commission's action, the investment adviser agreed to a censure and the imposition of a cease and desist order. Moreover, the adviser agreed to pay $9.2 million into a settlement fund for distribution to the funds' shareholders, and agreed to undertake certain remedial measures to correct its procedures for the allocation of investment transactions.

In *Embry*, the sole owner and chief executive officer of an investment adviser, and fund manager for three registered investment companies, profited at the expense of his clients by engaging in numerous undisclosed personal securities transactions. In particular, the fund manager: received lucrative investment opportunities by purchasing high risk bonds for several of his clients, while purchasing common stock of the same issuers for himself; acted on several occasions as a principal in securities transactions with his clients without disclosing the capacity in which he was acting and without obtaining their consent; traded jointly, or in a block, with clients to obtain lower prices, and then resold the securities at a pre-arranged markup, resulting in substantial profit to himself; and failed to report over 750 of his personal securities transactions as required by rule 17j-1. In an administrative proceeding, the Commission ordered the fund manager to make no personal securities transactions unless (1) he retained an independent consultant and adopted the consultant's recommendations for improved compliance systems at the adviser, and (2) the consultant audited for five years the fund manager's personal securities transactions and the adviser's operations.[35]

The seriousness with which the Commission views the issue of abusive personal investing by fund personnel is shown not only in the *Strong*, *Kemper*, and *Embry* cases, but also in a number of other administrative proceedings brought by the Commission against advisers failing to adhere strictly with the requirements of rule 17j-1. The Commission has

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[34] Section 17(a) of the 1940 Act prohibits an affiliated person of a registered investment company from buying from or selling to the company any securities or other property. Section 17(d) of the 1940 Act and rule 17d-1(a) under the 1940 Act prohibit an affiliated person of a registered investment company from effecting any transaction in connection with a joint enterprise or other joint arrangement in which the company is a participant.

[35] Abusive personal investing also has been the subject of a number of court cases. *See, e.g., United States v. Ostrander*, 792 F. Supp. 241 (S.D.N.Y. 1992), *aff'd* 999 F.2d 27 (2d Cir. 1993) (manager of high-yield bond fund who accepted investment opportunities in exchange for investing fund assets in certain securities sentenced to prison term and made to pay substantial fine); *United States v. Griggs*, Crim. No. 445 (S.D.N.Y. May 21, 1992) (analyst employed by an investment adviser entered guilty plea in connection with a scheme in which outside investor profited on information received from the analyst with respect to the adviser's recommendations of high-yield debt securities and the probable timing of fund purchases); *SEC v. Bayse*, Civ. No. 92-0549 (S.D.N.Y. Jan. 23, 1992) (manager of high-yield bond fund who failed to report over 100 personal trades and who accepted investment opportunities in exchange for investing fund assets in certain securities consented to a permanent injunction against future violations of several provisions of the 1940 Act, including section 17(j) and rule 17j-1, and the Advisers Act). The Commission subsequently barred each of Ostrander, Griggs, and Bayse from associating with any investment company, investment adviser, broker, dealer, or municipal securities dealer. *See* Investment Advisers Act Release Nos. 1371 (May 3, 1993) (Ostrander), 1311 (May 28, 1992) (Griggs), and 1301 (Feb. 26, 1992) (Bayse).

brought actions, for example, alleging the failure of funds to adopt codes of ethics and the failure of access persons to submit required reports.[36]

D. Recent Media and Congressional Attention to Personal Investing

Fund managers' personal investment activities became the focus of media attention early this year after Invesco Funds fired a prominent manager for allegedly failing to report a number of his personal securities transactions as required under both the 1940 Act and the Advisers Act.[37] Less than two weeks later, *The Wall Street Journal* reported that two funds managed by the same individual had purchased the stock of a small Canadian biotech company for which the manager served as director and whose stock he had personally acquired at very low prices.[38]

At about the same time of the Invesco firing, the media reported that Fidelity, the country's largest fund complex, had recently amended its internal rules on personal investing.[39] *The Washington Post* reported that Fidelity's rule changes were prompted by several instances of front-running in small company stocks by employees of Fidelity's investment department.[40] In response to *The Washington Post* article, Edward J. Markey, Chairman of the House Subcommittee on Telecommunications and Finance, wrote to Chairman Levitt seeking information regarding "the practice of mutual fund managers trading for their personal accounts, and the potential conflict of interest that poses in their

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[36] In 1992, for example, the Commission ordered the corporate adviser to a large family of mutual funds to implement procedures reasonably designed to ensure compliance with rule 17j-1, including employment of a full-time compliance officer. The adviser's access persons consistently had submitted their quarterly reports late, in many cases as much as one year after the reports were due. *In re First Investors Management Co.*, Investment Advisers Act Release No. 1316 (June 12, 1992). In 1983, the Commission sanctioned a mutual fund access person who, over a three-year period, reported only 35 of 250 securities transactions in which he had a beneficial interest. In addition, at least 15 transactions occurred at or about the time that one or more of his employer's advisory clients were trading, or considering trading, the same security. The Commission suspended the access person from associating with any registered investment adviser or registered investment company, and prohibited him from accepting any new advisory clients, for six months. *In re Farrer*, Investment Advisers Act Release No. 847 (Mar. 31, 1983). *See also In re Cummings*, Investment Advisers Act Release No. 1304 (Mar. 23, 1992) (failure to adopt code of ethics); *In re Bench*, Investment Advisers Act Release No. 1202 (Sept. 19, 1989) (failure to maintain copies of personal transaction reports); *In re Frantzman*, Investment Company Act Release No. 16349 (Apr. 5, 1988) (failure to report personal transactions and failure to maintain copies of transaction reports); *In re Guilden*, Investment Company Act Release No. 15578 (Feb. 13, 1987) (failure to report personal transactions); *In re Lubart*, Investment Company Act Release No. 15577 (Feb. 13, 1987) (same); *In re Flusfeder*, Investment Company Act Release No. 15575 (Feb. 12, 1987) (same); *In re Leibowitz*, Investment Company Act Release No. 14310 (Jan. 10, 1985) (failure to adopt code of ethics).

[37] *E.g.*, Robert McGough and Sara Calian, *Invesco Funds Fires Kaweske, a Star Manager*, Wall St. J., Jan. 6, 1994, at C1.

[38] Sara Calian and Suzanne McGee, *Kaweske Scored on Canada Play Long Before Funds Did*, Wall St. J., Jan. 17, 1994, at C1.

[39] *See, e.g.*, Brett D. Fromson, *Fund Managers' Own Trades Termed a Potential Conflict; Biggest Mutual Fund Firm Tightens Rules*, Wash. Post, Jan. 11, 1994, at A1.

[40] *Id.* at A8.

work for the funds they manage."[41] Chairman Levitt answered Chairman Markey's inquiry by a letter dated February 9, 1994, accompanied by a memorandum prepared by the Division describing the existing provisions of law that prohibit abusive trading by fund managers and other access persons. Chairman Levitt also said that the Divisions of Investment Management and Enforcement would be conducting a special examination of 30 fund groups in an effort to analyze the fund industry's current policies and practices relating to personal investment activities of access persons.[42] That examination serves as the principal basis of this Report.

The articles relating to Invesco and Fidelity, as well as the correspondence between Congress and the Commission, led to a number of press reports on the investment activities of mutual fund investment personnel. These articles focused on several different issues. Some, for instance, described various abusive transactions in which fund managers might engage, including front-running, participating on favorable terms in initial public offerings ("IPOs") or private placements, and investing in companies on whose boards the fund managers serve.[43] Other articles noted that fund shareholders may not fully understand the potential conflicts of interest regularly faced by the managers of their funds[44] and reported that many fund groups were unwilling to make the terms of their codes of ethics available to the public.[45] Finally, a number of articles raised concerns about the ethical standards maintained by the fund industry and suggested that a total ban on personal investing by fund personnel might be the only way to ensure high moral conduct by industry participants.[46]

E. The ICI Report

Shortly after Chairman Levitt's letter to Chairman Markey described above became public, the ICI, the national association of the American investment company industry, formed a special advisory group "to review practices and standards governing personal investing and to make any recommendations deemed necessary or desirable in the interest of

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[41] Letter from Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (Jan. 11, 1994).

[42] Levitt letter, *supra* note 29.

[43] *E.g.*, Tracey Longo, *SEC Places Front Running On the Front Burner*, Financial Planning, Feb. 1994, at 24; Sara Calian, *Mutual Fund Managers Can Often Get Part of the Action in Private Placements*, Wall St. J., Jan. 28, 1994, at C1; Robert McGough, *Mutual-Fund Managers Face Conflicts of Interest While Serving as Directors*, Wall St. J., Jan. 21, 1994, at C1

[44] *See* Fromson, *supra* note 39, at A1 ("Unknown to most of the nation's 38 million mutual fund shareholders, many of the fund managers who do the investing use information available only to them and other big investors to speculate for their personal accounts.").

[45] Christopher Phillips, *Keeping Your Fund Manager Honest*, Kiplinger's Personal Finance Magazine, April 1994, at 57, 58 (noting that "[f]unds are tight-lipped about their ethics codes" and that, in response to the author's request, a few of the largest fund groups sent summaries of their codes, while others would not discuss their codes at all, or discussed them only generally, without giving specifics); John Accola, *Only 1 of Top 4 Mutual Fund Firms Reveals Ethics Codes*, Rocky Mountain News, Feb. 6, 1994, at 93A ("Only one of Denver's four biggest mutual fund companies has agreed to a *Rocky Mountain News* request to provide a copy of their internal guidelines governing personal trading for officers and portfolio managers.").

[46] *Mutual Funds Need Tighter Rules*, Business Week, Feb. 14, 1994, at 134.

investors."[47] The advisory group, in a report issued on May 9, 1994 (the "ICI Report"), concluded that "an across-the-board prohibition on personal investing [would be] unnecessary, unfair and, in the final analysis, contrary to the interests of investors."[48] Notwithstanding this conclusion, the ICI Report recommends that all participants in the fund industry adopt certain policies and procedures governing personal investment activities of fund personnel, short of a total ban, designed to address "recognized potential for abuse."[49] On June 30, 1994, the ICI's Board of Governors unanimously endorsed the conclusions and recommendations in the Report and urged all ICI members, whose funds hold approximately 95% of total industry assets, to implement the Report's recommendations by January 1, 1995.

The ICI Report recommends, among other things, that each fund adopt the following restrictions and procedures with respect to the personal investing and other activities of its investment personnel:[50]

- investment personnel should be prohibited from acquiring any securities in an IPO and should be strictly limited in their ability to participate in private placements of securities;

- each fund manager should be subject to "blackout periods" during which he would be prohibited from buying or selling securities for seven days before and after the fund he manages purchases or sells the same securities, and other investment personnel should be prohibited from buying or selling securities on a day during which the fund or any other fund in the same fund group has a pending buy or sell order for those securities;

- investment personnel should be prohibited from profiting from the purchase and sale, or the sale and purchase, of the same securities within 60 days, and any profits realized on any such short-term trades should be required to be disgorged;

- investment personnel should be prohibited from serving on the boards of directors of publicly traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the fund and its shareholders;

- investment personnel should be prohibited from receiving any gift or other thing of more than *de minimis* value from any person or entity that does business with, or on behalf of, the fund;

- investment personnel should be required to pre-clear all personal securities transactions;

- investment personnel should be required to disclose to the fund all personal securities holdings at the commencement of employment and annually thereafter;

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[47] Report of the Advisory Group on Personal Investing (May 9, 1994) at (i).

[48] *Id.* at 25.

[49] *Id.*

[50] As used in the ICI Report, the term "investment personnel" is essentially synonymous with the term "access person" as defined in rule 17j-1. *See supra* note 23.

- investment personnel should be required to instruct their brokers to send copies of trade confirmations and account statements directly to their employers;

- appropriate procedures should be implemented by the fund to monitor personal investment activity by access persons after pre-clearance has been granted;

- access persons should be required to certify annually that they have read and understood the fund's code of ethics and recognize that they are subject to it; and

- fund management should submit to the fund's board of directors or trustees an annual report summarizing, among other things, any changes made during the past year to the fund's procedures governing personal investing by access persons and identifying any violations of the procedures by an access person requiring significant remedial action during the past year.

The ICI Report also recommends that funds disclose in their prospectuses or, at a minimum, their statements of additional information,[51] the policies applicable to personal investing by their access persons. In addition, the Report recommends that the NASD adopt a rule requiring all broker-dealers to notify a registered investment adviser when any of the adviser's employees opens a brokerage account.

