Ethical Framework and Best Practices in Professional Conduct

Securities and Exchange Commission of Sri Lanka

Ethical Framework and Best Practices in Professional Conduct

Individuals involved in conducting investment analysis, making investment recommendations, taking investment actions and/or engaging in any other investment profession activities ("**Practitioners**") should:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients and their employers.
- Place the integrity of the investment profession and the interests of their clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment in the course of their professional activities.
- Practice in a professional and ethical manner.
- Promote the integrity of the capital market.
- Maintain and improve their professional competence.
- Abide by the rules and regulatory framework relating to the capital market.

Best Practice I: Knowledge of and Compliance with the Law

Practitioners should understand and comply with all laws, rules and regulations governing their professional activities. The laws, rules and regulations referred to herein are those which may have been made by the government (Eg: laws made by Parliament or regulations made by the Minister) or by any regulatory organization (eg: regulations made by the SEC) or even those made by a self governing organization. (Eg: rules made by the CSE). These persons should also not participate or assist in any violations of such laws, rules and regulations.

In order to be in compliance with this obligation it is recommended that

1. There should be a systematic procedure by which employers keep their employees informed of changes in applicable laws, rules and regulations. Eg: All SEC and CSE Circulars should be filed systematically and made available to the staff for their review.
2. Compliance procedures should be reviewed periodically in order to ensure that they reflect the current law and provide adequate guidance to members of staff.

A. Independence and Objectivity

Practitioners must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. They should not accept any gifts or other consideration from clients or 3rd parties which could reasonably be expected to compromise their objectivity.

Independence and objectivity could be compromised where

(a) Companies give benefits to analysts to seek expanded or favourable research coverage;
(b) Issuers seeking additional promotion of IPO's;
(c) Brokers seeking additional commissions from Fund Managers;

Pressure in certain situations may come from within the Practitioner's employer/company. Eg: to issue favourable research reports for clients, to recommend securities on IPO's which are being underwritten or managed by the employer etc.

It is recommended that the following procedures be put in place

(a) the creation of a restricted list where the Company would not issue research recommendations or recommend investment action in situations where independence may be compromised;
(b) limit gifts and reimbursement of expense arrangements;

Application of the Best Practice

Example 1. Mr. Perera who is employed at ABC Ltd gives investment advice to clients on the purchase of securities. His compensation is closely linked to the volume of transactions carried out. ABC Ltd has a large portfolio of Mars Ltd shares which it has obtained pursuant to an underwriting. Sales people have asked Mr Perera to recommend the Mars shares to his clients.

> *Comment:* Mr. Perera should not recommend Mars Ltd shares unless he can independently justify the purchase for his clients. If he recommends shares without being able to independently justify his recommendation, Mr. Perera has violated Best Practice I (A).

Example 2. Mr. Silva who is employed at the GB Unit Trust Company directs a large amount of the Unit Trust transactions to Bingo Ltd a stock broker. In appreciation of his services the stock broking company gives Mr Silva 2 business class tickets to London and tickets to watch all the Sri Lankan matches at the T 20 World Cup. Mr Silva does not disclose this to his employer.

> *Comment:* Mr. Silva may be in violation of his duty of independence and objectivity since the gift which he has received seems to be unusually large and could be reasonable expected to impair his judgment with regard to selection of brokers for the Unit Trust. Mr. Silva has violated Best Practice I (A).

B. Misrepresentation

Market Intermediaries and their employees and agents should not knowingly make any misrepresentations with regard to investment analysis, investment recommendations, investment actions or other professional activities. Misrepresentation involves untrue statements of fact or the omissions of fact or any other statement that is otherwise false or misleading. The false statements could be in oral or written communications or in advertisements or presentations or in electronic communications.

There should be no misrepresentation of the services which could be performed on behalf of the client. Furthermore there should be no guarantees on investment performance where returns are not guaranteed.

C. Misconduct

Practitioners must not engage in any professional conduct involving dishonesty, fraud or deceit or commit any act that reflects adversely on their professional reputation, integrity or competence. This covers the professional integrity, good reputation and competence of the practitioners. The conduct need not necessarily be illegal. Eg: if a Practitioner is habitually drunk after the lunch break it would affect his ability to discharge his professional responsibilities and would therefore be a violation.

