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IN THIS ISSUE

Personal trading: Key concepts for compliance professionals

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I. Introduction

In its February 2017 Risk Alert, the Securities and Exchange Commission (SEC) identified personal trading by investment advisor "access persons" as an area in which examination staff frequently find compliance failures.[1] This notification to firms underscores the importance that the SEC ascribes to personal trading compliance. This white paper details the rule covering personal trading, provides practical tips for compliance, and discusses relevant enforcement cases that have resulted from noncompliance.

II. Identifying access persons

Rule 204A-1 (the "Codes of Ethics Rule" or the "Rule") of the Investment Advisers Act of 1940 (the "Advisers Act") (17 CFR §275.204A-1)[2] requires that SEC-registered investment advisors establish, maintain, and enforce a written code of ethics that at a minimum includes, among other things, provisions that require all of the firm's "access persons" to report, and the firm to review, their personal securities transactions and holdings periodically as provided in the Rule. The Rule defines an "access person" as a supervised person[3] who has access to nonpublic information regarding any client's purchase or sale of securities, who has access to nonpublic information regarding the portfolio holdings of any reportable fund, who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic. Additionally, if providing investment advice is the firm's primary business, all of the firm's directors, officers, and partners are presumed to be access persons.[4]

Employees are most commonly among a firm's access persons under the Rule. But a non-employee, such as an outside consultant, may qualify as a firm's access person in certain circumstances. In a recent enforcement action brought by the SEC, an advisor to mutual funds used the services of a third-party consultant who worked closely with the advisor's investment professionals and periodically provided securities research as well as buy, sell, and hold recommendations.[5] The consultant had access to nonpublic information regarding the funds, including the

[1] U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE), "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers," National Exam Program Risk Alert (February 7, 2017).

[2] U.S. Securities and Exchange Commission, *Investment Adviser Codes of Ethics: Final Rule*, Advisers Act Release No. IA-2256 (July 6, 2004).

[3] Section 202(a)(25) of the Advisers Act defines "supervised person" as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser."

[4] See Prudential Insurance Company of America No Action Letter, SEC File No. 801-12484 (March 1, 2005).

[5] See *In the Matter of Federated Global Investment Management Corp.*, SEC Administrative Proceeding No. 3-17264 (May 27, 2016).

funds' holdings and the views of the advisor's management regarding the funds' holdings. At the same time, the consultant sat on the boards of several companies in the sectors he covered and held and traded securities of companies of which he was a board member. Additionally, the consultant traded in his personal brokerage accounts the same securities that the funds held, at times in "close proximity" to trades made by the funds. While the advisory firm's code of ethics imposed obligations and restrictions on access persons, the firm did not identify the consultant as an access person and did not subject the consultant to the obligations and restrictions outlined in its code. After terminating its relationship with the consultant and enhancing its compliance program, the firm settled the SEC charges and agreed to pay a $1.5 million civil monetary penalty.

In short, advisors should conduct a function analysis to determine who may be considered access persons: consider what the access persons do and the information they have access to, not just their title or employer. What is their functional role with the firm? Do they have access to confidential information? If they do, that person should be subject to the oversight and controls carried out by the firm's compliance department.

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III. Access person reporting

Access persons must provide holdings reports to the firm

The firm's code of ethics must require access persons to submit to the chief compliance officer (CCO), or his or her designees, a holdings report of the access person's current securities holdings. The holdings report must contain:

1. The title and type of security held, number of shares, and the principal amount of each security in which the access person has any direct or indirect beneficial ownership[6]
2. The name of any broker, dealer, or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit
3. The date the report is submitted

Access persons must provide their holdings report to the firm no later than 10 days after they become access persons, and the information must be current as of a date no more than 45 days prior to the date they became access persons. After the initial report, access persons must provide holdings reports to the firm at least once each 12-month period thereafter, on a date the firm selects, and the information must be current as of a date no more than 45 days prior to the date the report was submitted.