Although it contemplates that "substantive standards [relating to personal investing] should apply across the industry," the ICI Report acknowledges that "[i]ndividual investment companies, of course, may elect to implement more rigorous standards should these be deemed more appropriate in a specific case."[52] Moreover, the Report states that a guiding principle in drafting its recommendations was that "flexibility to allow investment companies to tailor restrictions to unique or exceptional circumstances is critical to successful implementation of [the] standards [reflected in the recommendations.]"[53] Reflecting this principle, the Report does not advocate that the Commission adopt the Report's recommendations as rules under the 1940 Act.

III. EXAMINATION OF 30 FUND GROUPS

A. Request for Information

In his letter to Chairman Markey dated February 9, 1994, Chairman Levitt reported that, to ensure that the confidence of the public in the investment company industry is well-founded, "the Divisions of Investment Management and Enforcement, through a written request for information, are examining fund managers' personal trading practices to ascertain the extent to which such trading occurs and how closely these trades are linked to a fund's

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[51] Forms N-1A and N-2, the forms for registering open-end and closed-end investment companies, respectively, under the Securities Act and the 1940 Act, provide for a prospectus and a separate "statement of additional information" ("SAI"). The SAI, which is available upon request, is designed to provide shareholders with information about the registrant that is not required to be included in the prospectus but that may be of interest to at least some investors.

[52] ICI Report, *supra* note 47, at 26.

[53] *Id.*

portfolio."[54] The special examination was begun in February and March of this year when the two Divisions sent letters to 30 fund groups[55] requesting the following documents and information for calendar year 1993:

- the identity of each fund in the group and each individual who managed a fund;

- a copy of the code of ethics for each fund and its adviser, any other written or unwritten policies regarding personal investing, and descriptions of any violations of those codes or policies;

- the number of personal transactions made by each fund's manager; and

- specific information about certain fund manager personal transactions and certain fund portfolio transactions, as more fully described in Part III.C.1. of this Report.[56]

B. Codes of Ethics: Content and Compliance

Although the 30 codes of ethics reviewed by the Commission's staff had certain provisions in common, no two codes were identical. Exhibit B to this Report contains a statistical summary of the various provisions found in the codes of ethics reviewed by the staff.

The most common restriction placed on personal trading (21 of the 30 fund groups) prohibits an access person of a fund from purchasing or selling any securities that he knows are being considered for purchase or sale, or are being purchased or sold, by the fund. In addition, 15 of the 30 groups impose a blackout period that prohibits trading securities for a specified time before and/or after one of the funds in the group has purchased or sold the same securities. The length of the blackout period varies from one day to 30 days, and the restriction frequently applies to all employees rather than being limited to access persons. Five fund groups prohibit or restrict employees from purchasing securities in an IPO; nine other groups prohibit or restrict employees from purchasing IPOs that qualify as "hot issues."[57]

All 30 funds, as mandated by rule 17j-1, require their access persons (and frequently other employees as well) to report their personal transactions. Although the rule requires only quarterly reporting, more than half of the funds require contemporaneous reporting, accomplished either by requiring employees to trade through approved (and usually affiliated) broker-dealers, or by requiring employees (or their broker-dealers) to provide duplicate confirmations of all personal securities transactions. Seventeen of the 30 fund groups require employees to pre-clear all personal securities transactions. Seven others

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[54] Levitt letter, *supra* note 29.

[55] Exhibit A to this Report includes copies of the February and March letters. The criteria used to select the 30 fund groups are discussed in Part III.C.3 of this Report.

[56] The staff requested information about personal transactions by fund managers, and not other access persons, because it concluded that managers generally have the most information about, and control over, impending fund transactions, as well as the financial ability to act on that information and control.

[57] The term "hot issue" is defined in the NASD's Rules of Fair Practice. *See infra* note 121.

require pre-clearance for certain defined categories of transactions, such as options and futures, or securities on a "restricted" list.

Most of the 30 codes of ethics reviewed by the staff provide for employees to receive a copy of the code upon commencement of employment. Many funds distribute copies annually thereafter, and each employee usually must certify each time that he has received a copy and has read and understood it. When a fund amends its code, it typically distributes a copy of the amended code to all employees. It appears that a number of funds regularly review their codes to determine whether changes are appropriate. At least six of the 30 fund groups amended their codes in 1993, including four fund groups that added a pre-clearance requirement.

The oversight of employees' compliance with a fund's code of ethics is usually a function of the fund group's compliance department. Compliance responsibilities often include determining whether to pre-clear a trade, or checking an employee's duplicate confirmations against his quarterly report of transactions to identify discrepancies.

In its review of the records of the 30 fund groups, the staff found that fund groups often deal severely with employees who violate codes of ethics provisions. Five of the 30 fund groups reported code violations by 12 employees; the remaining 25 fund groups did not report any code violations.[58] Most of the violations involved failure to pre-clear a trade. Nine of the 12 employees had their trades cancelled, disgorged profits, or were required to sell their positions at a loss. The three others received written reprimands, and one of them also was fined $600. Exhibit C of this Report contains a description of each violation reported, and the remedial action taken.

C. Analysis of Trading Data

1. Introduction

In response to the staff's requests for information, the 30 fund groups submitted data about their funds' portfolio transactions and their fund managers' personal transactions during 1993. As of the end of 1993, the 30 fund groups employed 622 portfolio managers and had $521 billion under management in 1,053 funds. As of the same time, these fund groups managed approximately 36.5% of the assets, and constituted 28.4% of the funds, in the investment company industry, excluding unit investment trusts, money market funds, and funds investing primarily in United States government securities.[59]

In conducting its examination, the staff requested information on three categories of personal securities transactions made by fund managers:

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[58] The staff limited its request for information about code violations to those violations that prompted a fund to take "significant remedial action" against an employee. In its request for information, the staff defined significant remedial action to include firing, suspending (with or without pay), reassigning, or demoting the employee; requiring the reversal of a trade or the disgorgement of profits; formal censure; and any other remedial action that might affect the employee's promotion opportunities. This request was designed to keep the quantity of information manageable by eliminating the need for funds to report certain violations, such as the occasional late filing of quarterly reports.

[59] Rule 17j-1 currently excludes money market instruments and United States government securities from its definition of "securities." *See supra* note 22. Unit investment trusts were excluded from our special examination because they are not managed investment vehicles.

(a) all personal transactions;

(b) personal transactions that were "matching trades," which were defined to include any personal transaction that preceded by ten days or less a transaction by a related fund on the same side of the market (i.e., buy/buy or sell/sell) in the same or related securities;[60] and

(c) matching trades that were "fund matching trades," which were defined to include any matching trade in which the related fund was a fund whose portfolio securities were selected by the fund manager.

Requests (b) and (c) were designed to identify potential instances of front-running by fund managers.[61] Fund matching trades were considered particularly relevant to the Division's analysis because managers are likely to have more information about their own funds than about other funds in a fund group, and thus have more of an opportunity to profit by buying or selling ahead of their own funds.

Other information requested by the staff included a listing of fund purchases of any equity securities that, at the time of the purchase, were held by that fund's manager (regardless of the time lapse between the purchases). As noted below in Part III.C.8 of this Report, these purchases can result in potential conflicts of interest between a fund and its manager.

2. Summary of Findings

The data submitted by the 30 fund groups shows that, generally, fund managers do not invest extensively for their personal accounts. In 1993, 43.5% of the fund managers employed by the groups did not buy or sell any securities; 75% engaged in ten or fewer transactions. The median number of personal transactions per manager for 1993 was two.

The data also indicates that fund managers generally avoid purchasing or selling securities that might cause a conflict of interest. Only about one of every 21 personal transactions, for example, was a matching trade and only about one of every 49 personal transactions was a fund matching trade.[62] In the majority of matching and fund matching trades, the manager did not receive a better price than the fund.

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[60] A "related fund" was defined as any fund whose portfolio securities were selected by the fund manager, or any other fund in the same fund group. For purposes of the examination, two securities were deemed "related" if the value of one security was related to the value of the other. For example, options or warrants to purchase common stock, convertible debt, and convertible preferred stock were deemed related to the underlying common stock. For convenience, all references hereafter to "the same securities" include related securities, unless specifically noted otherwise.

[61] In the interest of collecting a manageable quantity of relevant data, the staff asked the fund groups to exclude equity securities contained in the Standard & Poor's 100 Composite Stock Index from the data submitted in response to requests (b) and (c). Front-running typically contemplates the ability of a fund's trade to move the price of securities. Because of the degree of liquidity of the markets for S&P 100 stocks, it would seem highly unlikely that a single fund's purchase or sale transaction would affect the price of these stocks.

[62] Exhibit E illustrates, in pie chart form, the relative number of matching trades and fund matching trades in relation to the total number of personal transactions.

The investment activities of certain of the fund managers employed by the 30 fund groups were inconsistent with the general trends. A small percentage of the fund managers invested very actively for their personal accounts. More significantly, some managers (usually the most active investors) made a large number of matching trades. The data also shows that many of the managers who were the most active investors and who were responsible for the most matching trades (including fund matching trades) were associated with four fund groups.

3. Limitations of the Data

The data received from the 30 fund groups must be considered in the context of certain limitations. First, although the staff sought to obtain a broad cross-section of the fund industry, the 30 fund groups selected were not selected randomly and are not necessarily representative of the industry as a whole. The staff selected an approximately equal number of small, medium, and large fund groups based on assets under management,[63] and attempted to select funds that employed a variety of investment strategies and objectives. Other selection criteria included geographic location and type of sponsoring organization (e.g., broker-dealer, investment adviser, or bank). Three fund groups were selected based on the staff's experience, through prior inspections, that the groups' managers had invested actively for their personal accounts. The three groups were among the four fund groups examined whose managers invested most frequently and were responsible for the highest number of matching trades and fund matching trades. The Division believes that, if all 30 fund groups had been selected without regard to how frequently their managers had traded in the past, the data from the special examination may have reflected fewer personal transactions, matching trades, and fund matching trades.

Second, the staff's analysis is based on the data as submitted by each fund group, except that the staff in certain instances treated serial purchases or sales of the same securities as a single transaction.[64]

Finally, certain of the 30 fund groups employ unaffiliated (and separately located) subadvisers to manage all or a portion of their funds' assets. Two fund groups contended that it was unnecessary to report as matching transactions the personal transactions of portfolio managers employed by unaffiliated subadvisers that matched the portfolio transactions of funds in the groups managed by other advisers ("unaffiliated matching trades"). The two fund groups represented that the unaffiliated subadvisers did not share information about securities under consideration for purchase or sale with advisers of other funds in the group. The staff concluded that unaffiliated matching trades in all probability

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[63] For purposes of the examination, the staff considered fund groups to be small, medium, or large based on whether they managed less than $1 billion, between $1 billion and $10 billion, or more than $10 billion, respectively.

[64] To avoid overstating the number of personal transactions and matching trades, the staff consolidated multiple reported transactions into one transaction whenever multiple transactions resulted from a single investment decision. This occurred in two situations -- when a manager purchased or sold the same security for multiple accounts in which he had a beneficial interest, and when a manager's single order to purchase or sell a security on behalf of a fund was executed in multiple transactions. Each group of consolidated transactions was effected by the same broker, within approximately 24 hours, and at approximately the same price. We consolidated the transactions of 10 fund groups that were responsible for the overwhelming majority of matching trades and fund matching trades (82% and 86%, respectively). The consolidation had no material effect on the outcome of the examination, although had the staff combined transactions for all 30 fund groups, the data would reflect fewer matching trades and fewer fund matching trades.

were coincidental and therefore did not reflect front-running or any other abusive practice, and permitted the two fund groups to exclude such trades from the matching trades they reported. Some of the other 28 fund groups likewise employ unaffiliated subadvisers to manage their funds, but did not seek staff clarification on the manner in which to report subadviser transactions. If those other groups have in fact reported unaffiliated matching trades as matching trades, the number of matching trades reported may be overstated.

4. Exclusion of One Fund's Data

The data presented below excludes data for one of the funds in one of the 30 fund groups. The fund in question is managed in a style that is atypical of the fund industry. The staff concluded, after close analysis of the fund's operations and investment history and an on-site inspection of two of its subadvisers, that this management style resulted in personal trading data that was dramatically inconsistent with the other 1,052 funds covered by the special examination and that was not necessarily representative of the fund industry.

