Compliance Program Transparency™ Series – Session 3

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Introduction

- Reference Codes:
  - Regulatory Compliance Association, Inc. Compliance Officer Professional Code of Conduct™
  - CFA Institute Asset Manager Code of Professional Conduct©
  - CFA Institute Code of Ethics and Standards of Professional Conduct ©

- If it represents compliance with the Asset Manager Code, the investment manager holds itself out to the public and investors as adhering to a higher level of ethical conduct as established in the Asset Manager Code, and must be able to document its policies and procedures supporting its claim of compliance with the Asset Manager Code.

- The Model Compliance Manual establishes supervisory policies and procedures based on the Asset Manager Code and also on actions by the Securities and Exchange Commission and other governing authorities. References are to Chapters of the Model Compliance Manual.

- A certain level of familiarity with governing requirements is assumed, and someone sufficiently familiar with the requirements for compliance with applicable federal securities laws should be responsible for supervisory policies and procedures as contained in any compliance manual and seek assistance as necessary.
Asset Manager Code Principle: Section C. Trading

1. Material Nonpublic Information

Managers must: 1. Not act or cause others to act on material nonpublic information that could affect the value of a publicly traded investment.

*Newman* US 2\textsuperscript{nd} Circuit Case.

Shifting area of the law, 9\textsuperscript{th} Circuit case *Salman* on appeal to US Supreme Court.

Practical considerations apart from case law, remain cautious regarding insider trading.

b. Fundamental Concepts of Insider Trader
   • Confidential and Proprietary Nature of Company Information
   • Tippor and Tippee Liability
   • Regulation FD
   • Mosaic Concept

- Difficult issues with tippor and tippee liability.

- Reference AMC Appendix language regarding Mosaic concept

c. Identifying Material Inside Information
   • Materiality
   • Inside Information

- Materiality in terms of whether information important in investment-decision making process.

- Inside as not publicly disseminated.

d. Potential for Material Inside Information

• Company Interviews
• Experts and Expert Networks
• Discussions with Rating Agencies and Similar Organizations

➢ Circumstances reflective of potential for material inside information.

➢ Additional care and precaution taken.
d. Potential for Material Inside Information (cont.)

- Companies More Subject to Insider Trading

- Information More Likely to be Material Inside Information

- Persons More Likely to Convey Inside Information

- Circumstances exist that prompt heightened awareness.

e. Indicia of Insider Trading

- Nondisclosure and Confidentiality Agreements
- Trading Activity
- Activities of Associated Persons

- Company asking for a nondisclosure indicates most likely to receive inside information, may desire to defer discussions.

- Trading activity: excessive profits, illiquid low priced securities, short-swing profits, and timing.

- Furtive and unusual activity by associated persons.

f. Restricting Access to Material Nonpublic Information

- General
- Firewalls
- Investment Vehicles
- Securities Holdings and Trading Activity

g. Possession of Material Inside Information
   • Inadvertent Possession of Inside Information

h. Prevention of Insider Trading

- Procedures to address handling of material inside information once in possession of firm or associated persons.

- Prevent trading on material inside information.

- Protection of firm in the adoption of these procedures.

i. Detection of Insider Trading

- Tie associated persons’ trading activity into firm’s trading activity.
- Review personal securities transaction reports.
- Review emails and other compliance testing.
- Aberrant behavioral patterns of associated persons.

j. Resolving Issues Concerning Insider Trading

k. Regulatory Inquiries, Enforcement Actions

- Compliance addresses insider trading within firm or by associated persons.

- Procedures to resolve questions exclusively through Chief Compliance Officer.

- Associated persons notify firm if receive “inquiry” letter or similar regulatory notification.
20. Trading

i. Confidentiality of Trades

- Firm’s own trading activity confidential and not acted upon by firm or associated persons.

- Trades directed by clients who are officers, directors and other similar persons associated with a public company, may be deemed material inside information.
31. Code of Ethics

a. Purpose of Code

b. Why Do We Have a Code of Ethics?