Access persons must provide transaction reports to the firm

The firm's code of ethics must require access persons to submit to the CCO, or his or her designees, quarterly securities transactions reports. The transaction reports should contain at a minimum:

1. The date of the securities transaction, the exchange ticker symbol or CUSIP number, number of shares, principal amount of each reportable security involved, and any interest rate and maturity date
2. The nature of the transaction (e.g., purchase, sale, or any other type of acquisition or disposition)
3. The price of the security at which the transaction was effected
4. The name of the broker, dealer, or bank with or through which the transaction was effected
5. The date the report is submitted

Some firms permit access persons to satisfy this requirement by authorizing their brokerage firms, banks, or custodians to provide the firm with monthly or quarterly account statements.

Exceptions from reporting

No direct or indirect "influence or control"

Access persons need not submit reports with respect to securities held in accounts over which the access person had no direct or indirect "influence or control." The SEC provided guidance in 2015 relating to whether a reporting person had "influence or control."[7] For example, the SEC indicates that blind trusts can be established such that an access person would have no direct or indirect influence or control. The guidance indicates that the SEC staff has received questions regarding the application of the rule in certain scenarios, and that the Office of Compliance Inspections and Examinations (OCIE) has encountered situations in which advisors have asserted that other types of access persons' trusts qualify for the reporting exception when the access person (a) is a grantor or beneficiary of a trust managed by a third-party trustee and (b) has limited involvement in trust affairs.

The SEC guidance instructs that the fact that an access person provides a trustee with management authority over a trust for which he or she is grantor or beneficiary, or

[6] "Beneficial ownership" includes securities owned by the access person's immediate family members sharing the access person's household.

[7] SEC IM Guidance Update No. 2015-03 (June 2015).

provides a third-party manager discretionary investment authority over his or her personal account, by itself, is insufficient for an advisor to reasonably believe that the access person had no direct or indirect influence or control over the trust or account for purposes of relying on the reporting exception. The SEC staff was concerned that despite the grant of discretionary authority over the personal account, the access person could nevertheless influence investment decisions in the account by, for example, suggesting or directing trades or by discussing investment allocations in the account with the trustee or discretionary manager.

Indeed, the SEC guidance suggests that control procedures should be reasonably designed to determine whether the access person actually had direct or indirect influence or control over the trust or account, rather than whether the third-party manager had discretionary or nondiscretionary investment authority. In the staff's view, such controls might include:

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

Note that access persons also need not submit transaction reports with respect to securities transactions effected pursuant to an automatic investment plan.

Non-reportable securities

The Rule's requirement that access persons provide initial and annual holdings reports and quarterly transaction reports applies only to "reportable securities" in which the access person has, or acquires, any "direct or indirect beneficial ownership." The following securities are not treated as reportable securities under the Rule:

- Direct obligations of the Government of the United States
- Bankers' acceptances, bank certificates of deposit, commercial paper, and other high-quality short-term debt instruments, including repurchase agreements
- Shares issued by money market funds
- Shares of other types of open-end registered mutual funds, unless the firm or a control affiliate acts as the investment advisor or principal underwriter for the fund
- Transactions in units of a unit investment trust if the unit investment trust is invested exclusively in mutual funds, unless the firm or a control affiliate acts as the investment advisor or principal underwriter for the fund

The SEC staff has further recognized that investments in qualified tuition programs established pursuant to Section 529 of the Internal Revenue Code of 1986 ("529 Plans") do not present the opportunity for the type of improper trading that access person reports are designed to address.[8] Accordingly, 529 Plans are not considered "reportable securities" under Rule 204A-1(e)(10)(iv) of the Advisers Act.