The fund in question was designed to provide individual investors with the opportunity to invest with advisory firms that otherwise manage money exclusively for wealthy individuals and institutional investors. The fund's investment adviser, an affiliate of the fund's sponsor, allocates a portion of the fund's assets to each of four subadvisers who are unaffiliated with the fund's adviser and with each other. None of the four subadvisers, and none of the four individuals who managed the fund's portfolio on behalf of the subadvisers, had managed the assets of a registered investment company prior to serving the fund. In managing a portion of the fund's assets, two of the individuals employed investment strategies identical to those employed on behalf of their other advisory clients. Those strategies contemplated the two managers' typically purchasing and selling the same securities for all of their clients, as well as for their personal accounts, at the same time. Such co-investment by a manager is characteristic of managers of hedge funds and other institutional investors, but is not a strategy generally followed by managers of registered investment companies.[65]

The investment strategy followed by two of the fund's managers appears to have resulted in personal investment data for these managers that is inconsistent with the data collected from the managers of the other 1,052 funds examined. The two managers each engaged in over 1,400 personal securities transactions in 1993, or almost three times the number of the next most active manager in the group of 30 funds examined. The two managers also had a total of more than 1,000 matching trades, each of which also constituted a fund matching trade. By contrast, the 618 managers not associated with the fund in question whose investments were examined by the staff had a total of only 471 matching trades, of which 201 were fund matching trades.

Because the trading data from the managers of this one fund deviates so greatly from the data from the other managers, and because the fund may not be representative of the fund industry generally, the Division concluded that it was appropriate to exclude this fund in presenting the results of the special examination. In the Division's view, including this fund's data would diminish the significance and utility of the data submitted by the other 1,052 funds examined. To illustrate the effect of the data submitted by the fund in question,

[65] Co-investment may not be characteristic of registered investment companies because of difficult interpretive issues raised by the practice under section 17(d) of the 1940 Act.

Exhibit D of this Report compares the data for the other 1,052 funds with the data for all 1,053 funds included in the examination.

The staff conducted an on-site inspection of the two subadvisers whose managers' personal investment activities were atypical of the other managers whose investments were reviewed. The inspection of one subadviser did not reveal evidence of abusive trading activities. The inspection of the other subadviser has not yet been completed.

5. Securities Transactions of the Fund Managers Examined

The data provided to the staff revealed that a substantial majority of the fund managers employed by the 30 fund groups examined either did not buy or sell securities in 1993, or did so infrequently; only a small percentage of managers invested actively for their personal accounts. The 30 fund groups reported a total of 9,843 personal securities transactions by 618 fund managers during 1993.[66] Of these managers, 269, or 43.5%, reported no personal transactions. The median number of personal transactions for all 618 fund managers was two.[67] In addition, personal transactions were concentrated among a small number of managers. Ten managers had over 200 transactions each; two of these individuals had over 500 transactions each. The five managers who invested most actively accounted for almost 25% of all personal transactions included in the data received by the staff; the 10 most active managers accounted for over 37% of all personal transactions, and the 20 most active managers accounted for 50% of all personal transactions. The following table summarizes the number of fund managers' personal securities transactions:

Number of Personal Transactions	Number of Managers
0	269 (43.5%)
1 - 2	70 (11.3%)
3 - 10	124 (20.1%)
11 - 20	59 (9.5%)
21 - 40	43 (7.0%)
41 - 100	37 (6.0%)
> 100	16 (2.6%)

Significantly, most of the active investors were concentrated among a few fund groups. Of the 20 managers who had the greatest number of personal transactions, 16 were associated with four fund groups. As the following table illustrates, fund managers associated with those four fund groups accounted for almost half of all personal securities transactions reflected in the data received by the staff:

[66] Although it received data with respect to 622 fund managers, the staff excluded the data from the four managers of one fund, for the reasons set forth in Part III.C.4 above.

[67] By contrast, the average number of personal securities transactions per manager was 16. The wide disparity between the median and average figures results from a small number of fund managers engaging in a substantial number of personal securities transactions. This result may be due, in part, to the selection of certain fund groups based on the staff's experience that the groups' managers had, in the past, invested actively for their personal accounts. *See supra* Part III.C.3. The Division concluded that, in this instance, the typical fund manager's personal investment activities are presented more accurately by using the median instead of the average.

Number of Fund Groups	Number (%) of Managers	Number (%) of Personal Transactions	Avg. Number of Personal Transactions Per Manager
4	96 (15.5%)	4,807 (48.9%)	50.0
26	522 (84.5%)	5,036 (51.1%)	9.6

6. Matching Trades

Of the 9,843 personal transactions reported to the staff, 471 (4.8%) were matching trades.[68] The staff's examination revealed that a sizable majority of fund managers had no matching trades, and that those managers who had such trades had only a small number of them. Over 80% of the 618 fund managers in our sample had no matching trades at all. The average number of matching trades for all 618 fund managers was less than one. The following chart illustrates that the fund managers whose transactions were reviewed by the staff generally did not actively buy or sell securities ahead of a related fund:

Number of Matching Trades	Number of Managers
0	504 (81.6%)
1 - 2	73 (11.8%)
3 - 4	16 (2.6%)
5 - 10	17 (2.8%)
11 - 20	4 (0.6%)
> 20	4 (0.6%)

The data showed that a small number of managers engaged in a large percentage of matching trades. Four managers accounted for 30% of all matching trades; twelve managers accounted for just under 50% of all matching trades. Eight of those 12 managers (and all of the four managers who had the most matching trades) were associated with four fund groups -- the same four groups whose managers had the highest concentration of personal securities transactions. The following table illustrates the concentration of matching trades among these four fund groups:

Number of Fund Groups	Number (%) of Managers	Number (%) of Matching Trades	Avg. Number of Matching Trades Per Manager
4	96 (15.5%)	235 (49.9%)	2.45
26	522 (84.5%)	236 (50.1%)	0.45

For each matching trade involving equity securities (433 of the 471 matching trades), the staff examined the length of time between the manager's transaction and the fund's transaction, and the difference in the respective transaction prices.[69] On average, fund

[68] This number may overstate the actual number of matching trades. See the discussion in Part III.C.3 of this Report.

[69] In comparing the prices that funds and managers paid or received in matching trades, the staff focused on equity securities because the per share price of equity securities affords a basis for comparison. Because it would not be helpful in this context to compare the price of equity securities to the price of a warrant or option relating to the securities, the statistics cited in the table above relate to matching trades of the same securities only, and not to related securities. *See supra* note 60.

managers purchased or sold equity securities 3.4 days before a related fund, and did so at a less favorable price than the fund.[70] Notwithstanding the average statistics, fund managers received a better price than a related fund in 175 transactions (1.8% of the 9,843 personal transactions reported by the fund managers covered by the staff's examination). These 175 manager transactions consisted of 118 purchases and 57 sales. Favorable purchases by managers, on average, occurred 3.5 days before a matching fund transaction and the price per share paid by the manager was $1.24 less than the fund paid. Favorable sales by managers, on average, occurred 4.1 days before the matching fund trade and the price per share received by the manager was $1.47 more than the fund received. Approximately half of the matching trades in which the fund manager received a better price than a related fund were pre-cleared by the manager's employer.

7. Fund Matching Trades

The data collected by the staff revealed that, in 1993, the overwhelming majority of fund managers whose transactions were examined -- more than 90% -- had no fund matching trades, and most of those who had fund matching trades had only one or two of them. The following table summarizes these results:

Number of Fund Matching Trades	Number of Managers
0	570 (92.2%)
1	25 (4.1%)
2	8 (1.3%)
3 - 10	12 (1.9%)
11 - 20	2 (0.3%)
> 20	1 (0.2%)

The 30 fund groups reported 201 fund matching trades, or 2.0% of all personal securities transactions in 1993. A large percentage of the 201 fund matching trades was undertaken by a few managers. One manager, for example, had 60 fund matching trades and another had 20, accounting for 30% and 10%, respectively, of all fund matching trades. The four fund groups responsible for the highest concentration of personal transactions and matching trades also were responsible for more than two-thirds of all fund matching trades, as the following table illustrates:

Number of Fund Groups	Number (%) of Managers	Number (%) of Fund Matching Trades	Avg. Number of Fund Matching Trades Per Manager
4	96 (15.5%)	140 (69.7%)	1.46
26	522 (84.5%)	61 (30.3%)	0.12

The data collected shows a correlation between the size of a fund and the proportion of personal securities transactions by the fund's managers that are fund matching transactions. The proportion is considerably higher for fund managers associated with small

[70] Of the 295 matching trades that involved the purchase of the same equity securities by a fund manager and a related fund, the price per share paid by the manager averaged $0.10 higher than the fund paid. Similarly, of the 138 matching trades that involved the sale of the same equity securities by a fund manager and a related fund, the price per share received by the manager averaged $0.43 lower than the fund received.

and medium size fund groups (4.3% and 3.8%, respectively) than it is for those associated with large fund groups (0.7%).[71]

For each fund matching trade involving equity securities (183 of the 201 fund matching trades), the staff examined the length of time between the manager's transaction and the fund's transaction, and the difference in the respective transaction prices.[72] Like that relating to matching trades generally, the data for fund matching trades shows that, on average, managers purchased and sold securities at less favorable prices than their funds.[73] Notwithstanding the average statistics, fund managers received a better price than their funds in 69 transactions (less than 1% of the 9,843 personal transactions reported by the fund managers covered by the examination). The 69 manager transactions consisted of 46 purchases and 23 sales. Favorable purchases by managers occurred, on average, 3.7 days before a matching fund trade and the price per share paid by the manager was $1.03 less than the fund paid. Favorable sales by managers occurred, on average, 4.2 days before the matching fund trade and the price per share received by the manager was $1.90 more than the fund received.

8. <u>Fund Equity Purchases of Securities Held by the Fund's Manager</u>

The staff asked the 30 fund groups to identify all fund purchases of equity securities that, at the time of purchase, were held by the fund's manager ("matching fund equity purchases").[74] This request was designed to identify circumstances involving either of two potential conflicts of interest. First, a manager who causes his fund to purchase securities he holds may be attempting to increase the price of the securities. Second, a manager who holds the same securities as his fund may, in seeking to protect the value of his personal investment, not sell the securities held by the fund at a time most beneficial to the fund.

The number of matching fund equity purchases reported to the staff was small. Approximately one of every 34 fund equity purchases (2.9%) was a matching fund equity purchase. The number of matching fund equity purchases that raised potential conflict of interest situations was even lower, because many matching purchases involved actively

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[71] The staff believes that these results may indicate greater potential for compliance problems at smaller fund groups. The concern that smaller funds and new entrants to the fund industry may have less developed compliance programs caused the Division late last year to focus more of its inspection resources on these types of funds. *See supra* note 28 and accompanying text.

[72] *See supra* note 69.

[73] Of the 123 fund matching trades that involved the purchase of the same equity security by a fund manager and the fund he managed, the price per share paid by the manager averaged $0.24 higher than the fund paid. Similarly, of the 60 matching trades that involved the sale of the same equity securities by a fund manager and his fund, the price per share received by the manager averaged $0.99 lower than the fund received. On average, managers who purchased or sold stock in advance of their funds did so 3.5 days before their funds' transactions.

[74] The data presented with respect to matching fund equity purchases covers only 28 of the 30 fund groups examined by the staff. Two groups did not respond to this request because they could not obtain information about their managers' securities holdings before the managers began working for the groups. The inability of these fund groups to obtain information about their managers' pre-employment holdings underscores the need for a requirement that fund personnel disclose their securities holdings at the commencement of their employment with a fund or a fund's adviser. The Division is recommending that the Commission adopt such a requirement. See Recommendation 3 in Part V of this Report.

traded securities of large capitalization companies whose prices were unlikely to have been affected given the size of a fund's purchase.

The number of matching fund equity purchases as a percentage of a fund group's total equity purchases ranged from a low of zero to a high of 15.8%. The four fund groups whose managers accounted for the highest concentration of personal securities transactions, matching trades, and fund matching trades, were also among the fund groups with the highest percentages of matching fund equity purchases. The following table illustrates these findings:

Number of Fund Groups	Number (%) of Fund Equity Purchases	Number (%) of Matching Fund Equity Purchases	Avg. Pctg. of Matching Fund Equity Purchases
4	47,109 (20.0%)	3,991 (57.9%)	8.5%
24	187,909 (80.0%)	2,902 (42.1%)	1.5%

The staff found a correlation between the size of a fund group and the proportion of the group's matching fund equity purchases. Small groups had the highest proportion of matching fund equity purchases, 5.1%, medium groups had 3.0%, and large groups had 1.7%.