- Rule 204A-1 under Investment Advisors Act.

- Variety of reasons for Code of Ethics, address insider trading and conflicts of interest.

- Supervision of associated persons’ investment activities.

- Uniform requirements coming into existence based on industry standards and regulatory imposition.
c. Does the Code of Ethics Apply to You?
   • Investment Persons
   • Access Persons
   • Non-Access Persons
   • Independent Board Members

- Different classifications for associated persons may allow different restrictions.

- Flat firm structure may cause classification of all associated persons as investment persons and access persons.
31. Code of Ethics (cont.)

d. Restrictions on Personal Investment Activities

- Preclearance Personal Securities Transactions
- Additional Restrictions
  - Initial Public Offerings
  - Private Placements
  - Short-Term Trading Profits
  - Black-Out Periods

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31. Code of Ethics (cont.)

e. Reporting Requirements

- Initial Disclosure of Personal Securities Holdings
- Reporting Requirements
- Copies of Confirmations and Statements

- Suggested practice is electronic downloads of statements and electronic monitoring of activity.

31. Code of Ethics (cont.)

e. Reporting Requirements (cont.)
  • Certification
  • Annual Reporting

m. Annual Certification of Compliance

- Certification that instructed all broker-dealers to forward personal securities transactions.

- Annual certification of compliance.
f. Can there be any exceptions to the restrictions?

• How to Request
• Factors Considered
• Exemption Reporting

- Very limited basis for exemptions.

- Report exemptions granted to boards of investment vehicles and registered investment companies.
31. Code of Ethics (cont.)

k. Do you have to report violations of the Code of Ethics?

l. What happens if you violate Code of Ethics?

- Internal policing, failure to report same as violation.
- Disciplinary procedures to be imposed upon violation.
n. Reporting to Investment Vehicle Board

o. Approval of Code of Ethics

- Violations reported.

- Approval of Code required.

- Superimposed higher supervision by boards of investment vehicles and registered investment companies.
APPENDIX 1: DEFINITIONS

- Code-Exempt Security
- Reportable Fund
- Initial Public Offering
- Private Placement
- Security

- Certain instruments exempt, not pose potential for abuse: US Government obligations, money market funds, and similar instruments.

- Broad definition of security to include almost all instruments to avoid any misunderstanding about reportable securities.
APPENDIX 2: WHAT IS “BENEFICIAL OWNERSHIP”

- Are securities held by family members “beneficially owned” by me?
- Are securities held by a company I own also “beneficially owned” by me?
- Are securities held in trust “beneficially owned” by me?
- Are securities in pension or retirement plans “beneficially owned” by me?
- Examples of Beneficial Ownership

- Questions and answers, and examples for easy understanding.
- Reporting requirements hinge on definition of beneficial ownership.
- Recent interpretations on “blind” trusts: no influence or control must be established and exist.
Asset Manager Code Principle: Section C. Trading

2. Priority of Transactions

Managers must: 2. Give priority to investments made on behalf of the client over those that benefit the Managers’ own interests.
17. Allocation of Investment Opportunities

a. Specific Procedures

c. Prohibited Allocations
   • Proprietary and Related Accounts

- Procedures to designate responsible persons and bases of allocation of investment opportunities.
- Not allocate limited and unique investment opportunities to proprietary and related accounts.
- Definition of related accounts includes accounts in which have an interest, such as investment vehicles.
- Not allocate to “hype” performance of funds to gain additional investments.
17. Allocation of Investment Opportunities (cont.)

d. Restrictions on Allocation to Certain Accounts
   • Performance-Based Accounts
   • Other Accounts with Potential Favoritism

- Allocations to these accounts have potential to cause breach of fiduciary duty.

- Performance-based accounts receive higher fees, incentive to place own interests first.