Pre-approval for certain investments

The firm's code of ethics must also require access persons to obtain the firm's approval prior to directly or indirectly acquiring beneficial ownership in any security in an initial public offering (IPO) or in a limited offering. A limited offering refers to private placements that are exempt from registration under Section 4(a)(2) or 4(a)(5) of the Securities Act of 1933 or Rules 504, 505, and 506 thereunder. Although the Rule only requires pre-clearance for IPOs and limited offerings, it is not uncommon for investment advisors to adopt broader approaches, requiring pre-clearance for certain, or even all, securities transactions.

Books and records requirements

With respect to personal securities transactions, the Advisers Act Rule 204-2(a)(13) requires advisors to maintain the following records for a period of five years:

- A record of all holdings reports and transaction reports made by an access person, including any brokerage statements and confirmations provided instead of transaction reports
- A record of the names of persons who are currently, or within the past five years were, access persons of the investment advisor
- A record of any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons, for at least five years after the end of the fiscal year in which the approval is granted[9]

IV. Developing robust personal trading policies

Advisory firms must include within a code of ethics a comprehensive personal trading policy. The code of ethics must require that access persons (1) report their personal securities transactions to the CCO or another designated person each quarter, (2) submit a complete report of the

[8] See WilmerHale, LLP No Action Letter, SEC File No. 132-3 (July 28, 2010).

[9] 17 CFR 275.204-2(a)(13).

securities they hold at the time they become an access person, and then at least once per year after that, and (3) obtain pre-approval prior to investing in IPOs or private placements or other limited offerings. The code must also provide for the firm's CCO or another designated person to review these personal securities transaction reports and must require supervised persons to promptly report violations of the code of ethics to the CCO or his or her designee. The policy should also detail which securities are "reportable securities" and explain the exemptions contained in the Rule and no-action relief.[10] Furthermore, firms are required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the misuse of material non-public information (MNPI); such provisions are frequently contained in the code of ethics.

Firms must include, under Item 11 of their Form ADV, Part 2, a description of the firm's code of ethics. Additionally, firm employees should be provided with the firm's code of ethics and personal trading policy at the time of hire and with all updates in a timely manner.

Firms should ensure their codes of ethics are thorough and robust as well as tailored to the size, scope, and nature of the firm's business activities. While the Rule mandates certain minimum standards, the SEC has also recommended best practices[11] to be incorporated into firms' codes of ethics regarding personal trading, including:

- Requiring prior written approval before access persons can engage in a personal securities transaction ("pre-clearance")[12]
- Maintaining "restricted" lists of issuers about which the firm has MNPI and prohibiting personal trading in securities of any issuers on the firm's restricted list
- Detailing "blackout" periods, during which access persons are not permitted to engage in personal trading because client securities trades are being placed or recommendations are being made to clients
- Reminding the firm's supervised persons of the firm's fiduciary duties and of the requirement to offer investment opportunities to clients first before supervised persons trade on such opportunities
- Prohibiting or restricting "short swing" trading and market timing trades
- Requiring that employees trade only through certain brokers or limiting the number of brokerage firms used for personal trading, as a means of facilitating compliance review and oversight of personal securities transactions
- Requiring that access persons provide the firm with duplicate statements and confirmations
- Assigning new research/analysis to employees whose personal holdings do not present conflicts
- Requiring client trades to be executed prior to employee trades

Schwab Compliance Solutions can help

Schwab's Compliance Solutions offers comprehensive employee-monitoring solutions such as Schwab Trade Check™, which simplifies the process of monitoring employees' trading activity. With automated technology, designated brokerage services, and dedicated ongoing support, Compliance Solutions helps you save time, effort, and resources. For more information, visit the Employee Monitoring section of the Schwab Corporate Services website (or corporateservices.schwab.com > Employee Monitoring).

V. Common SEC exam deficiencies

The SEC's 2008 Compliance Alert

In July 2008, the SEC issued a Compliance Alert informing firms that personal trading by access persons was an area of focus during examinations of investment advisors.[13] The SEC implored firms to review their compliance controls regarding employee trading and trading by the firm for its own proprietary accounts. The Compliance Alert noted that SEC examination staff often saw the following issues:

- Codes of ethics were not complete: firms' codes of ethics failed to address all regulatory requirements.