D. Need for Further Examinations

The vast majority of the fund managers subject to the staff's examination did not invest actively for their personal accounts, and invested infrequently or not at all in advance of a related fund. A few managers, however, engaged in a significant number of transactions, including numerous matching trades. At this time, the staff lacks sufficient information to assess whether these transactions involved front-running or other prohibited practices. The staff is in the process of obtaining additional information about these transactions, particularly those in which the manager received a better price than a related fund. In addition, the staff is examining the compliance programs of the four fund groups whose managers effected the most personal securities transactions, matching trades, and fund matching trades, and a significant number of matching fund equity purchases, to determine whether these groups exercised adequate oversight over the personal investment activities of their employees. If the Division's inspection staff finds evidence of abusive conduct or materially deficient procedures, it will refer those matters to the Division of Enforcement for further action.

IV. ANALYSIS OF CERTAIN ISSUES

In developing recommendations designed to enhance the existing rules governing the personal investment activities of fund access persons, the Division considered two key policy issues that have been raised by members of Congress, certain Commissioners, and numerous press articles. Those issues are: whether personal investing by access persons should be banned entirely and whether the standards of conduct recommended by the ICI Report, or other similar or comparable standards, should be made mandatory for all funds through Commission rules. For the reasons described below, the Division believes that the Commission should continue to follow its long-standing positions that personal investing by access persons should not be banned and that specific standards governing personal investing should not be mandated.

A. Banning Personal Investing

In a letter dated May 23, 1994, Representative John D. Dingell, Chairman of the House Committee on Energy and Commerce, asked the Commission to consider whether the practice of personal investing by fund access persons should be banned entirely.[75] Commissioner Roberts and Judge Stanley Sporkin, former director of the Commission's Enforcement Division, among others, have suggested that a ban may be appropriate.[76] At least one fund group reportedly has imposed a ban on certain access persons.[77]

Commentators have offered several reasons to support a ban on personal investing by fund access persons. First, some say that a ban is the only way to deal effectively with real or perceived conflicts of interest that exist when access persons invest for their own accounts.[78] Others contend that the fund industry must adhere to the highest possible ethical standards in light of the substantial number of investors, particularly new investors, now turning to mutual funds, and the substantial amount of assets now under the control of fund managers.[79] Still others have said simply that a ban may be the only way for the industry to retain its "squeaky clean" reputation.[80] Finally, some observers maintain that the time spent

[75] Letter from John D. Dingell to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, and Matthew Fink, President, Investment Company Institute (May 23, 1994).

[76] "Portfolio Manager Trading, Investment Adviser Fees and Bank Mutual Fund Activities," Remarks of Richard Y. Roberts, Commissioner, U.S. Securities and Exchange Commission, before the District of Columbia Bar and George Washington Univ. Merging Financial Markets Conference in Washington, D.C. (Mar. 25, 1994); "Does an Ethical Dilemma Exist in the Financial Services Industry?," Remarks of Stanley Sporkin, U.S. District Court Judge, before the Association of Investment Management & Research Conference in Washington, D.C. (Dec. 1, 1993).

[77] Berger Associates, an advisory firm that manages three public mutual funds with approximately $2.3 billion in assets, prohibits its fund managers from holding individual stocks in their personal accounts. Jonathan Clements, *Personal Trading is Common Among Fund Managers*, Wall St. J., Jan. 25, 1994, at C1.

[78] "Mutual Fund Directors: On the Front Line for Investors," Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Mutual Funds and Investment Management Conference in Scottsdale, Arizona (Mar. 21, 1994), at 6 ("Many in the industry argue that trading by managers . . . create[s] only a perceptual problem. That is precisely the point. With millions of inexperienced investors leaving the safety of bank CDs for the expectation of higher returns in the mutual fund market, we can ill afford even the perception of conflict. . . . If I were a [mutual fund] director I would have reservations about trading by managers . . . .") (emphasis in original); B.J. Phillips, *Mutual Funds, Mutual Conflicts*, Phila. Inquirer, Mar. 9, 1994 ("As absolutist as it seems, abolishing personal trading entirely may be the only approach the investment industry can afford.").

[79] Levitt remarks, *supra* note 78; Robert McGough & Sara Calian, *SEC Focuses on Personal Trades*, Wall St. J., Jan. 13, 1994, at C1, C25 (quoting Kathryn McGrath, former Division director) ("The mutual fund industry 'has a very clean reputation,' she says. But because of the industry's explosive growth, 'there is so much more money being handled in the care of these folks that the standards for watching them need to be raised.'").

[80] *Mutual Funds Need Tighter Rules* (editorial), Bus. Week, Feb. 14, 1994, at 134 ("One way for the mutual-fund industry to retain its squeaky-clean image is to forbid its managers from trading for themselves."); Tom Petruno, *When It Comes to Fund Industry, Public Trust Must Be a Mutual Issue*, L.A. Times, Jan. 12, 1994, at D1, D3 ("If investors begin to doubt that fund managers are much different from the market crooks who paraded through federal courts in the 1980s -- people whose main goal was to enrich themselves, to others' detriment -- the fund industry will lose one of its most important selling points with the small investor.").

by fund managers analyzing particular investments should benefit only fund investors and not the managers themselves.[81]

Opponents of a ban cite a variety of reasons for their view. Some maintain that a ban is simply unnecessary to encourage high ethical standards among investment personnel. The ICI Report argues, for instance, that competitive pressures in the fund industry should induce funds to adopt high standards. According to the Report "[n]o investment management firm will succeed in [today's competitive] environment unless it consistently serves the interests of the customer first."[82] Some commentators opposed to a ban contend that personal investing potentially provides benefits to fund shareholders by sharpening fund managers' skills.[83] Other opponents argue that a ban would place mutual funds at a competitive disadvantage, in terms of hiring and retaining qualified personnel, to other institutional investors, such as employee benefit plans, hedge funds, insurance company separate accounts, and bank trust departments, which do not prohibit personal investing by their investment professionals.[84]

From the Division's perspective, it is relevant to consider whether the Commission's authority under section 17(j) is sufficiently broad to enable it to prohibit the practice. As noted above in Part II.A.1 of this Report, by its terms, section 17(j) does not contemplate a ban on all personal investing. The legislative history of section 17(j) is consistent with the view that the Commission's authority under the section is limited. At no time, in considering the provision that became section 17(j), did Congress indicate a desire to prohibit personal trading. Moreover, in making the recommendation to Congress that ultimately resulted in the enactment of section 17(j), the Commission, as pointed out above, stated expressly that "persons affiliated with investment companies cannot be expected to

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[81] Susan Antilla, *Fund Managers Testing the Rules*, N.Y. Times, Jan. 23, 1994, at F15 (quoting a trustee of a mutual fund, who said that fund managers are "spending time analyzing stocks that aren't benefiting the fund. . . . They can all say 'I do it at home after my kids are in bed,' but, well, give me a break."); Henry Dubroff, *Expect Your Mutual Fund Manager to 'Eat His Own Cooking'*, Denver Post, Jan. 16, 1994, at 1C ("I don't want the people who manage my mutual funds spending a lot of time or making a lot of money on personal deals when they should be watching the funds' money.").

[82] ICI Report, *supra* note 47, at 21.

[83] Robert McGough, *A Primer on Questions Surrounding Personal Trading by Fund Managers*, Wall St. J., Jan. 17, 1994, at C10 (quoting a Fidelity spokeswoman, who said "We strongly believe that allowing our managers to trade individual stocks sharpens their skills, educates them about the markets, and ultimately produces even better performance for our shareholders."); John Durie, *Government Ready to Rein in Funds Biz.*, N.Y. Post, Jan. 12, 1994 ("It is ridiculous to ban fund managers from buying stocks, if for no other reason than personal experience in the game makes for a better manager.").

[84] *See Mutual Satisfaction* (editorial), Wall St. J., May 25, 1994, at A16 ("[A]n outright prohibition on trading . . . would impel more top investment pros to leave the public funds, or else to demand far higher salaried compensation and thus boost management fees for mutual [fund] shareholders."); Richard M. Phillips, Christian E. Plaza, and Mitchell B. Birner, *Personal Trading by Persons Associated with Mutual Fund Advisers: A Time for Re-Evaluation*, The Inv. Law., at 3, 4 (May 1994) ("To . . . prohibit investment company employees from managing their personal portfolios could place the mutual fund industry at an unfair competitive disadvantage with other money managers in competing for qualified personnel."); James M. Pethokoukis, *Controversy Has Yet to Sully Funds' Image*, Investor's Bus. Daily, Mar. 4, 1994 (quoting A. Michael Lipper, president of Lipper Analytical Services) ("And what I think would happen [with a ban on personal trading] is that the good money managers would leave for hedge funds.").

refrain from engaging in securities transactions for their personal accounts."[85] In view of the language and legislative history of section 17(j), the Division believes that the Commission should not prohibit all personal trading by fund insiders unless its authority to do so is clarified and confirmed by Congress. The Commission's Office of the General Counsel concurs with the Division's position.

In the Division's view, whether personal investment activities by fund access persons should be banned depends on an analysis of three related issues: the prevalence of abusive securities transactions by access persons; the potential harm to fund shareholders caused by access persons' personal investment activities; and the likelihood that a ban would curb abusive trading by access persons. The Division has considered each of these issues and has concluded that prohibiting investment by access persons is not warranted at this time.

The evidence the Division has reviewed to date suggests that abusive investing by fund access persons is not prevalent throughout the fund industry. The Division's inspectors, who review personal securities transactions in the normal course of fund examinations, have found few instances of abusive investing by fund access persons.[86] The results of the staff's special examination support the experience of the Division's inspection staff. The data from the special examination shows that a substantial percentage of fund managers did not invest, or invested only infrequently, for their personal accounts.[87] The data also suggests that those managers who invested generally did not engage in transactions that raised potential conflicts of interest with their funds.[88]

The special examination indicates not only that potentially abusive personal securities transactions by fund managers are infrequent, but also that the fund industry seeks to ensure that abusive transactions do not occur. The examination suggests that funds review their codes of ethics regularly and that at least some funds sanction severely employees who violate fund codes. The Division believes that the recent interest shown by Congress and the Commission in the issue of personal investing, the increase in the number of Division examiners currently contemplated,[89] an increase in the frequency of the Division's investment company inspections, and widespread acceptance of the recommendations contained in the ICI Report and this Report should all serve to further minimize abusive investing by fund access persons.

In the absence of compelling evidence that abusive personal investing by fund access persons is widespread throughout the fund industry, the Division believes that a ban on personal investing could be justified only on the basis of a finding that the potential harm to fund shareholders resulting from the practice is so great as to be contrary to the public interest. In the Division's view, such a finding is unwarranted.

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[85] *See supra* note 11 and accompanying text.

[86] As suggested above in Part II.B of this Report, the Division believes that more examinations of funds need to be undertaken to confirm this finding.

[87] *See* Part III.C.5 of this Report.

[88] *See* Parts III.C.6 through III.C.8 of this Report.

[89] The Division currently has 203 investment company examiners, an increase of 50 examiners during fiscal year 1994. The Division's fiscal year 1995 budget contemplates the hiring of another 50 investment company examiners. The Division anticipates requesting an additional 50 examiners in fiscal year 1996.

As suggested by Congress in enacting section 17(j) and by the Commission in adopting rule 17j-1, many personal investments by fund managers raise no public policy concerns.[90] Among the transactions that the Commission itself has cited as not abusive and not contrary to the purposes of section 17(j) are "ones which are: non-volitional on the part of the access person involved in the transaction; only remotely potentially harmful to [the fund managed by the access person] because they would be very unlikely to affect a highly institutional market; or clearly not related economically to the securities to be purchased, sold or held by the fund." The Commission has said that none of these transactions is contrary to the interests of a fund's shareholders because they do not "create the conflict of interest situations to which Section 17(j) was addressed."[91]

The kinds of transactions to which section 17(j) and rule 17j-1 are addressed all share a common characteristic. Each such transaction involves an access person's placing his interests ahead of those of the fund he serves when making personal investment decisions.[92] Because such abusive transactions already are prohibited by a number of existing provisions of the federal securities laws,[93] banning all personal securities transactions by access persons is not necessary. A ban on all forms of personal investing by access persons would not provide fund shareholders with any additional protection from abusive investing than they have now, but could deny access persons the benefits of many legitimate investment opportunities.[94] The Division believes that such a result is not desirable.

