ETHICS

1. In General

- MEMBERS (Regular & Affiliate members of AIMR & its constituent analyst societies, holders of the CFA charter, & CFA Candidates are REQUIRED to conduct themselves in accordance with the AIMR Code of Ethics & Standards of Professional Conduct.
- Members who fail to comply with these obligations may be subjected to disciplinary sanction by the Board of Governors of AIMR, acting though its Professional Standards Policy Committee.
- Professional Standards are NEEDED in the field of Financial Analysis & investment management because →
  - Public needs COMPETENT, OBJECTIVE & TRUSTWORTHY investment advice and financial management
  - There are certain FUNDAMENTAL Standards of Conduct that can be commonly applied to all who are engaged in the profession of financial analysis & investment management
  - A BODY of KNOWLEDGE exists that persons engaged in the professional practice of financial analysis and investment management should KNOW, UNDERSTAND, & APPLY
- AIMR has taken on the mission to →
  - Establish EDUCATIONAL Standards, including the compilation of the Body of Knowledge, for the field of investment management and research, conduct examinations designed to measure a person's understanding of the Body of Knowledge, and to award the CFA designation to persons demonstrating competency in financial analysis and investment management
  - Promote HIGH ETHICAL & PROFESSIONAL Standards for financial analysts & investment professionals world wide.

2. AIMR Code of Ethics

- Conduct yourself with INTEGRITY & DIGNITY, and act in an ETHICAL manner in your dealings with the public, clients, customers, employers, employees and fellow professionals
- Conduct yourself and encourage fellow investment professionals to conduct themselves in a professional & ethical manner that will REFLECT CREDIT on yourself and the profession as a whole
- Act COMPETENTLY and strive to improve competence
- Use Proper Care and Exercise INDEPENDENT PROFESSIONAL JUDGMENT

Memorize these Key Phrases to Know the Code of Ethics

- *Act with Integrity*
- *Be a Credit to the Profession*
- *Be Competent*
- *Use Independent Professional Judgment*

3. AIMR Standards of Professional Conduct

- ***Standard I: Fundamental Responsibilities***
  - **I(A): Know & Comply with Laws, Regulations, Ethical Codes, & Professional Standards**
  - **I(B): Do not Knowingly participate or assist others in any violation of applicable regulations or ethical codes**
- ***Standard II: Relationships with and Responsibilities to the Profession***
  - **II(A): Use the CFA Designation with Dignity. Refer to Membership in AIMR, FAF, ICFA, or the CFA Program in a Dignified & Judicious Manner. Do not use the CFA Designation unless you are the holder of a CFA Charter**
  - **II(B): Do not engage in any act that Adversely reflects upon your honesty, trustworthiness, or professional competence**
  - **II(C): Do not Plagiarize**
- ***Standard III: Relationships with & Responsibilities to the Employer***
  - **III(A): Members must inform employers of their obligation to comply with the Code of Ethics and Standards of Professional Conduct and deliver a copy of the Code and Standards to their Supervisor**
  - **III(B): Do not undertake any independent practice in competition with your employer without written consent from both your employer and your other client**
  - **III(C): Disclose to your employer all matters that could reasonably be expected to impair your ability to render unbiased and objective advice. If a conflict of interest exists, comply with any prohibitions on activities imposed by your employer**
  - **III(D): Disclose, in writing, all monetary or other benefits received for your services other than the usually & customary compensation paid to you by your primary employer**
  - **III(E): Members with Supervisory responsibilities must exercise control over their subordinates to prevent violations of laws, statutes, or the Code & Standards by setting and/or relying on reasonable procedures designed to detect & prevent such violations**
- ***Standard IV: Relationships with & Responsibilities to Clients & Prospects***
- ***(A) Investment Process***
  - **IV(A.1): Have a Reasonable & Adequate Basis, supported by appropriate research, for recommendations or investment action. Be diligent to avoid any material misrepresentation & maintain appropriate records to support the recommendation or action**
  - **IV(A.2): In research reports:**
    - **Use Reasonable Judgment to Include Relevant Factors**
    - **Distinguish between Fact & Opinion**
    - **Indicate the basic characteristics of the Investment**
  - **IV(A.3): Use care to achieve & maintain independence & objectivity in making investment recommendations or taking investment action**
- ***(B) Interaction with Clients & Prospects***
  - **IV(B.1): Members have the affirmative responsibility to understand and comply with their fiduciary duties. Members must place client interests ahead of their own**
  - **IV(B.2): Before making any investment recommendation or taking investment action for a client, a member must:**

    - **Make inquiry into the client's financial situation, investment experience, and investment objectives (should be done at least once per year to make sure the client profile is current)**
    - **Consider the appropriateness and suitability of investment recommendations or action for the client with respect to his needs, objectives, and the effect on the portfolio**
    - **Distinguish between fact & opinion in presenting recommendations**
    - **Disclose to clients the general principles and format of the investment process by which securities are selected and portfolios are constructed. Promptly disclose any changes that might significantly affect the process**
  - **IV(B.3): Deal Fairly & Objectively with all clients when disseminating investment recommendations, material changes in prior recommendations, and in taking investment action**
  - **IV(B.4): Priority of Transactions should be given to clients and employers over those in which you have a beneficial interest. Personal transactions should not adversely affect the interest of clients**
  - **IV(B.5): Preserve the Confidentiality of Client & Employer information unless it concerns illegal activities**
  - **IV(B.6): Members may not Misrepresent:**
    - **The services that they or their firms are capable of performing**
    - **Their or their firm's qualifications**
    - **Their academic or professional credentials**
    - **By making or implying any guarantees regarding investment outcomes, except to communicate accurate information regarding the terms of the investment and the issuer's obligations**
  - **IV(B.7): Disclose to Clients and Prospects all matters that could reasonably be expected to impair your ability to render unbiased & objective advice**
  - **IV(B.8): Disclose to clients any consideration you have paid to others for recommending your services to that client**
- ***Standard V: Relationships with & Responsibilities to the Investing Public***
  - **V(A): Do not Trade, or cause others to trade, in a security when possessing material non-public information on the security if such trading would breach a duty or if the information was mis-appropriated or relates to a tender offer. Make a reasonable effort to have the company make a public announcement of material non-public information that it (or its agents) have disclosed to you, or that you know was disclosed to someone in a manner that represents a breach of fiduciary duty**
  - **V(B): Make every effort to assure that investment performance information presented to clients or to the public is fair, accurate and complete**

4. Key Concepts to MEMORIZE

- **Know & Comply with All Rules**
- **Do not Knowingly aid and abet others to break the rules**
- **Use the CFA designation correctly**
- **Be honest, even in your personal life**
- **Do not plagiarize**
- **Inform your employer about the Code and the Standards**
- **Do not do 'outside' work without your employer's approval**
- **Disclose conflicts of interest to employers, clients & prospects**
- **Disclose all income from an 'outside' job**
- **Supervisors must adequately supervise their subordinates**
- **Back up recommendations with good reasons**
- **Do not make misrepresentations**
- **Keep Good Records**
- **Put all relevant facts in research reports**
- **Distinguish facts from opinions**
- **Indicate the basic characteristics of investments**
- **Maintain independence & objectivity**
- **Know & carry out your fiduciary duties**
- **Know what is suitable for your clients**
- **Tell your clients your basic methodology**
- **Treat clients fairly**
- **Transaction priority belongs to the client & employer**
- **Keep client & employer information confidential**
- **Do not give guarantees**
- **Disclose referral fees**
- **Do not use material non-public information**
- **Present your investment performance fairly & accurately**

5. Amplifications of the Standards of Professional Conduct

▪ *Standard I: Fundamental Responsibilities*

- **I(A): Know & Comply with Laws, Regulations, Ethical Codes, & Professional Standards**
  - Know & Comply with all applicable laws & regulations of ANY government, regulatory organization, or professional association governing the member's professional activities, including the AIMR Code of Ethics. Members that work with or within other countries may be subject to varied securities laws & regulations. Members must comply with the laws and regulations of their HOME country when residing & working in foreign countries, or in trading foreign securities. Plus, the member must comply with the local laws & regulations while residing abroad or trading foreign securities. When the laws & regulations are different, the member must comply with the MORE strict laws & regulations to which he is subject. The Code of Ethics and Standards of Professional Conduct should govern a member's actions in the absence of a specific local law or regulatory requirement. If the Code & Standard require a higher duty than the law, the Code & Standards should guide the member.
  - *Compliance Procedures*
    - Maintain Current Files of applicable laws & regulations and distribute such information to employees
    - Establish procedures, whereby employees are regularly informed about changes in these laws & regulations
    - Regularly review written compliance procedures of the firm to make sure they reflect current law and provide adequate guidance to employees

- **I(B): Do not Knowingly participate or assist others in any violation of applicable regulations or ethical codes**
  - Members are responsible for violations which they KNOWINGLY participate in. Although members are presumed to know all applicable laws & regulations, AIMR recognizes that a member may not realize there is a violation if the member is not aware of all the facts giving rise to the violation.
  - *Compliance Procedures*
    - When Member suspects a client, fellow employee, or employer is doing something illegal or unethical, the following steps should be taken:
      - Consult Counsel to determine the legality of conduct
      - Disassociate oneself from the illegal or unethical activity and from those committing it. Urge the firm to persuade those engaged in the illegal or unethical activity to stop such actions
      - Report those who are engaging in the illegal or unethical activities to the appropriate authorities, if required by la or by regulatory agency regulations to do so. This could be necessary to prove disassociation. Counsel can give advice as to whether this is required.
      - Inaction, combined with continued association with those involved in illegal conduct may be construed as participation or assistance in the illegal conduct
    - Code & Standards do NOT REQUIRE that members report legal violations to the appropriate authorities, but such disclosure may be prudent under certain circumstances
    - When question arises re: meaning of a rule of regulation or whether or not a certain practice is permissible, the professional should consult with his immediate supervisor for a resolution of the problem. If not satisfied, consult with legal counsel (normally the firm's compliance official, but in some cases, outside counsel should first be consulted)
    - When member commits an illegal act, he may not claim ignorance as an excuse. He is still responsible when such illegalities would be evident to someone familiar with the *Handbook*, the firm's compliance manual, or regulations deemed to be common

knowledge to a reasonably informed professional. The professional should be familiar enough with the rules of conduct for his job, so as to be able to recognize when an act may be in violation of acceptable norms of conduct. At that point, counsel advice should be sought before engaging in the questionable act.

- If advice of counsel is sought and it turns out to be erroneous, the fact that the professional made a good faith effort not to violate the Code, Standards, or Law may be used as a defense against charges that he violated this Standard provided:
    - The advice was sought from someone that was competent to render it (specialist in the relevant law)
    - All relevant facts were told to counsel
    - Advice was followed without material deviations
    - Professional had NO reason to believe that counsel's advice was erroneous

▪ *Standard II: Relationships with and Responsibilities to the Profession*

- **II(A): Use the CFA Designation with Dignity. Refer to Membership in AIMR, FAF, ICFA, or the CFA Program in a Dignified & Judicious Manner. Do not use the CFA Designation unless you are the holder of a CFA Charter**
    - Members of AIMR, FAF, ICFA may reference these organizations in a dignified and judicious manner. An accurate explanation of the requirements that have been met to obtain membership may be included.
    - Holders of the CFA designation may use "Chartered Financial Analyst" or the CFA mark in a dignified & judicious manner. An accurate explanation of requirements that have been met to obtain designation may be included
    - Candidates may reference their participation in the CFA program as long as it is made clear that they are merely candidates. Only those awarded the CFA charter may use the initials "CFA" after their name. There is no special entitlement or partial designation to someone who has passed one or more examinations, but who has not been awarded the charter
    - *Compliance Procedures*
        - On letterheads, business cards and in directory listings, only the mark, CFA, or the words "Chartered Financial Analyst" should appear after the charterholder's name.
        - The designation cannot appear in type larger than the holder's name
        - Any description or explanation of the CFA designation, AIMR or ICFA should be limited to a concise description of the requirements needed to obtain it and/or a concise description of the organization
        - No claim of superior performance, ability or knowledge by virtue of having a CFA designations should be given or implied
        - Candidates may state that they are Level I, II, or III candidates, but should not cite a date of completion. To be a candidate requires the individual be enrolled to take the next scheduled exam.
        - The Firm's compliance, public relations, and marketing departments should be made aware of this Standard in writing, as well as a description of AIMR, ICFA, FAF and the requirements of the CFA designation
        - "CFA" is a registered trademark of AIMR and therefore should never be used as a noun, or in pluralized form. A person is not a "CFA", the person is the "holder of the CFA designation" Firms do not have 15 CFAs, they have 15 holders of the CFA designation

- **II(B): Do not engage in any act that Adversely reflects upon your honesty, trustworthiness, or professional competence**
  - This Standard goes beyond acts committed in a professional capacity. This concerns personally integrity & individual behavior that reflect on the entire profession. Potential Violations include:
    - Criminal Convictions for felonies or similar violations, even if not related to professional activities
    - Repeated convictions for misdemeanors, no matter how inconsequential, that might suggest a disrespect for the law.
    - Engaging in dishonest business schemes
    - *For Example*:
      - Excessive drinking at lunch and subsequent intoxication at work. This is a violation since it reflects poorly on the member's conduct and professionalism, as well as on his or her firm and the investment industry in general
      - Padding expense accounts. With or without criminal charges, this is a violation, because the member engaged in intentionally dishonest behavior.
  - *Compliance Procedures*
    - Generally, it is a matter of the member's own character & integrity to ensure compliance. The information required by regulatory agencies, such as the SEC, stock exchanges, and the Investment Management Regulatory Organization, provides further incentives to maintain a high level of ethical conduct.
    - Plus, members should encourage employers to adopt a clear policy indicating that personal behavior, which reflects poorly on the individual, the institution, or the investment industry, will not be tolerated
    - Members who are supervisors should conduct background checks on potential employees to ensure they are not ineligible to work in the investment industry because of past law infractions.