Application of the Best Practice

Example 1. Mr Perera a Practitioner is entitled to a reimbursement from his employer of his petrol expenses on a monthly basis. He purchases his petrol requirements from a particular shed and has an arrangement whereby he is issued petrol bills which are inflated which in turn are submitted to his employer for reimbursement.

> *Comment:* His action would be a violation of Best Practice I (C) since it involves fraud and dishonesty.

D. Insider Trading

Section 32 of the Securities and Exchange Commission Act No 36 of 1987 contains prohibitions on trading on the basis of unpublished price sensitive information. Such information relate to specific matters relating to the listed company which is not known to the public at large and which is likely to materially affect the price of those listed securities.

The detailed provisions relating to Insider Trading are contained in Section 32 – 34 of the said Act.

E. Market Manipulation

Practitioners must not engage in practices that distort prices or artificially inflate trading volume with intent to mislead market participants.

Regulation 12 and 13 of Gazette Extraordinary 1215/2 dated 18th December 2001 contains the specific rules relating to Market Manipulation.

Best Practice II: Duties to Clients

A. Loyalty, Prudence, and Care

Practitioners have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgement. Practitioners must act for the benefit of their clients and place their clients' interests before their employer's or their own interests. In relationships with clients, Practitioners must determine applicable fiduciary duty and must comply with such duty to persons and interests to whom it is owed.

Guidance:

Practitioners must exercise the same level of prudence, judgment, and care that they would apply in the management of their own interests under similar circumstances.

Prudence requires caution and discretion. The exercise of prudence by an investment professional requires that they must act with the care, skill, and diligence under the circumstances that a reasonable person acting in a like capacity and familiar with such matters would use.

Best Practice II (A) also requires practitioners to understand and adhere to any legally imposed fiduciary responsibility they assume with each client.

Fiduciary duties are often imposed by law or regulation when an individual or institution is charged with the duty of acting for the benefit of another party, such as managing of investment assets. The duty required in fiduciary relationships exceeds what is acceptable in many other business relationships because the fiduciary is in an enhanced position of trust.

The first step for practitioners in fulfilling their duty of loyalty to clients is to determine the identity of the "client" to whom the duty of loyalty is owed. In the context of an investment manager managing the personal assets of an individual, the client is easily identified. When the manager is responsible for the portfolios of pension plans or trusts, however, the client is not the person or entity who hires the manager but, rather, the beneficiaries of the plan or trust. The duty of loyalty is owed to the ultimate beneficiaries and not just the client.

Investment decisions may be judged in the context of the total portfolio rather than by individual investments within the portfolio. The practitioner's duty is satisfied with respect to a particular investment if they have thoroughly considered the investment's place in the overall portfolio.

Application of the Best Practice

Example 1. XYZ Bank serves as fund manager for the ABC Company's employee pension plan. ABC Company is the target of a hostile takeover attempt by DEF Ltd. In attempting to ward off DEF, ABC's managers persuade Gamini Perera, the investment manager at XYZ Bank, to purchase ABC shares from the market for the employee pension plan. ABC's officials indicate that such action would be viewed favourably received and would probably result in other accounts being placed with the bank. Although Gamini believes the stock to be overvalued and would not ordinarily buy it, he purchases the stock to support ABC's managers, to maintain the company's good favour, and to realize additional new business. The heavy share purchases cause's ABC's market price to rise to such a level that DEF Ltd withdraws its takeover bid.

> *Comment:* Best Practice II (A) requires that a practitioner, in evaluating a takeover bid, act prudently and solely in the interests of plan participants and beneficiaries. To meet this requirement, a practitioner must carefully evaluate the long-term prospects of the company against the short term prospects presented by the takeover offer and by the ability to invest elsewhere. In this instance, Gamini, acting on behalf of his employer, XYZ Bank, the trustee, clearly violated Best Practice II (A) by using the profit-sharing plan to perpetuate existing management at ABC, perhaps to the detriment of plan participants and ABC's shareholders, to benefit himself. Gamini's responsibilities to the plan participants and beneficiaries must take precedence over any ties to corporate managers and self-interest. A duty exists to examine such a takeover offer on its own merits and to make an independent decision.
>
> The guiding principle is the appropriateness of the investment decision to the pension plan, not whether the decision benefits Gamini or the company that hired him.