- Currying favors with certain high profile or “favorite” accounts, placing interests first.
17. Allocation of Investment Opportunities (cont.)

e. Certain Unique Investment Opportunities
   • Initial Public Offerings
   • Other Limited Investment Opportunities

- Certain investments placed in proprietary or related accounts indicative as placing own interests first

- Limited investment opportunities: high yield bonds, private placements, anything not available for all accounts.

- With initial public offerings, underlying assumption of increased after-market value, and vary policy according to market conditions.

- Market conditions also change what is a “limited” investment opportunity.
20. Trading

a. Trading Process Flowchart

b. Authorization

- Manner in which trades flow through system.
- Limit actual trading authority to those persons responsible and accountable.
- Trading staff separate from investment staff who have inherent interest in account performances.
20. Trading (cont.)

d. Execution Allocation

e. Block Trades

f. Processing Block Trades

h. Monitoring and Modification

- Specific procedures in trade processing to assure fairness as between clients and manager.

- Applicable in this instance for accounts in which manager has additional interests.

- Actual trade processing procedures in more detail under “Principle C.5 Trade Allocation.”
d. Restrictions on Personal Investing Activities
   • Preclearance Personal Securities Transactions
   • Additional Restrictions
     – Initial Public Offerings
     – Private Placements
     – Short-Term Trading Profits
     – Blackout Period

- Use Code of Ethics to monitor conflicts of interest.
- Procedures to assure clients’ interests first.
3. Soft Commissions

Managers must: 3. Use commissions generated from client trades to pay for only investment-related products or services that directly assist the Manager in its investment decision making process, and not in the management of the firm.
19. Trade Execution

m. Soft Commission Arrangements
   • Benefits to Clients
   • Best Qualitative Execution
   • Allocation of Transactions in Soft Commission Arrangements

- Benefit to client, not to support manager’s administrative and operational responsibilities.

- Encompasses research, services and products.

- Reference AMC Appendix language.
19. Trade Execution (cont.)

m. Soft Commission Arrangements (cont.)
   • Mixed Uses
   • Disclosure
   • Standards
   • Annual Review

- Allocate mixed use items, and manager’s administrative portion paid in hard dollars.

- Permitted practices not the best practices, especially without controls.

- Annual review of all arrangements, address shifts in conduct.
12. Miscellaneous Other Regulatory Requirements

19. Trade Execution (cont.)

a. ERISA

m. Soft Commission Arrangements (cont.)
   • ERISA
   • Special Client Considerations

- Commissions generated considered assets of ERISA plan.

- Co-fiduciary of ERISA plans required to monitor soft commission use by manager.

- If certain clients require soft commissions benefit only their accounts, consider impracticalities to administer.
Asset Manager Code Principle: Section C. Trading

4. Best Execution

19. Trade Execution

a. General
b. Process in Establishing the Relationships
c. Standards for Selection and Review
f. Market Centers and Other Trading Venues

- Standards by which select and review broker-dealer relationships with reference to execution.

- Other considerations may influence trade execution over long-term, such as financial stability, responsiveness, access and disciplinary history.
d. Execution Quality Considerations

e. Reasonable Diligence

g. Review Process for Ongoing Execution
   • General Procedures for All Securities
   • Additional Procedures for Fixed Income

- Procedures to review execution as occurs, based on available information.

- Standards by which base reasonable diligence in obtaining best execution: market, price volatility, liquidity, transaction size, and similar factors.

- Document ongoing review of execution quality, depending on security type.
19. Trade Execution (cont.)

j. Client Directed Brokerage

k. Varying Execution

- Client directed execution impacts ability to seek best execution.

- Procedures to address client directed execution, including disclosure.

- Procedures to address varying execution, including disclosure.

- See Asset Manager Code Additional Guidance (March 2015)
19. Trade Execution (cont.)

h. Responsible Parties

i. Annual Review

l. Disclosures of Policies and Procedures

- Appoint responsible parties for implementation of execution policies.