- **II(C): Do not Plagiarize**
  - Plagiarism is a violation of the Code & Standards. All outside sources used in reports should be acknowledged, identifying the source, its author, and publisher. The only exception is the use of Factual Information published by Recognized Financial & Statistical Reporting Sources. The standard applies to ORAL, WRITTEN & ELECTRONIC communications. Violations include:
    - Using parts of reports/articles prepared by others either verbatim or with slight wording changes without acknowledging the source
    - Citing specific quotations to "Leading Analysts" or "Investment Experts" without specifically referring to them by name
    - Presenting statistical estimates or forecasts made by others with the source identified but without any of the caveats that appeared in the source
    - Using a chart or graph prepared by others without stating the source
    - Copying proprietary spreadsheets or algorithms without seeking the cooperation or authorization of their creators
  - *Compliance Procedures*
    - Maintain copies of any materials prepared by others that were relied on in preparing a report.
    - Attribute the source for any direct quotation including tables, projections & new methodologies (prepared by a source other than a recognized financial & statistical reporting service)
    - Attribute the source when paraphrasing or summarizing material prepared by others

- ***Standard III: Relationships with & Responsibilities to the Employer***
  - **III(A): Members must inform employers of their obligation to comply with the Code of Ethics and Standards of Professional Conduct and deliver a copy of the Code and Standards to their Supervisor**
    - Holders of the CFA designation, CFA candidates, & AIMR members must inform their IMMEDIATE supervisor in writing that they are required to conform to the Code of Ethics & Standards of Professional Conduct. They are obligated to deliver a copy of the Code & Standards to their Supervisor.
    - *Compliance Procedures*
      - Notify one's immediate supervisor in writing about the need to abide by AIMR Code of Ethics & Standards of Professional Conduct. This is not necessary ONLY if the supervisor has stated, in writing, that the firm's policies already include AIMR's Code and Standards
      - Along with the copy of the Code & Standards delivered to supervisor, make a written request that the Code & Standards be adopted and disseminated throughout the firm. Maintain a written record of notification.
      - Members who are supervisors should inform new employees about the high degree of ethical conduct expected of them.

  - **III(B): Do not undertake any independent practice in competition with your employer without written consent from both your employer and your other client**
    - Do not undertake independent practice in competition with your employer that may result in some compensation or other benefit, unless you have written consent from both your employer and the outside entity to do so. If a member contemplates performing services for an entity other than his employer that could result in compensation, by rendering a service currently available by the employer, a written statement must be made describing:
      - The Types of Services offered
      - The Expected Duration
      - The Compensation
    - No service should be rendered until the client gives written acknowledgement indicating he or she has read and understood the written disclosure. If member plans to leave a current employer, he has a duty to act only in the best interest of the employer until employment is terminated. Thus, the employee must refrain from doing anything that would injure the employer, deprive it of profit, or deprive it from using the employee's skills until the employment terminates. Violations include:
      - Misappropriating the trade secrets of the employer
      - Misusing confidential information
      - Engaging in a conspiracy to bring about mass resignation of other employees
      - Coaxing customers to leave the employer prior to ceasing employment with the employer
      - Self-dealing (appropriating for oneself a business opportunity or information that belongs to the employer)
      - Taking the Employer's customer lists, records, or files without written permission of the employer
      - Taking property of the Employer or Interfering with the employer's business
      - Deviating from any understanding that has been reached and agreed upon between the member & employer, or member & client

- **III(C): Disclose to your employer all matters that could reasonably be expected to impair your ability to render unbiased and objective advice. If a conflict of interest exists, comply with any prohibitions on activities imposed by your employer**
    - Members must disclose any material fact that could reasonably be expected to interfere with their duty to their employer or their ability to act in an unbiased and objective manner. Conflicts of interest exist with any situation that would interfere with the member rendering unbiased investment advice, or cause the member not to act in the employer's best interest.
    - Many firms have policies that restrict personal trading and prohibit employees from holding outside trustee positions or corporate directorships. Members should abide by employer guidelines

- **III(D): Disclose, in writing, all monetary or other benefits received for your services other than the usually & customary compensation paid to you by your primary employer**
    - Inform Employers IN WRITING of compensation for services that are in addition to the compensation received from the employer. The employer is entitled to have full knowledge of a member's compensation arrangements in order to assess the true cost of services, and their likely effects on the employee's loyalties and objectivity.
    - The use of payment-in-kind and expense reimbursement used as a means of concealing compensation is discouraged
    - If a member is proposing to enter into an agreement to perform work for a fee paid by some entity other than the primary employer, he must file a written report with the primary employer outlining:
        - Source of compensation
        - Description of the compensation
        - Amount of compensation
        - Duration of agreement
    - No arrangement may be entered into without the employer's approval

- **III(E): Members with Supervisory responsibilities must exercise control over their subordinates to prevent violations of laws, statutes, or the Code & Standards by setting and/or relying on reasonable procedures designed to detect & prevent such violations**
    - Members with supervisory responsibilities must establish procedures designed to prevent violations of laws, regulations, compliance procedures, or provisions of the Code & Standards
    - Supervisor responsibility applies to any member who has employees subject to their control or influence. Members with supervisory responsibility are expected to understand what constitutes an adequate compliance system for their firm and to make reasonable efforts to see that appropriate procedures are established, documented & communicated to subordinates, monitored & enforced. They must exercise their responsibility with respect to both persons who hold and do not hold the CFA designation
    - Supervisors must make every effort to detect improper work conduct, fraudulent behavior, & misleading statements or practices on the part of subordinates. Member may not be in violation if he is unable to detect violations that occur even after reasonable procedures have been adopted and steps have been taken to institute an effective compliance program
    - Once a supervisor learns an employee has or may have violated the law or Code & Standards, he must promptly institute an investigation to determine the extent of wrong-doing. It is not enough to rely on an employee's statement about the extent of wrong-doing, or as assurance by the employee that it will not reoccur. The member must report the misconduct to their superior and take steps to ensure the violation will not be repeated.
    - If a member is in a supervisory position in a firm with an inadequate compliance system, he should recommend corrective action to senior management. If corrective steps are not welcomed and the member would not be able to discharge supervisor responsibilities due to an inadequate compliance system, the member should refuse to accept supervisor responsibility, in writing, until reasonable procedures are adopted

- *Compliance Procedures*
  - Identify situations in which a violation of the law or Code/Standards could occur
  - Establish compliance procedures designed to prevent such violations
  - Disseminate the procedures & policy to appropriate personnel
  - Periodically update procedures to ensure measures are adequate under the law
  - Enforce those procedures
  - Review actions of employees in order to prevent violations
  - When violations occur, prompt action is taken to investigate and measures taken to prevent re-occurrence.
  - Standards of Reasonableness should be used to judge the actions of supervisors
- *Important Legal Cases in the Area of Supervision*
  - Petrites v. J.C. Bradford & Co.
    - Since JC Bradford's supervisory procedures did NOT meet stock exchange rules, the firm suffered a liability
  - Alm, Kane, Rogers & Co. SEC Release
    - The firm's supervisory procedures were found to be INFORMAL and not designed to prevent or uncover the solicitation of business based on inside information. Plus, the firm's compliance manual provided NO guidelines indicating on what basis salesmen could solicit trades. Consequently, the firm was guilty in certain related matters.
  - SEC v. First Boston Corporation
    - Firm's head trader & supervisor were confidentially given inside information about some bad news pertaining to a stock. Trades took place based on this information. The firm had to disgorge its profits from the trade, pay a fine, and review its restricted list & method of separating information between departments.

- ***Standard IV: Relationships with & Responsibilities to Clients & Prospects***
- ***(A) Investment Process***
  - **IV(A.1): Have a Reasonable & Adequate Basis, supported by appropriate research, for recommendations or investment action. Be diligent to avoid any material misrepresentation & maintain appropriate records to support the recommendation or action**
    - Be diligent thorough in investigations when making recommendations, or when undertaking investment actions for others
    - Have a reasonable & adequate basis, supported by appropriate research, for recommendations & investments
    - Avoid material misrepresentations in any research report or investment recommendations
    - Maintain files & records to support the reasonableness of recommendations and investment decisions
    - Members should not use any information from a source he has reason to suspect is not accurate
    - It would be unprofessional to compare financial ratios prepared under different accounting rules without some attempt to make them comparable. Plus, it is unprofessional not to inform clients of unusual risks that may exist in certain foreign securities.
    - Financial professionals need to know the laws & regulations of their home country & those of foreign countries where they trade, have clients, or whose securities they analyze. They should be familiar with accounting, disclosure standards, market liquidity & other relevant factors of the foreign countries they analyze. This information needs to be communicated to clients when advising them on foreign securities & markets. Significant differences include:
      - Accounting Data
      - Timeliness, depth & accuracy of corporate disclosures
      - Degree of protection from securities laws & regulations
      - Extent of compliance with laws & regulations
      - Degree of liquidity

        - Other relevant factors, like tax withholding, currency controls, expropriation of assets, capital flow restrictions, etc. which may affect foreign investments
    - Members must maintain record that refer to specific research analysis or quantitative system used, as well as records that indicate reasons for specific transactions. All files, including work pages, that indicate the scope of research and reasons for conclusions, need to be retained.
    - *Account Executives & Portfolio Managers are in Compliance* if they recommend a security based upon
        - The firm's research department reports and recommendations; or other sources that can be relied upon as having done a diligent and thorough job of analysis
        - Analysis of the basic characteristics of an investment. Keep written records that indicate quality rating and basis for recommendations
        - Analysis of portfolio needs. At the onset of the relationship, the account executive or portfolio manager and the client should develop, in writing, a STATEMENT of Investment Objectives. Investment Objectives should be reviewed with the client at least annually, or after a significant change in the client's circumstances. Every recommendations should be considered with those objectives in mind. Then, the member must consider the investment's affect on the portfolio. The focus of all recommendations or investment actions should be on characteristics of the total portfolio, re: client's needs, rather than on a security-by-security basis
        - Member must also maintain files to support the investment recommendations or investment actions. Keep files on paper or electronic form (with an adequate backup)
    - *Corporate Finance members are in Compliance* if they have:
        - Performed diligent & thorough investigations re: IPOs, Private Placements, & Secondary Offerings
        - Performed General Industry Analysis, Company Financial Analysis, & Personnel Reviews
        - Studied the USE of Proceeds, Capital Structures, Potential Conflicts of Interest, Legal Matters & Environmental Considerations
        - Maintained All Records

- **IV(A.2): In research reports:**
    - **Use Reasonable Judgment to Include Relevant Factors**
    - **Distinguish between Fact & Opinion**
    - **Indicate the basic characteristics of the Investment**
    - The Term Research Report encompasses all means of communicating an investment recommendation, including:
        - Traditional research reports on the market, a class of investments, asset allocation or a specific security in paper form
        - In-person or Telephone recommendations
        - Media Broadcasts
        - Computer transmissions (including the Internet)
    - Capsule Recommendations (Buy or Sell) must be supported by background reports or data that are available to interested parties. Members should notify clients that additional information & analysis are available
    - If making a recommendation based on a research report, members should outline to clients the limitations of the analysis and conclusions contained in the report
    - For diligence & thoroughness to be exercised in writing a research report, basic investigative steps must be undertaken. Members should follow research report guidelines issued by national securities exchanges, regulatory bodies & their employer
    - A supervisory analyst should check research reports to assure compliance with these standards
    - As long as the member preparing the report has done an adequate investigation, he can select the important elements to emphasize, briefly discuss other factors, and omit factors that investigations show to be unimportant

- Members need to take reasonable steps to assure the reliability, accuracy, and appropriateness of the databases used in drafting the report. Acknowledgement of sources need to be made when appropriate
- Members need to distinguish facts from opinion; violations occur when reports fail to identify that the earnings estimates, dividend outlook, and/or future market outlook are opinions subject to future circumstances
- Written research reports need to include an indication of the investment's basic characteristics, so the reader can understand the nature of the security discussed

- **IV(A.3): Use care to achieve & maintain independence & objectivity in making investment recommendations or taking investment action**
  - Every member should avoid situations that might cause, or perceived to cause, a loss of independence and objectivity in recommending investments, or taking investment actions
  - Analysts & Portfolio managers are in violation when they:
    - Take an allocation in oversubscribed IPOs for their personal account
    - Accept Expensive Gifts or Entertainment from corporations (non-clients)
    - Allow their firm's business relationship with a corporation to affect a research review or investment decision
    - Allow compensation schedules to cloud judgment
  - *Compliance Procedures*
    - Members & their firms should establish policies to ensure independence and objectivity in making investment recommendations, or taking investment actions. The compensation system should be structured so that objectivity is not at risk
    - Members should DISCLOSE:
      - The relationship if any employee or owner of securities firm is a director of the company recommended
      - Whether their firm underwrites the security or makes a market in the company recommended
      - Ownership of the security in their personal holdings or in accounts of beneficial ownership, such as that of a spouse or relatives.
    - Create a RESTRICTED List. If senior management at a member's firm is unwilling to permit dissemination of adverse opinions about a particular company, the company in question should be put on a restricted list. The firm would then only disseminate factual information, not estimates or opinions about the company
    - When attending corporate functions or meetings, the member should pay for his transportation & lodging. Transportation & lodging provided by the corporation being analyzed should be accepted ONLY when alternative commercial arrangements are unavailable, or would make efficient movement too difficult
    - Gifts from anyone having a business relationship with one's firm whose value is above a TOKEN amount should NOT be accepted; members should not be the recipient of lavish entertainment by corporations
    - Members should restrict, or encourage their firm to restrict, employee purchases of Equity, IPOs, & Private placements
    - Members should implement, or encourage their firm to implement, effective supervisory & review procedures to ensure that analysts & portfolio managers comply with policies relating to their personal investments
    - Members may accept gifts from clients in excess of $100, as long as the member discloses the gift to his employer and the employer gives permission to accept it. Disclosure is necessary so that the member's supervisor can monitor the accounts to ensure that preferential treatment is not given to the gift-giving client.