In the Division's view, banning personal investing would in all likelihood not curb abusive transactions any more effectively than does the scheme currently contemplated by section 17(j). Fund managers have in the past made personal investments that are prohibited under existing laws. In many, if not most, of those cases the illegal investments were not reported to the managers' employers.[95] It is quite likely that a ban would not, any more

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[90] Because many forms of personal investing are consistent with sound public policy, a ban in all likelihood would need to be subject to numerous exceptions or provide for an exemption procedure. Such exceptions or exemptive procedure would likely result in the Division's receiving a significant number of requests for administrative or interpretive relief, which could strain the Division's resources even further. The Division's compelling need for resources has been discussed with Congress on a number of recent occasions. *E.g.*, Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning the Investment Company Industry Before the House Subcommittee on Telecommunications and Finance (Aug. 5, 1993) (there is a "dangerous shortfall in the Commission's resources to oversee" the investment company industry and without additional resources "the task [the staff] face[s] may become too great to provide any real measure of deterrence or investor protection").

[91] Release No. 11421, *supra* note 21.

[92] *Id.*

[93] See the discussion in Part II.A.3 of this Report.

[94] Some observers have suggested that fund managers should be allowed to invest only in the funds they manage. The Division believes that such a limitation on fund managers similarly would not afford greater protection to fund shareholders than the existing regulatory scheme. In addition, such a limitation could penalize a manager whose personal financial situation was inconsistent with the investment objectives and policies of the fund he manages.

[95] *E.g.*, *Ostrander*, *supra* note 35. In addition, press accounts regarding the transactions undertaken by the fired Invesco fund manager have noted that his transactions were not reported to his employer. *E.g.*, McGough and Calian, *supra* note 37, at C1.

than current regulation, deter persons who are willing to hide securities transactions from engaging in abusive trading.

The Division believes that, like a total ban, a partial ban on investing by access persons, under which they would be prohibited from holding only securities held by their fund, would not deter wrongdoers any more effectively than current regulations. In addition, such a partial ban could encourage an unscrupulous fund manager to divide investment opportunities between the fund and his personal account.[96]

The Division's decision not to recommend an industry-wide ban on all personal transactions by access persons is not intended to indicate that it would be inappropriate for individual funds to prohibit personal investing by some or all of their personnel. The Division agrees with Chairman Levitt that each fund's board of directors or trustees, in determining the appropriate restrictions to place on personal investing by access persons, should consider whether to ban all personal transactions.[97] In particular, the board should ask fund management for an explanation of the purpose personal investing serves. If fund management and the board are satisfied that personal investing is desirable and not inconsistent with the interests of shareholders, the board should ensure that the fund's code of ethics contains comprehensive safeguards, reporting, and verification procedures.[98]

B. Incorporating the ICI Report's Recommendations into Commission Rules

Many observers have commented favorably on the ICI Report. Chairman Dingell has commended the ICI for its "swift and comprehensive" response and has referred to the Report's recommendations as "tough and far-reaching."[99] Chairman Markey has said that he is "very impressed" with the Report's "forceful and impressive" recommendations.[100] Chairman Levitt has said of the recommendations: "We were pleased with [them.] They go a long way toward responding to our concerns."[101] Even many industry participants who could be subject to more stringent investment restrictions praised the Report's recommendations.[102] Like these commentators, the Division commends the ICI special advisory group for taking a decisive initiative in addressing the conflicts of interest that can result from personal investing by fund personnel.

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[96] To the extent that a fund manager withholds opportunities from the fund to benefit himself, he would violate certain provisions of the federal securities laws. *See, e.g.*, *SEC v. Embry*, Litigation Release No. 13777 (Sept. 9, 1993).

[97] Levitt remarks, *supra* note 78, at 6.

[98] *Id.*

[99] Dingell letter, *supra* note 75.

[100] Brett D. Fromson, *Mutual Fund Industry Panel Would Curb Personal Trades*, Wash. Post, May 10, 1994, at C5; Susan Antilla, *Raining on Fund Managers' Parade*, N.Y. Times, May 8, 1994, at F13.

[101] Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, at the Investment Company Institute Annual Conference, Washington, D.C. (May 18, 1994), at 1.

[102] Sara Calian, *Few Funds Gain in Past Three Months*, Wall St. J., May 10, 1994, at C1, C27 (quoting Shelby Davis, a portfolio manager and president of the Selected/Venture fund group, and John C. Bogle, chairman of the Vanguard Group).

In light of its assessment of the ICI Report, the Division believes it appropriate to consider whether the Commission should adopt some or all of the Report's recommendations as rules under the 1940 Act or other federal securities laws. Some commentators specifically have cited standards such as blackout periods, pre-clearance, and prohibitions on short-term trading as being particularly appropriate candidates for Commission rulemaking.[103]

As noted above in Part II.E of this Report, the ICI Report does not conclude that any of its recommendations should be adopted as Commission rules. Although certain of the Division's recommendations mirror, or are substantially similar to, certain of the Report's recommendations, the Division is not recommending that any of the substantive restrictions on personal investing activities recommended by the Report be implemented as Commission rules.[104] While the Division strongly encourages funds to adopt the ICI Report's recommendations, it believes that the Commission's rationale for not mandating uniform standards of conduct governing personal investing was correct in 1980 and is even more compelling today.

In determining not to mandate uniform standards when it adopted rule 17j-1, the Commission emphasized the need for each fund to have the flexibility to design specific means to prevent abusive investing by access persons, with restrictions and procedures suited to the fund's particular size, investment objectives, structure, and operations. The Commission said at the time that:

> [t]he broad language of the Rule is intended to permit entities to consider transactions by access persons in the context of their particular business operations when adopting their individual codes of ethics.[105]

The Commission added that it:

> has determined . . . to let individual entities take fully into account their own unique circumstances in designing their codes of ethics prescribing standards of conduct which effectuate the purposes of the Rule. . . . The Commission believes the current approach is more desirable [than mandating or suggesting particular standards] because it gives maximum flexibility to the entities which must design the codes of ethics.[106]

In affording funds the flexibility to design their own codes of ethics, the Commission acknowledged, as it and Congress have recognized consistently over the past 30 years, that no one set of standards is appropriate for every fund.[107] The Division believes that this

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[103] Phillips, Plaza, and Birner, *supra* note 84.

[104] In the Division's view, the Commission's authority under section 17(j) to adopt certain of the ICI Report's recommendations is unclear. The Commission's Office of the General Counsel concurs in this view.

[105] Release No. 11421, *supra* note 21.

[106] *Id.*

[107] *See* Part II.A of this Report.

principle continues to be valid today.[108] Funds need to have the ability to tailor codes of ethics to their individual characteristics. Pre-clearing all personal securities transactions may not be necessary, for example, for a fund that distributes to its employees a list of restricted securities on a daily basis. A fund whose investment policies contemplate significant portfolio turnover will likely need more restrictions to address ethical concerns than a fund whose investment policies contemplate only limited trading activities. A fund that invests primarily in securities of large capitalization companies traded over major U.S. exchanges may not need as many restrictions in a code of ethics as a fund that invests in thinly traded securities of smaller capitalization companies. Finally, a fund that seeks to mirror the performance of a particular index may not require the same restrictions as a fund that invests primarily in a particular industry sector or in the securities of companies located in a foreign country.

In determining not to provide for mandatory code of ethics provisions in rule 17j-1, the Commission spoke not only of the need for flexibility in developing codes of ethics, but also of the "difficulties of interpretation and administration" it concluded were likely to result if it adopted uniform code standards.[109] The Division believes that, in light of the diversity of fund types that now characterizes the fund industry, the Commission's adoption of uniform code of ethics provisions would in fact lead to countless requests for interpretations of, or exemptive relief from, provisions that did not fit a particular fund's specific circumstances. Such a result could only serve to burden further the Division's limited resources, without necessarily providing increased protection to fund shareholders.

Although, for the reasons described above, the Division does not support amending rule 17j-1 to require all funds to adopt uniform code of ethics provisions, the Division believes that the management and board of directors or trustees of each fund should specifically consider the recommendations in the ICI Report. Moreover, the Division would expect all funds to adopt the Report's recommendations, in whole or substantial part, absent special circumstances.

The ICI expects that 85-90% of the mutual fund industry will revise their codes of ethics to meet the standards of conduct reflected in the ICI Report's recommendations.[110] The Division will request a report from the ICI within the next six months describing, among other things, the number of ICI members that have adopted the recommendations and any interpretive, administrative, or other problems ICI members have experienced in implementing the recommendations. On the basis of that report, the Division may reconsider the issue of amending rule 17j-1 to provide for uniform code of ethics standards.

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[108] The need for flexibility may be even more compelling today than it was in 1980 when rule 17j-1 was adopted, in light of the proliferation of different types of funds. Lipper Analytical Services, for example, currently tracks 56 different categories of non-money market mutual funds.

[109] Release No. 10162, *supra* note 19.

[110] *See* Fromson, *supra* note 100, at C5.

V. RECOMMENDATIONS

Although the Division believes that fundamental changes in the regulatory scheme governing personal investing by fund access persons are not warranted at this time, the Division believes that the regulatory scheme can and should be improved. In seeking that result, the Division has developed six recommendations.

The Division's recommendations are designed to further protect fund shareholders by making available to the public additional information about fund policies on personal investment; enhancing the oversight of personal investment policies by fund boards of directors or trustees; making it easier for both funds and the Commission's staff to monitor the personal transactions of fund personnel; and clarifying the scope of prohibited activities by fund personnel. The specific recommendations of the Division are described in detail below.

Recommendation 1: DISCLOSURE OF PERSONAL INVESTING POLICIES
The Division recommends that funds be required to publicly disclose their policies and procedures regarding personal investing by fund personnel.

Recent press accounts, as noted above, have suggested that fund shareholders may not fully understand the potential conflicts of interest raised when fund personnel invest for their personal accounts[111] and have reported that many fund groups are unwilling to make the terms of their codes of ethics available to the public.[112] Correspondence received by the Division from fund shareholders has confirmed that investors want more information about funds' personal investment policies. The Division believes that investors have a right to know whether and to what extent fund personnel are permitted to invest for their own accounts. The Division, therefore, recommends that each fund be required to disclose to existing and prospective shareholders its policies regarding personal investing.

The Division contemplates that its recommendation would be implemented by the Commission requiring each fund to disclose briefly in its prospectus its policies with respect to personal investing by its personnel and the manner in which an investor can obtain a copy of the fund's code of ethics.[113] In addition, the Division anticipates recommending that the Commission require each fund to attach as an exhibit to its registration statement under the 1940 Act a copy of its code of ethics as currently in effect. The latter requirement would be designed to make the terms and conditions of codes of ethics available not only to fund shareholders, but also to the press and other media, which could analyze and compare codes for the benefit of the general public.

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[111] *See supra* note 44 and accompanying text.

[112] *See supra* note 45 and accompanying text.

[113] If, as the ICI expects, the recommendations included in the ICI Report become the industry norm, the Division would anticipate proposing that the Commission expand this disclosure requirement to include a discussion by the fund comparing or contrasting the terms of its code of ethics to the recommendations. *See supra* text accompanying note 110.

Recommendation 2: ENHANCED BOARD REVIEW
The Division recommends that rule 17j-1 be amended to require that a fund's board of directors or trustees annually review all codes of ethics applicable to the fund.

Under section 17(j) and rule 17j-1, the board of directors or trustees of a fund, particularly the fund's directors or trustees who are not interested persons of the fund, have a significant oversight role with respect to the personal investment activities of fund personnel. Consistent with the rule, the board is responsible for ensuring that the fund establishes a code of ethics that meets the requirements of the rule, and for monitoring the ongoing operation of the code. As suggested above in Part IV.A of this Report,[114] the board should determine as an initial matter whether personal investing is consistent with the interests of the fund's shareholders and should be permitted. The board should, among other things, also examine whether both the fund and its adviser (and any subadvisers) have adopted appropriate measures designed to prevent and detect abusive investment practices and whether they have instituted effective compliance procedures.[115] If any violations of the policies applicable to the fund occur, the board should consider whether the individual engaged in the improper conduct received an appropriate sanction.[116]

To enhance board oversight of personal investment activities of fund access persons, the Division recommends that rule 17j-1 be amended to require each fund's board to review, at least annually, the fund's code of ethics to determine whether any changes are appropriate in light of particular violations or changing circumstances generally. Among the information the Division believes should be provided to a fund's board to enable it to evaluate the fund's code of ethics in a meaningful way is a copy of the fund's existing code, a description of any code violations and any significant remedial actions taken in response, and recommendations (if any) for changes to the code. The Division notes that this recommendation is similar to a recommendation in the ICI Report.