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[10] See e.g., WilmerHale, LLP No Action Letter, SEC File No. 132-3 (July 28, 2010).

[11] U.S. Securities and Exchange Commission, *Investment Adviser Codes of Ethics: Final Rule*, Advisers Act Release No. IA-2256 (July 6, 2004).

[12] The SEC has suggested that pre-clearance procedures may be automated through the use of compliance software and has suggested that such procedures may also identify who has authority to approve a trade request, the length of time an approval is valid, and procedures for revoking an approval, as well as procedures for verifying post-trade reports or duplicate confirmations against the log of pre-clearance approvals. U.S. Securities and Exchange Commission, *Investment Adviser Codes of Ethics: Final Rule*, Advisers Act Release No. IA-2256 (July 6, 2004).

[13] U.S. Securities and Exchange Commission, Compliance Alert (July 2008).

- Firms' codes of ethics were not followed: trades were not pre-cleared, pre-clearance forms did not contain the required information, or trades were placed in securities that were on an advisor's "do not trade" list.
- Control procedures regarding oversight of supervised investment personnel were weak.
- Reporting requirements were not followed and/or monitoring was not performed: access persons failed to submit, or did not submit in a timely manner, reports of their personal securities transactions or holdings consistent with the Rule or the firm's policies, or firms failed to perform trade reviews.
- Firms' disclosures were inaccurate: the firm's Form ADV, Part 2 contained inaccuracies regarding controls over personal trading.

These deficiencies are likely still on SEC examiners' checklists.

The SEC's OCIE 2017 Risk Alert

The OCIE issued a Risk Alert in February 2017, informing firms that the Rule was one of the five compliance topics most frequently identified in deficiency letters.[14] Common deficiencies identified by the SEC examination staff include:

1. Firms failed to properly identify access persons.
2. Firms' codes of ethics were missing required information: codes of ethics did not specify review of the holdings and transactions reports or did not identify the specific submission time frames, as required by the Rule.
3. Transactions and holdings were not submitted in a timely manner: certain access persons submitted transactions and holdings less frequently than required by the Rule.
4. Form ADVs did not describe the code of ethics: certain firms did not describe their codes of ethics in their Form ADV, Part 2 and did not indicate that their codes of ethics are available to any client or prospective client upon request.

VI. Importance of personal trading policies

Under the Advisers Act, advisory firms and their personnel owe clients a fiduciary duty. Indeed, Section 206 of the Act prohibits an advisor from defrauding clients and acting deceptively vis-à-vis its clients. Moreover, in *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), the Supreme Court stated that the "Investment Advisers Act of 1940… reflects a congressional recognition of 'the delicate fiduciary nature of an investment advisory relationship'" (citations omitted). Personal trading policies are important tools to promote ethical conduct by advisory employees, carry out a firm's fiduciary obligations, and prevent and detect unlawful trading.[15]

Moreover, the February 2017 OCIE Risk Alert put firms on notice that examiners will expect that firms have addressed the commonly observed deficiencies in the alert, notably compliance with the Rule. This means that SEC examiners have prioritized personal trading compliance by investment advisor firms and will be scrutinizing firms for deficiencies in this area. Because this area of focus has been provided to firms before their examination, there is no excuse for noncompliance and the SEC is likely to have little patience for noncompliance. Penalties for failing to address these issues could include fines for firms in addition to fines and suspensions for compliance officers and other firm personnel. It is far better to address these issues prior to an examination to help mitigate the risk of facing an enforcement action.

VII. Practical guidance

What should compliance professionals consider when evaluating an access person's trade request?