- ***(B) Interaction with Clients & Prospects***
  - **IV(B.1): Members have the affirmative responsibility to understand and comply with their fiduciary duties. Members must place client interests ahead of their own**
    - Member has the responsibility to understand and comply with his or her FIDUCIARY Duties. This standard relates primarily to those who have discretionary authority in managing clients' assets or have other relationships of a special trust.
    - To satisfy this standard, members have an affirmative obligation to determine what the fiduciary duties are. These duties can be found in:
      - The Legal Statutes of their Jurisdiction
      - Rules & Regulations set down by Governing Agencies
      - Employer Compliance Manuals
      - AIMR Code of Ethics & Standards of Professional Conduct
    - Members are obliged to follow the highest set of standards imposed by any of the previous
    - While there is NO CLEAR definition of what a fiduciary duty is, it generally means that one is held to a higher than ordinary standard of LOYALTY, CARE, PRUDENCE, IMPARTIALITY, and DISCRETION in dealing with the assets of others. Consequently, investment fiduciary duties include:
      - Loyalty: Act only in ways that are in the Best Interests of their Clients. They should always avoid conflicts of interest, always put their client's interests above their own self-interest, and refrain from any form of Self-Dealing.
      - Care: Carefully analyze investment alternatives, using all the skills, knowledge, and insights customarily expected of a professional in the field
      - Prudence: Make the preservation of the value of assets entrusted to one's care the prime investment objective and earning a reasonable return on those assets the secondary concern. No more risk should be taken than is appropriate for the client's circumstances (suitability)
      - Impartiality: Treat all clients fairly. This means that all clients of equal circumstances should be treated equally.
      - Discretion: Keep information about client affairs, wealth, transactions, etc. confidential.
    - *Trust Management*
      - Most US jurisdictions do not have a "legal list" statute that specifies the type of assets that may be used for trust investments. Instead, they have either the **Prudent Man Rule** or **Prudent Investor Rule** to define the fiduciary duty of trustees
      - *Prudent Man Rule* requires trust fiduciaries to manage the assets entrusted to them with the SAME CARE & Prudence as persons of prudence, discretion & intelligence would manage their OWN affairs; make each investment with the prime directive of preserving the corpus of the trust, and or secondary importance, to provide a safe return on the capital invested
      - *Prudent Investor Rule* has replaced the Prudent Man Rule in most US jurisdictions. Imposes the same general standards of prudence, care, discretion, & loyalty upon trust fiduciaries, but, ≠ Prudent Man Rule in following respects:
        - No Asset Class is considered legally imprudent by its nature.
        - Standard of prudence is based on the OVERALL PORTFOLIO (not individual securities as under the Prudent Man Rule)
        - Reasonable Diversification of Assets within a trust is explicitly required, rather than being an implicit requirement of what it means to be prudent
        - Prudence & Care is extended beyond actual investment decisions to include the delegation of authority & the selection of advisors & supervisors
        - The Trustee is required to operate the portfolio in a cost-efficient manner. Costs of operating the trust should be reasonable & appropriate. Paying excessive commissions can be a breach of the fiduciary duty.
        - A PROFESSIONAL Standard of Care & Prudence is imposed rather than an ORDINARY standard.

- Other US Fiduciary Duties in managing Trust Assets include:
  - Treat all beneficiaries of the trust equally. (both beneficiary & remaindermen)
  - Best Efforts must be applied to maximize After-Tax Returns. Prudent to consult tax experts.
  - Legal Requirements must be known & satisfied (filing periodic financial statements, etc.) Prudent to consult trust attorneys.

▪ *Qualified Private Retirement (ERISA) Plans*

- The controlling law governing all qualified private retirement & employee stock-option plans is ERISA (Employee Retirement Income Security Act). This is a FEDERAL Law, administered by the US Dept. of Labor based on the Common Law of Trusts.
- ERISA defines a fiduciary of a retirement plan as being any person who:
  - Exercises any discretionary authority or control re: management of plan or disposition of its assets
  - Is Compensated, directly or indirectly, for rendering investment advice to a plan
  - Has Discretionary Authority of Responsibility in the Administration of a Plan
  - Is Named, Appointed, or Identified as a Fiduciary by, or under provisions of, the plan documents
  - Fiduciaries include Officers & Directors of the retirement plan, the company sponsoring the plan, members of the investment committee, and persons responsible for administration of the plan. But, the DESIGN & DRAFTING of Pension Trust Documents are NOT Fiduciary functions under ERISA since no such duties exist until the trust is brought into existence.
- Under ERISA, Fiduciaries have the following Affirmative Duties
  - Loyalty: must act solely in the interest of the plan participants & beneficiaries with the Exclusive Purpose of Providing Benefits & Defraying Reasonable Expenses.
  - Care: Must use all the skills of a Professional in carrying out their responsibilities (Prudent Expert Rule)
  - Prudence: must not take risks that endanger the ability of the plan to provide promised benefits & earn a reasonable return commensurate with the risk taken; requires:
    - Establish Written Investment Policies for the Plan
    - Diversify plan assets by asset class, industry, risk level, geography, etc. so as to reduce the risk of incurring large losses. Limits of 10% on any investment in Sponsor Asset, unless specifically provide for a higher limit.
    - Monitor & Evaluate the performance of the investment portfolio.
  - Know & Carry out Responsibilities as defined in Plan's Trust Documents – unless the plan requires actions that are contrary to ERISA
- Under ERISA, Fiduciaries are Prohibited from →
  - Self-Dealing: Buying from, Selling To, Borrowing from, Lending to the Plan. But, fiduciary may;
    - Receive normal benefits as a plan beneficiary
    - Receive reasonable compensation for services rendered
    - Be an officer, employee or representative of a party in interest
  - Conflicts of Interest: Engage in a transaction involving the plan on behalf of a party with interests that are adverse to the plan participants & beneficiaries
  - Receiving Kick-backs: Receiving compensation from a party who is involved with a transaction involving the plan
  - Enter into dealings with Parties having an Interest in the Plan: Party in Interest = anyone who is able to exercise influence over some aspect of a plan or whose dealings with the plan could involve a conflict of interest. Under ERISA, plan participants & beneficiaries who believe their retirement trust is not being operated solely for their best interest may bring civil action against the plan fiduciaries. If victorious, they have the right to recover both the losses and their

attorneys' fees. Plan fiduciaries are PERSONALLY LIABLE for these damages, unless:

- Delegate investment management responsibilities to a QUALIFIED Investment Manager who accepts the role as a fiduciary in writing. (must be a registered investment advisor, bank, or insurance co. qualified as a money manager under the laws of the state)
- Plan permits plan participants & beneficiaries to control investment in their OWN accounts

- Fiduciaries can be JOINTLY responsible for actions committed by another if:
  - One fiduciary KNOWINGLY participates in, or conceals, breaches of fiduciary duty by another fiduciary
  - Fiduciary fails to meet his administrative duty of being reasonably informed of how the plan is being operated (oversight function)
  - Fiduciary delegates tasks that he should be reasonably expected to perform himself
  - Fiduciary delegates tasks to persons imprudently
- To AVOID Legal problems, Fiduciaries should
  - Maintain records documenting that all investment actions were undertaken after undertaking a diligent research effort that appropriately weighed the expected returns against the probably risks, and there was a bona fide judgment that the action would be in the best interest of plan beneficiaries
  - Know the probably Payout requirements of the plan and make sure that liquid funds are available to make the required payouts when due
  - Make sure to adhere to oversight responsibilities, and document & keep a record of the steps taken to meet these responsibilities
  - When misconduct occurs, take prudent, corrective action immediately to correct the problem

- *Public Pension Plans*
  - Public Employee retirement plans are NOT governed by ERISA, so local jurisdiction rules & laws apply.
  - Sometimes, these plans are pressured to invest in the local economy & local businesses to an extent that may appear imprudent. Such pressure should be resisted. Should obtain counsel to secure their right, as a matter of law, to do their duty in resisting such pressures.
- *Money Management*
  - Money Managers can look to the INVESTMENT ADVISORS ACT of 1940 for some behavioral guidance. This Act Prohibits Investment Advisors from:
    - Defrauding or Attempting to Defraud a Client or Prospective Client
    - Acting as a Principal or Agent in a Client's Account without Client's permission
  - General Principles to guide the money manager:
    - Be Honest & Loyal to the client, always acting in Client's best interest
    - Use Care & Independent Professional Judgment in Investment matters. Have a reasonable & adequate basis for investment decisions
    - Avoid Conflicts of Interest or Make full disclosure of facts and circumstances that could be construed as a conflict of interest
    - Make sure investment actions & advice are suitable for the client
    - Obtain the best executions on trades for clients. Make sure commissions & expenses are reasonable for services rendered
    - Avoid misrepresentations of all kinds, particularly with respect to performance presentations
- *Brokers & Dealers*
  - Though brokers & dealers do not invest funds for others, and thus without fiduciary duties, they are held to a professional standard.
    - Should not CHURN Customer accounts
    - Should not accept funds when INSOLVENT

    - Should not engage in Fraudulent, Deceptive, or Manipulative practices
    - Should not exploit their customers' trust or ignorance
    - Should deal fairly with their clients

- *Securities Analysts*
  - Research analysts have responsibilities under the Standards of Professional Conduct to
    - Do the best job they can for their employer & their employer's clients
    - Use Independent Judgment
    - Have an adequate basis for recommendations
    - Deal Fairly with clients & fellow Professionals
- *Charitable Organizations & Endowments*
  - Directors, Officers, & Investment Managers of Charitable & Endowment Fund assets are Fiduciaries. Their Duties are governed by the Uniform Management of Investment Funds Act (UMIFA). UMIFA has roots on corporate law, not the common law of trusts. Duties under UMIVA are closer to a director of a corporation than that of a trustee. Held to a Standard of ORDINARY BUSINESS CARE & PRUDENCE. Not as high a standard as the Prudent Man or Prudent Investor Rule because
    - Fiduciary must only exercise ORDINARY & Reasonable care, acting with honesty and in good faith; there is no requirement to act like a prudent person of intelligence
    - Absent proof to the contrary, it is PRESUMED that the fiduciary has acted in the CORRECT manner; the burden of proof is on the Accuser.
  - UMIFA does impose some unique affirmative duties on Institutional Fiduciaries.
    - To formulate policies for the investment program of the organization's assets. Such policies should be based upon
      - Amount of funds needed, on a long- & short-term basis, to carry out the work of the institution
      - The current, and probably future, resources of the organization
      - The expected return on its assets
      - Probable future economic trends
    - To Follow spending & investment policies adopted by the institution
  - Board of trustees on an institution can, under UMIFA, delegate the management of the funds of the institution to investment professionals. However, they cannot delegate the responsibility of setting overall policy, and they retain the responsibility of supervising the investment manager and their investments
- *Social & Relationship Investing*
  - Social Investing is having a policy that includes or excludes the securities of certain issuers from a managed portfolio, based on moral or social, rather than economic or financial, considerations. This is permitted under most fiduciary laws & guidelines ONLY if:
    - Return & Risk Factors are Not Compromised
    - Diversification is Still Sufficient to Avoid the Risk of Sustaining unusually Large Losses
    - Excessive Costs are not incurred
  - ERISA plans may give social concerns secondary consideration, but their primary consideration is to be economic & financial matters.
- *Proxy Voting*
  - The right to vote a proxy has an economic value. Thus, anyone exercising this right on behalf of a client, beneficiary, or participant incurs fiduciary responsibilities. General duties of loyalty, care, prudence, impartiality, & discretion apply. In addition, federal agencies have rules & regulations controlling proxy voting by fiduciaries.
  - ERISA Guidelines on Proxy Voting
    - Investment Manager has the fiduciary duty to vote proxies arising from plans under his control unless the plan documents designate another as the responsible party

    - Fiduciaries must assure that the number of proxies received equals the number that the plan is entitled to vote; if not, discrepancies should be rectified
    - Fiduciaries must formulate, and review, written policies, guidelines and procedures for voting proxies
    - Fiduciary must cast an Informed Vote
    - The Wall Street Rule has been to sell securities of companies that an investment manager believes is not being managed well.
    - Records must be kept documenting how proxies were voted & reasons that votes were in best interest of beneficiaries
    - Anyone who votes a proxy on behalf of a fiduciary accepts the same fiduciary responsibilities and is subject to the same laws, regulations, rules & standards as the fiduciary
- *Soft Dollars*
  - When an investment manager pays for goods or services that benefit the manager by channeling security transactions through specific brokers who are paid commissions for those transactions, the funds paid are called 'soft dollars'. When managers use their own funds to pay for goods & services, such payments are called 'hard dollars'
  - Fiduciaries MUST not use client funds for their own benefit. Bu, transactions involving soft dollars are permitted under the following circumstances:
    - Goods & Services purchased help the manager make a better investment decision
    - Manager has sought out the best price for the brokerage services, taking into account the quality of services received, and has come to a bona fide conclusion that the commissions paid are reasonable in relation to the services obtained.
    - Soft dollar practice is disclosed to clients

- **IV(B.2): Before making any investment recommendation or taking investment action for a client, a member must:**
  - **Make inquiry into the client's financial situation, investment experience, and investment objectives (should be done at least once per year to make sure the client profile is current)**
  - **Consider the appropriateness and suitability of investment recommendations or action for the client with respect to his needs, objectives, and the effect on the portfolio**
  - **Distinguish between fact & opinion in presenting recommendations**
  - **Disclose to clients the general principles and format of the investment process by which securities are selected and portfolios are constructed. Promptly disclose any changes that might significantly affect the process**
  - To fulfill the requirement, a member should put the needs, circumstances, risk constraints & investment objectives of each client into a written investment policy. Such investment policy should include the following Elements:
    - Client Identification: nature of client & existence of separate beneficiaries
    - Investor Objectives: Return Objectives (income, capital gains, maintenance of purchasing power) and Risk Tolerance
    - Investor Constraints:
      - Liquidity needs
      - Expected Cash Flow patterns
      - Investable Funds
      - Time Horizon
      - Tax Considerations
      - Regulatory & Legal Circumstances
      - Unique preferences, needs & circumstances
      - Proxy Voting Responsibilities & Guidelines