- Annual review of trade execution in a formal process: review of executions received and review based on criteria for selection and review of relationships.
19. Trade Execution (cont.)

m. Soft Commission Arrangements
n. Rebates, Directed or Other Arrangements

- Soft commission arrangements allowable as an exception to hard requirement of best execution.

- Commissions must benefit accounts, rebates back to manager prohibited.

- Benefits to manager for directing trades prohibited.
20. Trading

a. Trading Process Flowchart

b. Authorization

c. Approved Broker-Dealers and Use in Execution

- Trading process integral element of best execution, qualified trading staff.

- Defined procedures to avoid denigration of best execution.

- Based on selection and review process, approved universe of broker-dealers, subject to limited exceptions.
20. Trading (cont.)

e. Block Trades

- Block trades may further best execution in lowering costs with larger trades and volume.

- Procedures for block trades, further discussed under Principle C.5, Trade Allocation, fair as among client accounts.
Asset Manager Code Principle: Section C. Trading

5. Trade Allocation

Managers must: 5. Establish policies to ensure fair and equitable trade allocation among client accounts.
Trading: Fair Allocation Among Clients

Addresses allocation as among clients, duty and responsibility to all clients the same, and avoid varying outcomes.

Series of trades as among clients may result in varying best execution, not a fair and equitable result.

Differs from Principle C.4 Best Execution, which may be achieved in any trade, but varying results if a block trade executed in a series of trades over time.

Differs from Principal C.2 Priority of Allocations as between clients and manager.
17. Allocation of Investment Opportunities

a. Specific Procedures

b. Applicable Considerations

e. Certain Unique Investment Opportunities
   • Initial Public Offerings
   • Other Limited Investment Opportunities

- Procedures for allocation of trades in advance as fair among all clients.
- Considerations: investment strategies, suitability, cash availability, other defined considerations.
- Address allocation limited investment opportunities as among clients.
- Enforcement action if benefit one client over another constituting breach of fiduciary duty.
20. Trading

a. Trading Process Flowchart
b. Authorization
h. Monitoring and Modification

- Defined procedures in advance to execute trades.

- Fairness in allocation according to investment decisions.

- Segregation of trading process from investment process minimizes “rigging” system.

- Monitoring of trade execution as to varying results.
20. Trading (cont.)

d. Execution Allocation

e. Block Trades

f. Processing Block Trades
   • Execution in Full

  - Allocation in advance, process back into accounts, as pre-allocated.

  - Fairness and equitable to treat everyone the same.

  - Pro rata allocation of execution and costs as among accounts.
20. Trading (cont.)

f. Processing Block Trades (cont.)
   • Execution in Series, Pro Rata
   • Execution in Series, Rotational
   • Partial Execution

- Addresses instances when a block trade not executed in full but in series over time.

- Procedures to process back into accounts, on a fair and equitable basis.
g. Minimum Transaction Sizes

i. Special Considerations With Varying Account Sizes

- Reduce minimum transaction size to allow pro rata processing.

- Minimum transaction size an operational and customer concern: multiplicity of transactions and confirmations.

- Disparate, varying sizes of accounts in block trades may prevent pro rata processing.

- May desire to raise minimum account size to avoid smaller accounts never receiving pro rata allocation.
20. Trading (cont.)

j. Disclosure

m. Errors

- Disclose material information on trading practices: potential varying results, conflicts of interest, mitigation and similar matters

- Errors back to responsible party, not client accounts.
Closing Thoughts
Jane Stafford, JD, General Counsel, Regulatory Compliance Association

Ms. Stafford serves as General Counsel to the Regulatory Compliance Association, Inc (RCA). As an international non-profit, the RCA supports a community of over 78,000 alternative investment, asset management and financial institution executives as well as regulators, while serving as the accreditation agency for Continuing Compliance Education™ (CCE™).