Firms' compliance staff, when conducting a trade review, should, among other things, ensure that the proposed trade (1) is in an account that has been disclosed to the firm, (2) is not a transaction involving an IPO or limited offering, each of which typically requires added scrutiny, (3) is not on a "restricted" list or during a blackout period, (4) does not constitute "front-running" a client's trade or create short swing profits or otherwise present a conflict of interest between the access person or the firm and clients, (5) is not based on MNPI or pose risks of being based on MNPI, and (6) does not take an investment opportunity that is available to clients.

What steps can my firm take to avoid potential problems?

Fortunately, there are many things firms and their compliance personnel can do to avoid personal trading issues arising in trade reviews—or worse—in SEC examinations. As described previously, firms are well served by having a robust and up-to-date code of ethics containing policies and procedures reasonably designed to achieve compliance with the Rule. The firm should confirm the adequacy of those policies and procedures, and the effectiveness of their implementation, as part of the firm's annual compliance review conducted pursuant to Rule 206(4)-7(b).

But firms should also be adopting additional measures to foster compliance with personal trading policies and procedures. These may include comprehensive training to its access persons, as well as its other staff, both at the time of hire and on an ongoing basis. Firms may also require employees to annually certify that they have

[14] National Exam Program Risk Alert, *supra* note 1.

[15] U.S. Securities and Exchange Commission, Information for Newly-Registered Investment Advisers (November 23, 2010).

complied with the firm's code over the past year and that they have accurately reported all personal investments and personal trading accounts as required by the code. Additionally, firms may consider requiring employees to complete an annual compliance questionnaire, in which employees provide information regarding "outside income" and "outside trading accounts and private investments." The questionnaire may also inquire about relationships (e.g., family) with individuals involved in the financial services industry and about service on corporate boards and credit committees, among others. Firms may choose to actively provide reminders to employees and access persons regarding key compliance topics through a firm intranet or other internal database. Firms should further require strict adherence to the firm's code of ethics, including the personal trading policies and procedures, from all access persons, regardless of seniority: lax enforcement in one area, or with respect to senior executives, can breed a culture of noncompliance across other areas.

Moreover, firms are typically well served by periodically conducting forensic compliance reviews and testing their policies and procedures related to personal trading.

Best practices to consider when testing your firm's personal trading policies and procedures:

1. Analyze the personnel working for or with the firm, including outside consultants, to ensure all access persons are correctly identified.
2. Compare holdings reports to brokerage statements to ensure access persons are completely and accurately submitting their holdings reports.
3. Examine quarterly transaction and annual holdings reports to ensure that all access persons submitted them in a timely fashion.
4. Compare access persons' pre-clearance requests with their account statements and trade confirmations or transaction reports to verify that all relevant trades were on the terms requested and in the time frame approved.[16]
5. Test for "red flags" in access persons' personal trading, such as a high percentage of profitable personal trades (in absolute terms and in relation to clients) or personal trades resulting in exceptional returns.[17]
6. Compare access persons' trades with client trades to evaluate whether there are patterns showing favoritism, preferential treatment, or noncompliance with the firm's trade allocation policies.
7. Examine whether pre-clearance approvals and exceptions were in writing and timely documented.
8. Determine whether the reviewer of personal securities transactions had his or her own personal securities transactions reviewed by another officer or control person of the firm.
9. Test whether access persons who violated the code's provisions with respect to personal trading were appropriately reprimanded, with such reprimands documented properly.
10. Ensure that trade allocations were determined prior to (or soon after) the trade was executed, and any post-execution change to trade allocation was documented and reviewed by an appropriate individual to ensure that the allocation was consistent with the advisor's policies and procedures.[18]

VIII. Relevant enforcement cases

If firms fail to adequately comply with the requirements of the Rule, the SEC can, and has, brought enforcement actions that have resulted in significant penalties. For example, in 2014, an investment firm's CCO failed to prevent, detect, and respond to insider trading.[19] The SEC noted that the CCO failed to design written compliance policies and procedures in light of unique insider trading risks and failed to adequately collect and review records of personal trading by employees. Additionally, the CCO did not adequately maintain restricted or watch lists of stocks as required under the firm's policies and procedures and failed to conduct any investigation of trading as required by the firm's policies and procedures. The SEC also determined that the CCO overly relied on employees to self-report violations and failed to annually assess the adequacy or effectiveness of the company's policies and procedures that were in place. As a result, the SEC imposed a $100,000 civil monetary penalty against the CCO as well as an industry bar from associating in any compliance or supervisory capacity.

