



# ETHICS IN PRACTICE

ETHICS IN INVESTMENT MANAGEMENT CASEBOOK



CFA Institute



## ETHICS IN PRACTICE

This book is a collection of 100 Ethics in Practice cases originally published on-line by CFA Institute over the course of two years. Since October 2017, at the beginning of each week, CFA Institute published a short vignette on the CFA Institute Members App asking readers to use their ethical decision-making skills to review the facts and choose the best response to a multiple-choice question. At the end of the week, after readers had a chance to analyze the situation, choose a response, and post their response and reasoning, CFA Institute published the analysis providing an analysis of the case and the correct response. These cases are drawn from real-world circumstances, regulatory enforcement actions, CFA Institute Professional Conduct investigations, and facts submitted by CFA Institute members and volunteers.

This Ethics in Practice casebook is a great resource for continued professional learning (each case qualifies for 0.25 CE/SER credit) or for use in classroom discussions. It gives you an opportunity to "exercise" your ethical decision-making skills. Just as you need to practice to become proficient at playing a musical instrument, public speaking, or playing a sport, working through the scenarios in this book will allow you to develop your skill at assessing and analyzing investment-related situations and making ethical decisions. We encourage you to assess the cases through the lens of the CFA Institute Code of Ethics and Standards of Professional Conduct and to apply the CFA Institute Ethical Decision-Making Framework.

ETHICS IN PRACTICE  
Ethics in Investment Management Casebook

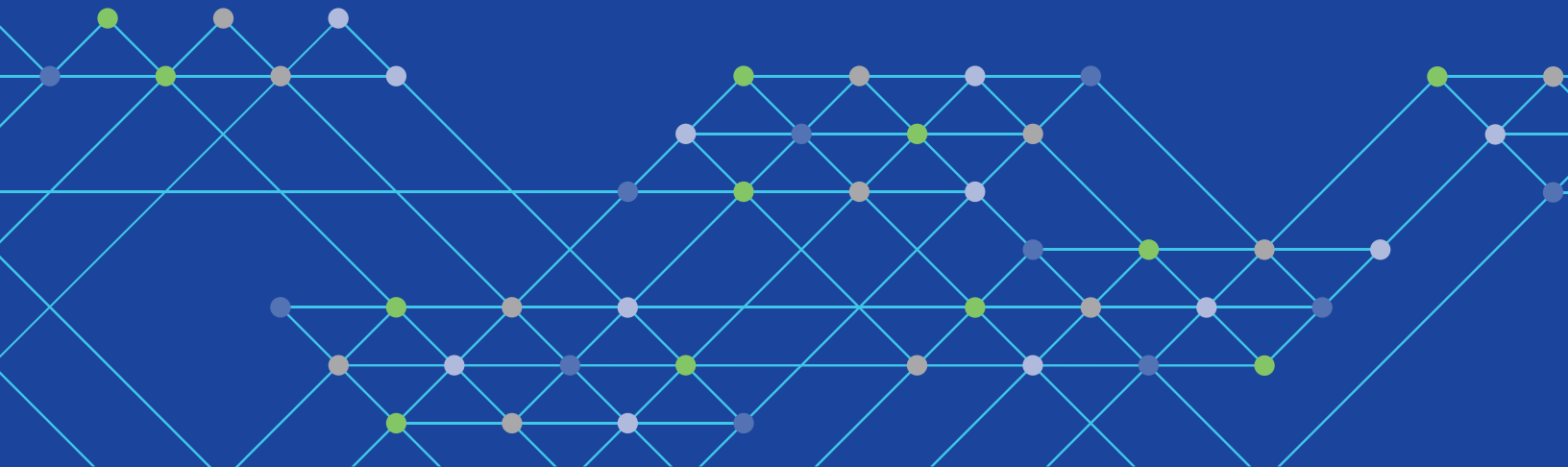
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# CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

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## PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

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## THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
  - Place the integrity of the investment profession and the interests of clients above their own personal interests.
  - Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
  - Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
  - Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
  - Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.
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## STANDARDS OF PROFESSIONAL CONDUCT

### I. PROFESSIONALISM

- A. Knowledge of the Law.** Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.
- B. Independence and Objectivity.** Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

- C. Misrepresentation.** Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.
- D. Misconduct.** Members and Candidates 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.

### II. INTEGRITY OF CAPITAL MARKETS

- A. Material Nonpublic Information.** Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.
- B. Market Manipulation.** Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

### III. DUTIES TO CLIENTS

**A. Loyalty, Prudence, and Care.** Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

**B. Fair Dealing.** Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

**C. Suitability.**

1. When Members and Candidates are in an advisory relationship with a client, they must:

- a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
- b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
- c. Judge the suitability of investments in the context of the client's total portfolio.

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

**D. Performance Presentation.** When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

**E. Preservation of Confidentiality.** Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

### IV. DUTIES TO EMPLOYERS

**A. Loyalty.** In matters related to their employment, Members and Candidates must 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.

**B. Additional Compensation Arrangements.** Members and Candidates 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.

**C. Responsibilities of Supervisors.** Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

### V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

**A. Diligence and Reasonable Basis.** Members and Candidates must:

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, or action.

**B. Communication with Clients and Prospective Clients.** Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

**C. Record Retention.** Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

### VI. CONFLICTS OF INTEREST

**A. Disclosure of Conflicts.** Members and Candidates 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 employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

**B. Priority of Transactions.** Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

**C. Referral Fees.** Members and Candidates 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.

### VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

**A. Conduct as Participants in CFA Institute Programs.** Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA Institute programs.

**B. Reference to CFA Institute, the CFA Designation, and the CFA Program.** When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

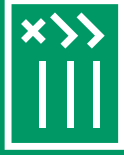
## IDENTIFY

- **ETHICAL PRINCIPLES:** Which fundamental investment profession principles are at issue?
- **DUTIES TO OTHERS:** To whom do you owe a duty?
- **IMPORTANT FACTS:** What facts or additional information do you need to make an informed decision?
- **CONFLICTS OF INTEREST:** Are there any incentives or relationships influencing your actions?



## CONSIDER

- **SITUATIONAL INFLUENCES:** Are outside pressures or internal biases affecting your decision making?
- **ALTERNATIVE ACTIONS:** Have you brainstormed multiple solutions and avoided a particular preconceived path?
- **ADDITIONAL GUIDANCE:** Have you sought the objective assessment of other parties to gain additional perspective?



# THE CFA INSTITUTE ETHICAL DECISION- MAKING FRAMEWORK



This framework provides a lens for situations where the answer is not simply 'right' or 'wrong'. Neither a linear model nor checklist, it presents four key elements of ethical decision-making.

## CONSIDER

## ACT

## REFLECT



## REFLECT

- **ON WHAT YOU'VE LEARNED:** Once you have taken action, take the time to review the path taken. The lessons learnt will make future ethical decision-making quicker.
- **ON STRENGTHS AND WEAKNESSES:** Regardless of positive or negative consequences, understand strengths and weaknesses for better future decisions.



## ACT

- **BY MAKING A DECISION:** The specific action varies depending on the situation. Some decisions may require multiple actions or none at all.
- **BY ELEVATING THE ISSUE TO A HIGHER AUTHORITY:** The best course of action may be to elevate your concerns to a more appropriate party.





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# BILLING AND FEES



# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 1

### CASE STUDY

Maalouf works in a branch office for a large wealth management firm. The firm's fees are based on a percentage of the value of the assets managed in each client account. The firm has a standard method for valuing assets and calculating fees for all of its clients, which is disclosed to each client at the outset of the relationship. Over time, the firm transitions to (1) using the market value of client assets at the end of the billing cycle instead of the average daily balance of the account; (2) including assets in the fee calculation, such as cash or cash equivalents, that were previously excluded; and (3) charging clients for a full billing period rather than prorating fees for clients that start or terminate accounts mid billing period. Maalouf

- A. cannot use end-of-cycle valuations, include cash equivalents, or charge full fees for a full billing cycle for partial cycle accounts.
- B. can change the valuation and fee calculation methodology as long as actual fees charged to clients are lower.
- C. must notify clients of the changes in the valuation and fee calculation methods.
- D. cannot change fundamental elements of the client relationship, such as valuation and fee calculation methodology, once it is disclosed to the client.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 1

#### ANALYSIS

This case involves Standard V(B): Communication with Clients and Prospective Clients, which requires CFA Institute members and candidates to disclose to clients the basic format and general principles of the investment process. Advisory fees are a critical part of the investment management process. Developing and maintaining clear, frequent, and thorough communication with clients allows them to make well-informed decisions about their investments, including about whether to engage or retain an investment adviser.