At De Morgan Global, Ms. Stafford comprises part of the firm’s leadership team. As a 30 year industry veteran, Ms. Stafford has served in senior level roles within investments advisers, funds and other members of the asset management industry. Ms. Stafford brings a unique perspective to a compliance engagement, as she maintained an active plaintiffs’ practice for over 25 years. Some have remarked: “When it comes to compliance, former regulators pale in comparison to Stafford.”

For three decades, Stafford has assisted firms with their registrations, compliance programs and reporting requirements, examination issues and enforcement representations. In working closely with the industry she understands the full gambit of regulatory issues and requirements, as well as the underlying operations, investment strategies and service deliveries.

De Morgan Global delivers compliance administration services to hedge funds, private equity firms, commodity trading advisers, commodity pool operations, registered investment advisers and other asset management firms.

De Morgan Global provides a full suite of compliance administration services including daily compliance support, registration, compliance policies and procedures, annual compliance review, marketing and advertising review, personal trading review, electronic communication review, quarterly compliance support services onsite, and regulatory filing support. Additionally, De Morgan offers out-sourced CCO and shadow CCO services.

She started Stafford Law Firm to focus on a securities practice after working in a number of large firms. The firm assists members of the asset management industry in their compliance efforts and enforcement actions. Based on referrals from the industry, the firm also maintains a plaintiff’s practice.

After graduating cum laude from Vanderbilt University with a degree in Economics, she received her JD from the Washington College of Law at American University, while being a member of Law Review and a Teacher’s Assistant. She frequently speaks for bar associations, trade associations and other entities.
James Jones, CFA, Founder/Portfolio Manager, Sterling Investment Advisors

James G. Jones, CFA, is the founder and Managing Member of Sterling Investment Advisors, LLC, a fee-based, private client investment management firm. With over 25 years of experience in wealth management, Jones has extensive experience in insurance, estate planning, tax planning, as well as the entire investment management process of defining investor goals, risk assessment, asset allocation, and ongoing review/adjustment.

Prior to founding Sterling Investment Advisors, LLC, Jones was a tenured Assistant Professor of Business Administration at Southwest Baptist University and the 1990 recipient of the Orien B. Hendrex Distinguished Teacher Award.

Jones has served on the CFA Institute Board of Governors since 2010, serving a term as Chair of the Planning Committee and a member of the 2014-15 CEO Search Committee. Jones was awarded the CFA Institute C. Stewart Sheppard Award in 2008 and the Donald Tuttle Excellence in Grading Award in 2010. Other CFA Institute activities include: member of the Council of Examiners (10 years, with a three-year term as Chairman), CFA exam grader (14 years), member of the 2006 Practice Analysis Task Force, and member of the 2007 Continuing Education Task Force.

Jones has a B.S. in Economics/Business Administration from Southwest Baptist University, and a M.B.A. from the University of Arkansas.
Mike Thorfinnson, CFA, CAO, TD Asset Management

Michael Thorfinnson is CAO of TD Asset Management, TDAM USA, and Epoch Investment Partners, and is President of TDAM's US Fund Company. He is responsible for various front and middle office groups in support of TDAM’s Mutual Fund and Institutional Investment Management businesses in Canada and the U.S., as well as Epoch Investment Partners in the U.S. Michael joined TD in 1991 to start TD’s Private Investment Counsel after five years working as a Financial Planner, and a Portfolio Manager at a major Canadian trust company. He was appointed TDAM’s Chief Operating Officer in 1998, and served as CFO of the Wealth Management division from 2001 to 2002. In 2002, Michael championed TDAM's Risk Management strategy when he was appointed CRO, and in 2010 Michael was appointed Chief Administrative Officer. He continues today as TDAM's "acting" CRO.

Michael holds Masters and Honors degrees in Business from the Richard Ivey School of Business, and is a CFA charterholder. He is an active participant in the Buy Side Risk Managers (CRO) Forum, volunteers on a CFA Institute Global committee, and serves as a Board member for Young Life Canada. Michael and his wife Sylvia have two children and live in Oakville.