- **IV(B.3): Deal Fairly & Objectively with all clients when disseminating investment recommendations, material changes in prior recommendations, and in taking investment action**
  - It is physically impossible to reach all clients simultaneously. However, every effort should be made to communicate investment ideas to clients, for which the ideas are suitable and who have a known interest in them, as simultaneously as possible within reasonable limits defined by communications technology. Members should make sure procedures are developed that ensure the selection process by which customers receive information, is based on suitability & known interest without preferential treatment given to a select group.
  - *Compliance Procedures*
    - Limit the number of people privy to a recommendation, change in opinion, or portfolio decision (access persons)
    - Keep the time as short as possible between the time when a decision to recommend an opinion, change an opinion, or undertake a portfolio change is made and when this information is disseminated or action is taken. With research reports involving a change of opinion, if a long time is required to get a full report published, a short summary report should be published, first stating the essence of the recommendation
    - Publish guidelines that prohibit firm personnel from discussing or taking any action on the pending recommendation, change of opinion, or portfolio decision before official dissemination
    - Establish procedures that reasonably assure the simultaneous disclosure of recommendations, or opinion changes to appropriate clients
    - Establish procedures to control and monitor the trading action of firm personnel to ensure transactions for clients take precedence over transactions that benefit the firm, its officers, partners, or employees
    - Maintain a list of clients who hold securities on the firm's research list to facilitate notification of a change in opinion
    - Develop trade allocation procedures that ensure
      - Fairness to advisory clients in priority of execution
      - Timeliness of execution
      - Accurate records of trade orders and client account positions
    - Review accounts of clients periodically to make sure no one is receiving preferential treatment
    - Disclose to all clients any difference in levels of service offered or fees paid.

- **IV(B.4): Priority of Transactions should be given to clients and employers over those in which you have a beneficial interest. Personal transactions should not adversely affect the interest of clients**
  - This standard applies to all members & access persons. There is nothing unethical about access persons investing for their own benefit. But, due to special fiduciary duties imposed upon them, the personal investments of access persons & investment professionals must be undertaken within the confines of the following restrictions
    - Interest of clients, the employer, & integrity of the professional must be put ahead of the access person's or member's own personal interests
    - Care must be taken that personal investments do not create conflicts of interest or impair the investment professional's ability to be objective and render independent professional judgments about securities
    - All applicable laws, regulations & compliance procedures must be followed
    - Investment professional should not receive a personal benefit from investment actions taken on behalf of a client
  - To ensure that personal transactions do not adversely affect client & employer interests, clients and employers have priority in transactions involving investments in which an access person has a beneficial ownership.

- ***Compliance Procedures***
  - Limit the number of access persons to reduce the chances of information 'leaks'. Implementing physical & procedural barriers (Fire Walls) to prevent the flow of information from one group to another within the firm may be appropriate
  - Make sure employees understand the meaning of such terms as 'personal transaction', 'beneficial interest', 'immediate family members', 'restricted transactions', 'prohibited transactions', etc.
  - Make it clear that if trading in (or owning) particular securities are restricted or prohibited, all related securities are also covered by the restriction or prohibition (like options)
  - Restrictions should be placed on the ability of investment professionals to invest in IPOs and private placements. These restrictions need not apply to government issues, though. When investment professional makes a personal investment in IPO or private placement, there is an Appearance of Impropriety
  - Establish blackout periods in which persons engaged in the decision making process (access persons) are prohibited from trading in a security during the same 24-hour period in which the firm has a pending buy or sell order until the order is executed or canceled.
  - Establish a minimum waiting period between the time a recommendation is made and when employees are permitted to trade in the securities for their own accounts. Usually 3 days for brokerages, but maybe longer for investment counseling firms.
  - Short-term trading should be discouraged. (within 60 days). Try to avoid front-running
  - Employees of investment firms should be required to disclose their investment holdings (as required by NYSE Rule 342.21(a) for member firms)
  - Employees of investment firms should be required to obtain prior approval before any trade is made for their own account or for one in which they have a beneficial interest.
  - Employees should be required to break any trade that is made in violation of the principles stated herein and should be required to pay back any profit on such a trade.
  - Disciplinary procedures should be established and enforced for violations of this standard.

- **IV(B.5): Preserve the Confidentiality of Client & Employer information unless it concerns illegal activities**
  - Preserve the confidentiality of client & employer information, unless it concerns illegal activities. The best approach is never to disclose information received from a client, except to authorized persons when it is necessary to improve services for the client
  - In the case of illegal activities, there may be an obligation to consult with a supervisor or legal counsel and report such activities to appropriate authorities if counsel deems necessary
  - It is not a violation to forward confidential information to the AIMR Professional Conduct Program in cooperation with an investigation (which will be held in strict confidence)

- **IV(B.6): Members may not Misrepresent:**
  - **The services that they or their firms are capable of performing**
  - **Their or their firm's qualifications**
  - **Their academic or professional credentials**
  - **By making or implying any guarantees regarding investment outcomes, except to communicate accurate information regarding the terms of the investment and the issuer's obligations**
  - Misrepresentation is defined as making an improper or imperfect representation, or giving a false or misleading impression.
  - Members should ensure that misrepresentation does not occur in oral presentations, advertising, or written materials. For employees who make presentations to clients or prospects, firms should provide a written list of the firm's available services and a description of the firm's qualifications.
  - No guarantees should be given regarding the outcome or the probable return on the investment

- It is a misrepresentation to claim that possessing a CFA charter, passing any number of CFA examinations, or being a member of AIMR means one has the ability to produce superior investment results, or has any unique knowledge or expertise in investment managers

- **IV(B.7): Disclose to Clients and Prospects all matters that could reasonably be expected to impair your ability to render unbiased & objective advice**
  - Members must disclose to clients and prospects any potential conflict of interest.
  - Conflicts that must be disclosed are:
    - A Special Relationship between the member, or member's firm, and an issuer, such as a directorship or consultancy
    - Underwriting or financial relationships
    - Broker-dealer & market-making activities
    - Material beneficial ownership of the security. Material ownership by an immediate family member must also be disclosed.
  - *Compliance Procedures*
    - Establish adequate review & compliance procedures for governing the personal investing of employees
    - Inform all employees of the 'special relationships' that must be disclosed
    - Require prior approval before investment personnel can serve as consultants, directors or purchase securities

- **IV(B.8): Disclose to clients any consideration you have paid to others for recommending your services to that client**
  - The existence of referral fees, their nature, and their amount should be disclosed in writing to any prospective client, as soon as the client is referred to a member.
  - *Compliance Procedures*
    - Disclose the existence & terms of referral fee agreements in writing
    - In the disclosure, describe the nature of the referral fees paid and their amounts
    - Before making a referral fee agreement, consult one's supervisor & legal counsel regarding the legality or ethical nature of the terms of the proposed agreement
    - Follow the instructions of legal counsel re: referral agreements and their disclosure

- ***Standard V: Relationships with & Responsibilities to the Investing Public***
  - **V(A): Do not Trade, or cause others to trade, in a security when possessing material non-public information on the security if such trading would breach a duty or if the information was mis-appropriated or relates to a tender offer. Make a reasonable effort to have the company make a public announcement of material non-public information that it (or its agents) have disclosed to you, or that you know was disclosed to someone in a manner that represents a breach of fiduciary duty**
    - Members shall not take any investment action or communicate the information while in the possession of material non-public information related to the value of a security if such action would breach a duty, the information was misappropriation, or if it relates to a tender offer
    - When such material non-public information is received, effort should be made to get the company about whom the information relates to make a public disclosure of the information, except if the information was received because a special or confidential relationship with the company and the information is kept confident
    - Purpose of inside information prohibition is to assure the fair & equitable distribution of important information. It is not meant to prohibit contact with company analysts. But there is no standard definition of inside information. There are theories pertaining to it and a person is subject to criminal & civil liability for securities fraud under 2 theories: traditional theory & misappropriation theory

- *The Traditional Theory*
  - According to the traditional theory, trading on inside information is an act of securities fraud ONLY when the person taking the investment action has or inherits a FIDUCIARY DUTY to the company whose securities are acted upon and Breaches that Duty.
    - Information Must be Material: Information is material if
      - It would significantly change the total mix of information about the company, its affairs, or its securities in a Meaningful Way (reasonable investor would want to know it before making an investment decision or forming a valuation)
      - It pertains to a Tender Offer. Rule 14(e)-3 makes it an act of fraud for any person to trade on or communicate material non-public information regarding a tender offer that is know to have been obtained from the tender offerors, the target or other persons involved in the offer. This rule is broader than 10(b)-5 because it does NOT require a Breach of a fiduciary duty for a violation to occur. Mere possession of information prohibits a person from trading.
      - It is a specific FACT, rather than an opinion
      - Materiality is determined at the TIME the information is communicated. If later events show it to be material, but it was not vital at the time made, it is not material for purposes of the material theory. People can arrange immaterial, non-public information together under the MOSAIC Concept to trade.
    - Information Must be Non-Pubic: Information becomes public as soon as it is disclosed by a company in a way CALCULATED to make it Available to the GENERAL Investing Public. Select Disclosure to a group of investors or analysts does NOT constitute public disclosure. Corporate officials who give select disclosure of material information to certain investors can be guilty of being Illegal TRIPPERS. Persons in possession of material non-public information in advance of its public disclosure cannot use that information for investment purposes immediately after disclosure: instead, they must Wait until an adequate time has elapsed for the information to be disseminated and assimilated by the investing public before using it for their own investment purposes.
    - Source of Information must be an INSIDER: Insider is someone who knows the information because he or she is in a position to receive confidential information and who has a fiduciary duty not to disclose it. TIPPEES, like analysts who receive the information, may legally use it Unless they obtained the information from an Insider or KNOW that the information was misappropriated or obtained illegally (i.e., if they heard it from a non-insider, they can use it under the theory). Tippers Must Receive a Benefit from disclosing the information
      - Financial (tipper is paid for information)
      - Reputational (disclosure may improve tipper's reputation)
      - Quit Pro Quo (Tipper & Tippee are in some relationship)
      - GIFT (from Tipper to Tippee)
  - Fiduciary Duty Exists as a Matter of LAW; it cannot be imposed by telling someone to 'keep the information secret'. Information received inadvertently does not constitute inside information unless the tippee knows (or should know) that it was illegally obtain.
- *The Misappropriation Theory*
  - Under misappropriation, Individuals Commit Securities Fraud IF they obtain Material non-public information from another to whom they owe a duty of trust & confidence, and then communicate it or use it as the basis of a trade, even if they owe no fiduciary duty to the issuer of the involved securities. They also commit fraud if they obtain material non-public information illegally
  - Thus, the fraud provision s of 10(b)-5 are extended to duties owed not only to issuers & shareholders, but anyone to whom a duty not to disclose information obtained through a special relationship applies, as well as to information obtained illegally. Concept:

Material non-public information is "property". Anyone who has access to it (accountants, attorneys, etc.) is only entitled to use it within the scope of the employment function. Such insiders owe the company a duty not to use this 'property' for their personal benefit. If they use it for their own personal benefit or give it to others, they misappropriate company property. This is a form of theft, punishable by criminal & civil actions

- Law also extends these duties to any tippee who receives such misappropriated information from an inside tipper, if the tippee knows (or should know) that the tipper breached a duty in imparting the information to them
- In 1995, the US Court of Appeals for the 4th Circuit rejected the misappropriation theory in 2 cases; in that circuit, ONLY the Traditional Theory applies. But, it is unresolved in other circuits.