Any changes to the methods for valuing assets or calculating fees that are different from the process set out and agreed to by the client must be disclosed. It is improper to change fee calculation methodology without disclosure even if it results in lower fees. Using end-of-cycle valuations, including cash equivalents, or not pro-rating fees for newly acquired or terminated clients are possible methods for calculating fees as long as those policies are disclosed and agreed to by the client. It is also permissible to change valuation and methodology and fee calculation policies overtime for existing accounts. Maalouf and his firm can negotiate with their clients about changing the methods for calculating fees that were originally disclosed. So, the best answer is C, Maalouf must notify his clients of the changes in the valuation and fee calculation methods.

*This case is based on a US SEC Office of Compliance Inspections and Examinations Risk Alert.*

#### ABOUT CFA INSTITUTE

CFA Institute is a global not-for-profit organization and the world's largest association of investment professionals. We are dedicated to developing and promoting the highest standards of ethics, education, and professional excellence in the investment industry, for the ultimate benefit of society. Our goal is to create an environment where investors' interests come first, markets function at their best, and economies grow.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 2

### CASE STUDY

Corrales manages a hedge fund that seeks out investment opportunities in developing markets. Using assets of the fund's investors, the fund hires local companies to serve as "sub-advisers" to explore and obtain promising investment opportunities and navigate local laws and regulation. The sub-advisers often have very limited experience as financial consultants or advisers but do have close relationships and connections with local high-ranking government officials. The payments made by Corrales, through the sub-advisers, often cover substantial "deal fees" and other expenses that facilitate governmental support of each investment. Corrales does not require the local business partners to provide details of their activities or what specific expenses are covered by the fees. Corrales reports these expenditures to fund investors as operating expenses necessary to the success of the investment. Over several years, the hedge fund is very successful producing an 18% annual rate of return for its investors. Did Corrales actions violate the CFA Institute Code of Ethics and Standards of Professional Conduct?

- A. Yes.
- B. No because it is acceptable to hire sub-advisers and business consultants to assist in procuring investment opportunities and managing specialized assets.
- C. No because the payments to the sub-advisers represent legitimate expenses to ensure the success of investments and protect the interest of investors.
- D. No, as long as the sub-advisers provide more detail about the nature and purpose of the payments and this information is disclosed to the hedge fund investors.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 2

#### ANALYSIS

To better serve clients, investment professionals may choose to delegate to third parties work that requires particular specialization, knowledge, or expertise. For example, an investment adviser may hire sub-advisers to handle a particular strategy or investment style outside the scope of the adviser's ability or experience. A global adviser may hire a sub-adviser to manage an asset allocation invested in a particular market, and the payments to the sub-adviser would be legitimate investment expenses that could properly be passed on to investors in the fund.

But the facts of this case indicate that Corrales is not hiring a true sub-adviser but essentially paying locally connected officials to secure access to investment deals to ensure the success of the fund's investments. The "sub-advisers" have no financial experience but are close to the government officials, and the "deal fees" are not supported by any documentation that details legitimate investment expenses. The "operating expenses" charged by Corrales to the fund are most likely funding corrupt transactions and bribes through local intermediaries. This practice violates multiple standards:

- I(A): Knowledge of the Law because the conduct would violate any type of anti-bribery laws.
- I(C): Misrepresentation because he is improperly labeling the expenditures as investment fees.
- V(A): Diligence and Reasonable Basis because no reasonable and adequate basis for the "investment" action exists.
- V(C): Record Retention because no appropriate records are being kept to support the action.
- VII(A): Conduct as Participants in CFA Institute Programs because assuming Corrales is a charterholder, his conduct compromises the integrity to the CFA designation.

*This case is based on a US SEC enforcement action from 2017.*

#### ABOUT CFA INSTITUTE

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 3

### CASE STUDY

Braun and his firm are hired by a regional government to serve as its financial adviser for issuing general obligation bonds. The municipality conducts several bond offerings over a number of years for constructing a number of municipal facilities, including a maximum security detention facility and two school buildings. In connection with the bond issues, Braun makes a number of trips to New York City to meet with ratings agencies in connection with these offerings. The trips are typically planned for a Monday or Friday so Braun can obtain the cheapest travel costs. Braun's wife accompanies him on the trips and they typically spend the weekend either before or after the meetings in New York City to enjoy sporting events, theater performances, and museums. Braun often makes a number of flight and hotel changes after a trip is booked to accommodate meetings with other clients. Braun submits his trip expenses to his supervisor who deducts trip costs she believes are unrelated to the business purpose of the trip and submits the bills to the municipality for reimbursement. Which of the expenses below can most likely be billed to the client—for example, the government entity issuing the bonds?

- A. Braun's accommodation and meal expenses for the weekend days because the travel rates are cheaper over a weekend.
- B. Tickets to the sporting and theater events, as long as they do not exceed an amount for reasonable business entertainment.
- C. Flight and hotel change fees that result from the regular course of Braun's business activities.
- D. The travel and accommodation expenses for Braun's wife if he discloses to his supervisor that she is making the trips and receives written approval for her travel. .

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 3

#### ANALYSIS

This case relates to CFA Institute Standard III(A): Loyalty, Prudence, and Care, which states that members have a duty of loyalty to their clients, must act for their clients benefit, and must place client interests before their own interests. Under this standard, investment professionals, including municipal security dealers, must not engage in any deceptive, dishonest, or unfair practice when handling client accounts. Charging excessive or lavish expenses for the personal benefit of the investment professional at the expense of the client can constitute a deceptive, dishonest, or unfair practice that violates Standard III(A). All of the expenses incurred by Braun can, in some way, be considered personal or business-related expenses that should not be charged to the municipality seeking to issue the bonds.

In the context of conflicts of interests, the CFA Institute Code of Ethics and Standards of Professional Conduct allow members to accept or provide modest gifts and entertainment done in the ordinary course of business (a gift basket at the holidays from a vendor or to a client, for example). But that "ordinary course of business" does not allow investment professionals to charge clients for obviously extraneous entertainment expenses tangentially connected to a business meeting. Even if Braun notified and received permission from his employer for his spouse to accompany him on the business trip, that permission cannot extend to treating the client unfairly by charging the client for the spouse's expenses. And although busy investment professionals may be forced, by other priorities, to change travel arrangements when a trip on behalf of a client has already been scheduled, additional expenses resulting in the change most likely must be borne by Braun as an overhead cost, not charged to the client. (Under some limited circumstances, those expenses might be charged to the client necessitating that the travel changes be made).

It is possible that the savings in travel fees for booking a weekend travel schedule is greater than the additional accommodation and meal expense for Braun to stay in New York City the extra days, making the cost to the client lower. If this is the case, Braun would be meeting his duty of loyalty to the clients by choosing the most inexpensive travel schedule overall, thus limiting costs to the client. Under these circumstances, choice A describes the expenses most likely to be able to be billed to the client.

*This case is based on an enforcement action by the US Financial Industry Regulatory Authority.*

#### ABOUT CFA INSTITUTE

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 4

### CASE STUDY

O'Reilly is chief financial officer of Global Strategic Partners (GSP), a global investment adviser that merged with Holland Advisers, a smaller regional investment adviser. As a result of the merger, GSP becomes the adviser of record for several thousand Holland clients. For a period following the merger, GSP maintains Holland's legacy billing system for original Holland clients until those clients can be converted to GSP's billing system and platform. When the Holland billing system is converted, O'Reilly reviews the client billing information to ensure that it is correctly copied into the GSP billing system.

Unbeknownst to O'Reilly, Holland's billing system has a number of billing inaccuracies. For instance, Holland's billing system inadvertently causes client advisory fees to default to the highest available account fee when client accounts in one advisory program are transferred between branches. Also, Holland's billing system charges outside manager fees on assets that are held in money market accounts that do not use an outside manager. Finally, Holland's billing system does not reimburse advance-billed fees when clients terminate their accounts. Some of these fee billing errors resulted from coding or other systems errors, whereas others were caused by administrative errors, including the failure of Holland personnel to immediately input negotiated lower fee rates into the billing system. As chief financial officer of GSP, O'Reilly

- A. is not responsible for inadvertent billing system errors by Holland before the merger.
- B. fulfills his responsibilities by reviewing client billing information for Holland clients to ensure that it is correctly copied into the system.
- C. fails to meet his ethical responsibilities to his firm's advisory clients.
- D. acts appropriately as long as he remedies Holland's billing errors once the client accounts are converted to GSP's billing system and platform.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 4

#### ANALYSIS

This case relates to CFA Institute Standard III(A): Loyalty, Prudence, and Care, which states that CFA Institute members must act with reasonable care and prudent judgment when acting for the benefit of their clients. According to the facts, advisory clients of Holland Advisers are overcharged on their fees as a result of errors in the Holland billing system. After the merger, these investors become clients of GSP, and "for a period following the merger," GSP uses Holland's billing system. Although the errors may have been inadvertent and created by personnel of another entity at a time that predated O'Reilly's involvement, they carry over and become O'Reilly's responsibility once GSP uses the inaccurate billing system, even temporarily.