Recommendation 3: DISCLOSURE OF PRE-EMPLOYMENT HOLDINGS
The Division recommends that rule 17j-1 be amended to require each access person of a fund to disclose his personal securities holdings at the time at which the access person is first employed by the fund or its investment adviser.

A fund cannot effectively monitor the potential conflicts of interest arising when its access persons invest for their own accounts unless fund management knows the identity of all securities held by those persons. When examining the records of the 30 fund groups for

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[114] *See supra* text accompanying notes 97-98.

[115] Levitt remarks, *supra* note 78; Phillips, Plaza, and Birner, *supra* note 84, at 8. Many fund boards appear to be giving increasing attention to personal trading matters as a result of the Commission's recent focus on this area. Phillips, Plaza, and Birner, at 8.

[116] The Division believes that the board of a fund that is part of a fund group also has the responsibility of inquiring of fund management whether appropriate policies have been adopted with respect to the group to ensure that investment personnel of one fund in the group are not able to benefit personally as a result of investments made or intended to be made by another fund in the group. In the Division's view, this obligation is implicit in subparagraph (a) of rule 17j-1, which prohibits fraudulent personal trading by all employees of an investment adviser, including those employees whose job responsibilities are not related directly to a particular fund.

purposes of the special examination, the Division's inspection staff found that some of the 30 fund groups did not obtain information about the securities held by new employees.[117]

The Division believes that potential conflicts of interest can arise whenever an access person holds the same securities as his fund, regardless of when the access person acquired the securities.[118] As currently written, however, rule 17j-1 does not explicitly require access persons to report their existing personal securities holdings at the time they commence employment with a fund or an adviser.[119] The Division therefore recommends that rule 17j-1 be amended to require access persons to disclose their personal securities holdings upon becoming employed by the fund or its adviser. The Division believes that implementation of this recommendation would improve a fund's ability to monitor potential conflicts of interest between the fund and its access persons, and reduce the potential for abusive investing by those persons.

Recommendation 4: NOTIFICATION OF BROKERAGE ACTIVITY
The Division recommends that the NASD be asked to consider adopting a rule requiring its members (a) to notify a fund or investment adviser whenever an employee opens an account with the member, and (b) upon request of the fund or adviser, to transmit duplicate copies of the employee's trade confirmations and account statements.

The Division believes that, if the information contemplated by this recommendation was provided directly to funds and their advisers, it would serve as an independent verification of information reported by fund investment personnel to their employers, thus assisting funds and their advisers in monitoring their employees' personal investment activities. The proposed rule would mirror an existing NASD rule that requires member broker-dealers to take similar action with respect to accounts opened and maintained by employees of other broker-dealers.[120]

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[117] Several fund groups had difficulty responding to the staff's request to identify securities purchased by a fund that were, at the time, owned by the fund's manager. To respond, several fund groups had to obtain information from their managers about the managers' holdings at the time of their employment by the groups. Two fund groups could not obtain this information and did not respond to this particular request. *See supra* note 74.

[118] The Commission itself has said that a "situation which would appear to present a conflict of interest of the type of which Section 17(j) is addressed might occur where access persons already own a particular security and through their position of influence over the investment company attempt to cause the investment company to purchase, sell or hold the same security." Release No. 11421, *supra* note 21. Several examples illustrate the conflict of interest presented by an access person's pre-employment holdings. A manager who owns a stock (acquired before his association with a fund) whose price is declining may be tempted to cause the fund to purchase the stock in an effort to stabilize or increase its price. A manager who received warrants to purchase a stock at a fixed price as part of an IPO in which he participated before becoming employed by a fund or its adviser could increase his personal profit by causing the fund to purchase the underlying stock shortly before he exercises the warrants. Finally, any access person who acquired a stock before his association with a fund, and who learns that the fund is considering selling a large block of the stock, may be tempted to sell his personal holdings before the fund's transaction causes the stock's price to decline.

[119] The rule's reporting provisions simply require fund access persons to file reports detailing information about personal investments made during the preceding calendar quarter.

[120] NASD Rules of Fair Practice § 28(b).

Recommendation 5: BAN ON PARTICIPATING IN "HOT ISSUE" PUBLIC OFFERINGS
The Division recommends that the NASD be asked to consider prohibiting the purchase by certain fund access persons of hot issue securities.

Chairman Levitt, as well as certain commentators, have expressed concern that participation by access persons in IPOs, especially "hot issue" IPOs,[121] creates the potential for troublesome conflicts of interest.[122] Because hot issues are expected to increase in value, broker-dealers could offer them as an incentive to induce fund personnel to do business with them. The purchase of a hot issue by fund personnel, therefore, raises an appearance of impropriety. In addition, conflicts of interest can result when access persons compete with their funds for the same hot issues.

The ICI Report seeks to address potential abuses associated with IPOs by recommending that funds prohibit their access persons from acquiring any securities in an IPO. The Division believes that the Commission's authority under section 17(j) may not be sufficiently broad to adopt such a limitation.[123]

In an effort to address the issue of IPO purchases by fund access persons, the Division recommends that the NASD undertake a review of the application to fund personnel of its Free-Riding and Withholding Interpretation (the "Free-Riding Rules") under its Rules of Fair Practice.[124] In particular, the Division intends to ask the NASD to examine its Free-Riding Rules to consider whether the existing ban on sales of hot issues to broker-dealer employees should be extended to personnel of investment companies, investment advisory firms, banks, savings and loans, and insurance companies who have authority to direct business to NASD members.[125] Such a change would effectively prohibit certain investment company and investment advisory personnel from participating in hot issue public offerings.

Recommendation 6: AMENDMENT OF SECTION 17(j)
The Division recommends that Congress amend section 17(j) to cover purchases and sales by a fund access person of property other than securities and to clarify that the section is violated by abusive personal trading in securities and other instruments related in value to the fund's portfolio securities.

The Commission's existing rulemaking authority under section 17(j) to define and proscribe fraud is limited to transactions involving securities. Increasingly, funds are

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[121] The NASD defines "hot issue" securities in its Free-Riding and Withholding Interpretation under its Rules of Fair Practice to be "securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins."

[122] Levitt remarks, *supra* notes 78 and 101; ICI Report, *supra* note 47, at 32-33.

[123] The Commission's Office of the General Counsel shares this view.

[124] The Free-Riding Rules prohibit NASD broker-dealers from selling hot issue securities to, among others, any employee of a broker-dealer. The Free-Riding Rules, however, currently permit sales of hot issues to advisory personnel of investment companies, investment advisory firms, banks, savings and loans, and insurance companies if, among other things, the NASD member can demonstrate that the sales are consistent with a person's usual investment practice and are insubstantial in amount.

[125] Because bank, savings and loan, and insurance company personnel who make investment decisions are subject to the same conflicts of interest as employees of investment companies and investment advisers, the Division believes that any action taken by the NASD should apply equally to all of these groups.

engaging in transactions involving instruments other than securities, such as futures and commodities.[126] The Division believes that the types of abusive conduct to which section 17(j) was addressed can occur with respect to financial instruments that are not securities as that term is defined in the federal securities laws.[127] Thus, the Division recommends that Congress amend section 17(j) to cover purchases and sales by fund access persons of property other than securities.[128]

The Division recommends that, if Congress determines to amend section 17(j) in any manner, Congress should at the same time confirm the section's applicability to transactions by a fund's access persons involving securities and other instruments related to, but not the same as, securities held or to be acquired by the fund.[129] Although Congress appears to have intended section 17(j) to cover activities involving related securities,[130] and the Commission has taken the same position with respect to rule 17j-1,[131] the language of these provisions, as currently drafted, could be interpreted otherwise.

VI. CONCLUSION

Public trust is the foundation underlying the fund industry's recent success. That trust is threatened when fund personnel take advantage of their positions to benefit themselves. Over the past seven months, the Division has examined the personal investment transactions of over six hundred fund managers and compared those transactions to the portfolio transactions of the more than one thousand funds they manage.

The data the Division reviewed indicates that fund managers generally have not engaged in extensive investing for their personal accounts. When engaging in personal securities transactions, fund managers appear to avoid potential conflict of interest situations. Nevertheless, a small number of managers, concentrated within a few fund groups, have actively invested for their personal accounts, in some cases buying or selling securities ahead of their funds or other funds in the complex. The Division currently is examining the personal transactions made by those managers to determine whether they were improper. The Division also is examining the compliance programs of these fund groups to determine whether they exercised adequate oversight over the personal investment activities of their

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[126] *E.g.*, Steven T. Goldberg, *Why Your Bond Fund Got Clobbered*, Kiplinger's Personal Finance Magazine, Sept. 1994; *Amid Fund Losses, SEC Examines Derivatives Limits*, Wall St. J., Sept. 8, 1994, at A20.

[127] The recent *Kemper* case, described above in Part II.C, for example, involved the alleged misallocation of financial futures contracts and not securities.

[128] If Congress amends section 17(j) in accordance with this recommendation, the Division will recommend that the Commission amend the reporting requirements of rule 17j-1 to include property other than securities.

[129] Two securities would be related if, for example, one security is convertible into the other, or gives its holder the right to purchase the other security.

[130] House Report, *supra* note 15, at 28; Senate Report, *supra* note 15, at 28-29.

[131] *See* Release No. 10162, *supra* note 19.

managers. If the examinations indicate abusive conduct or materially deficient compliance procedures, the Division will refer matters to the Division of Enforcement for further action.

The Commission's staff will continue to aggressively investigate and pursue enforcement actions against any fund insiders whose trading activities place their personal interests ahead of their funds'. The Division believes that aggressive inspection and enforcement programs are the most effective deterrent to abusive trading. Inspections and enforcement actions will continue to be effective, however, only if sufficient resources are allocated to those programs.

The Division has concluded that the advantages of banning personal securities transactions, or mandating uniform standards to restrict such transactions, are outweighed by the disadvantages. The Division, however, is recommending changes to the existing regulatory scheme that it believes would enhance investor protection while preserving the flexibility that Congress and the Commission have considered important over the past thirty years. The Division believes that its recommendations, together with widespread industry acceptance of the recommendations described in the ICI Report, will enhance the ethical standards of the industry, thereby benefiting all fund shareholders.

The Division will continue to monitor whether the existing provisions of the federal securities laws are adequate to protect the interests of investors, and whether fund boards of directors or trustees are scrutinizing personal investment policies and activities. As part of its monitoring, the Division will request a report from the ICI within six months describing the industry's efforts to implement the ICI Report's recommendations, and will assess, at that time, the extent to which funds are adhering to those recommendations. If, in the future, the Division deems it necessary or appropriate in the public interest, the Division will recommend that the Commission propose rule amendments or seek additional legislation to impose stricter and more uniform standards on the fund industry.

Exhibit A

Exhibit A

February __, 1994

Mr./Ms. xxxxxxx
XYZ Management, Inc.
[ADDRESS]

Re: In the Matter of Certain Trading by Portfolio Managers (MHO-4568)

Dear Mr./Ms. xxxxxxx:

The Divisions of Investment Management and Enforcement are currently examining issues associated with personal trading by investment company portfolio managers. 1/ As part of that examination, we request that XYZ Management, Inc. ("XYZ") provide the following documents and information as applicable to calendar year 1993 (the "reporting period") with respect to each fund 2/ for which XYZ or any of its affiliates acts as investment adviser and/or sub-adviser 3/ (the "XYZ Funds"):

1. General Information

(a) Please list each XYZ Fund by name and give the fund's investment objective as characterized by Lipper Analytical Services, Inc. Identify each fund's portfolio manager(s) and indicate, for each manager, the dates he or she started and (if applicable) stopped rendering advisory services to the fund (do not limit your response to the reporting period).

(b) For each portfolio manager identified in subparagraph (a) above: (i) name the manager's employer, (ii) state whether the employer is affiliated with the XYZ funds other than as investment adviser, (iii) specify the dates the manager was employed by the employer; and (iv) provide the names of any company for whom the manager served during the reporting period as an officer or director, if any securities issued by that company were held by any XYZ fund during the reporting period.

(c) For each XYZ fund that is not a money market fund within the meaning of rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"), please state

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1/ For purposes of this letter, an investment company's "portfolio manager" is the person (or persons) primarily responsible for the day-to-day management of the company's portfolio. See paragraph (c) of Item 5 in Form N-1A.

2/ For purposes of this letter, a "fund" is any management investment company registered under the Investment Company Act of 1940, whether open-end or closed-end. Each series of a registered open-end company should be deemed a separate fund for purposes of this letter.

3/ To the extent any XYZ Fund uses the services of an investment adviser or sub-adviser not affiliated with XYZ, you should provide information about that adviser or sub-adviser in response to the following questions.