- *Important Laws & Regulation Pertaining to Inside Information*
  - Section 10(b) of the Security Exchange Act ('34) and SEC Rule 10b-5
    - Makes it Unlawful to USE or Employ, in connection with the purchase or sale of any security, any Manipulative or Deceptive Scheme or Business Action to defraud in Contravention of the Rules of the SEC. Under these laws, it is illegal to:
      - Scheme to defraud
      - Deliberately make a false disclosure or to omit from disclosure a material fact
      - Engage in any act, practice or course of action that operates, or would operate, to defraud or deceive any person
      - Applies to Face to Face communications, disclosure documents, private communications, projections, analyst recommendations, and research reports
    - Violations of these laws can result in:
      - A civil suit where an injured party seeks to recover monetary damages
      - An SEC Administrative action against registered individuals or firms
      - A suit by the SEC in federal court asking for an INJUNCTION against further violations
      - Criminal Action in federal court
  - Insider Trading Sanctions Act (1984)
    - Amendment to Section 21(d) of the SEA ('34) that stipulates the following penalties may be imposed on persons who trade on, or aid and abet those who trade on, inside information
      - Civil Monetary Damages of up to THREE TIMES the profit obtained or loss averted
      - Fines of up to $100,000
    - Employers are NOT subject to penalties under this act since the employee violated the law. The Statute of Limitation under the Act is 5 Years
  - Insider Trading & Securities Fraud Enforcement Act (1988)
    - Requires broker-dealers & Investment Advisors to Establish, maintain & Enforce written policies and procedures designed to reasonably prevent illegal insider trading. Banks are EXCLUDED from this provision, but insurance companies are not
    - Imposes a Maximum Civil Penalty similar to that of the Insider Trading Sanctions Act ('84) on anyone who directly or indirectly controls another person (supervisors) who illegally traded on inside information if:
      - The supervisor knew, or recklessly disregarded the fact, that the subordinate was likely to engage in the illegal trade and failed to take the necessary steps to prevent it
      - The supervisor knowingly, or recklessly, failed to establish, maintain or enforce any policy or procedure established to prevent illegal trading and in so doing substantially contributed to the illegal trades

    - This makes Employers & Supervisors responsible for the actions of their employees under certain circumstances
    - Enables persons who have been harmed on the other side of an insider trade to recover damages from the Insider. Since it may be difficult to determine who the harmed persons may be, the Act gives this right to Any Contemporaneous Traders
    - Grants to the SEC the power to award Bounties of up to 10% of the penalties imposed to persons who provide information on illegal traders
    - Enables the SEC to force US citizens to give information that will help foreign governments enforce their securities laws
    - Orders the SEC to study the adequacy of US security laws and make recommendations as to any change required
    - Provides the following maximum penalties for criminal violations of federal securities laws regarding insider trading:
        - $1,000,000 and 10 years of jail for individuals
        - $2,500,000 for businesses
- Securities Enforcement Remedies & Penny Stock Reform Act (1990)
    - Amends Securities Act ('33) and Securities Exchange Act ('34) and Investment Advisor's Act ('40) to give the SEC the ability to remedy violations of these acts. These remedies allow the SEC to:
        - Impose penalties if it finds willful violations, willful aiding & abetting, willful material misrepresentations or omissions in an SEC filing, or a failure of a supervisor to reasonably supervise his subordinates. Violations involving Fraud, Deceit, Manipulation, or a Reckless disregard that results in a Substantial Loss (or risk of substantial loss) can be penalized up to $100,000 if the violation is committed by an individual, or $500,000 if committed by a business entity OR by the gross amount of any pecuniary gain that accrued to the violator as a result of the violation; whichever is greater. If it did not result in a substantial loss, then the individual can be fined up to $50,000 (business entity $250,000) or the gross amount of any pecuniary gain accruing to the violator as a result of the violation, whichever is greater. If the violation did NOT involve fraud, deceit, manipulation, or a reckless disregard of a regulatory requirement, the penalty can be up to $5,000 for an individual ($50,000 for business) or the gross amount of any pecuniary gain, whichever is greater.
        - SEC may commence a Court proceeding to impose civil penalties according to the system above. If it can demonstrate a violator's unfitness, the court may prohibit a violator from serving as an officer or director of any corporation registered under the SEA
        - SEC may issue permanent or temporary Cease & Desist orders if it finds that a person has violated, is violating, or will violate by act or omission any provision f the 4 Acts amended by this law.
- Section 20A of the Securities Exchange Act ('34)
    - Makes TIPPERS jointly & severally liable for the profits gained (or losses avoided) of those whom they tipped (if the tipees traded on the information given them), net of amounts disgorged by legal actions
- Commodities Exchange Act
    - Contains several Anti-fraud provisions, including prohibition of misrepresentation, manipulation, cornering, & churning in commodities and futures markets. Act seemingly prohibits insider trading, though, in commodities markets, information is more apt to deal with external market information rather than insider corporate information.
- Commodities Futures Trading Commission Rule 1.59
    - Illegal for employees of exchange & regulatory bodies to communicate material non-public information obtained as a result of their employment is such a

regulatory body. Also requires these regulatory organizations to adopt rules prohibiting employees from trading in any commodity when the employee has access to material non-public information concerning the commodity

- Treaties Enforcing Insider Trading Rules
    - Almost all developed nations have laws prohibiting trading while in possession of inside information. However, details of these laws vary across nations.
    - SEC's jurisdiction has been expanding, so even parties who believe that their trading activities are outside the US may be subject to sanctions under US laws when those activities have an impact on US markets
    - There are various treaties and memorandums of understanding with various nations.

- ***Representative Cases***
    - Cady Roberts (1961)
        - Director of a co. told his partner about the co.'s pending dividend cut before the fact was disclosed publicly. The partner sold shares. This was deemed to be a classic case of trading on inside information.
    - Texas Gulf Sulphur (1968)
        - Insiders knew of a major mineral discovery made by the co., but they did not immediately disclose the information to the public.
            - Insiders who bought the stock with this knowledge were deemed guilty of trading on insider information
            - Insiders who advised friends to buy the stock had to pay back the friend's profits to those who sold shares to the friends
            - Insiders who bought the stock AFTER public disclosure, but BEFORE the public could assimilate the information were deemed guilty of trading on inside information
    - Investors Management Company (1968)
        - An investment firm was known to be in the process of underwriting an issuance of securities by a major corporation. In the course of conducting its financial analysis of the Co. which was part of the underwriting procedure, the corporate finance department discovered that earnings would be significantly below consensus estimates. This information was conveyed to some of the firm's institutional brokers by some of their corporate finance associates. These brokers then gave this information to their clients or advised institutional clients to sell shares in the Company.
            - The firm was guilty of failing to have (or enforce) proper compliance procedures
            - Those personnel who disclosed the information were guilty of being tippers of inside information
            - The institutional clients who sold the stock on the basis of this information were guilty of trading on inside information because they knew or should have known that they were receiving inside information. It was presumed that as professional investors they knew of the special underwriting relationship between the investment firm and the Co. as well as the extent to which this information differed from consensus estimates
    - Faberge, SEC v. Lums; SEC v. Geon; SEC v. Ligget & Myers, etc.
        - These cases conclude the Employer's are guilty, together with their employees, for violations of the inside information prohibitions, UNLESS the employer can show that it:
            - Informed employees of the ethical & legal prohibitions involved
            - Had instituted reasonable procedures and policies designed to prevent such violations
            - Enforced such procedures & policies
            - Had a policy of appropriately punishing employees who violated these

- SEC v. Bausch & Lomb (1976)
  - An analyst met with the chairman of the firm and found out:
    - Earnings estimates of $3.00 were too low while estimates of $5.00 were too high for the upcoming year
    - A new lens product introduction would be delayed
    - A Softlens marketing kit would not be out as soon as previously announced
    - Sales of an important product were growing at a slower rate than in the past
    - The growth rate of Softlens sales were less than prior estimates
    - The company was lowering its internal earnings estimates
  - The analyst lowered his quarterly earnings estimate on the stock from $0.90 to $0.65 per share and withdrew a previous buy recommendation
  - Later, the chairman called the analyst and told him the $0.65 estimate was too low and that a $0.70 estimate was better. But, the chairman did not issue a press release disclosing this information publicly
  - SEC's position was that inside information had been given to the analyst and he used it to change his recommendation. But, a court reversed the SEC ruling. The court found that NONE of the original disclosures were specific enough to be considered material under the law. However, the Chairman's $0.70 earnings disclosure was material and constituted a breach of HIS fiduciary responsibility. However, since the analyst changed his recommendation & earnings estimate before receiving the Material information of the $0.70 estimate, and the remainder of his analysis was based on the mosaic process. Thus, there was no legal violation by the analyst.
- Chiarella v. US (1980)
  - An employee in a financial printing firm, which printed materials in connection with corporate takeovers. For security purposes, all materials were printed for proof-reading with the name of the target left blank. Chiarella had access to the proof copies. Using the information in the copies, plus library research, he would decipher the takeover target & invest in it. He was charged with trading on inside information
  - The court held Chiarella had NO DUTY to the companies targeted for the takeover, as he was not an agent of those companies, and had no fiduciary duty to those firms. The court rejected the theory that the TIPPEE inherits fiduciary duty as a corporate insider just because he receive inside information. The court also rejected the theory that ALL parties to a trade must enjoy equal information. It said the Tippee's duty to refrain from trading on inside information is NOT based on the fact that he has it; but it comes from the fact that he may have obtained it improperly. In this case, the court said Chiarella used a form of the MOSAIC concept. His inside information, by itself, was insufficient. Only through additional library research did it have value
  - In the decision, the court found a concept of CONSTRUCTIVE TEMPORARY INSIDERS (accountants, lawyers, etc) who may receive inside information in the normal course of their dealings with a corp. Such persons have a fiduciary duty to shareholders to keep such information confidential.
  - In a footnote, the court stated that in some circumstances, trading on inside info. may be legal, yet it falls below the ethical standards of conduct. Thus, a self-policing agency, like AIMR, can find its member guilty of a breach of its Code of Ethics or Standards of Professional Conduct even if the member is not guilty of wrong-doing under legal statutes.

- US v. Chestman
  - Court upheld the Misappropriation theory. But, a substantial amount of proof is required to convict under the theory. TO convict a person of trading on inside information under the misappropriation theory, the prosecution must prove the accused;
    - Had a fiduciary duty to abstain from trading
    - Breached that fiduciary duty
    - Had knowledge of that fiduciary duty
  - Chestman was a stockbroker who received material non-public information about a proposed sale of a publicly traded company at a price well above its currently traded market price. The information was received from a client who was a nephew (by marriage) of a member of the top management of the firm. The nephew was not an employee of the company being sold, nor was he part of the controlling family's 'inner circle'. The nephew got the news about the proposed sale from his wife, who had learned about it in a casual way from other relatives. The wife told the nephew (husband) to keep it confidential, and though the nephew cautioned Chestman to keep the matter confidential, Chestman failed to. Chestman bought shares for the nephew & himself. He was charted with criminal violation of misappropriation & trading on non-public, material inside information under Rule 14e-3(a) and Rule 10b-5 of SEA.
  - Court Acquitted Chestman under Rule 10b-5 because:
    - Chestman WOULD be guilty of violating 10b-5 if
      - The NEPHEW had breached a fiduciary duty owed to the family that managed the company OR his wife: and
      - Chestman knew that the nephew had breached a fiduciary duty by giving information to him
      - But, Chestman's duty to either Abstain from trading or Disclose the information he possessed to the parties from whom he bough shares existed ONLY if there was a fiduciary or similar duty of trust between the nephew and the family which owned the business OR between the Nephew & his wife
    - For A Fiduciary or Similar Duty to exist, the PARTY RECEIVING the information must have received it in the course of some BUSINESS-RELATED or similar activity; a fiduciary duty cannot be imposed by asking the person to keep it quiet or by marriage/kinship
    - Nephew was NOT a member of the controlling family's inner circle, nor an employee of the firm being sold, nor a confidant of the controlling faction. Thus, the information given to him was done so in a gratuitous manner and not in a manner serving any business purpose.
    - Since the nephew did not breach any fiduciary duty, Chestman did not become a Constructive Insider and thus had no duty to abstain from trading
  - Chestman was Guilty under Rule 14e-3(a) because the information involved a TENDER offer. Under that rule, mere POSSESSION of material non-public information about a tender offer prohibits a person from trading, recommending or communicating the information; whether or not there is any fiduciary duty is irrelevant

- Dirks v. SEC (1983)
    - Information was given to an analyst (Dirks) by an ex-employee (who had been an officer) of Equity Funding. The information was that massive fraud was being perpetrated by the firm. Management denied the allegation. But the analyst passed the information on to clients, including 5 investment firms which sold the stock. SEC found that Dirks & the 5 firms had violated the inside information statutes.
    - SEC stated the analyst had received material non-public information about the company from an insider, along with persons who could confirm the allegations. The information was neither an opinion nor rumor. Since Dirks sold the firm based on nothing other than this information, it must have been material. SEC stated that its rules were clear: insiders who trade on the basis of material non-public information without disclosing it to the other side of the trade are in violation of Rule 10b-5. Tippees & Tippers are equally guilty
    - Dirks Claimed, in his defense;
        - Information he told clients were rumors & unverified allegations rather than material facts. (SEC said no, it was specific information from an insider, that was verifiable)
        - Source was not an insider (SEC said source was insider → insider = anyone privy to a company's internal affairs; not necessarily an officer)
        - Claimed information was not confidential (SEC said it was as the firm wanted to keep it secret)
    - Supreme Court overruled the SEC & Lower courts → its decision
        - Tippee use of material inside information has NO restrictions unless the tippee knew that the insider from whom he received the information BREACHED a duty owed to shareholders
        - Tippers (insiders) have a fiduciary duty NOT to use inside information for their own personal benefit or to disclose such information to outsiders in order to receive some personal benefit. If there is NO expectation of PERSONAL PROFIT to the Tipper for disclosing the information, there is no breach of fiduciary duty and the tippee may use the information
        - To determine a personal benefit from the disclosure of such information, Court ruled that objective measures should be used. Could be financial gain, reputation enhancement, or bequeathing of a gift. Disclosure of material non-public information in order to get that information into the hands of the investing public for purely altruistic reasons is not a breach of fiduciary duty
- US v. Newman & SEC v. Materia
    - Similar to Chiarella → had access to inside information because of their jobs. Newman had access to information about M&As from his firm's clients; Materia worked for a financial printer. Both used this information for their own trading purposes
    - These men were not prosecuted under the traditionally theory of insider theory, but rather the Misappropriation theory; prosecution argued they had a fiduciary duty to their EMPLOYERS not to use or disclose the information they received (since part of their employers business dealt with keeping secrets, thus those secrets were employer property).
    - Court of appeals found them guilty, and the Supreme Court endorsed this theory in 1985 in Bateman Eighler, Hill Richards, Inc. v. Berner. Usually, the typical employers who are owed this duty are Investment Bankers, Financial Printers, & Newspapers.