As chief financial officer, O'Reilly becomes responsible for the accuracy of the rates charged clients and the billing system used to collect client fees. Fixing the issues when the billing is converted to the GSP system does not account for the initial period of overbilling by GSP when using the Holland system. It is not enough for O'Reilly to ensure the accuracy of the information being transferred. He also should have confirmed that the fee information was accurate and consistent with the clients' advisory agreements. Otherwise, the billing anomalies have the potential to cause the incorrect fee rates to transfer into GSP's billing system. Choice C is the best answer.

*This case is based on a 2017 Enforcement Action by the US SEC.*

#### ABOUT CFA INSTITUTE

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 5

### CASE STUDY

Washington is a senior portfolio manager for Valley Forge Asset Management, a US registered investment adviser and broker/dealer. Valley Forge provides advisory services on a discretionary basis to approximately 2,000 separately managed retail and institutional accounts, focusing its investments on large-capitalization stocks and fixed-income securities. Valley Forge offers its advisory clients three choices for brokerage services, all of which are outlined in its investment advisory contract with clients: Affiliated Brokerage, Directed Brokerage, or Discretionary Brokerage.

Under an Affiliated Brokerage, clients can direct their brokerage to Valley Forge's own "full-service brokerage." Valley Forge discloses in the client agreement that this arrangement could be viewed as a conflict of interest, the firm would benefit monetarily, similar services by other brokers may be offered at lower prices, and clients should "carefully consider the services offered relative to the brokerage commission being paid." But Washington informs clients that they can negotiate a commission rate, and that the firm is willing to provide a discount of at least 70% off Valley Forge's "full commission rate." Around 1,200 clients choose Affiliated Brokerage, and 92% of these clients received the 70% discount.

The Directed Brokerage allows clients to designate a third-party broker/dealer to handle all aspects of the brokerage relationship. Under this option, the client negotiates the fees and/or commissions directly with the third-party broker/dealer. Of the nearly 840 clients who choose this option, approximately 690 clients choose Broker B, a broker referred by Washington. Under the Discretionary Brokerage, clients choose where their assets will be custodied and designate a "preferred broker," but Valley Forge has discretion to select the broker/dealer for each trade on a "best price and execution basis." Only about 24 clients choose this option.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 5

#### **CASE STUDY** (CONTINUED)

Washington does not disclose what services Valley Forge provides to its Affiliated Brokerage clients, and Valley Forge does not provide any services to its Affiliated Brokerage clients that are not also provided to clients who choose the other brokerage options. The brokerage costs under the Affiliated Brokerage are 4.5 times higher than those under the other two options, even with the 70% discount on Valley Forge's supposed retail brokerage rate. Nearly every trade is more expensive with the Affiliated Brokerage option because the minimum commission per trade is more than double the maximum commission charged for each trade under the other options. Washington's actions are

- A. acceptable because clients are free to choose which of the three brokerage options to use.
- B. acceptable because Washington significantly discounts brokerage fees for clients choosing the Affiliated Brokerage option.
- C. acceptable because the conflicts regarding the Affiliated Brokerage option are fully disclosed in the advisory agreement.
- D. unacceptable.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 5

#### ANALYSIS

Washington's statements regarding Valley Forge's brokerage options are misleading by giving the impression that clients will receive a high level of service at low cost. CFA Institute Standard I(C): Misrepresentation prohibits CFA Institute members from knowingly making any misrepresentations about their investment services. Washington states that Valley Forge's Affiliated Brokerage option provides full-service brokerage services, but the firm does not provide any services to Affiliated Brokerage clients that are not also provided to clients who chose one of the other brokerage options, which have significantly lower costs. And although clients can choose their brokerage option, because Washington does not disclose what services Valley Forge is providing to its Affiliated Brokerage clients, clients cannot effectively "consider the services offered relative to the brokerage commission being paid" as directed in the investment advisory contract. Nearly 92% of Valley Forge's Affiliated Brokerage clients receive the 70% discount on the full commission retail rate, but this discounted price is still significantly higher than other available options, rendering inaccurate Washington's suggestion that the pricing of the Affiliated Brokerage option works to clients' benefit.

Washington and Valley Forge have an obligation to disclose fully all material facts to advisory clients, including any conflicts of interest that could affect the advisory relationship. To meet this disclosure obligation, Washington and Valley Forge are required to provide advisory clients with sufficient information so they can understand and give informed consent to the conflicts or choose another course of action. Although the conflict of interest around the Affiliated Brokerage option is disclosed, Valley Forge's clients lack the information they need to truly evaluate these conflicts of interest and to make an informed decision regarding their brokerage options because of Washington's misleading statements. An adviser's duty of loyalty, prudence, and care to act in the client's best interest is implicated when the adviser explains and recommends brokerage arrangements to a client. That duty includes an obligation to not mislead clients regarding the services provided and their costs. Choice D is the best response.

*This case is based on a March 2019 Enforcement Action by the US Securities and Exchange Commission.*

#### ABOUT CFA INSTITUTE

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 6

### CASE STUDY

Murdoch is founder, president, and head portfolio manager of IOM Capital Management (IOM), an investment adviser providing investment advice to four affiliated hedge funds as well as separate client accounts. IOM accumulates and uses soft dollar credits primarily at a single broker/dealer through equity and options trading for the IOM funds and individual client accounts. IOM discloses allowable uses of soft dollars through its regulatory filings and offering memoranda for IOM funds. The disclosures provide that soft dollars may be used for "overhead expenses," including "office services, equipment, and supplies." IOM rents a portion of Murdoch's personal residence to conduct its business. IOM pays \$6,000 in rent to a company Murdoch owns, which, in turn, pays \$5,855 to a local bank to cover the monthly mortgage payment for the property. Eventually, IOM and Murdoch request that the broker use soft dollars to make the rental payment. Once the broker starts paying rent using soft dollars, Murdoch raises the rent first to \$10,000 per month and then to \$15,000 per month. Murdoch's actions are

- A. appropriate because rental payment on office space is an acceptable use of soft dollars.
- B. appropriate because IOM disclosed that it would use soft dollars for overhead expenses.
- C. appropriate because Murdoch may charge (and increase) rental rates for use of his property to the extent that the market will bear.
- D. inappropriate.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 6

#### ANALYSIS

This case relates to Standard III(A) Loyalty, Prudence, and Care and the use of soft dollar credits. Soft dollar credits arise from the client commission arrangement between an investment adviser and the broker/dealer that handles the trades for the adviser. Generally, a client's investment assets are used to pay additional commissions – called "soft dollar credits" – that the broker/dealer sets aside as payment for legitimate research and expenses of the adviser. CFA Institute members who pay higher brokerage commissions to receive soft dollar credits to purchase goods or services, without ensuring a corresponding benefit to the client, violate their duty of loyalty to the client under CFA Institute Standard III(A). In many regulatory regimes and under CFA Institute soft dollar standards, using soft dollars to make office rental payments would not be an acceptable use of soft dollars. Even assuming that such a practice was allowed, in this case, Murdoch and IOM disclose only that soft dollars will be used for "overhead expenses," but they do not provide that soft dollars would be used to pay rent. Therefore, the disclosure is incomplete and ineffective. Finally, it appears that the 150% increase in rent once soft dollars are used to make payments is simply an attempt to enrich Murdoch at the expense of his clients. A reasonable client or investor would not know that IOM uses its commissions to pay rent on a property that Murdoch also uses for personal purposes, that IOM pays inflated rent on that personal property, and that Murdoch could divert soft dollars for his personal use. Choice D is the best response.

*This case is based on a May 2019 US SEC Enforcement Action.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Billing and Fees – Case 7

### CASE STUDY

Slate Brothers Bank (SBS) serves as a custody bank for a wide range of clients, including many registered investment companies. SBS offers a variety of services to its custody clients, including custody, clearing, payment, settlement, and record-keeping functions. SBS charges custody clients an asset-based fee for these services. Pursuant to the bank's client agreement, custody clients also agree to reimburse the bank for out-of-pocket (OOP) expenses for items paid by the custodian on behalf of the investor. The bulk of these expenses are related to Society of Worldwide Interbank Financial Telecommunication (SWIFT) messages, a secured messaging network used by banks and other financial institutions.