Example 2. JNI, a successful investment management firm, serves as investment manager for pension funds of several large, companies. Its trading activities generate a significant amount of brokerage for the broking firms. JNI uses the brokerage and research services of many broking firms, but most of its trading activity is handled through a large brokerage company, HSD Securities Ltd, principally because of close personal relationships between the executives of the two firms. HSD's brokerage structure is high in comparison with charges for similar brokerage services from other firms. JNI considers HSD's research services and execution capabilities average. In exchange for JNI directing its brokerage to HSD, HSD absorbs a number of JNI overhead expenses, including those for rent.

> *Comment***:** JNI executives breached their fiduciary duty by using client brokerage for services that do not benefit JNI clients and by not obtaining best price and execution for

their clients. Because JNI executives failed to uphold their duty of loyalty, they violated Best Practice II (A).

Example 3. Amali Dias is an Investment Advisor at MSP Fund Management. Amali's supervisor is responsible for reviewing transactions carried out for client's handled by Amali and Amali's monthly reports of her personal stock transactions. Amali has been using KLM Securities, a broker, almost exclusively when making transactions for the clients as well as her own. KLM has always given Amali a lower price for personal purchases and a higher price for sales than they have obtained for Amali's client's accounts and other investors.

Comment: Amali is violating her duty of loyalty to the MSP's clients by using KLM for brokerage transactions simply because KLM trades Amali's personal account on favourable terms.

B. Fair Dealing.

Practitioners must deal fairly and objectively with all clients.

Guidance

When a practitioner has multiple clients, the potential exists for the practitioner to favour one client over another. This favouritism may take various forms, from the quality and timing of services provided to the allocation of investment opportunities. The term "fairly" implies that the practitioner must take care not to discriminate against any clients when disseminating investment recommendations or taking investment action.

Best Practice II(B) does not state "equally" because practitioners could not possibly reach all clients at exactly the same time—whether by mail, telephone, computer, facsimile, or wire. Each client has unique needs, investment criteria, and investment objectives so that not all investment opportunities are suitable for all clients. In addition, practitioners may provide more personal, specialized, or in-depth service to clients willing to pay for premium services which are formally through higher management fees or higher levels of brokerage. Practitioners can differentiate their services to clients, but different levels of service must not disadvantage or negatively affect clients.

Application of the Best Practice

Example 1. Kishani Amarasinghe, the chief investment officer of MSP Investments, a medium-sized money management firm, has been trying to retain a difficult client, ABC Company. Management at the disgruntled client, which accounts for almost half of MSP's revenues, recently told Kishani that if the performance of its account did not improve, it would find a new money manager. Shortly after this threat, Kishani purchases corporate bonds for several accounts, including ABC's. Kishani is busy with a number of transactions that day, so she fails to allocate the trades to the respective client's immediately. A few days later, when Kishani is allocating trades, she notes that some of the corporate bonds she purchased have significantly increased in price and some have dropped. Kishani decides to allocate the profitable trades to ABC and spread the losing trades among several other MSP accounts.

Comment: Kishani violated Best Practice II (B) by failing to deal fairly with her clients in taking these investment actions. Kishani should have allocated the trades prior to executing the orders, or she should have had a systematic approach to allocating the trades, such as pro rata, as soon after they were executed as practicable.

C. Suitability.

When practitioners are in an advisory relationship with a client, they should make a reasonable inquiry into a client's or prospective clients' circumstances and investment experience prior to making any investment recommendation or taking investment action.

Guidance:

Example 1. Amali Dias, an investment advisor, has two clients: Ajith Perera, 60 years old, and Kavinda Gunatileka, 40 years old. Both clients earn roughly the same salary, but Ajith has a much higher risk tolerance because he has a large asset base. Ajith is willing to invest part of his assets very aggressively; Kavinda wants only to achieve a steady rate of return with low volatility to pay for his children's education. Amali recommends investing 20 percent of both portfolios in very low yielding small-cap companies.

Comment: In Ajith's case, the investment may be appropriate given his financial circumstances and aggressive investment position but, this investment would not be suitable for Kavinda. Amali would violate Best Practice II(C) by applying Ajith's investment strategy to Kavinda because Kavinda's financial circumstances and objectives are different.

D. Preservation of Confidentiality.

Practitioners must keep information about current, former, and prospective clients confidential unless:

- The information concerns illegal activities on the part of the client or prospective client.
- Disclosure is required by law, or
- The clients or prospective clients permit disclosure of the information.