- SEC v. Willis
  - Willis was a stock broker who received inside information from a psychiatrist, who had received it from one of his patients. Willis traded on this information
  - Information obtained by a psychiatrist from patients is confidential. Therefore, the psychiatrist had a duty to keep that information confidential. Giving Willis the information breached the psychiatrist's duty to his patients, making it misappropriated information. Willis knew, or should have known, that this information was misappropriated. Therefore, Willis was guilty of using misappropriated information for his own personal gain.
- SEC v. Certain Unknown Purchasers of the CS of, & Calls for, CS of Sante Fe Int'l Corp.
  - Middle Eastern Citizens residing in Europe received inside information from a director of Sante Fe International about a tender offer for the company that was to be made by Kuwait Petroleum. They used Swiss bank accounts to trade in the securities of the company. The SEC obtained an agreement with the Swiss government to order the Swiss banks to disclose the individuals who traded in these accounts. The director had to pay back the profits made on these trades and later was indicted for his activities.
- SEC v Musella
  - The office services manager of a law firm tipped information regarding a planned tender offer by a client of the firm's. The Tippee's bought stock in the co. that was the takeover target. Relying on the misappropriation theory, the court ruled that the office service manager received this information because of his position in the law firm and that the law firm had a special confidential relationship with its client. Therefore, the manager misappropriated this information. The tippees were also guilty because they knew, or should have known that the information was misappropriated. This could be inferred based upon the professional backgrounds of the tippees and circumstantial evidence.
- SEC v. Switzer
  - Switzer overheard a conversation between a corporate insider & his wife at a racetrack. He used the information as a basis for trading & tipping others. Switzer was not guilty because there was no breach of fiduciary duty as defined under Dirks (he received the info. inadvertently and was not brought into the fold of confidentiality)
- SEC v. Gaspar
  - An investment banker tipped a professional colleague about information concerning an acquisition. The court ruled that this was a misappropriation of the employer's assets, insofar as this cause the employer's reputation to be sullied and injured the negotiation process (the employer's business). In revealing the information to the friend, the defendant obtained a reputational benefit (though no money). Under Dirks, he's liable
- SEC v. Taylor
  - Taylor & her 2 brothers purchased securities in a company of which her husband was a director, based on information she found in her husband's home office. The SEC charged these trades were based on misappropriated information, not because of the husband-wife relationship, but because the information was effectively STOLEN from the home office
- US v. Carpenter
  - A columnist for the Wall Street Journal was engaged in a scheme of tipping information about the timing, content & tenor of stories in his columns about companies before their publication. The tippees traded on this information. Even though none of the parties owed any duty to the firms involved, the court ruled that the writer owed a duty to his employer (WSJ) to keep pre-publication news confidential. Consequently, the information was misappropriated. Therefore, the writer & tippees were all guilty of trading on misappropriated information.

- *Compliance Procedures*
  - Employers should devise procedures to help prevent the seeking out, or use of material inside information by their employees. Written compliance manuals should be distributed to employees explaining the law with regard to material non-public information and giving detailed instructions regarding the prohibitions against seeking, or using, such information. They should also explain the procedures in place that employees must follow when they come into possession of such information. Any investment professional who possess inside information should consult a supervisor, compliance officer, or legal counsel before undertaking any investment action in the securities of the company about whom the information pertains
  - Analysts & Portfolio managers should be separated from corporate finance functions, and the solicitation of inside information from outsiders or fellow employees should be forbidden. A FIRE or CHINESE WALL should be established to prevent the communication of material non-public information between one department to the other.
  - Require that any employee who receives information that is known or reasonably believed to be material non-public information communicate that information to a designated supervisor, compliance officer or legal counsel without discussing that information with other employees.
  - Keep all Research Records documenting reasons behind recommendations, etc. Can show inside information was not the basis of an investment decision
  - Regularly review CLIENT Accounts to investigate patterns of heavy/unusual trading in a particular security; inquire about trading in securities not cleared by the research department; require employees to report on trades made for family members
  - ISSUING Corporations should →
    - Refrain from making Selective Disclosures of material information
    - Not engage in the practice of "Blackballing" analysts (i.e., refusing to give info. to analysts who have written negative reports about the company)
    - Issue press releases prior to analyst meetings disclosing any new info. that will be disclosed at the meeting
    - Issue press releases after any analyst or investor meeting disclosing any new, material, previously non-public information that was disclosed at the meeting
    - Make a public disclosure when information that is brought to their attention that is material and selectively known within the investment community
  - Establish training & continuing ed. for employees to develop their ability to recognize material non-public information and learn the procedures to follow when they have that knowledge
  - Harsh Disciplinary actions should be provided for, and carried out, for violations
  - Employers who comply with these procedures are not legally responsible for violations committed by their employees; employers who fail to comply with them could be held liable for the illegal actions of the employees under the Insider Trading Sanctions Act of 1988.

- Member Obligations Under Standard V(A)
  - Be alert to the possibility that material non-public information has been received at meetings with company officials or if company officials provide guidance in the interpretation of drafts of reports, financial statements, or public announcements
  - Do not see out material non-public information
  - When acting as a consultant, or any other temporary insider role, keep information received confidential and do not use it for investment purposes or communicate it to others
  - If material non-public information is received on a 'select' basis, evaluate it from the point of view as to whether or not it is 'inside' or misappropriated information. Seek help if necessary. If it is inside or misappropriated information, urge the affected company to disclose it. Refrain from using or communicating such information until it is disseminated & assimilated by the market

- **V(B): Make every effort to assure that investment performance information presented to clients or to the public is fair, accurate and complete**
    - Members may not misrepresent the investment performance that they or their firms have achieved, or can reasonably be expected to achieve
    - If information about the investment performance of an individual or firm is communicated to others, every reasonable effort should be made to ensure that it is fair, accurate & complete.
    - Members are ENCOURAGED, though not required, to adopt AIMR's Performance Presentation Standards for reporting investment results.

6. Enforcement of the AIMR Code of Ethics & Standards of Professional Conduct

- AIMR Board of Governors is responsible for maintaining & enforcing its Professional Conduct Program. Authority to Deal with matters of ethics & standards has been delegated to the Professional Standards & Policy Committee, whose staff is supervised by AIMR's Designated Officer. The committee has 3 sub-committees, each of whom is responsible for a different aspect of the Professional Conduct Program
    - Ethics Awareness Subcommittee
    - Standards & Policy Subcommittee
    - Disciplinary Review Subcommittee → primarily responsible for enforcement of the Code & Standards of Professional Conduct. Gets assistance from Hearing Panels & Review Panels.
- **Violations that are Punishable by SANCTION**
    - Failure to comply with the Articles, Bylaws, Code of Ethics, Standards of Professional Conduct, or other rules & regulations of AIMR
    - Having been disciplined by a governmental agency, national securities association, regulatory agency, or court for violating securities laws
    - Pleading guilty to, or having been convicted of, a felony
    - Having been permanently or indefinitely barred from performing professional investment-related activities by a governmental or regulatory authority
    - Failing to Complete, Sign & File with AIMR a required Professional Conduct Statement for 2 successive years (applies to regular and affiliate members of AIMR & CFA Charterholders ONLY)
    - Falsifying information on CFA Candidate or AIMR society membership applications
    - Failing to cooperate with AIMR inquiries & investigations into professional misconduct
    - Any Good Cause
- **Sources of AIMR Information about the Professional Conduct of Covered Persons**
    - Every regular & affiliate member of AIMR & holders of the CFA designation must fill out, sign & submit a Professional Conduct Statement to AIMR annually, disclosing whether or not their professional conduct has been questioned in the past year. This self-disclosure is a primary source of information upon which AIMR can determine whether or not a member should be subjected to the disciplinary process. Plus, AIMR can receive information about the conduct of members from other sources, including legal records, transcripts of regulatory proceedings, & complaints received from its members or the general public.

- **Regular Procedure for Handling Inquiries & Complaints about the Professional Conduct of Members**
  - Anyone may issue a complaint about a member's conduct that might involve a violation of the Code of Ethics, the Standards of Professional Conduct, or other rules & regulations to which members must abide. Such complaints should be sent to AIMR. The regular procedure is →
    - Complaints about a member must be submitted to AIMR in WRITING. Complaining parties should furnish facts & circumstances upon which the complaint is based, documentation supporting the complaint, and citations specifying which Code, Standard or Rules were violated (if known). The identity of the complainant is kept in confidence by the Designated Officer if requested to do so by the Complainant
    - Upon receiving a written complaint, AIMR sends a NOTICE of INQUIRY to the accused member stating the nature of the complaint it has received. Upon receipt, the accused must respond in writing within 30 days. Failure to respond constitutes grounds for a Summary Suspension. The Notice of Inquiry is considered delivered if such documents are mailed to the accused's last known address as it appears in AIMR's records.
    - After AIMR receives a response to its Notice of Inquiry from the accused, the Professional Conduct Committee Staff investigates the matter by interviewing relevant parties & collecting appropriate records & documents. The results of this investigation are given to the Designated Officer who may:
      - Find no violation & DISMISS the complaint. This finding does not preclude the filing of additional complaints about the member regarding the same conduct in the future
      - Find a MINOR VIOLATION has occurred and impose a PRIVATE CENSURE by sending the accused a NOTICE of PRIVATE CENSURE (cautionary letter). The private censure becomes effective 30 days after the Notice of Private Censure has been delivered to the accused, unless the accused notifies AIMR, in writing, that the private censure is rejected. If rejected, the matter is turned over to the Disciplinary Review Sub-Committee for further action. Upon review the Sub-committee may dismiss the complaint or impose any sanction permitted under the AIMR Rules of Procedure. If sanction is imposed by the Subcommittee, the accused may accept the sanction or request that the case be heard by a HEARING PANEL
      - Find a SERIOUS VIOLATION has occurred that deserves more than a private censure. Then, a STIPULATION AGREEMENT may be entered into by AIMR & the Accused, in which the accused stipulates that he has committed the agreed-upon violation and agrees to accept the more serious sanction proposed by the Designated Officer. By accepting the Stipulation Agreement, the accused WAIVES the right to further review. The Stipulation Agreement is then reviewed by the Disciplinary Review Subcommittee; upon review, they may:
        - Dismiss the matter
        - Impose the agreed upon, or lesser, sanction

    - Request the Designated Officer reconsider the matter
    - Convene a Hearing Panel

- If the Accused & Designated Officer fail to agree to a stipulation, or if the Disciplinary Subcommittee convenes a Hearing Panel, a STATEMENT of CHARGES (indictment) will be prepared and a HEARING PANEL (jury) convened.
  - Hearing Panels consist of 3-5 members, at least 1 of whom is a member of the Professional Standards & Conduct Committee. No member of the Hearing Panel shall have a conflict of interest in the matter, nor have been previously associated with the investigation of the complaint
  - Hearings may be conducted via conference call, unless the accused requests, in writing, that the hearing be conducted in person. The accused must be given at least 30 days notice of the hearing in writing. The notice must include the Statement of Charges and a list of the rights of the Accused in the Hearing Process. Rights of the Accused include →
    - The right to make a Statement
    - The right to Legal Representation
    - The right to Present Witnesses & Evidence
    - The right to Cross-Examine Witnesses
  - At the hearing, the Designated Officer, his appointee, or a member of the Disciplinary Review Committee will present evidence against the accused. All evidence shall be presented in the presence of the accused, unless he waives this right. The Hearing Panel is NOT bound by the RULES of EVIDENCE applicable in a court of Law. But, the presiding officer shall exclude evidence that, in his judgment, are IRRELEVANT. Recordings of the proceedings will be made, and the cost of obtaining a transcript will be borne by the accused member if he request such a transcript be made.
  - Upon hearing the Evidence, the Hearing Panel prepares a report of its findings, and if a violation is found, imposes whatever sanction it deems appropriate. Hearing Panel Decisions are by MAJORITY VOTE. The sanction imposed by the hearing panel become effective 30 days after submission of its findings, unless the ACCUSED requests, in writing, for a review of the Decision by the Professional Standards & Conduct Committee.
  - If the accused so requests, a REVIEW PANEL will be appointed, to be composed of members who have no previous involvement with the case. The accused may submit additional evidence and the review panel may demand any new information it deems reasonable in assisting it to perform its task. Upon conclusion of review, the sanction imposed by the HEARING PANEL shall be imposed UNLESS the REVIEW PANEL determines that BECAUSE of EXCEPTIONAL or UNUSUAL Circumstances, it would be INEQUITABLE to impose the

sanction. The Review Panel shall notify the member of its decision within 30 days after its review is completed.
- Members are notified of the sanction by a Notice of Disciplinary Action

- **Sanctions that May be Imposed on Members**
  - **Private Censure**: facts & circumstances of the case, nature of the offense, and violations that occurred are published in AIMR newsletter. But, the NAME of the convicted covered person is NOT Disclosed
  - **Public Censure**: facts & circumstances of the case, nature of the offense, and violations that occurred are published in the AIMR newsletter along with the NAME of the convicted covered person
  - **Suspension of Membership** in AIMR or an AIMR member organization for a STIPULATED period of Time
  - **Suspension of the Right to Use the CFA Designation** for a STIPULATED period of Time
  - **Revocation of Membership in AIMR or an AIMR Member Organization** (permanently)
  - **Revocation of the Right to Use the CFA Designation** (permanently)
  - **Summary Suspension or Revocation** which is a suspension (for a time) or permanent removal of a covered person from membership in AIMR or an AIMR member organization, and/or the suspension (for a time) or the permanent loss of the right to use the CFA designation without a hearing
  - **Suspension or Revocation from Further Participation in the CFA Professional Designation Study & Examination Program** (applies to CFA candidates ONLY)