Although SBS charges custody clients an established rate for SWIFT messages, the rate is greater than the actual cost of providing this service. Mandracken, a vice president at SBS who oversees client services' responsibilities for the custody clients, recognizes this discrepancy and brings it to the attention of his supervisor. In an email, Mandracken states that "although SWIFT resides in the OOP language of most client fee schedules, the fees have always include an increase over true costs so that the SWIFT fee is not a true pass-through to the client because we tack on a margin." Mandracken's supervisor directs him to reduce the SWIFT rate for new custody clients and to revisit the rate for existing custody clients during contract renegotiations. To be consistent with his obligations under the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards), Mandracken should

- A. comply with his duty of loyalty to his employer and implement the corrective procedures as directed by his supervisor.
- B. implement the corrective procedures as directed by his supervisor but report any objections to the bank's board of directors.
- C. refuse to participate in any interactions with clients utilizing the fee schedule until the bank revises the SWIFT rate charged to all custody clients to reflect actual OOP costs.
- D. report SBS's client billing practices to the bank's regulator.
- E. none of the above.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Billing and Fees – Case 7

#### ANALYSIS

This case involves how to appropriately and effectively address the misconduct of others in carrying out your professional responsibilities. CFA Institute Standard I(A): Knowledge of the Law prohibits CFA Institute members from knowingly participating or assisting in legal or ethical violations and requires them to dissociate from any such activity. In this case, because the SWIFT rate the bank charges to clients does not represent true OOP expenses, SBS is misrepresenting its reimbursable expenses to its custody clients, leading to significant overcharges. Mandracken recognizes this issue and brings it to the attention of his supervisor in an attempt to rectify the misconduct. His supervisor directs him to undertake corrective measures that are inadequate because they address the issue only for new clients going forward, do not immediately address the issue for current clients, and do not address the historical misrepresentation and overcharges to clients in the past.

Under the Code and Standards, Mandracken cannot continue to participate in or be associated with this misconduct. Inaction combined with continuing association with those involved in illegal or unethical conduct may be construed as participation or assistance in the illegal or unethical conduct. Ultimately, Mandracken may have to take drastic measures to dissociate from the activity and to protect client interests by leaving the bank or by reporting the misconduct to the bank's Board of Directors or regulators. Several interim steps should be considered, however, such as bringing the inadequacy of the proposed remedial action to the attention of his supervisor or the bank's compliance department to develop an effective method for addressing this misconduct. In any case, Mandracken cannot continue to interact with clients using a fraudulent fee schedule.

The actions stated in C represent the minimum level of conduct. Thus, choice C is the best response. Any additional actions potentially considered and set forth under choice E that would also address client reimbursement for the past misconduct would have to also include the measures listed in choice C.

*This case is based on a June 2019 US SEC Enforcement Action.*

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# CFA INSTITUTE



# CFA INSTITUTE

## ETHICS IN PRACTICE: CFA Institute – Case 1

### CASE STUDY

Ahmed recently earned his CFA designation and joined a medium-sized hedge fund as a senior analyst. His supervisor, Bennett, the founder of the firm, earned her CFA designation 10 years ago. But she has not paid her CFA Institute membership dues for the past four years and no longer participates in the organization's continuing education program. Bennett uses the CFA designation on her business card and on all the marketing materials for the fund. When Ahmed asks Bennett about her using the designation, Bennett tells him that since she passed the exam and earned the charter, the credential is similar to a degree from university that cannot be taken away. Later, during a marketing pitch by Ahmed and Bennett to a potential investor, the investor notes that he has narrowed down his manager search to firms that only employ CFA charterholders in senior positions. He asks Bennett if everyone in the firm on the investment side is a CFA charterholder. Bennett responds "Yes, that is correct." Ahmed does not respond. Did either Ahmed or Bennett violate the CFA Institute Standards of Professional Conduct?

- A. Ahmed violated the CFA Institute Standards of Professional Conduct.
- B. Ahmed did not violate the CFA Institute Standards of Professional Conduct.
- C. Bennett violated the CFA Institute Standards of Professional Conduct.
- D. Bennett did not violate the CFA Institute Standards of Professional Conduct.

## CFA INSTITUTE

### ETHICS IN PRACTICE: CFA Institute – Case 1

#### ANALYSIS

This case relates to CFA Institute Standard VII(B): Reference to CFA Institute, the CFA Designation, and the CFA Program, which states that when referring to the CFA designation, CFA Institute members and candidates "must not misrepresent ... holding the designation." The CFA designation is unlike a degree from university in that once granted the right to use the designation, individuals must also satisfy CFA Institute membership requirements (including paying dues) to maintain the right to refer to themselves as CFA charterholders. Although Bennett earned her charter, her membership is considered lapsed because she has not been paying dues to CFA Institute. Until her membership is reactivated, she must not present herself as a charterholder, and by continuing to use the CFA designation and representing herself as a charterholder to a potential client, Bennett has violated Standard VII(B).

Participation in the CFA Institute Continuing Education Program is not mandatory for maintaining your designation, but it is encouraged as a way to meet the CFA Institute Code of Ethics provision that calls for members to maintain and improve their professional competence. Ahmed hears Bennett refer to herself as a charterholder, but knows that Bennett's CFA Institute membership has lapsed. Standard I(A): Knowledge of the Law prohibits members from knowingly participating or assisting in the violations of others and requires members to dissociate from any unethical or illegal conduct. The issue for Ahmed is whether his acquiescence and silence in the face of Bennett's misrepresentation rises to the level of assisting or participating in Bennett's violation of the standard.

It could be argued that Ahmed's participation in a sales meeting in which he knows false information is given to a potential investor, and which could cause harm to that investor, constitutes assisting in the violations of those who provide that false information even if there is no active conduct by Ahmed. Best practice would be for Ahmed to address Bennett directly about her conduct and ask her to reinstate her membership or correct the statement made to the potential investor. If Bennett refuses to take corrective action, Ahmed could bring this conduct to the attention of the fund's compliance department for them to address and dissociate from the activity by not participating in any additional sales meetings with Bennett.

*This case was written by Tanuj Khosla, CFA, CAIA.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: CFA Institute – Case 2

### CASE STUDY

Taveras is a CFA® charterholder who leads an exam preparation course given by his local CFA® Society for candidates in the CFA® Program. The society hosts a celebration for the students after the exam is over. During the celebration, a number of Taveras's students describe their experience sitting for the exam. Most give their opinion about the relative difficulty of the exam given their expectations and some describe their surprise about areas of the curriculum that were not tested. Taveras asks his students their opinion on the most difficult questions on the exam. Taveras

- A. is free to pass along information about the exam to candidates in future prep classes to help prepare them for the exam.
- B. can provide the opinions of his students about the difficulty of the exam to candidates in future prep classes to emphasize the need to thoroughly prepare.
- C. can solicit information about the exam questions from students in an effort to improve the course for future prep classes.
- D. must not discuss the exam with students after it is over.

## CFA INSTITUTE

### ETHICS IN PRACTICE: CFA Institute – Case 2

#### ANALYSIS

This case relates to CFA Institute Standard VII(A): Conduct as Participants in CFA Institute Programs, which states that candidates must not engage in any conduct that compromises the integrity, validity, or security of CFA Institute Programs. It is natural and expected that a group of colleagues who have collectively gone through the rigorous process of studying for and taking the CFA® exam will want to celebrate the accomplishment and discuss the exam after it is over. Candidates can discuss their exam experience with Taveras in general terms. But they cannot provide specific information about the exam regarding the questions or the general areas tested.

And Taveras cannot pass along that information to future candidates and should not be soliciting information about specific questions or he would be in violation of the standard, which is designed to protect the integrity and security of future exams. The best answer is B because it is acceptable for Taveras to advise future prep classes that his previous students found the CFA exam to be more difficult than expected, so they should study the curriculum and prepare as much as possible.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: CFA Institute – Case 3

### CASE STUDY

Strong is a well-known host of a popular financial news program. Two days after the CFA® Exams are held in June, Strong makes a joking comment on her program: "Congratulations to all those who sat for the CFA Exams! I understand the portfolio management questions were amazing this year! Now that the test is over, you can have your life back!" Strong's actions are

- A. inappropriate because she shared confidential information about the CFA exam.
- B. appropriate because the exams are over, so the information is no longer confidential.
- C. appropriate because she is free to express her opinion about the exam questions.
- D. appropriate because the fact that the topic portfolio management is tested on the CFA exam is not confidential.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: CFA Institute – Case 3

#### ANALYSIS

This case relates to a CFA charterholder's responsibility to refrain from any conduct that compromises the integrity or security of CFA Institute Programs under CFA Institute Standard VII(A): Conduct as Participants in CFA Institute Programs. Providing confidential exam information to candidates or the public is a violation of this standard. CFA Institute considers information about past exams confidential until such time as the organization elects to release it publicly. This includes all aspects of the exam, including questions, broad topical areas, and formulas, either tested or not tested.