(i) the total number of portfolio transactions (purchases and sales of securities 4/) effected during the reporting period, (ii) the dollar value of the securities purchased or sold, whichever is greater, and (iii) the aggregate net assets at the beginning and end of the reporting period.

2. Code of Ethics

For each XYZ fund, please submit a copy of any code of ethics ("Code") required by paragraph (b)(1) of rule 17j-1 under the Investment Company Act that was in effect during the reporting period. If the same Code governs more than one XYZ fund, multiple copies need not be submitted, but please indicate which XYZ funds were governed by that Code. If a Code was amended during the reporting period, please submit a copy of each version that was in effect during the period, and mark each version to show when it was effective and how it was amended. In addition, please submit any rules, guidelines, procedures, or policies (collectively, "Policies"), including but not limited to the Policies required to be implemented by section 204A of the Investment Advisers Act of 1940, regarding personal trading activity by XYZ access persons 5/ that were in effect during the reporting period but were not part of a fund's Code. If any Policies have not formally been reduced to writing, please submit a written description of those Policies.

Please attach to each Code submitted in response to this request a completed questionnaire substantially in the form attached as Exhibit A to this letter.

3. Violations

For each violation of XYZ's Code(s) or Policies that occurred within the reporting period please provide: (i) the name of the violator, (ii) the date of the violation, (iii) a description of the violation, (iv) the name and job title of the person responsible for discovering and/or investigating the violation, (v) whether any disciplinary action was taken as a result of the violation, and (vi) whether any steps were taken to prevent a recurrence. If you answered affirmatively to either (v) or (vi) above, provide detailed explanations.

4. Personal Trading Activity by Portfolio Managers

(a) Did any portfolio manager, during the reporting period, purchase (or sell), for his or her own account, 6/ any security that was purchased (or sold) by any XYZ fund (not

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4/ Unless otherwise noted, for purposes of this letter, the term "securities" means: equity and debt securities (except as set forth below); options on and warrants to purchase equity or debt securities; and shares of closed-end investment companies. The term does not include: money market securities; securities issued by the United States government; or shares of open-end investment companies or unit investment trusts.

5/ The term "access persons" is defined in paragraph (e)(1) of rule 17j-1 under the Investment Company Act.

6/ For purposes of this letter, the purchase or sale of a security for a portfolio manager's own account includes any transactions in a security in which the portfolio manager has or is acquiring a direct or indirect beneficial interest. See paragraph (c)(1) of rule 17j-1.

including any index fund) within the next thirty days? 7/ If so, provide the information requested in paragraph (e) below.

(b) Did any portfolio manager, during the reporting period, purchase (or sell), for his or her own account, any security whose value or return was related, in whole or in part, to the value or return of a different security that was purchased (or sold) by any XYZ fund (not including any index fund) within the next thirty days? 8/ If so, provide the information requested in paragraph (e) below.

(c) For purposes of subparagraphs (a) and (b) above, you should (i) only report instances where a portfolio manager *purchased* a security that subsequently was *purchased* by a fund, or where a portfolio manager *sold* a security that subsequently was *sold* by a fund; and (ii) exclude a portfolio manager's purchase or short sale of a security if he or she closed out the position in its entirety prior to any purchase or sale of the same, or a related, security by an XYZ fund.

(d) Did any portfolio manager, during the reporting period, purchase, for his or her own account, any security that was sold during the preceding thirty days by an XYZ fund managed by the portfolio manager? If so, provide the information requested in paragraph (e) below.

(e) For each set of transactions identified in response to subparagraphs (a), (b), and (d) above, name the portfolio manager and the fund that engaged in the transactions, and provide the following information about the transaction effected by each party: (i) a description of the security traded, (ii) the type of transaction (i.e., purchase or sale (specify if short sale)), (iii) the trade date, (iv) the price per unit of the security traded, the quantity traded, and the total amount of the transaction, and (v) the name of the broker/dealer through whom the trade was effected.

(f) Please provide a summary sheet that specifies, for each portfolio manager, and for all portfolio managers as a group: (i) the number of personal trades involving securities, (ii) the number of trades identified in response to each of subparagraphs (a), (b), and (d) above, and (iii) the number of trades identified in response to subparagraphs (a) and (b) above that involve a set of trades by a portfolio manager and the particular XYZ fund(s) he or she manages.

7/ Thirty days may be longer or shorter than the trading restriction period, if any, specified in a particular fund's Code. The selection of the thirty-day period should not be construed as an indication of the Commission staff's views as to an appropriate restriction period for a code of ethics adopted pursuant to rule 17j-1 or for any other purpose.

8/ For example, options or warrants to purchase common stock, and convertible debt and convertible preferred stock, should be considered "related to" the underlying common stock for purposes of Item 4. Preferred stock and debt issued by a particular company that are not convertible should not be considered related to the company's common stock for purposes of Item 4. Different classes of a company's common stock should be considered to be related securities unless the value or return of one class unequivocally is unrelated to the value or return of the other class.

5. Trading Activity by XYZ Funds

(a) Did any XYZ fund, during the reporting period, purchase any equity security that at the time was beneficially owned by an XYZ portfolio manager, regardless of when the portfolio manager acquired the security? 9/ If so, for each transaction identified, name the fund that purchased, and the portfolio manager(s) who held, the security, and provide the following information about the transaction effected by each party: (i) a description of the security acquired, (ii) the trade date, (iii) the purchase price per share, (iv) the number of shares purchased, (v) the total value of the shares purchased, and (vi) whether the security was purchased as part of an initial public offering.

(b) Please provide a summary sheet that specifies, for each XYZ fund: (i) the total number of purchase transactions involving equity securities effected during the reporting period, and (ii) the number of purchase transactions that involved an equity security that at the time of purchase was owned by any XYZ portfolio manager.

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The information requested in Items 1(a)-(c), 4(e)-(f), and 5(a)-(b) should be submitted in spreadsheet form on the formatted diskette enclosed with this letter. We have also enclosed a short set of general instructions to assist you in inputting the requested data into the spreadsheet. A more detailed set of instructions will follow.

This request for documents and information should not be construed as an adverse reflection upon any person, entity, or security or as an indication by the Commission or its staff that any violation of law has occurred. Enclosed is a copy of Commission Form 1661, which discusses how the Commission can use the information you provide, and other important matters.

Please respond by March 31, 1994. The information requested, and any questions about the spreadsheet format, should be directed to Greg Jaffray, Financial Analyst, Division of Investment Management, Mail Stop 10-6, 450 Fifth Street, NW, Washington DC 20549, phone number (202) 272-3014. All other inquiries should be directed to the Division of Investment Management's Office of Chief Counsel, at (202) 272-2072.

Barry P. Barbash
Director, Division of Investment Management

William R. McLucas
Director, Division of Enforcement

9/ For purposes of this item, include all equity securities issued by the same issuer unless the value or return of one security unequivocally is unrelated to the value or return of the other security.

March __, 1994

VIA REGISTERED MAIL

Mr./Ms. xxxxxxx
XYZ Management, Inc.
[ADDRESS]

Re: In the Matter of Certain Trading by Portfolio Managers (MHO-4568)

Dear Mr./Ms. xxxxxxx:

This letter supplements our letter to you dated February _, 1994 (the "February Letter"), in which we requested information about the personal trading activities of certain XYZ Management, Inc. ("XYZ") personnel. We received several inquiries seeking clarification of the February Letter. In response to these inquiries, we are amending the February Letter as indicated below.

All information requested in the February Letter should be submitted to the Commission's staff in the manner prescribed in the February Letter unless otherwise specifically indicated in this letter. Unless otherwise indicated, all terms used in this letter have the same meaning as in the February Letter.

1. Items 1, 4, and 5 of the February Letter require XYZ to name the portfolio managers of the XYZ Funds. Item 3 (see paragraph 2 below) requires XYZ to identify individuals who have committed certain violations of XYZ's Code(s) or Policies. In responding to these Items, numerical or letter codes, rather than names, may be used to identify particular individuals. Only one code, however, may be used for each individual. In addition, XYZ must make available to the Commission's staff, upon request, the name of the individual corresponding to each code.

2. Item 3 of the February Letter is superseded by the following request:

> Describe generally how XYZ's Code(s) or Policies are implemented, administered, and enforced. Identify all instances during the reporting period when (i) XYZ took significant remedial action against any individual for a violation of XYZ's Code(s) or Policies, or (ii) an individual resigned from his or her position to avoid significant remedial action by XYZ. For purposes of this Item, significant remedial action includes any action that has a pecuniary effect on an individual, such as firing, suspending, or demoting the person, or requiring the reversal of a trade or the disgorgement of profits. Significant remedial action also includes any non-pecuniary action that might affect the person's promotion opportunities, such as reassignment, suspension with pay, or formal censure. For each significant remedial action taken, identify the person who violated XYZ's Code(s) or Policies, state the person's job title/position, and describe the violation, how it was discovered, the disciplinary action taken against the person, and the steps taken, if any, to prevent a recurrence of the violation.

3. Item 4 of the February Letter is amended as follows:

(a) A ten (10) day period should be substituted for the thirty (30) day period provided for in paragraphs (a), (b), and (d) of Item 4.

(b) Except as set forth in the last sentence of this paragraph, transactions by XYZ Funds or portfolio managers in any equity or debt security issued by the companies listed in Attachment A to this letter do not have to be reported. 1/ This exclusion does not extend to transactions by XYZ Funds or managers in options, warrants, and other securities whose value or return was related, in whole or in part, to the value or return of a security issued by one of the companies listed in Attachment A. Moreover, transactions by XYZ Funds in securities issued by companies listed in Attachment A must be reported if they occurred ten (10) days or less after a transaction by an XYZ portfolio manager in an option, warrant, or other security whose value or return was related, in whole or in part, to the value or return of a security issued by one of those companies.

(c) In responding to paragraph (e) of Item 4, indicate whether the portfolio manager's trade was pre-cleared or otherwise pre-approved. To answer this question, add a column (Column S) to Worksheet 3 and enter in this column: "Yes" if the trade was pre-cleared; "No" if the fund had a pre-clearance procedure and the trade was not pre-cleared; and "N/A" if the fund had no pre-clearance procedure.

4. Item 5 of the February Letter should incorporate the changes indicated below:

(a) The first sentence of paragraph (a) of Item 5 is amended as follows: "Did any XYZ Fund, during the reporting period, purchase any equity security that at the time <u>of purchase also</u> was beneficially owned by ~~an XYZ~~ <u>its</u> portfolio manager, regardless of when the portfolio manager acquired the security?" Part (ii) of paragraph (b) of Item 5 is amended to reflect the change in paragraph (a), so that the summary sheet specifies, for each XYZ Fund, "the number of purchase transactions that involved an equity security that at the time of purchase <u>also</u> was owned by ~~any XYZ~~ <u>the fund's</u> portfolio manager."

(b) Part (vi) of paragraph (a) of Item 5 is amended to add the underlined material: "(vi) whether the security was purchased as part of <u>a private placement (PP) or</u> an initial public offering <u>(IPO)</u>." In Columns H and N of Worksheet 4, enter "PP," "IPO," or "N/A," as appropriate.

5. In addition to responding to all Items in the February Letter as amended by this letter, please respond to the following new Item 6:

(a) Describe XYZ's policies, if any, regarding cross-trading, <u>i.e.</u>, do the same prohibitions that apply to personal trading by a portfolio manager in securities that are held by or under consideration for purchase or sale by the fund(s) served by the manager apply to securities that are held by or under consideration for purchase

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1/ The stocks listed in Attachment A represent the 100 stocks that comprised the Standard & Poor's 100 Composite Index as of June 30, 1993. Since the index may have changed during the course of the year, we have used the midpoint as a representative date.

or sale by other funds or other clients advised by XYZ or any of its affiliates? If XYZ has no policies regarding cross-trading, explain why not.

(b) Describe XYZ's policies, if any, with respect to its portfolio managers' purchase of securities in offerings not registered under the Securities Act of 1933 (including, for example, private placements) and purchase of securities when initially offered to the public.

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In light of the changes and additional information requested in this letter, we have determined to extend the date by which all information must be submitted to the Commission's staff from March 31, 1994 to April 15, 1994. If you have any questions about inputting data into the worksheets (provided in diskette form with the February Letter), including how to add a column to Worksheet 3 (as requested in paragraph 3(c) above), you should call Greg Jaffray of the Division of Investment Management at (202) 272-3014. All other inquiries should be directed to the Division of Investment Management's Office of Chief Counsel, at (202) 272-2072.