Guidance:

As a general matter, practitioners should comply with applicable law. If applicable law requires disclosure of client information in certain circumstances, practitioners must comply with the law. Similarly, if applicable law requires practitioners to maintain confidentiality, even if the information concerns illegal activities on the part of the client, practitioners should not disclose such information. When in doubt, practitioners should consult with their employer's compliance personnel or outside counsel before disclosing confidential information about clients.

This Best Practice protects the confidentiality of client information even if the person or entity is no longer a client of the practitioner. Therefore, practitioners should continue to maintain the confidentiality of client records even after the client relationship has ended. However, if a client or former client expressly authorizes the practitioner to disclose information, the practitioner may follow the terms of the authorization and provide the information

Application of the Best Practice

Example 1. Kishani Amarasinghe is an investment officer at the MSP Trust Company. She has an advisory customer who has talked to her about giving approximately Rs 50,000 to charity to reduce her income taxes. Kishani is also treasurer of the Home for Widows (HW), which is planning its annual donation giving campaign. HW hopes to expand its list of prospective donors, particularly those capable of substantial gifts. Kishani recommends that HW's vice president for corporate gifts call on her customer and ask for a donation in the Rs 50,000 range.

> *Comment:* Even though the attempt to help the Home for Widows was well intended, Kishani violated Best Practice II (D) by revealing confidential information about her client.

Best Practice III: Duties to Employers

A. Loyalty

In matters related to their employment Practitioners should act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer

Guidance

Best Practice III (A) requires practitioners to protect the interests of their firm by refraining from any conduct that would injure the firm, deprive it of profit, or deprive it of the advantage of the practitioner's skills and ability.

Independent Practice

Practitioners should abstain from independent competitive activity that could conflict with the interests of their employer.

Practitioners who plan to engage in independent practice for compensation must provide notification to their employer describing the types of service the practitioners will render to prospective independent clients, the expected duration of the services, and the compensation for the services. Practitioners should not render services until receiving consent from their employer to all of the terms of the arrangement.

"Practice" means any service that the employer currently makes available for remuneration. "Undertaking independent practice" means engaging in competitive business, as opposed to making preparations to begin such practice.

Leaving an Employer

When practitioners plan to leave their current employer, they must continue to act in the employer's best interest, and must not engage in any activities that would conflict with this duty until their resignation becomes effective. Activities that might constitute a violation, especially in combination, include the following:

- Misappropriation of trade secrets,
- Misuse of confidential information,
- Solicitation of employer's clients prior to cessation of employment,
- Self-dealing (appropriating for one's own property a business opportunity or information belonging to one's employer),

• Misappropriation of clients or client lists.

A departing employee is generally free to make arrangements or preparations to go into a competitive business before terminating the relationship with his or her employer provided that such preparations do not breach the employee's duty of loyalty. Once an employee has left the firm, the skills and experience that an employee obtains while employed are not "confidential" or "privileged" information.

Simple knowledge of the names and existence of former clients is generally not confidential information unless deemed such by an agreement or by law. However, firm records or work performed on behalf of the firm stored on a home computer for the practitioner's convenience while employed should be erased or returned to the employer unless the firm gives permission to keep those records after employment ends.

Practitioners are free to use public information about their former firm after leaving to contact former clients. However, employers sometimes require employees to sign "non-compete" agreements that preclude a departing employee from engaging in certain conduct. Practitioners should take care to review the terms of any such agreements when leaving their employer to determine what, if any, conduct those agreements may prohibit.

Whistle blowing

A practitioner's personal interests, as well as the interests of his or her employer, are secondary to protecting the integrity of capital markets and the interests of the clients. Therefore, in certain circumstances, it may be justified for practitioners to act contrary to their employer interests. Such action would be permitted only if the intent is clearly aimed at protecting clients or the integrity of the market and not for personal gain.

Application of the Best Practice

Example 1. Bimal Bandara is a broker at Johnson Securities Pvt Ltd., but has become frustrated with the working environment and has been offered a position with Donald Securities Pvt Ltd. Before resigning from Johnson Securities, Bimal asks four big accounts to leave that firm and open accounts with Donald Securities. Bimal also persuades several prospective clients to open accounts with Donald Securities. Bimal had previously made presentations to these prospects on behalf of Johnson Securities.

> *Comment:* Bimal violated the employee–employer principle requiring him to act solely for his employer's benefit. Bimal's duty is to Johnson Securities as long as he is employed there. The solicitation of Johnson Securities' current clients and prospective clients is unethical and violates Best Practice III (A).