This confidentiality requirement allows CFA Institute to maintain the integrity and rigor of exams for future candidates. Expressing an opinion about the difficulty or quality of a particular topic area on an exam indirectly divulges the fact that that topic area was tested. In this case, Strong made comments about a broad topic area that was tested on the most recent exam. But CFA Institute publicly acknowledges that the general topic of portfolio management regularly makes up a certain percentage of the CFA Exam each year, so that information is not confidential. If Strong had mentioned that a particular topic in the area of portfolio management was on the test, her statement would have been problematic. Choice D is the best choice.

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# CLIENT ADVICE

# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Advice – Case 1

### CASE STUDY

Miriam works as an investment adviser for JVC Wealth Managers. JVC provides wealth management services to high-net-worth clients through discretionary, diversified, risk-adjusted investment management accounts that hold positions in both mutual funds and hedge funds. On average, Miriam has invested 74% of her clients' mutual fund assets and 63% of her clients' hedge fund assets in JVC proprietary funds, earning JVC and its affiliates additional fees. Miriam's actions are

- A. acceptable because clients hiring JVC as an investment manager should expect that the firm will prefer investing in its own funds.
- B. acceptable if Miriam indicates her preference for investing client assets in JVC proprietary funds.
- C. unacceptable if there are non-proprietary mutual funds and hedge funds that meet the clients' investment needs.
- D. unacceptable because the additional fees earned by JVC violate the duty of loyalty, prudence, and care that Miriam owes to her clients.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Advice – Case 1

#### ANALYSIS

This case involves a potential conflict of interest for Miriam between providing cost efficient investment vehicles for her clients and selling her employer's investment products. CFA Institute Standard VI(A): Disclosure of Conflicts states that CFA Institute members "must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity" or interfere with their duties to their clients. Best practice is to avoid conflicts of interest if possible, otherwise mitigate the conflict of interest through the disclosure called for in Standard VI(A). Although the additional fees earned by JVC from selling proprietary funds present a potential conflict, the fees do not automatically violate Miriam's fiduciary duty to her clients (Answer D).

It is possible that those proprietary funds are the best and most appropriate investment vehicles for Miriam's clients even with the additional fees. But because there is a potential conflict of interest, Miriam must clearly disclose those fees "such that the disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively" according to Standard VI(A). And although Answer C is based on the existence of alternative non-proprietary mutual funds, that response does not say that those funds are superior to JVC funds or have lower costs. Assuming that the clients understand that Miriam, who works for JVC, will sell JVC products at every opportunity, is not sufficient (Answer A). The best answer in this case is Answer B, which calls for Miriam to disclose the conflict. This disclosure should be made at the outset of the relationship and address what investment vehicles will be used by JVC along with their costs.

*This case is based on a 2015 SEC enforcement action.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Advice – Case 2

### CASE STUDY

Urquhart is a financial planner for AKC, which runs a large network of financial planners. AKC compensates its planners based on the number of sales of AKC products. Urquhart advises a husband and wife to roll their retirement funds, which combined are worth \$125,000, from one service provider into a single AKC investment fund that follows a large-cap equity strategy. Urquhart discloses to the couple that they will have to pay a penalty totaling \$30,000 for closing their accounts, but they will make up this loss with better investment returns from the AKC product. Urquhart's actions are

- A. acceptable if the AKC product is suitable for the couple.
- B. unacceptable because he is promising a specific rate of return.
- C. acceptable because he fully disclosed the negative consequences of closing their accounts.
- D. unacceptable unless the performance history of the AKC product supports his statement about future returns.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Advice – Case 2

#### ANALYSIS

This case involves CFA Institute Standard I(C): Misrepresentation, which states that CFA Institute members and candidates must not knowingly make any misrepresentation related to investment analysis, recommendations, or actions. This standard prohibits making any statements promising or guaranteeing a specific rate of return on volatile investments. Even if the AKC product is suitable for the couple, it is an equity-based investment that is inherently volatile. Urquhart cannot make promises about future returns, even if the historical performance return would have reached the performance goal. Although he fully discloses the negative consequences of transferring their assets to the AKC product, that disclosure does not mitigate the inappropriate statement about future expected returns. Therefore, the best answer is B. As an aside, this case also raises questions about whether advising the couple to take such a significant loss in their retirement savings would be in their best interest and whether Urquhart's independence and objectivity is compromised because he is influenced to make such a recommendation by the compensation scheme of his employer.

*This case is based on details coming out of a 2018 regulatory inquiry into the practices of financial services company AMP in Australia.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Advice – Case 3

### CASE STUDY

Reeves is the CEO and founding partner of Luxor Asset Management. Reeves provides asset management and allocation services for high-net-worth individuals and a number of small institutional clients. His services include investing client funds with third-party subadvisers who have a specialty in a particular asset class. Reeves' clients are aware of and approve Luxor's allocation of their assets to subadvisers. The third-party subadvisers make payments to Luxor based on the total amount of a client's assets placed or invested in certain subadviser funds. Reeves initially sought to negotiate a direct economic benefit for clients, but the subadvisers would not agree and payments were made directly to Luxor. Reeves' actions are

- A. appropriate because Reeves has disclosed the use of subadvisers.
- B. inappropriate unless Reeves discloses the financial arrangement with the subadvisers to his clients.
- C. appropriate if the clients receive the ultimate benefit of the subadviser payments in the form of discounted Luxor fees.
- D. inappropriate because the payments are an improper referral fee.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Advice – Case 3

#### ANALYSIS

This case relates to conflicts of interest between an advisor and clients. CFA Institute Standard VI(A): Disclosure of Conflicts requires CFA Institute members to make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their duties to their clients. The payments by subadvisers to Luxor based on the amount of client assets that Luxor places with the subadvisers create a potential conflict of interest because it incentivizes Reeves to hire those subadvisers that pay the fee to Luxor, but who may not necessarily be the best subadvisers for his clients. Reeves could mitigate the conflict by passing on any economic benefit received from the subadvisers to his clients.

Reeves initially attempted to negotiate a direct benefit for his clients, but his proposal was rejected by the subadvisers. And it is not clear from the facts that Reeves is ultimately passing the benefit on to his clients. Even if that were the case, Reeves should disclose the source and nature of the discount to clients. Reeves has disclosed Luxor's use of subadvisers, but it seems the financial incentive for Luxor has not been disclosed. Although referral arrangements may be acceptable with full disclosure to clients, Reeves is not referring clients to the subadvisers but hiring them directly on his clients' behalf. Choice B is the best answer.

*This case is based on a US SEC enforcement action from June 2018.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Advice – Case 4

### CASE STUDY

Duri is a registered account representative providing financial advice to retail clients. She is also principal partner of Tabak Accountants. Duri assists a number of advisory clients who want to move their retirement assets from existing superannuation accounts to establish self-managed superannuation funds (SMSFs) that have the goal of investing in direct residential property. When clients express interest in these types of SMSFs, Duri defers to their reasons for wanting to invest in direct property and presumes that they have the time and expertise to manage their superannuation affairs. She reclassifies their investment objectives as "growth" to match their new investment strategy. Duri charges her clients for establishing the SMSF and recommends that her firm, Tabak Accountants, prepare their annual accounts and tax returns. Duri's actions are

- A. acceptable because she is following the directives of her clients.
- B. acceptable if the SMSFs invested in direct residential property provide superior returns to her client's prior investments.
- C. acceptable if the services provided by Tabak Accountants are reasonable and the costs of services are competitive.
- D. unacceptable.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Advice – Case 4

#### ANALYSIS

This case relates to acting in the best interests of clients, specifically ensuring the suitability of their investments. CFA Institute Standard III(C): Suitability requires CFA Institute members in an advisory relationship to make a reasonable inquiry into a client's investment experience, risk and return objectives, and financial constraints to determine whether an investment is suitable to the client's financial situation and consistent with the client's objectives and mandates before taking investment action. In this case, it appears that when Duri's clients want to switch their retirement assets into an SMSF that invests in direct residential property, Duri defers to their reasoning without any apparent suitability analysis. The case facts do not indicate whether Duri does a number of things:

- Assesses the reasons for her clients interest in investing in direct property
- Considers her clients' financial goals
- Compares the benefits, risks, and costs associated with establishing an SMSF or owning rental property
- Considers asset diversification
- Determines whether clients intend to draw a pension from the SMSF once they reach retirement, and how they can achieve this with an illiquid asset, such as investment property
- Evaluates whether the clients have the time and expertise to manage their superannuation affairs
- Considers whether the SMSF investment strategy will remain viable if the clients' income is reduced or the property is unoccupied for a period of time

Without analyzing these and other factors, it would be inappropriate for Duri to move her clients to the SMSF, even if the investment provided a superior return. If her clients request a change in their investment strategy, it is Duri's responsibility as their investment adviser to conduct an analysis to ensure that the new direction is suitable and appropriate. It appears that Duri classified all clients as growth investors without undertaking an analysis of whether this classification was true to superficially justify their investment in an SMSF vehicle. With regard to the use of Duri's firm to provide client's accounting services for the SMSF investments, Standard III(A): Loyalty, Prudence, and Care requires members to act for the benefit of their clients and place their clients' interests before their own. It appears that Duri recommended these services to create additional income for herself. At a minimum, Duri's relationship with Tabak must be fully disclosed to clients as a potential conflict of interest. Choice D is the best response.

