



Advancing Standards™

# Portfolio Management Association of Canada

## Employee Personal Trading Guidelines

### Introduction

The purpose of monitoring and restricting employee personal trading is to ensure that employees do not take advantage of their knowledge of confidential client trading information or their position with the Investment Counselling firm to unfairly profit through their personal trading activities. Directors, officers and portfolio managers owe a fiduciary duty to clients and in this position of trust, they must always place the best interests of the client ahead of their own personal interests and avoid any actual or perceived conflict of interest.

The guidelines below comprise a range of practices to be considered by member firms in establishing their employee personal trading policies. The guidelines were developed following a review of Canadian and US regulatory requirements, and the recommendations of the Investment Funds Institute of Canada, the Investment Company Institute, and the CFA Institute. They reflect common practices of PMAC members in dealing with employee personal trading. It should be recognized that some practices will be more suited to some members than others, depending on the size of the firm and the nature of its business, and may not be feasible or appropriate for all firms. Other compensating controls may be more effective in any particular situation.

### 1. Policy Framework

- Firms should have a clear written policy dealing with employee personal trading.
- The policy should designate an officer responsible for the policy, preferably the Chief Compliance Officer.
- The policy should be distributed to all affected employees.
- Larger firms should provide training and field support to explain the policy and answer questions.
- Firms should obtain annual acknowledgements from affected employees confirming that they have read and understood the policy and agree to comply with it.

### 2. Application of the Policy

- Affected Persons
  - The policy should apply to employees with access to information on proposed client trades or strategies. This is not limited to those with direct involvement in investment decision-making or access to computer systems containing the information, but also includes employees working with or in proximity to persons involved in decision-

making who would frequently have the opportunity to see written information or hear discussions relating to client trading or strategy.

- Directors and officers should be included if they have access to information as described above or are involved in the business of the firm on a day to day basis.

- Trading Accounts

- All brokerage or investment accounts for which the employee is named as a holder, or has a beneficial interest in or control over, including accounts of family members living in the same home, should be included. Any accounts in which the trading is influenced by the employee should also be included.
- Exceptions may be given for spousal or family member accounts where the employee certifies that he or she has no interest in the account and does not influence trading or investment strategy. Consideration may be given to obtaining details of these accounts or requiring the reporting, but not pre-clearance, of trades in family member accounts.

### 3. Employee Reporting Requirements

Employees should report their trades and holdings, and the details of their accounts to the firm through the following documentation:

- duplicate statements of account & trade confirmations, which should be sent directly from the broker to the firm's compliance officer. Alternatively, the firm may develop systems to receive and store the information electronically.
- an annual certification of their holdings & accounts
- timely disclosure of any new accounts opened

### 4. Personal Trading Restrictions

- Personal investments in limited offerings (private placements and new equity issues) should be prohibited where there is a possibility that employees will benefit from their position with the firm to obtain allocations for personal accounts that are not generally available to clients or public investors, particularly in hot IPOs.
- Pre-clearance of personal trades should be required to ensure that they do not conflict with client trading. Pre-clearance is not required of exempt securities, which should be clearly defined and would include government or money market securities, mutual funds and pools, and other securities if:
  - neither client nor personal trading affects the price of the securities and there is no limit on the availability of the securities such as index tracking trust units, or
  - the employee does not have control over the trading or influence the timing of the trading, such as a dividend reinvestment plan or some employee share purchase plans.

Other fixed income securities may be exempted from pre-clearance if due to the nature or size of the client trading, the same trading strategies and opportunities would not be available to employees in their personal accounts. Consideration should be given to

requiring pre-clearance of mutual funds and pools managed by the firm or an affiliate as it would enable the firm to review personal trades for market timing and late trading.

To ensure clarity for employees, securities that are exempt from pre-clearance should be listed in the policy. The following are examples of securities that may be considered for exemption from pre-clearance procedures:

- Securities of open-end mutual funds, segregated funds and pooled trust funds;
  - Securities issued or guaranteed by the Government of Canada, or the government of any province in Canada;
  - Securities issued or guaranteed by other Governments (i.e. United States, United Kingdom, Germany, Japan, France and Italy)
  - GICs, CD's and other deposits with financial institutions
  - Short-term debt securities maturing in less than 91 days from their date of issue;
  - All broadly based market Exchange Traded Funds ("ETF"), with the exception of ETFs that contain Holding Company Depository Receipts ("HOLDRs"), which are subject to pre-clearance
  - Investments with external discretionary money managers;
  - Physical commodities
  - Options, futures or other derivatives based on any broadly based market indices approved by the CCO
  - Purchased made as part of an automatic dividend reinvestment plan; stock purchase plan acquisitions and transactions resulting from a corporate action applicable to all similar security holders.
- Black-out periods and Alternative controls
    - Pre-trade blackout periods may be used to reduce opportunities for front-running. They require personal trades to be unwound if the trade occurs within a specified time period before a client trade is entered. But pre-trade black-out periods can be difficult to administer because the unwinding of trades is cumbersome. They can also be inappropriate where the firm is constantly trading in a large number of securities or where trading strategies are volatile, and employees are not able to reasonably avoid trading during the blackout period. In addition, potential front-running concerns may be addressed by other means including:
      - Requiring certification that the employee is not aware of any pending or contemplated client trades in the security at the time pre-clearance is requested
      - Maintaining a watch list of securities being analyzed or recommended for clients and prohibiting personal trading in those securities.
      - Post trade monitoring of all personal trades that occur in the same securities prior to client trades for evidence of front-running
    - A same day plus 1 day post-trade blackout period is generally recommended for all affected persons to prevent personal trades from conflicting with client trading. This prevents employees from obtaining pre-clearance on the same day or the day after a client account trades. Longer periods may be considered for portfolio managers depending on the size of the client trades they have authority for and the liquidity of the securities involved. It may also be appropriate to allow general exemptions from the black-out period for personal trades:

- in large cap stocks if it is highly unlikely that any of the firm's client trading or the personal trading could affect the market price.
  - that are so small that they would not reasonably be considered to conflict with client trading.
- *Qualitative periodic review of personal trading* as an alternative to black-out periods. This is best suited for smaller firms with a limited number of investment mandates where the compliance officer reviewing the personal trading is aware of all of the firm's investment strategies and performance. A periodic post trade review could be done of each personal trading account to look for signs of abuse of confidential information or disparities in performance between the employee's personal account and client accounts.

## 5. Exemptions

Exemptions may be allowed on a case-by-case basis by the designated officer if:

- the policy requirements would result in undue hardship to an employee, and
- the trade will not conflict with the interests of clients or be contrary to any other legal or ethical obligations of the firm or its employees.
- exemptions from the policy should be applied for in writing and the reasons for granting any exemption should be documented

## 6. Excess Trading

While frequent personal trading may not in and of itself raise issues under applicable laws and regulations, a very high volume of personal trading can be time consuming and it can increase the risk of actual conflicts or mere appearance of conflicts with clients' portfolio transactions. Accordingly, firms should strongly discourage unusually high levels of personal trading activity. If possible, Compliance Officers should monitor excess trading of the firms' Access Persons and if a pattern of excessive trading is identified, Compliance Officers should be able to take appropriate action under their respective Codes.

## 7. Compliance Monitoring & Recordkeeping

The designated officer should ensure that processes are implemented for:

- Maintaining the following documents in employee files:
  - Trade confirmations & statements of account
  - An annual employee acknowledgement, including a list of accounts & holdings
  - All pre-clearances given to the employee
  - A record of the review and resolution of any non-complying trades
- Maintaining the confidentiality of all information received, and establishing and implementing a destruction schedule after a reasonable retention period
- Timely reconciliation of pre-clearance forms to account statements and trade confirmations

## **8. Non-Compliance**

When any employee discovers personal trading that is not in compliance with the policy, it should be reported immediately to the designated officer who must review the matter and consider actions to be taken. Generally a case-by-case determination will need to be made as to the seriousness of the situation and the appropriate action.

For failure to obtain pre-clearance the designated officer may consider:

- Whether the trade would have been approved if pre-clearance had been requested
- Whether the trade was in actual conflict with any client trades
- Whether there any history of non-complying personal trades by the employee

Other non-compliance may include making prohibited investments, maintaining undisclosed accounts, front-running of client orders, and market timing or late trading in mutual fund securities.

Sanctions for non-compliance may include:

- Issuing a warning or reprimand to the employee
- Requiring the employee to reverse the trade
- Requiring the disgorgement of any profit earned (the difference between the trade price obtained by the employee and any proximate client trade) and paying this amount to the client account if appropriate or making a donation of the amount to charity (with no tax deduction to the employee)
- Suspension or dismissal of the employee if a violation is serious or the employee has habitually violated the policy

In addition, it may be appropriate to alert regulators if the conduct is very serious and may have caused harm to clients, the markets or the public, or if the review indicates that there has been abuse that has taken place outside of the firm and the designated officer is unable to investigate further.

## **9. Benefits of Automating Code of Ethics Administration and Monitoring**

Employees' personal trading conduct represents one of major influences upon the reputation of any firm. For that reasons, firms would be prudent to automate as much as practicable their procedures for administration and monitoring of personal trading. Benefits of automating, for example, the pre-clearance of personal trades of a firm's Access Persons, could result in considerable reduction in risks of non-compliance with the firm's Code of Ethics. Merely having to go through the process of filing the pre-clearance form, waiting for its approval, and having system-driven restrictions in place that in essence foster a "buy-and-hold" trading strategy, often serves as a sufficient deterrent for frontrunning or day-trading.

Admittedly, third-party vendor designed systems for administration and monitoring of a firm's Code of Ethics can be very expensive and likely out of range for smaller firms. However, beside merely weighing costs versus minimized risks of non-compliance when making a business decision whether or not to pursue automated administration and monitoring of Access Persons' personal trading, we encourage firms to consider other venues, too, such as designing their own automated systems in-house with help of their IT departments.