Example 2. Malik Ahamed has hired Ruben Silva who previously worked for a competing firm. Ruben left his former firm after 18 years of employment. When Ruben begins working for Malik Ahamed, he wants to contact his former clients because he knows them well and is certain that many will follow him to his new employer. Is Ruben in violation of the Best Practice III (A) if he contacts his former clients?

Comment: Because client records are the property of the firm, contacting former clients for any reason through the use of client lists or other information taken from a former employer without permission would be a violation of Best Practice III (A). In addition, the nature and extent of the contact with former clients may be governed by the terms of any non-compete agreement signed by the employee and the former employer that covers contact with former clients after employment.

But, simple knowledge of the names and existence of former clients is not confidential information, just as skills or experience that an employee obtains while employed is not "confidential" or "privileged" information. The Best Practices do not impose a prohibition on the use of experience or knowledge gained at one employer from being used at another employer. The Best Practices also do not prohibit former employees from contacting clients of their previous firm, in the absence of a non-compete agreement. Practitioners are free to use public information about their former firm after departing to contact former clients without violating Best Practice III (A).

In the absence of a non-compete agreement, as long as Ruben maintains his duty of loyalty to his employer before joining Malik Ahamed's firm, does not take steps to solicit clients until he has left his former firm, and does not make use of material from his former employer without its permission after he has left, he would not be in violation of the Best Practices.

B. Additional Compensation Arrangements

Practitioners must not accept gifts, benefits, compensation, or consideration that competes with, or might reasonably be expected to create a conflict of interest with, their employer's interest unless they obtain written consent from all parties involved.

Guidance

Best Practice III (B) requires practitioners to obtain permission from their employer before accepting compensation or other benefits from third parties for the services rendered to the employer or for any services that might create a conflict of interest with their employer's interest. Compensation and benefits include direct compensation by the client and any indirect compensation or other benefits received from third parties. "Written Consent" includes any form of communication that can be documented (for example, communication via computer e-mail that can be retrieved and documented).

Practitioners must obtain permission for additional compensation/ benefits because such arrangements may affect loyalties and objectivity and create potential conflicts of interest. Disclosure allows an employer to consider the outside arrangements when evaluating the actions and motivations of practitioners. Moreover, the employer is entitled to have full knowledge of compensation/benefit arrangements to assess the true cost of the services practitioners are providing.

Example 1. Jeff Fernando, a portfolio analyst for A Trust Company, manages the account of Carol Vajira, a client. Fernando is paid a salary by his employer, and Vajira pays the trust company a standard fee based on the market value of assets in her portfolio. Vajira proposes to Fernando that "any year that my portfolio achieves at least a 15 percent return before taxes, you and your wife can fly to Singapore at my expense and use my condominium during the third week of January." Fernando does not inform his employer of the arrangement and vacations in Singapore the following January as Vajira's guest.

> *Comment:* Fernando violated Best Practice III (B) by failing to inform his employer in writing of this supplemental, contingent compensation arrangement. The nature of the arrangement could have resulted in partiality to Vajira's account, which could have detracted from Fernando's performance with respect to other accounts he handles for A Trust. Fernando must obtain the consent of his employer to accept such a supplemental benefit.

Example 2. Terry Jones sits on the board of directors of Exercise Unlimited, Inc. In return for his services on the board, Jones receives unlimited membership privileges for his family at all Exercise Unlimited facilities. Jones purchases Exercise Unlimited stock for the client accounts for which it is appropriate. Jones does not disclose this arrangement to his employer, as he does not receive monetary compensation for his services to the board.

> *Comment:* Jones violated Best Practice III (B) by failing to disclose to his employer benefits received in exchange for his services on the board of directors.

Best Practice IV: Investment Analysis, Recommendation and Action

This Best Practice only applies if a practitioner is acting in an advisory capacity. It does not apply if a practitioner is acting purely in a transactional and executing capacity.

A. Diligence and Reasonable Basis

1. Exercise diligence, independence and thoroughness in analyzing investments, making investment recommendations and taking investment actions
2. Have a reasonable and adequate basis, supported by appropriate research and investigation for any investment analysis, recommendation and action

Guidance

The application of this Best Practice is dependent on the investment philosophy followed, the role of the practitioner in the investment decision making process and the support and resources provided by the practitioner's employer. These factors will dictate the nature of the diligence, thoroughness of the research and level of investigation required.