*This case is based on a February 2019 Enforcement Action by the Australia Securities and Investment Commission.*

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# CLIENT RELATIONSHIPS



## CFA INSTITUTE

# ETHICS IN PRACTICE: Client Relationships – Case 1

### CASE STUDY

Elizabeth is an investment manager at a wealth management firm with high-net-worth clients. When Elizabeth was hired a few years ago, her sister opened an investment account with the firm. Elizabeth has decided to leave the firm to set up her own boutique hedge fund with her colleagues. She asks her sister to close her existing account and put that money in the new hedge fund. Elizabeth's request is

- A. acceptable since she has no obligation to keep her sister's account at the wealth management firm.
- B. unacceptable because she should not solicit her employer's client to join the new fund.
- C. unacceptable if she signed a non-compete agreement with her employer.
- D. unacceptable if her hedge fund strategy is not suitable to her sister.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 1

#### ANALYSIS

The main ethical principle at issue in this case is Duty to Employer. CFA Institute Standard IV(A): Duty to Employers–Loyalty, states that CFA Institute members "must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities" and must not "cause harm to their employer." In this case, Elizabeth could potentially cause harm to her employer by causing her sister to move her assets away from the wealth management adviser. But this case also highlights a key element of the CFA Institute Ethical Decision-Making Framework—to identify relevant facts before choosing a course of action. Sometimes not all the relevant facts are known. Is Elizabeth still working for her employer when she asks her sister to leave the firm? The facts are not clear. If so, her actions are unacceptable because she would be causing harm to her employer (choice B). The fact that the client is a close relation is irrelevant, Elizabeth's sister is still a client of the firm.

If Elizabeth is no longer employed by the firm, soliciting former clients may not pose a problem. But if she has left, does Elizabeth have a non-compete agreement with her employer prohibiting her from soliciting clients of her employer? If so, she would be prohibited from soliciting clients, including her sister, to the new hedge fund. Choice D brings up the issue of suitability of investments. Even if Elizabeth has already left the firm and a non-compete agreement is not in force, she should only be soliciting clients for whom the investment is suitable under Standard III(C): Suitability, which states that members must "determine that an investment is suitable to the client's financial situation" before making a recommendation or taking action. Is the hedge fund a suitable investment for Elizabeth's sister? The question does not provide any clues. Even if the hedge fund is a suitable investment, Choice D still does not address the main issue of whether Elizabeth is harming her employer. There may be no "obligation" to keep her sister's investments at the wealth management firm (Choice A), but depending on the facts, it would be unethical for her to do so. Properly applying the Ethical Decision-Making Framework calls for identifying the relevant facts. All the choices could be correct, depending on facts that are not provided in the question. We need to know more.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Relationships – Case 2

### CASE STUDY

McDermott is president of Enhanced Investment Strategies (EIS), a small investment firm. Most clients of EIS are longtime associates of McDermott who have had their investment portfolios with EIS for decades. Because of his close personal relationship with his clients, McDermott is very familiar with their investment profile, income and retirement requirements, and tolerance for risk. He keeps abreast of the life changing events (such as health issues, real estate purchases, children's university expenses, and retirement) of all his clients and adjusts their portfolios accordingly. McDermott regularly meets with his clients in EIS offices and sees them on numerous occasions outside the office where he has a chance to give them an update on their investments. EIS clients complete a client agreement and risk profile when opening their account and those profiles are updated as McDermott finds the time to do so. McDermott's business practices are

- A. acceptable because he adjusts client investments to ensure that they are suitable for client investment needs given their changes income and risk profile.
- B. acceptable because he regularly communicates with clients about their investments.
- C. unacceptable because he does not keep adequate written records regarding client investment profiles.
- D. unacceptable because his close personal relationship with clients will affect his independence and objectivity when providing investment advice.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 2

#### ANALYSIS

The issue in this case involves record keeping. CFA Institute Standard V(C): Record Retention states that CFA Institute members must "develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients." The facts make clear that McDermott is personally close to clients. Although this fact may raise fair dealing concerns (McDermott may be benefiting some clients with whom he has a particularly close personal relationship over other clients), it does not necessarily raise questions about the independence and objectivity of McDermott's investment advice (Answer D).

It also appears from the facts provided that McDermott is fulfilling his ethical obligations as an investment manager by communicating regularly with his clients (Answer B) and reviewing and adjusting client portfolios on a timely basis to meet clients' changing financial circumstances (Answer A). But McDermott only updates client records "when he finds the time to do so" and apparently not promptly or on a regular basis. Without necessary, relevant, and up-to-date know your client information, it would be difficult, if challenged, for McDermott to establish and prove that EIS identified the needs and circumstances of the clients and has taken these into account in recommending investments. When client circumstances, investment goals, risk tolerances, or income needs change, records should be promptly updated and reviewed on a regular basis to reflect and document these changes. The correct answer is C.

*This case is based on an UK Financial Services Authority enforcement action from 2010.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Relationships – Case 3

### CASE STUDY

Korloff is a money manager for several clients. One of the clients, a pension fund, accounts for 35% of the assets under management at Korloff's firm. The fund pays more management fees to the firm than any other client. The executive director of the pension fund has made it clear that, because of this dominant position, she expects Korloff to give the pension fund "enhanced service" service in the form of advance information on investment recommendations, priority position for initial public offerings, supplemental research reports on potential investments, and daily personal contact. Korloff should

- A. refuse to comply with the request.
- B. comply with the request only if his preferential treatment does not disadvantage other clients.
- C. comply with the request because the fund is such a large and important client.
- D. comply with the request because the fund is paying for the preferential treatment with the higher fees.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 3

#### ANALYSIS

This case relates to Standard III(B): Fair Dealing, which states that CFA Institute members and candidates "must deal fairly and objective with all clients when providing investment analysis, making investment recommendations, and taking investment action." Treating clients "fairly" means not favoring one client over another or discriminating against clients when disseminating investment recommendations or actions. Differentiated service to clients, in the form of personal, specialized, or in-depth service to clients who are willing to pay for premium service, is acceptable under the standard. Fair dealing also dictates that recommendations be distributed in way that all clients for whom the investment is appropriate for have a fair opportunity to act on the recommendation. Korloff may provide preferential treatment (reflecting the amount and level of fees paid by the pension fund) in the form of supplemental research and daily contact to the pension fund without disadvantaging other clients.

But different levels of service cannot disadvantage or negatively affect other clients and should be disclosed and made available to all clients and potential clients. So, in this case, providing "enhanced service" to the pension fund is acceptable as long as the preferential treatment does not disadvantage other clients and it has been disclosed to them that they can also receive enhanced service along with the pension fund. Two aspects of the request – providing advanced recommendations to the fund and giving the fund priority position for initial public offerings – would disadvantage other clients by systematically benefiting the pension fund at the expense of other clients. With all of this in mind, choice B is the best response.