In 2015, the SEC found that an investment firm failed to adopt and implement reasonably designed compliance policies and procedures. This included relying on an off-the-shelf investment advisory compliance manual template and failing to ensure that any procedures were adopted.

[16] For example, firms frequently require approved trades to be executed on the same business day that approval is received. Firms should test whether access persons' actual trades complied with this requirement.

[17] Utilizing one of the widely available technology platforms for maintaining personal and proprietary transactions electronically should permit such analyses to be done efficiently. Schwab Trade Check® technology automates pre-clearance activities and helps protect against potential trade violations. Visit http://corporateservices.schwab.com/public/corporate/employee-monitoring/technology for more details.

[18] See also U.S. Securities and Exchange Commission's Compliance Alert (July 2008).

[19] U.S. Securities and Exchange Commission, *In the Matter of Thomas E. Meade*, SEC Administrative Proceeding No. 3-15927 (June 11, 2014).

The firm also failed to conduct annual reviews of the adequacy of its investment advisory compliance program. The firm's code of ethics, contained in the firm's compliance manual, simply set forth that access persons' personal transactions and holdings reports be reviewed periodically, without indicating how the review should be carried out. In implementing the procedure, the firm did not assess whether a given access person had traded in his own account in the same security he was trading for clients. As a result of these compliance failures, the SEC imposed a $50,000 civil monetary penalty against the firm.[20]

In 2011, the SEC found that an investment advisor firm and two control persons (a CCO/investment advisor representative and an investment advisor representative) used an off-the-shelf code of ethics and an off-the-shelf policies and procedures manual. They failed to adapt the templates to the firm's specific practices and failed to adopt policies to address conflicts of interest associated with recommending investments in which its associated persons had a financial interest. The SEC also found that the firm, through its control persons, failed to follow or enforce its own policies and procedures to prevent insider trading. Specifically, it failed to place a company's securities on a "restricted list" or "watch list" when employees possessed MNPI about the company. Additionally, the firm's code of ethics stated that where its employees serve on the board of directors of a public company, the firm would implement an appropriate procedure to isolate such persons from making decisions relating to the company's securities, which it failed to do. Moreover, the SEC found that the firm and the relevant individuals placed their own interests ahead of firm clients and did not make adequate disclosures regarding investment recommendations. As a result of these and other violations, the SEC imposed a $177,596 civil monetary penalty against the CCO and revoked the registration of the firm.[21]

IX. Conclusion

As evidenced throughout this white paper, the SEC's focus on personal trading issues should move this item to the top of your firm's to-do list. Fortunately, there are clearly established best practices to take into consideration to help protect you and your firm as well as prevent smaller compliance issues from growing into larger problems.

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Andrew Melnick is a highly experienced securities litigator, regulatory attorney, and compliance advisor to a wide array of financial services firms. He regularly represents and advises investment advisors, broker-dealers, investment banks and asset managers and their executive management, boards, and employees in complex litigations and arbitrations, internal investigations, regulatory inquiries, compliance reviews, and employment matters.

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[20] U.S. Securities and Exchange Commission, *In the Matter of Du Pasquier & Co., Inc.*, SEC Administrative Proceeding No. 3-16350 (January 21, 2015).

[21] U.S. Securities and Exchange Commission, *In the Matter of Belsen Getty, LLC, et al.*, SEC Administrative Proceeding No. 3-14404 (July 11, 2012).

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