Examples of criteria that an individual can use in forming his or her opinion that research is sound include:

- Review of the assumptions used
- Rigor of analysis performed
- Date and Timeliness of the research
- Evaluation of the objectivity and independence of recommendation

Application of the Best Practice

Example 1. Brendan Soysa creates an Internet site with a chat room area to publish his stock recommendation. He views the site as a chance to attract new clients. In the chat room, he almost always writes positively about the technology stocks and recommends purchasing based on what the conventional wisdom of the markets has deemed the "hot securities of the day".

> *Comment:* Soysa's exuberance about technology and the conventional wisdom of the markets, without more information, do not constitute a reasonable and adequate basis, supported by appropriate research and investigation, on which to base recommendation. Therefore, Soysa has violated the Best Practice IV (A).

Example 2. Gamini Perera, a research analyst at ABC Securities puts out a research report in June 2009 with a sell recommendation on the hotel sector in Sri Lanka outlining a bleak outlook factoring in the protracted war, slowing economy and global recession leading to mounting losses. In June 2009 he uses the same research report to advise clients of the firm that they should sell their hotel stocks although there was a significant change in the landscape after the government announced an end to the war which would be very favourable for the hotel sector.

Comment: Perera is in clear violation of the Best Practice in terms of the timeliness of the research. There has been a significant development since he put out his report in January 2009, this report should have been updated and at the very least not be used to justify clients to sell their hotel stocks.

B. Communicating with Clients and Prospective Clients

1. Disclose to clients and prospective clients the investment process followed in analyzing investments, selecting securities and constructing portfolios.
2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendation or actions and include those factors in communications with clients and prospective clients.
3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

Guidance

Developing and maintaining clear, frequent and thorough communication practices is critical to providing high quality financial services to clients. When clients can understand the information communicated to them, they also can understand exactly how an individual in an advisory capacity is acting on their behalf, which gives clients the opportunity to make well-informed decisions regarding their investments. Such understanding can be accomplished only through clear communications.

A practitioner is required to include in their communication those key factors that are instrumental to the investment recommendation presented. A critical part of this requirement is to distinguish clearly between opinions and facts. A research report must outline the basic characteristics of the security being analyzed, which will allow the reader to evaluate the report and incorporate information the reader deems relevant to his or her investment decision making process.

If there are changes to a specified investment process all existing clients must be kept informed on an ongoing basis. Only by thoroughly understanding the nature of the investment product or service can a client determined whether the changes to that product or service could materially affect the client’s investment objectives.

Understanding the basic characteristics of the investment is of great importance in judging the suitability of each investment on a standalone basis, but it is especially important in determining the impact each investment will have on the characteristics of the portfolio. For example a stock's risk and return characteristics when viewed in isolation will be lot different when viewed in the context of a portfolio.

Communication is not confined to written reports but also in-person recommendation, telephone conversation, media broadcast or transmission by computer. Furthermore the nature of these communications are highly diverse from one word ("buy" or "sell") to in-depth reports of more than 100 pages. Brief communications must be supported by background reports or data that can be made available to interested parties on request.

A research report must include those elements important to the analysis and conclusions of the report so that the reader can follow and challenge the report's reasoning. A report writer who has done adequate investigations may emphasize certain areas, touch briefly on others, and omit certain aspects deemed unimportant.

Application of the Best Practice

Example 1. Richard Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment on the geological extent of the mineral reserves likely to be found on the company's land. Dox completed this calculation based on the core samples from the company's latest drilling. According to Dox's calculations, the company has in excess of 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommended a strong BUY."

> *Comment:* If Dox issues the report as written, he will violate the Best Practice IV (B). His calculation of the total gold reserves for the property is an opinion, no a fact. Opinion must be distinguished from fact in research reports.

Best Practice V: Conflict of Interest

A. Disclosure of Conflicts

Practitioners must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and their employer.

Practitioners must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

Guidance

Conflicts of interest often arise in the investment management profession. Conflicts can occur between the interests of clients, the interests of employers, and the practitioner's own personal interest. Managing these conflicts is a critical part of working in the investment industry and can take many forms. Best Practice is to avoid conflicts of interest when possible. When conflicts cannot be reasonably avoided, disclosure of their existence is necessary.