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Client Relationships – Case 4

### CASE STUDY

Soto is a founding partner and CEO of JPA, a large wealth management firm with offices throughout the world. The firm has many global institutional clients that include state-owned entities run by government officials. In an effort to build client relationships, Soto initiates a "Client Internship Program" that allows clients to refer candidates for internships at JPA. Referrals from this program are considered for employment outside of the firm's normal rigorous and competitive hiring process. The larger the JPA client, the more likely a referral from that client would be hired into a lucrative, career-building internship position. JPA hires more than 200 relatives and friends of the key executives of many JPA clients, including relatives and friends from many government agencies that JPA has investment banking or asset management relationships with. JPA generates more than \$100 billion in revenue from these investments and uses the connections generated with these clients to assist other clients and navigate complicated regulatory landscapes. Soto's actions in establishing the JPA "Client Internship Program" are

- A. appropriate because the internship program benefits clients.
- B. appropriate because the program is an incentive for clients that hire JPA, similar to discounted fees.
- C. appropriate because the program creates a mutually beneficial business relationship between JPA and its clients.
- D. a violation of the CFA Institute Code and Standards.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 4

#### ANALYSIS

This case related to CFA Institute Standard I(B): Independence and Objectivity, which states that CFA Institute members "must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise...another's independence and objectivity." JPA uses the internship opportunity to personally benefit the relatives and friends of certain key individuals, including government officials, with the intent to corruptly influence those decision-making officials and executives. So, response D is the correct choice because this practice is a violation of Standard I(B), and there are likely legal and regulatory provisions relating to anti-bribery, such as the US Foreign Corrupt Practices Act, that may be relevant depending on the legal regime(s) applicable to JPA.

Modest gifts and entertainment in the ordinary course of business may be acceptable in the context of promoting professional services. Similarly, firms may offer large or significant clients discounts or incentives commensurate with their position. But this does not extend to offering what amounts to bribes to individual executives or government officials to influence the hiring process or look favorably on investment transactions. In this case the benefits were not to JPA's investment clients but were personal to the individual decision makers.

*This case is based on a US SEC enforcement action from 2016.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Relationships – Case 5

### CASE STUDY

Kinner is an investment adviser with a number of elderly high-net-worth clients. One of her clients, Abbott, an 87-year-old globally well-known photographer, has been Kinner's client for more than 30 years. She visits Kinner's offices regularly to discuss her investment portfolio. Over the past several visits, Kinner has noticed that Abbott has increasing difficulty communicating and seems to be confused about concepts and ideas that she formerly was familiar with and able to understand. Abbott also appears significantly physically diminished. Lately, she has been accompanied by her grandson who describes himself as Abbott's caregiver.

During her most recent visit, Abbott asks Kinner to move a portion of her assets into some speculative investments and to withdraw a significant amount of funds so that she can invest in a bakery that her grandson is opening. Abbott assures Kinner that these are her wishes, stating, "I have talked about these changes with my grandson, and we are sure these are good investments." Kinner is alarmed by Abbott's new investment directives, believes Abbott's physical and mental health may be declining, and suspects Abbott has been improperly influenced by her grandson, who is taking advantage of Abbott's wealth. Kinner does not make the changes to Abbott's portfolio that Abbott requested. Instead, Kinner reports her concerns to a government agency charged with administering assistance to the elderly and infirm, as permitted by applicable law. Kinner's actions are

- A. inappropriate because Kinner should have contacted a close family member or trusted professional, such as Abbott's attorney or accountant, about her concerns regarding Abbott's apparent decline.
- B. appropriate because Kinner is working to protect Abbott's interests and is following applicable law.
- C. inappropriate because Kinner is violating her duty of confidentiality under the CFA Institute Standards of Professional Conduct by discussing Abbott's investments with the government agency.
- D. appropriate if Kinner speaks separately with Abbott's grandson in his role as Abbott's caregiver to advise against changing the investment directives.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 5

#### ANALYSIS

This case involves CFA Institute Standard III(E): Confidentiality, which requires CFA Institute members to keep information about clients confidential unless the information involves illegal activities, the client permits disclosure, or disclosure is required by law. This requirement can become problematic if an investment professional suspects that a client's mental faculties are failing and thus believes it is necessary to consult with outside parties. A best practice for investment advisers is to establish a secondary contact at the beginning of the client arrangement. The client provides permission for the investment professional to contact the designated person should concerns arise about the client's ability to make informed financial decisions.

In the absence of such an arrangement, investment professionals may make limited disclosures pertaining to the existence of a client account and concerns about the vulnerability of the client as directed by applicable law. Regulatory or government agencies often provide resources for intervening when such concerns arise. These entities have the authority to properly investigate the situation of the investor. CFA Institute members who are following applicable law regarding permitted disclosures are not in conflict with their obligations under Standard III(E). But speaking with other third parties, such as Abbott's attorney, accountant, or grandson, about confidential information in Abbott's account would violate Standard III(E). Choice B is the best answer.

*This case is based on new guidance on providing services to vulnerable clients under CFA Institute Standard of Professional Conduct III(E): Confidentiality, which was recently released by CFA Institute.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Relationships – Case 6

### CASE STUDY

After many years working for a large private equity (PE) firm in the United Kingdom, Adebayo, a CFA® charterholder, returns to his home country to take a position as CFO/CIO of his country's Sovereign Development Fund (SDF or the Fund). The Fund's goal is to benefit the local economy by financing local development projects that will generate high investment return to attract global investors as partners with the government through investment in the Fund. In that way, the capital deployed locally will have a leveraged impact on the economy and society. The Fund has a limited budget for professional staff, so Adebayo hires two junior analysts who have excellent professional credentials but who have not worked in the country.

Soon after taking the position, one of the country's regional governors (who is also the leader of the country's dominant opposition political party) strenuously advocates for the Fund to invest in a large mining project in an underpopulated and remote area of the country. The project will bring economic benefits to the governor's region. At the same time, the country's minister of finance, who hired Adebayo, is pushing for the Fund to invest in a large infrastructure project in an urban area that will create thousands of jobs for supporters of the political party currently in power.

In addition, former colleagues at the PE firm contact Adebayo and express interest in making a significant investment in the Fund. They ask to meet with Adebayo to get detailed information about the Fund's current and future investment. The PE firm seeks assurances that the Fund will continue to follow an aggressive strategy to maintain high returns. After the PE firm makes a large investment in the fund, they ask Adebayo to give them regular updates on the Fund's investment performance and financial health, on future government funding, and on the status of the Fund's projects.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 6

#### **CASE STUDY** (CONTINUED)

Choose one of Adebayo's actions from the below choices and describe how it implicates the ethical principles and requirements of the CFA Institute Code of Ethics and Standards of Professional Conduct.

- A. Making hiring decisions for the Fund's investment team.
- B. Investing Fund assets in the mining project as requested by the regional governor.
- C. Investing Fund assets in the infrastructure project as requested by the finance minister.
- D. Providing detailed information to former colleagues about the fund's current and future investments.
- E. Providing assurances to the private equity firm that the Fund will continue to maintain high investment returns through an aggressive growth strategy.
- F. Providing regular updates on the condition of the Fund to a large private investor.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 6

#### ANALYSIS

This case touches on several elements of the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards).

*Hiring Decisions.* The Code and Standards requires members to act with integrity and competence. Adebayo, himself an experienced CFA charterholder, seemingly meets this standard by hiring two junior analysts with excellent professional credentials to help manage the Fund. To be successful, the SDF personnel should have skills and expertise with global credibility consistent with building and maintaining investment partnerships so that co-investors are comfortable with the quality of the investment team running the SDF. It is crucial that the individuals be investment managers of the highest standing, and ideally, that they have a track record to back it up. A successful SDF should also have strong expertise in the local market to be able to source, assess, and structure investments in a credible way to provide confidence to co-investment partners that a return objective will be met. Ideally, the Fund would be staffed by qualified personnel with relevant education who have professional experience working in the locality. Adebayo, who has worked for years outside the country, might have considered seeking local expertise to enhance the competence of his team.

*Investment Decisions.* The Code and Standards require members to exercise diligence, independence, and thoroughness as well as to have a reasonable and adequate basis to support investment action. Adebayo has at least two different investment opportunities to choose from, each with its own benefits. The mining operations are likely to increase his country's wealth and boost the economy; at that same time, they have the potential for robust return on investment. The infrastructure project will similarly boost the economy by providing long-term employment for thousands of workers. Either investment may be justified on its merits and achieve the goal of the Fund to have a positive socioeconomic impact. Clearly, however, the government champions of each project are placing political pressure on Adebayo. Adebayo must be resolute in maintaining his independence and objectivity to act in the best interests of the Fund and its investors and not be swayed by conflicts of interest resulting from outside influences or pressures. A successful SDF should have a robust and rigorous governance framework for making investment decisions that can stand up to global due diligence. Development orientation is not an excuse for a lack of rigor in investments. If the Fund is going to originate deals locally and attract co-investors, it needs to be able to prove that it will act in the investor's best interest.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 6

#### **ANALYSIS** (CONTINUED)

*Transparency and Fairness.* Two fundamental ethical principles embodied in the Code and Standards are transparency and fairness to investors. Adebayo can develop trust in the Fund on the part of potential investors through regular transparency and accountability to the co-investment community. It would be appropriate and reasonable for Adebayo to provide detailed information to potential investors, such as his former employer, so that they can conduct due diligence on the Fund. But Adebayo must be careful that he does not improperly disclose confidential information or material nonpublic information to potential investors. Furthermore, he must treat all investors fairly. It may be acceptable in some circumstances to regularly communicate directly with a particular investor, but *all* investors of the fund should be treated fairly and receive the same disclosures about the financial prospects and other information about the Fund, not just those with whom Adebayo has a close relationship.