Barry P. Barbash
Director, Division of Investment Management

William R. McLucas
Director, Division of Enforcement

Exhibit B

Exhibit B

STATISTICAL SUMMARY OF THE CODES OF ETHICS SUBMITTED BY THE 30 FUND GROUPS 1/

Pre-clearance

- 19 fund groups require certain employees to pre-clear all personal securities trades. 2/

- 4 fund groups require certain employees to pre-clear defined categories of transactions, such as those involving options and futures, or securities on a "restricted" list.

Prohibition on Investing in Securities While Fund is Investing

- 21 fund groups expressly prohibit certain employees from purchasing or selling any securities that they know are being considered for purchase or sale, or are being purchased or sold, by the fund.

Blackout Period

- 16 fund groups impose a "blackout period" during which certain employees are prohibited from investing in securities for a specified time before and/or after the fund has purchased or sold the same securities, or the fund's adviser has issued a research report covering the securities. The blackout periods range from 15 days before to 30 days after the securities are bought or sold by a fund in the group or appear on a restricted list.

Initial Public Offerings/ Hot Issues

- 5 fund groups restrict or prohibit certain employees from purchasing securities in any IPO.

- 9 fund groups restrict or prohibit certain employees from purchasing "hot issues," including hot issue IPOs.

Private Placements

- 5 fund groups restrict or prohibit certain employees from purchasing securities through a private placement.

1/ The Commission staff reviewed the codes of ethics in effect for the 30 fund groups during calendar year 1993. For purposes of this Exhibit, the staff examined 31 sets of codes of ethics, rather than 30. Because one of the fund groups consisted of two fund groups that had recently merged, the two groups' operations had not been integrated, and each employed different codes of ethics, the staff treated each as a separate fund group for purposes of this Exhibit only. In addition, the statistics cited sometimes reflect (when such information was provided) restrictions and procedures that went into effect in 1994, after the reporting period for which the staff requested information.

2/ For purposes of this Exhibit, the term "securities" is defined the same as it is in rule 17j-1.

- 2 fund groups require pre-clearance for private placement securities but not other purchases of securities.

Scope of Restrictions

The staff asked each fund group to describe whether the same restrictions that apply to personal investment transactions by a portfolio manager with respect to securities that are held by or under consideration for purchase by the manager's fund also apply with respect to securities that are held by or under consideration for purchase by other funds or other clients advised by the manager's employer.

- 24 fund groups answered yes.

Short-Term Trading Ban

- 4 fund groups require certain employees to hold securities for a prescribed minimum period of time, whether or not the securities are held by a fund in the fund group.

Disclosure of Holdings at Commencement of Employment

- Only one fund group indicated that it requires new employees to disclose their securities holdings upon commencement of their employment.

Periodic Reports

- 18 fund groups require employees to report their securities transactions contemporaneously, either in addition to, or in lieu of, filing the quarterly reports required under rule 17j-1.

Exhibit C

Exhibit C

DESCRIPTION OF CODES OF ETHICS VIOLATIONS

The staff asked each of the 30 fund groups subject to the special examination to identify all instances in 1993 when (a) it took significant remedial action against any individual for a violation of any applicable code of ethics, or (b) an individual resigned from his position to avoid significant remedial action by the fund group. 1/ Five fund groups (referred to below as Fund Groups #1 through 5) reported code violations by twelve employees.

Fund Group #1:

Fund Group #1 reported that one of its access persons based outside the United States purchased $34,000 of the equity securities of a large foreign company on a foreign stock exchange. The transaction was neither pre-cleared nor reported in a timely manner. The fund group represented that authorization to purchase would not have been granted had pre-clearance been requested. The fund group concluded that the person's failure to pre-clear and report was not intentional and was an isolated incident. The fund group ordered the person to (a) sell all the shares purchased in the unauthorized transaction; (b) disgorge his profits to the funds holding shares of the foreign company; (c) pay a penalty to those funds equal to the amount of the unauthorized purchases, i.e., $34,000, and (d) refrain indefinitely from any personal transactions (other than exempt transactions), subject to reappraisal after one year.

Fund Group #2:

Fund Group #2 reported that it had censured one of its adviser's employees for failing to pre-clear, as required by the adviser's code of ethics, a number of personal transactions over a period of approximately 2 to 3 months. The employee was absent from work during a part of that period and claimed that he had asked one of his subordinates to obtain the necessary pre-clearance. Management concluded that the employee's absence did not excuse his failure to obtain written pre-clearance, and formally censured him by placing a reprimand in his compliance file. Because management determined that, had the requisite pre-clearance procedures been followed, each transaction would have been approved, the employee was not ordered to disgorge profits.

Fund Group #3:

Fund Group #3 reported one violation of the adviser's code and one violation of one of its fund's codes.

One incident involved an officer of the investment adviser and the funds it manages who is not involved in any portfolio management activities. This individual sold securities on the same day that one of the adviser's non-investment company clients sold the same securities. The transaction violated the adviser's policy prohibiting access persons from selling a security within seven days of a client's sale at a price more favorable than that obtained by the client. The individual failed to enter his proposed transaction in the adviser's computer checklist and was thus unaware of the client's contemporaneous

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1/ For purposes of this Exhibit, significant remedial action includes any action that has a pecuniary effect on an individual, such as firing, suspending, or demoting the person, or requiring the reversal of a trade or the disgorgement of profits. Significant remedial action also includes any non-pecuniary action that could affect the person's promotion opportunities, such as reassignment, suspension with pay, or formal censure.

transaction. The adviser's compliance personnel quickly discovered the violation and the individual agreed to disgorge his profit on the transaction (approximately $2,200) to the adviser's client.

The other incident involved a non-interested director who violated the fund's code by purchasing call options on a stock that had been sold by the fund during the previous 15 days. The director was aware of the fund's transactions in the underlying stock, but did not realize that those transactions prohibited him from purchasing options on the stock. The adviser's compliance department discovered the violation on the same day as the director's options transaction and explained to him why the transaction was improper. The director immediately sold all of his call options, sustaining a loss of approximately $1,600.

<u>Fund Group #4</u>:

Fund Group #4 reported violations of the investment adviser's code of ethics by four employees.

In the first incident, a fund manager purchased securities for his personal account and the next day purchased the same securities for two of his funds. The manager was given a written notice and warning and was fined $600.

In the second incident, a fund manager, without obtaining prior approval, sold out of his personal account securities that also were held by the fund he managed. The manager was given a written notice and warning and was required to cancel the transaction at his own expense.

In the third incident, one of the adviser's marketing employees failed to pre-clear a transaction that involved a security on the adviser's restricted list. The employee was given a written notice and warning and was required to disgorge his $100 profit.

In the fourth incident, a senior analyst violated a code provision that allowed employees to buy or sell up to 1,000 shares per day of securities on the restricted list if the securities had a market capitalization of at least $1 billion. The analyst exceeded the 1,000-share limit. He was given a written notice and warning and required to disgorge his $1,000 profit.

<u>Fund Group #5</u>:

Fund Group #5 reported two incidents involving violations of the adviser's code of ethics by four of its employees.

In one incident, a fund manager failed to obtain prior approval of several securities transactions effected by an investment partnership over which he exercised investment discretion. In addition, the manager failed to report these securities transactions within ten days, as required by the adviser's code. The fund manager was given a written reprimand and warned that future violations of the adviser's policies on personal securities transactions could be grounds for immediate termination.

In the other incident, a fund manager, an analyst, and a trader purchased in the aggregate 3,100 shares of a single company, and thereafter sold 1,100 of the shares. The individuals submitted written requests for approval on the same day as the transactions, but not until after the transactions were executed. Because the transactions were not pre-approved, the adviser's general counsel directed that all of the transactions be cancelled.

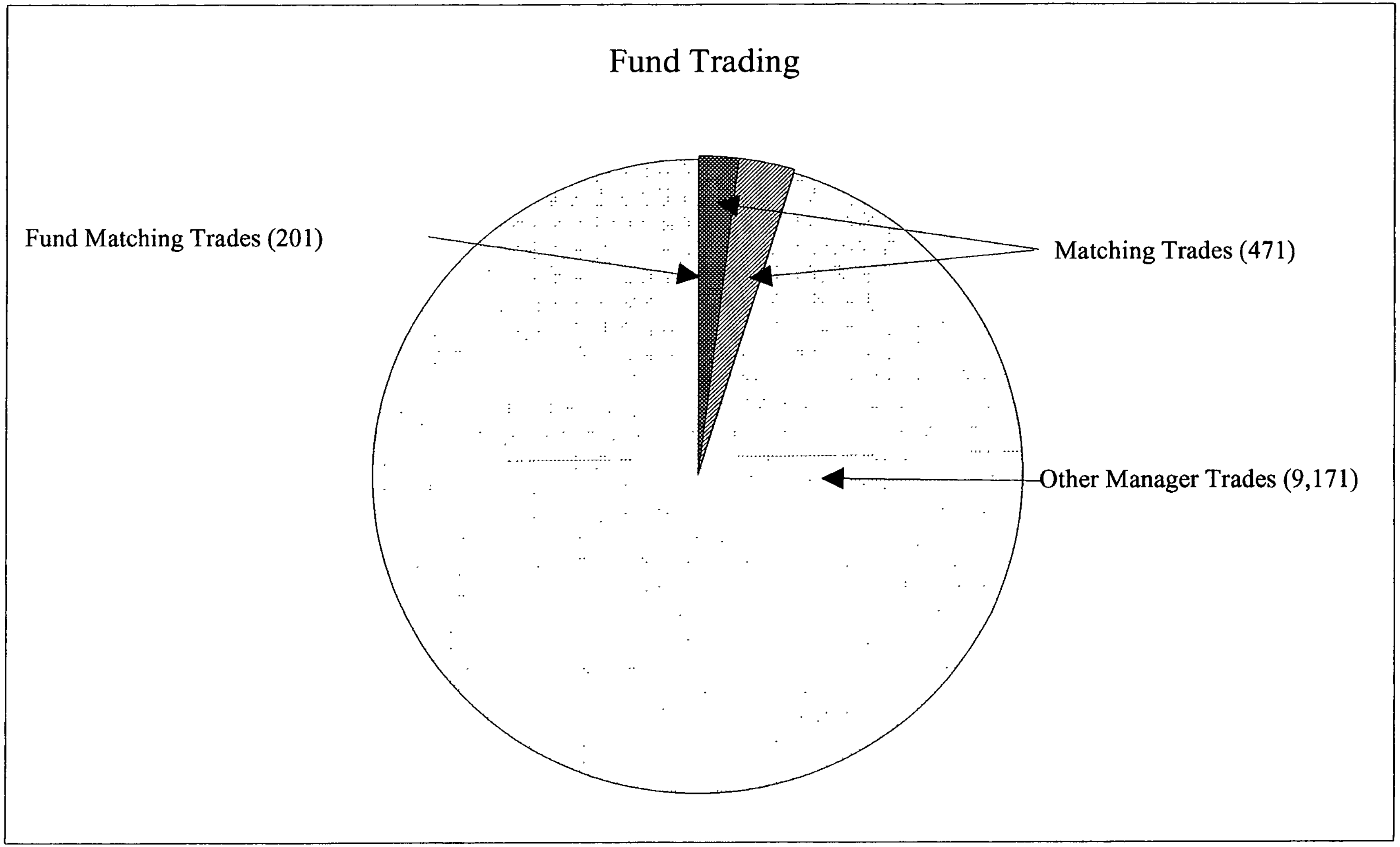
Exhibit D

Exhibit D

	Data Without Fund X (1,052 Funds)	Data With Fund X (1,053 Funds)	Fund X (1 Fund)
Total Number of Fund Managers	618	622	4
Total Number of Fund Managers Who Traded	349	353	4
Total Number of Personal Trades by All Managers	9,843	13,249	3,406
Average Number of Personal Trades Per Manager	15.9	21.3	851.5
Average Number of Personal Trades Per Manager Who Traded	28.2	37.5	851.5
Total Number of Matching Trades	471	1,618	1,147
Average Number of Matching Trades Per Manager	0.8	2.6	286.8
Average Number of Matching Trades Per Manager Who Traded	1.3	4.6	286.8
Total Number of Fund Matching Trades	201	1,348	1,147
Average Number of Fund Matching Trades	0.3	2.2	286.8
Average Number of Fund Matching Trades Per Manager Who Traded	0.6	3.8	286.8

Exhibit E

Exhibit E


Fund Trading
Fund Matching Trades (201)
Matching Trades (471)
Other Manager Trades (9,171)