In the investment industry, a conflict, or the perception of a conflict, often cannot be avoided. The most obvious conflicts of interest, which should always be disclosed, are relationships between the practitioner or their firm and an issuer (such as a directorship or consultancy), investment banking, underwriting and relationships, broker/dealer market-making activities, and material beneficial ownership of stock. A practitioner must take reasonable steps to determine if a conflict of interest exists and disclose to clients any conflicts of the practitioner's firm when known. Disclosure of broker/dealer market-making activities alerts clients that a purchase or sale might be made from or to the firm's principal account and that the firm has a special interest in the price of the stock.

Practitioners must maintain their objectivity when rendering investment advice or taking investment action. Investment advice or actions may be perceived to be tainted in numerous situations. Can a practitioner remain objective if, on behalf of the firm, he/she obtains or assists in obtaining fees for services? Can he/she give objective advice if he or she owns stock in the company that is the subject of an investment recommendation or if the practitioner has close personal relationship with the company managers? Requiring practitioners to disclose all matters that reasonably could be expected to impair their objectivity allows clients and prospects to judge motives and possible biases for themselves.

The most prevalent conflict requiring disclosure under Best Practice V (A) is a practitioner's ownership of stock in companies that they recommend to clients and/or that clients hold.

Application of the Best Practice

Example 1. Hunter Weiss is a research analyst with Farmington Company, a broker and investment banking firm. Farmington's merger and acquisition department has represented Vimco, a conglomerate, in all of its acquisitions for 20 years. From time to time, Farmington officers sit on the boards of directors of various Vimco subsidiaries. Weiss is writing a research report on Vimco.

> *Comment.* Weiss must disclose in his research report Farmington's special relationship with Vimco. Broker/dealer management of and participation in public offerings must be disclosed in research reports. Because the position of underwriter to a company presents a special past and potential future relationship with a company that is the subject of investment advice, it threatens the independence and objectivity of the report and must be disclosed.

Example 2. Betty Roberts is speculating in low value stocks for her own account and purchases 100,000 shares of Drew Plantations Plc for 30 cents a share. She intends to sell these shares at the sign of any substantial upward price movement of the stock. A week later, her employer asks her to write a report on low value stocks in the plantation industry to be published in two weeks. Even without owning the Drew stock, Roberts would recommend it in her report as a "buy." A surge of the price of the stock to the Rs.2 range is likely to result once the report is issued.

> *Comment.* Although this holding may not be material, Roberts must disclose it in the report and to her employer before writing the report because the gain for her will be substantial if the market responds strongly to her recommendation. The fact that she has only recently purchased the stock adds to the appearance that she is not entirely objective.

Example 3. Gary Carter is a representative with Bengal International, a licensed broker/dealer. Carter is approached by a stock promoter for Badger Company, who offers to pay Carter additional compensation for sales to his clients of Badger Company's stock. Carter accepts the stock promoter's offer but does not disclose the arrangements to his clients or to his employer. Carter sells shares of the stock to his clients.

Comment. Carter has violated Best Practice V (A) by failing to disclose to clients that he as receiving additional compensation for recommending and selling Badger stock. Because he did not disclose the arrangement with Badger to his clients, the clients were unable to evaluate whether Carter's recommendations to buy Badger were affected by this arrangement. Carter's conduct also violated Best Practice V (A) by failing to disclose to his employer monetary compensation received in addition to the compensation and benefits conferred by his employer. Carter was required by Best Practice V (A) to disclose the arrangement with Badger to his employer so that his employer could evaluate whether the arrangement affected his objectivity and loyalty.

B. Priority of Transactions

Investment transactions for clients and employers must have priority over investment transactions in which a Practitioner is the beneficial owner.

Guidance

Best Practice V (B) reinforces the responsibility of practitioners to give the interests of their clients and employers priority over their personal financial interests. This Best Practice is designed to prevent any potential conflict of interest or the appearance of a conflict of interest with respect to personal transactions. Client interests have priority. Client transactions must take precedence over transactions made on behalf of the practitioner's firm or personal transactions.

Best Practice V (B) states that transactions for clients and employers must have priority over transactions in securities or other investments of which a practitioner is the beneficial owner so that such personal transactions do not adversely affect the interests of their clients or employers. For purposes of the Ethical Framework and Best Practice, a practitioner is a "beneficial owner" if he/she has a direct or indirect personal interest in the securities.