- **Summary Suspensions & Revocations**
- The Designated Officer or Disciplinary Review Subcommittee can impose a Summary Suspension or Revocation on a member (without a hearing) for any of the following reasons:
  - **Being Convicted of, Pleading Guilty to, or Consenting to a Felony**
  - **Being Barred Permanently or Indefinitely from the Investment Business by a Governmental or Regulatory Authority**
  - **Failing to Cooperate with an AIMR Investigation** of the member's professional conduct
  - **Failing to file a Professional Conduct Statement with AIMR for 2 successive years**, if required to do so. Regular & affiliated members of AIMR & holders of the CFA designation have this requirement; CFA candidates do not.
  - Summary suspensions continue until TERMINATED by a Hearing Panel, the Designated Officer, the Disciplinary Review Subcommittee, or the Professional Standards & Conduct Committee. Summary Suspensions AUTOMATICALLY become REVOCATIONS of MEMBERSHIP if the covered person does not request a review of the Summary Suspension within FIVE years of the date it was imposed
  - Members who are to receive summary suspension are notified of the summary suspension by the Designated Officer. They have the right to Petition for Review before a Hearing Panel. If the summary suspension is due to conviction for a felony

or being permanently barred from the investment business, the suspension is AUTOMATIC once the Designated Officer receives documentation on the matter. If for another reason, the suspension is NOT imposed until the Member Receives a Notice of Summary Suspension
- Upon receiving the Notice of Summary Suspension, the member can submit a REJECTION of the Notice to the Designated Officer within 30 days. If the reason for the suspension is failure to cooperate in an AIMR investigation, the matter is referred to the Disciplinary Review Subcommittee which may impose any sanction, including the Summary Suspension
- If the Summary Suspension is for any reason other than failure to file a Professional Conduct Statement and the accused requests a Hearing, the hearing shall take place within 30 days of the request. The Summary Suspension can be terminated if the Hearing Panel determines that because of EXCEPTIONAL & UNIQUE Circumstances, it would be inequitable for the Summary Suspension to continue.
- If the Summary Suspension is for Failing to file a Professional Conduct Statement, the member may be reinstated upon compliance. But, the Designated Officer may require that the member demonstrate fitness to practice by some reasonable means, including passing a Standards of Practice Examination as a condition of re-instatement

- **Reinstatement of a Revoked Membership**
- A member who has had his membership revoked can seek re-instatement if:
  - 5 years have passed since the revocation took place
  - There has been a demonstration of rehabilitation, a full willingness to comply with the Code of Ethics & Standards of Professional Conduct, and a demonstrated fitness to practice
  - The Covered Person agrees to comply with conditions laid down by the Professional Standards & Conduct Committee, including passing a Standards of Practice Examination
  - A Petition for Re-instatement is filed with the Designated Officer
  - No Petition for Re-instatement has been denied within the Previous 2 years
- Members who received a Summary Suspension/Revocation due to Conviction of felony, or being barred from the investment industry may have the sanction lifted by filing, with the Designated Officer, documents demonstrating that the underlying convictions have been reversed. But the Professional Standards & Conduct Committee may still open an investigation into the matter

- **Confidentiality**
- All hearings & investigations are to be kept confidential, unless there is a clear violation of the law, serious damage could be done to the financial community or public by keeping the information private, or confidentiality is waived by the member. The Professional Standards & Conduct Committee may make the following information available to regulators:
  - Stipulation Agreement
  - Notice of Disciplinary Action
  - Hearing Panel & Review Panel Decisions

  - Public Information obtained by investigation
  - Information obtained by AIMR prior to it having been disclosed to AIMR by the member
  - Information AIMR received from sources other than the member that does not violate any confidences
  - Information received by AIMR from a member without restriction
  - Information that is not exempt from the disclosure of the Freedom of Information Act

- **Records**
  - All AIMR records of investigations, hearings, recommendations, findings, appeals, etc. are kept for 6 years

- **Considerations in the Disciplinary Process**
  - Complaining parties should be very careful about bringing complaints against members because accusations alone can damage the reputation of professionals
  - Professionals should expect to be held to a higher standard of ethical conduct and competency than a person who does not claim to be a professional
  - Professional competency of an investment manager must NOT be judged on the basis of hindsight; it should be based, instead, upon whether or not he followed sound procedures in accordance with the profession's accepted standards of conduct or analysis
  - No member of an AIMR organization or CFA candidate should expect to be protected by a 'fraternal' spirit among members of the financial profession. A professional body loses its credibility with the public if it unduly protects its members against JUSTIFIED accusations. Also a professional body loses its esteem if it uses its admissions procedures and procedures for dismissing members in ways that have the effect of keeping the supply of practitioners low relative to the demand for such services in order to enhance the potential income of its members

- ***"Avoiding Legal Problems in the Decade of Retribution" by Groskaufmanis***
  - If an investment professional is involved in a situation that may include misappropriation, insider trading, or a failure to supervise, the legal/regulatory actions that can be taken include:
    - CRIMINAL ACTIONS → though rare, prosecutors have broad provision in the US Criminal Code that may be used against individuals engaged in financial affairs. The "Scheme to Defraud" via mail & wire fraud can be used to make almost any financial or professional misconduct a criminal case
    - SEC ADMINISTRATIVE REMEDIES → range from fines to forbidding a person from association with any registered investment entity. Such actions can be taken against individuals who have done no wrong themselves, but failed to adequately supervise the misconduct of a subordinate. And, failure to supervise covers not just direct supervisors, but compliance officers and regional managers.
    - PRIVATE LAWSUITS → brought by offended parties seeking monetary damages for losses incurred

- To CREATE an EFFECTIVE Compliance Policy→
  - All management should KNOW & UNDERSTAND their Legal & Ethical responsibilities re: all activities that fit within their job description
  - Supervisors should enforce All Rules & Regulations keeping a record of procedures followed & disciplinary steps taken. Special attention must be given to:
    - Employees with a history of rule violations
    - Unusual account activity
    - Unauthorized trading, churning of accounts, or transactions in securities that do not appear suitable for the client
    - Informing employees of what their fiduciary duties are by giving them a compliance manual & training in proper procedures for their job
  - Designate a Compliance Officer who is knowledgable in Securities Law, Rules & Regulations, as well as the proper procedures that firms should follow to safeguard against the breaking of regulations by employees (intentionally or unintentionally)
  - Resolve compliance problems promptly
  - Keep compliance records and document that proper procedures were, in fact, followed
  - Avoid questionable personal investment transactions
  - Keep current on regulatory changes & enforcement trends

- ***"Regulatory Environments in Emerging Markets" by van der Bijl***
  - Government's Role in Fostering a Respectable Securities market for investors include:
    - Enforcement of Contracts
    - Guaranteeing Property Rights
    - Setting Regulations for proper Corporate Governance
    - Protecting Shareholder Rights
    - Setting Rules & Regulations to ensure that financial markets are operated fairly
    - Having tax laws that are equitable to both foreign & domestic investors
    - Permitting foreign investors to remit capital & profits back to their own nation
    - Providing Currency Regulation that is Fair
    - Fostering Laws & Regulations enabling investors to receive available, timely, accurate, & complete information for making investment decisions
    - Providing proper oversight of the institutions performing essential functions such as trading, settlement & custody
  - Securities Market Regulations can be Classified as follows:
    - *Defining the Financial System*: Regulatory system defines the key features of a nation's financial system and the role the securities markets play in that system
    - *Providing Incentives that Induce Market Participants to Act in the Best Interest of Investors*
    - *Providing Disincentives for Mis-behavior*, such as self-dealing, manipulation, fraud, etc.

- The FUNCTION & OBJECTIVE of Securities Market Regulation should be to enhance →
  - *Market Integrity*: this can be done by opening the securities markets to all potential investors, while minimizing risks that can engulf the entire financial system. Regulators must
    - Require financial institutions be solvent enough to allow for confidence in the integrity of the financial system
    - Encourage an Effective & Stable Payment system that will safeguard against financial panics
    - Prevent fraud, manipulation, insider trading & other abuses that can cause unsophisticated investors to lose confidence in the fairness of the securities market
  - *Fairness*: allow all investors to compete in the trading process so that prices are set by the investors themselves.
  - *Market Efficiency*: want markets to raise capital & allocate it to economically viable business ventures.
  - May not be able to perform all functions simultaneously.
- Ways to REGULATE Securities Markets
  - *Direct Regulation* → by the state, where laws & regulations, backed by government authority, are enforced by criminal or civil penalties
  - *Self-Regulation* → by private institutions. More flexible, but often anti-competitive. Often fails in emerging markets
- Emerging markets have needed to open up their markets because Foreign Aid has been reduced as a source of capital. Will need more integration with global markets.
- Market VIABILITY determined by:
  - *Nation's Financial Structure*
  - *Nation's Securities Market Structure*
  - *Broker/Dealer Activities*
  - *Dissemination of Company Information*
  - *Market Infrastructure*
  - *Extent of Foreign Participation*

- **AIMR Guidelines for Proxy Voting Policy**
- Under ERISA it is the responsibility of the parties designated in pension plan documents to vote the proxies received from the companies whose shares are held in trust. If the documents do not name a party, it is the investment manager's responsibility. The voting of proxies represents a fiduciary duty.
- The Following principles should be used as a guide to avoid proxy voting problems:
  - Proxies should be VOTED; failing to vote a proxy is a breach of one's fiduciary duty. The old "Wall Street Rule" where either vote with the management or sell is impractical.
  - Proxies should be voted in a way that represents the best interests of the clients
  - Proxies should be voted only after CAREFUL study of the issues. Voting without due diligence is a breach of fiduciary responsibility
  - Person voting the proxy should not be influenced by factors other than fiduciary duties

- While outside consultants may be employed to held decide issues, the ultimate responsibility lies with the fiduciary
- Records should be kept as to how & why votes were cast
- OBSTACLES that may prevent the EFFECTIVE formulation of proxy voting policies
  - Lack of Support from Management
  - Perception that most proxy issues are routine & unimportant
  - Uncertainty about voting responsibilities
  - Company managements attempting to influence fiduciaries to vote proxies in favor of current company policy
  - Foreign Security Problems like less disclosure, language barriers, delay, etc.
  - Using consultants with ultimate responsibility for voting
  - Delays in obtaining proxy information
- POLICY on PROXY VOTING should be Adopted & Include:
  - Designate the person responsible for voting proxies
    - Develop specific proxy voting guidelines & a review process to ensure they are followed
    - Affirm that proxies are to be voted in a way in the best interest of clients
    - Provide for a discussion of key issues
    - Provide for a review of unusually proposals to be voted upon
    - Apply financial ratios & other tests for evaluating management performance
    - Provide for a means by which, and under what circumstances, corporate managements should be informed of how proxies were voted
    - Decide under what conditions a person should be relieved of the power to vote proxies due to a conflict of interest
    - Determine how & when a report on proxy voting should be given to clients
  - Identify major proxy issues & learn from clients how they prefer to vote
    - Corporate Governance
    - Takeover Defense Measures
    - Compensation Plans
    - Capital Structure Changes
    - Social Responsibility Issues
  - Analyze the Issues in a Useful Format
    - State the Pros & Cons of the issue
    - Evaluate the proposal in light of the historic performance of management
  - Develop a system to monitor any delegation of responsibility to others
  - Provide for Record Keeping
  - Provide for the Education & Training of Staff
  - Be Aware of the Legal Consequences (ERISA enables beneficiaries to sue fiduciaries who breach responsibilities, etc.)

- ***["Fiduciary Responsibilities of Investment Managers & Trustees" by Droms]***
- A fiduciary is someone who acts in a position of trust on behalf of, or for the benefit of, another party. Guides to Fiduciary Behavior come from
  - ERISA
  - The Law of TRUSTS
  - The Restatement of Trusts
  - The Uniform Management of Institutional Funds Act (UMIFA)
  - The Prudent Man (Prudent Investor) Rule
  - The AIMR Standards of Professional Conduct
- The Law of Fiduciary Responsibility as it applies to an investment manager or trustee imposes TWO Basic Duties
  - LOYALTY – Fiduciaries must put the interests of their clients ahead of their own and act solely for the benefit of he client
    - *Solely in the Interest Rule* – a retirement plan (ERISA) fiduciary must act solely in the interest of the plan participants & beneficiaries
    - *Exclusive Purpose Rule* – fiduciary must act to provide the plan participants & beneficiaries with benefits, and to defray reasonable costs
    - *Avoid Conflicts of Interest* – fiduciary may not engage in any transaction or conduct that would, in any way, bring an advantage to the fiduciary. ERISA has 4 types of prohibited Transactions (engaging in them is a breach whether or not the beneficiaries are harmed)
      - *Specific Transactions Restrictions* – prohibit the sale, exchange, lease, loan, extension of credit, or other disposition of property between a retirement plan and a PARTY in INTEREST (virtually anybody with a relationship to the plan)
      - *General Transaction Restrictions*- prohibit any transfer of plan assets to any party in interest
      - *Fiduciary conduct restrictions* – prohibit any actual or potential conflict of interest between a plan & a party in interest.
      - *Property Restriction* – limit the amount of retirement plan investments that may be invested in the securities, or property, of the sponsoring employer of the plan
  - REASONABLE CARE – fiduciary must study the matters are before them and act only after considering the pros & cons of each decision. Under ERISA, use the PRUDENT EXPERT STANDARD in which the fiduciary is required to undertake a professional level of study when making an investment decision.
    - *Prudent Man Rule* (personal trusts) an ORDINARY standard of care is required unless the fiduciary holds himself out to be an expert, in which case the professional standard of care is required.
    - *Prudence* – can be measured on a security-by-security basis or on the basis of the total portfolio. MPT is currently ahead of the courts in suggesting that risk assets be added to portfolios to improve risk/return ratios.
    - *Diversification Rule* – considered to be prudent under MPT. Diversify across asset classes & across securities within class
    - *Documents Rule* – all retirement plan documents must be adhered to by the fiduciary unless they are inconsistent with the legal requirements of ERISA

- *Indicia of Ownership Rule* – documents indicating ownership of retirement plans must be kept within the jurisdiction of US district courts
- CONCLUSION of ARTICLE
  - Investment managers should have well-reasoned, written investment policy statements that document the reasons behind asset allocation decisions
  - As prudent experts, managers should take an active role in forming retirement plan objectives and investment policies
  - If novel investment strategies are undertaken, reasons behind them should be well documents and based on the fact that the approach will reduce risk without adversely affecting overall portfolio return