Conflicts between the client's interest and a practitioner's personal interest may occur. Although conflicts of interest exist, there is nothing inherently unethical about individual managers, advisors, or mutual fund employees making money from personal investments as long as (1) the client is not disadvantaged by the trade, (2) the practitioner does not benefit personally from trades undertaken for clients, and (3) the practitioner complies with applicable regulatory requirements.

Best Practice V (B) covers the activities of all practitioners who have knowledge of pending transactions that may be made on behalf of their clients or employers. Best Practice V (B) also applies to practitioners who have access to information during the normal preparation of research recommendations or who take investment actions. Practitioners should not convey such information to any person whose relationship to the practitioner makes him/her a beneficial owner of the person's securities. Practitioners must not convey this information to any other person if the information can be deemed material non-public information.

Practitioners may undertake transactions in accounts for which they are a beneficial owner only after their clients and employers have had adequate opportunity to act on the recommendation. Personal transactions include those made for the practitioner's own account, for family (including spouse, children, and other immediate family members) accounts, and for accounts in which the practitioner has a direct or indirect pecuniary interest, such as a trust or retirement account. Family accounts that are client accounts should be treated like any other firm account and should neither be given special treatment nor be disadvantaged because of an existing family relationship with the practitioner.

Application of the Best Practice

Example 1. A research analyst, Marlon Long, does not recommend purchase of a common stock for his employer's account because he wants to purchase the stock personally and does not want to wait until the recommendation is approved and the stock purchased by his employer.

> *Comment.* Long violated Best Practice V (B) by taking advantage of his knowledge of the stock's value before allowing his employer to benefit from that information.

Example 2. Carol Baker, the portfolio manager of an aggressive-growth mutual fund, maintains an account in her husband's name at several brokerage firms with which the fund and a number of Baker's other individual clients do a substantial amount of business. Whenever she identifies a share as a very attractive investment, she instructs the brokers to buy it for her husband's account before buying for the mutual fund.

> *Comment.* Baker must acquire shares for her mutual fund first and acquire them for her husband's account only after doing so. She also must disclose the trading for her husband's account to her employer because this activity creates a conflict between her personal interests and her employer's interests [Best Practice V (A)].

C. Referral Fees

Practitioners must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from, or paid to, others for the recommendation of products or services.

Guidance

Best Practice V (C) states the responsibility of practitioners to inform employer, clients, and prospective clients of any benefit received for referrals of customers and clients. Such disclosure will allow the client or employer to evaluate (1) any partiality shown in any recommendation of services and (2) the full cost of the services.

Appropriate disclosure means that practitioners must advise the client or prospective client, before entry into any formal agreement for services, of any benefit given or received for the recommendation of any services provided by them. In addition, the practitioner must disclose the nature of the consideration or benefit—for example, flat fee or percentage basis; one-time or continuing benefit; based on performance; benefit in the form of provision of research or other noncash benefit—together with the estimated rupee value. Consideration includes all fees, whether paid in cash, in gifts, or in kind.

Application of the Best Practice

Example 1. James Handley works for the Trust Department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust's brokerage and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department but does not disclose the arrangement within Central Trust to his clients.

> *Comment.* Handley has violated Best Practice V (C) by not disclosing the referral arrangement at Central Trust Bank to his clients. Best Practice does not distinguish between referral fees paid by a third party for referring clients to the third party and internal compensation arrangements paid within the firm to attract new business to a subsidiary. Practitioners must disclose all such referral fees. Therefore, Handley would be required to disclose, at the time of referral, any referral fee agreement in place between Central Trust Bank's departments. The disclosure should include the nature and the value of the benefit and should be made in writing.

Example 2. Katherine Roberts is a portfolio manager at Katama Investments, an advisory firm specializing in managing assets for high-net-worth individuals. Katama's trading desk uses a variety of brokerage houses to execute trades on behalf of its clients. Roberts asks the trading desk to direct a large portion of its commissions to Naushon, Inc., a small broker/dealer run by one of Robert's business school classmates. Katama's traders have found that Naushon is not very competitive on pricing, and although Naushon generates some research for its trading clients, Katama's other analysts have found most of Naushon's research not especially useful. Nevertheless, the traders do as Roberts asks, and in return for receiving a large portion of Katama's business, Naushon recommends the investment services of Roberts and Katama to its wealthiest clients. This arrangement is not disclosed to either Katama or the clients referred by Naushon.

> *Comment.* Roberts violated Best Practice V (C) by failing to inform her employer of the referral arrangement.