- ***"Managing Ethics from the Top Down' by Gellerman (1989)***
- Management is responsible for creating & sustaining conditions which will cause employees to act ethically. The steps that may be used to accomplish these objectives are:
  - ***Set a Tone*** – Lead from the top
  - ***Publish a Code of Ethics***
    - Standard of conduct will be EXPLICIT
    - Employees will be on NOTICE as to what kinds of acts will not be tolerated
    - Shifts some of the blame for unethical behavior from the firm to the responsible individual
  - ***Reduce Inducements that May Tempt Employees to Act Unethically***
    - Unusually high rewards for good performance
    - Unusually severe punishments for poor performance
    - Implicit sanctioning of unethical behavior by management
  - ***Raise the Risk to Those who Breach Ethical Conduct***
    - Publish a code of ethics that clearly indicates what activities will not be tolerated
    - Emphasize the code of ethics by training employees in its application
    - Emphasize that the code of ethics is to be interpreted conservatively
    - Establish mechanisms for disclosing unethical behavior among employees

- ***"Compliance Guidelines: Introduction" by Caccese***
- Under SEA ('34), firms are required to properly supervise their employees.
- Must establish & enforce compliance procedures
- To defend against an accusation of failing to supervise an employee, the firm must meet 5 pre-conditions
  - Compliance program had been in place prior to the violation
  - Program was designed to have a reasonable chance to discover the types of violations for which the employee is accused (& which is possible in the normal course of business)
  - Formality of the compliance program is appropriate given the size & culture of the firm
  - Program meets minimum industry standards
  - Program has been followed & enforced

- *Steps Required to Design an Effective Compliance Program*
  - Obtain the support of the Board of directors & COO of the firm
  - Review the firm's business activity & regulations under which it operates
  - Review the type of compliance programs used by other firms in the industry
  - Design a program:
    - Constructed by a knowledgable person familiar with the business of the firm, its culture, and the regulations under which it operates
    - Designate a Compliance Officer
    - State the Scope of the Program
    - State permissible conduct
    - Provide a procedure for reporting violations
    - Provide for enforcement
    - Put the entire program in writing & disseminate it to employees
  - Implement the Program. Make employees aware of the program, make sure they understand it, and remind employees of their responsibilities under it
  - Upgrade the program to reflect changes in the law, regulations & activities of the firm
- Compliance Officers are responsible for carrying out the compliance procedures of the firm (Direct Supervisors & Indirect Supervisors). Both have the Duty to
  - Identify Wrong-doing & conduct inquiries regarding violations or potential violations
  - Respond to misconduct by limiting the activities of employees who are committing violations or by instituting procedures that will prevent the violations from continuing
  - Make recommended changes or additions to existing procedures that will reasonably prevent foreseeable misconduct & verify that new procedures are being enforced

7. Cases in Ethics for CFA Level III

- **CASE I: TECHNOGRAPH CONSULTING**
  - FACTS:
  - Pardee Systems has recently made allegations of unethical conduct by Tine E. Timm, CFA. Pardee charged that Timm had a Conflict of Interest that prevented Timm from offering objective advice to his client. Timm is worried his unsullied personal reputation and integrity, & that of his employees, have been damaged, even though he was exonerated
  - Timm, a software designer with 30 years experience began his career at Carpell Design, where he worked for 15 years. He worked for a major brokerage house as a computer industry analyst for 8 years and acquired his CFA designation & became a member of AIMR. 7 years ago, Timm set up a consulting firm, Technograph Consulting, Inc. which employees 10 software professionals on a varied of consulting projects. Timm is known for his professionalism, expertise & integrity. Although Timm does NOT have written standards for company employees, Timm has made clear in personal communications the high standards he expects them to meet; re honesty, fairness, & avoiding conflicts of interest
  - Timm has a personal portfolio of almost $100,000. His years participating in Carpell's employee stock purchase plan has let Carpell stock be 25% of his portfolio. Another 25% is invested in computer companies and the remainder is in other industries
  - Technograph recently won a contract from Destars Computer Systems. The proposal Timm wrote for Destars would benefit Carpell. Pardee Systems, a Carpell competitor, filed an objection stating Timm had a conflict of interest arising from his personal portfolio position.
  - RECOMMENDATIONS: Factors to consider in looking for AIMR violations
  - Nothing in the case suggests that any member of Technograph acted unethically. However, the absence of a formal compliance program could expose Tehnograph to costly liability in the event of a mishap. Timm should establish a comprehensive formal compliance system, including detailed compliance policies & the communication & education of those policies

  - Whenever Timm has a real or perceived conflict of interest, he must disclose such conflicts to clients. If Timm keeps his portfolio position as it is, there is a potential conflict of interest since the price of securities Timm owns could be affected by his consulting recommendations. Timm must disclose this potential conflict of interest to the interested parties. To eliminate this conflict, he could sell his computer stocks, or maintain a computer oriented investment strategy by:
    - Establishing a BLIND TRUST account in which the account is fully discretionary and the trust beneficiary is not aware of the holding, until they are reported to him.
    - Can use mutual fund concentrated in computer stocks

- **CASE II: JEFFERS INVESTMENT**
  - FACTS:
  - Lynda I. Winn, CFA & President of Jeffers Investment, needs to determine which of several regulations to follow in 2 countries in order to respond to a request by her marketing department and a request by a client that could lead to illegalities
  - Jeffers Investment is a New York-based money management firm. The head of the London, England marketing department, Ed Hughes, wants to use SOFT DOLLARS to send 2 marketing people to a seminar on investing in emerging markets. One of the employees is a British Citizen, the other is a US citizen on temporary assignment from the New York office. The soft dollars that Hughes wants to use are from trades involving both US & British accounts. Hughes contends that because Jeffers Investment uses a team oriented system of decision making, the marketing personnel are an integral part of helping clients determine investment objectives & asset allocation & in monitoring accounts. Hughes states the seminar would help educate the marketing staff about risks involved in emerging market investing. The cost of the seminar, including travel & lodging for 4 days in Chicago, is large. Jeffers' London Compliance Officer, Joseph Wang, wants to keep expenses low, but does not believe this use of soft dollars falls with Jeffers Investment's soft dollar policies, established in New York. Wang asks if Jeffers' US soft dollar policies, established to meet the safe harbor provision of § 28(e) of the SEA '34 are applicable to the London Office.
  - Another issue involves one of the London office's largest US clients, Woodward Pension Fund, based in West Palm Beach, FL. Starting out as a NYC account, Woodward recently requested that the pension fund's international exposure be managed by Jeffers' London office. The fund's treasurer, Marilee Buckeye, has requested that 30% of the fund's trades from the London office be directed through Scurry Securities so that she can use the commissions generated from the pension plan's account to pay for gifts & vacations of Woodward employees as performance rewards. Scurry Securities is known as a broker that provides poor execution & charges high fees.
  - RECOMMENDATIONS: Factors to consider in looking for AIMR violations
  - Winn, CFA, must be careful not to violate US laws, British laws, Jeffers' policies, or AIMR's Code & Standards. In order not to violate Standard I, Winn must determine which laws & regulations apply to these 2 situations.
  - Sending Marketing personnel to emerging markets seminars does not fall within the definition of research services determined by § 28(a), since marketing personnel are not directly responsible for investment decision making. Non-research aspects of the trip, like travel, lodging & meals, do not fall under the safe harbor and are not allowed under US law
  - Basically, follow the most stringent rules (US, Brit. AIMR)
  - If Jeffers has one set soft dollar policy that is applied globally, then the London Office must comply so long as the policy meets or exceeds local law
  - If each of Jeffers' foreign offices is allowed to determine individual policy based on local law, Winn must find out British law
  - If there are no British laws covering soft dollars, the US clients with funds managed in London must meet US law, as US law would then be the higher standard
  - Given conflict between US & UK law, the London office could separate commission dollars generated by UK clients from those generated by US clients and use those segregated commissions as each country, & AIMR permit
  - RE; Woodward, ERISA states that commission dollars can be used to obtain services for the exclusive benefit of the pension plan, not the sponsor. Jeffers is required to act in the client's best interest & must seek the best price & execution on security trades. Winn must ensure that Jeffers employees to not assist in violation of the law by agreeing to Woodward's request

- Winn has responsibility as a supervisor to ensure that appropriate compliance procedures have been established & communicated to covered personnel

- **CASE III: INVESTMENT COUNSEL UNLIMITED**
  - FACTS:
  - ICU is an investment advisor firm that manages the pension plans of 15 companies in the Cleveland area. ICU has full discretionary authority in managing its client's pension plans. ICU has a compliance manual based on AIMR. However, the manual does NOT provide details on how to implement the Standards. Steve Little, CFA & founder of ICU, has not read the manual because he believes that being a CFA, he is familiar enough with the Standards. After reading an article about the ramifications of violating fiduciary duty, Little worries about whether or not ICU policies are adequate. Little requests that the newly hired Will Deel determine what constitutes a fiduciary responsibility, how well ICU carries out that duty, and any recommendations for changes to ICU's compliance manual.
  - Little gives Deel a brief description of ICU's philosophy on the 3 areas with which he has concern: soft dollars, proxy voting & diversification.
  - "My view on fiduciary duties is: as fiduciaries, we have the job of preserving & enhancing the financial position of the plan participants and beneficiaries of the clients we serve."
  - RE: Soft Dollars → "Every few months, our portfolio managers informally get together with our trader and indicate which brokers have been providing the best research and the most responsive service. We make our decisions on brokerage allocation and soft dollar purchases on this basis and steer our trading business accordingly. In some cases, our trader simply uses his own discretion and goes with the best execution. The clients may not be aware of it, but they are often getting the benefit of low-cost trades. When we do pay up for commissions, it's usually in conjunction with something a broker is doing, or providing for us. For example, on occasion, our portfolio managers may attend broker-sponsored seminars and one broker provides us with the latest in spreadsheet & word processing software."
  - RE: Proxy Voting → "Our proxy voting policy is simple; routine proxies are discarded. I don't believe we are really serving our clients by taking the time to ratify a corporate auditor or by voting for an uncontested slate of directors. For more complex proxies, the portfolio managers make decisions on proxy matter for their own accounts."
  - RE: Diversification → "I believe our portfolio managers adequately diversify their portfolios. I can think of only 1 case this year when one of our investments went really bad and was responsible for a horrible performance for that fund. Some of our clients have placed specific restrictions or stipulations on investment strategy. For example, 2 of our clients have instructed us to invest within very narrow industry sectors. Confining our investments in these areas has resulted in outstanding performance for these 2 funds. But, I sometimes wonder if there is a problem looming. What is our fiduciary duty to our clients that make portfolio restrictions?"
  - RECOMMENDATIONS: Factors to consider in looking for AIMR violations
  - ICU personnel need to understand that through their investment management relationships, they owe the plan beneficiaries a duty of loyalty that supersedes all other interests
  - As a CFA charterholder, Little is obligated under Standard I to be knowledgeable about and comply with all applicable laws & regulations re: fiduciary duties. Since ICU is based in the US and has discretion over the management of pension funds, ERISA controls
  - *Soft Dollars*
    - Some general office expenses can be paid through soft dollar commissions. Depending on the nature of the expense, paying the costs of attending broker-sponsored seminars with soft dollars could be considered a violation. It is legal to pay for investment information that can be used to help make better investment decisions, however, travel, meals, etc. should not be paid with soft dollars
    - ICU needs to establish a formal process for analyzing brokerage arrangements and transaction costs to ensure client assets are not being wrongfully appropriated by paying unreasonable commissions. ICU has an obligation to always seek the best price and execution on its trades. Plus, any soft dollar arrangement needs to be disclosed to clients
    - Compliance Policy
      - Employees and the firm are forbidden to use brokerage commissions, or any other client's, plan participant's, or beneficiary's assets for their own benefit

        - Records must be kept of all transactions involving soft dollars indicating the amounts spent and benefits received
        - Soft dollar practices must be disclosed to clients
- *Voting Proxies*
    - Proxy Voting Rights are an asset of the pension plan and the firm must cast its votes in a way that will maximize the economic value of plan holdings. Failing to cast a vote or casting a vote without considering its impact may violate a fiduciary duty
    - ICU managers must vote proxies on an informed and reasonable manner. Study & analysis must be part of the proxy process. All votes should be recorded & records kept indicating how proxies were voted and the reasons for the vote and why the vote was in the best interest of the client
- *Portfolio Diversification*
    - ICU has a duty under ERISA to diversify retirement portfolios to protect them from the risk of a substantial loss. Plan documents are the primary determination of a fiduciary's duty, but only to the extent the documents comply with applicable law. ICU violates its fiduciary duty by limiting all assets of a plan to only one or a few types of assets even though this 'policy' is specified in plan documents
    - As a general rule, no more than 10% of a retirement plan's portfolio should be invested in the assets of a plan sponsor. The assets should be diversified with respect to asset class, industry representation & quality instrument
    - <u>Policy Compliance Manual</u>
        - Portfolios under management by the firm shall be diversified with respect to its asset structure in order to minimize risk
        - Plan documents should be followed only to the extent they are consistent with the firm's fiduciary duties and securities laws & regulations
    - *Performance Override Investment Procedures?*
        - Regarding a security that lost its value due to a product liability suit (under-performing portfolio), ICU is not liable as long as the manager who purchased the security had a reasonable basis for the investment action. Under ERISA, as long as the PRUDENT EXPERT RULE was followed, the managing firm has no liability for an investing loss
        - There is a duty to thoroughly study & analyze investments, understand risks, be knowledgeable about facts & circumstances generally known by other investment professionals and to make sure that investment recommendation are suitable to the needs of the client.
    - <u>Policy Compliance Manual</u>
        - Investment decisions shall be made ONLY after exercising due diligence, thoroughly analyzing the investment itself re: return & risk
        - No investment action shall be made unless it is determined the needs, objectives & circumstances of the client for whom the investment action is to be under taken.
- Not only should the firm have written procedures to follow for all of these areas, but it should train employees in the procedures that are to be followed & designated individuals to monitor employees to insure firm policies are being carried out. Employees found to be in violation should be reprimanded in proportion to the seriousness of the offense. This could include dismissal for serious infractions of policy.