*Investment Mandate.* The Code and Standards require CFA Institute members responsible for managing assets to a specific mandate, strategy, or style to take only investment actions that are consistent with the stated objectives. In the case of the Fund, Adebayo has a dual mandate to invest in projects that have beneficial socioeconomic impact as well as have a positive investment return. This mandate is different from traditional investment funds that focus only on return on investments regardless of outside impact. A successful SDF will have a clear, commercial mandate that will guide the management team's decision making and help other investors understand and relate to its mission. Investors in the Fund must understand that investment return is not the single determinative factor that will guide Adebayo's decision. Any assurances or action by Adebayo to private co-investors in the Fund promising a set rate of return or promising to prioritize maximizing return would be contrary to the mission of the SDF.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Client Relationships – Case 7

### CASE STUDY

Morrison serves as the investment adviser to two private funds (the Funds). The private placement memoranda for the Funds permit Morrison to "pursue any objectives, utilize any investment techniques, or purchase any type of security that [Morrison] considers appropriate and in the best interests of the Funds." Through a mutual associate, Morrison is introduced to an individual from another country who purports to trade international notes for huge profits. Morrison has more than 30 phone calls with the individual to discuss his investment strategy. He conducts internet searches and learns that the individual supposedly owns an oil and gas trading operation under a name he gave to Morrison via email. Morrison never meets the individual in person.

Morrison personally loans \$100,000 to the individual and his company under the promise that Morrison will receive \$1 million in 25 days. When the payment comes due, Morrison agrees with the individual's suggestion to roll the purported proceeds into another investment. Morrison then invests \$4 million from the Funds' assets with the individual and his company, which promises to pay \$40 million to the Funds in 90 days. Shortly after the Funds' investment, Morrison receives a payment of \$250,000 from the individual. After several months, the individual makes a payment to the Funds of \$2.5 million, but no other proceeds of the Funds' investment are forthcoming. Morrison's actions are

- A. acceptable because the Funds' mandate allows him to make any type of investment.
- B. acceptable because he conducted sufficient due diligence on the investment scheme.
- C. unacceptable because he did not disclose a conflict of interest to the Funds.
- D. unacceptable because he should not have co-invested in the fund with his clients.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Client Relationships – Case 7

#### ANALYSIS

This case relates to CFA Institute Standard of Professional Conduct VI(A): Disclosure of Conflicts, which requires CFA Institute members to make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their duties to clients. Morrison did not disclose to his clients that he had personally loaned \$100,000 to the individual and his company. Therefore, he failed to disclose a conflict of interest arising out of his status, through his personal loan, as a creditor of the individual and his company. Morrison's loan is not, in and of itself problematic. In some cases, co-investing with clients may be appropriate and even advisable. But in this case, the loan was not disclosed. In addition, Morrison had an incentive to invest the Funds' assets because it would provide money that could be used to repay Morrison personally. Although the mandate of the Funds gave Morrison wide discretion on how he could invest the Funds' assets, it did not absolve him of disclosing any conflicts of interest with those investments.

The amount of appropriate due diligence an investment adviser must make when investigating a potential investment entails an investigation of the facts and circumstances of each case. Morrison performed limited due diligence on the investment, and the information he obtained is questionable, but it would be difficult to make a definitive call on the reasonableness and due diligence of the investment without further information. But Morrison's failure to disclose the conflict of interest is apparent. Choice C is the best response.

*This case is based on an April 2019 US SEC Enforcement Action.*

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# DISCLOSURES

# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 1

### CASE STUDY

Raphael, an investment adviser for Enright Financial Solutions (EFS), enters into an understanding with a friend who is a lawyer regarding the referral of clients. Raphael will refer EFS clients needing legal services to the lawyer in return for the lawyer recommending clients needing financial advisory services to Raphael and EFS. This arrangement is

- A. acceptable because there are no payments involved.
- B. acceptable as long as the lawyer discloses the arrangement to the clients he refers to Raphael.
- C. acceptable as long as EFS is aware of Raphael's agreement with the lawyer.
- D. unacceptable.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 1

#### ANALYSIS

This case deals with a mutually beneficial referral arrangement whereby service professionals refer clients to one another. Although such an agreement is not necessarily unethical and may ultimately be beneficial for the clients, there is a potential for a conflict of interest that must be disclosed. CFA Institute Standard VI(C): Referral Fees requires members to disclose to their employer, clients, and prospective clients "any compensation, consideration, or benefit received from or paid to others for the recommendation for products or services." This disclosure allows both clients and the employer to evaluate any partiality shown in the recommendation of services and the full cost of those services. Although there is no money changing hands between Raphael and his friend, there is mutual consideration and benefit. The fact that no money is exchanged would not preclude disclosure (Choice A).

Choice B addresses the disclosure issue but places the onus of disclosure on the lawyer and not on Raphael. Standard VI(C) requires Raphael to disclose the referral arrangement to any clients he refers to the lawyer and any potential clients referred to him by his friend. Choice C also addresses the disclosure issue by correctly stating that Raphael must disclose the arrangement to his employer. But this does not go far enough because Standard VI(C) requires disclosure to be made to clients, prospective clients, AND the employer. Does Raphael disclose any information about the arrangement to this clients or EFS? The facts of the case do not mention that he made the appropriate disclosure. The CFA Institute Ethical Decision-Making Framework calls for you to identify all relevant facts before making a decision. Assuming Raphael made no disclosure to his clients or employer, this arrangement would be unacceptable (Choice D).

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 2

### CASE STUDY

Joyce works as a research analyst at a private equity firm. Her personal investments are managed by her brother Neville, who works as a financial adviser. One day over lunch, Joyce's colleague, Roger, mentions to Joyce that he is looking for a financial adviser and asks Joyce who she uses to manage her investments. Joyce tells Roger that Neville is her investment adviser, but she does not disclose that Neville is her brother. After meeting with Neville, Roger hires him to manage his considerable assets. Neville regularly pays a €5,000 referral fee to his current clients who recommend new clients to his firm. Neville offers to pay his sister the €5,000 referral fee. Joyce was unaware of the potential referral fee and refuses to accept the money from her brother given their relationship. Did either Joyce or Neville violate the CFA Institute Standards of Professional Conduct?

- A. Neither Joyce or Neville violated the CFA Institute Standards of Professional Conduct.
- B. Only Joyce violated the CFA Institute Standards of Professional Conduct.
- C. Only Neville violated the CFA Institute Standards of Professional Conduct.
- D. Both Joyce and Neville violated the CFA Institute Standards of Professional Conduct.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 2

#### ANALYSIS

This case potentially involves the CFA Institute standards related to conflicts of interest. Standard VI(A): Disclosure of Conflicts requires members to "make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their duties to their clients, prospective clients, and employer." Does either Joyce or Neville have a conflict they need to disclose to Roger?

It is possible that Joyce is recommending Neville to Roger because he is a close family relation and not solely because of his abilities as an asset manager. But she could also not want Roger to feel pressured to hire Neville just because he is her brother. Also, the discussion between Joyce and Roger is personal rather than professional in nature. Roger is not a client or potential client for Joyce, but rather they are just colleagues having a friendly discussion over lunch. Roger is not seeking investment advice. But even though Joyce's actions in this particular scenario do not violate Standard VI(A), it may be prudent for Joyce to make such a disclosure at the outset. If Roger learns of the brother-sister relationship, he may feel that Joyce withheld important information from him. She could potentially still find herself on the receiving end of a complaint, especially if things later sour between Neville and Roger. One would hope that, in the interests of transparency and to promote her personal relationship with a colleague, Joyce would let Roger know that Neville is her brother.

As for Neville, there is no required disclosure to Roger under Standard VI(A) because the fact that Roger was referred to Neville by his sister does not present a discernible conflict on the part of Neville. Another thing to look at is Standard VI(C): Referral Fees. This standard requires members "to disclose to their employer, clients, and prospective clients any compensation, consideration, or benefit received from or paid to others for the recommendation for products of services." The facts indicate that Neville had a referral fee arrangement in place for his current clients when they referred his services to others. But in this particular case, Neville's sister Joyce was unaware of the potential payment and turned down the referral fee when it was offered. So, Joyce was not influenced by a potential referral fee arrangement. If Neville had paid the referral fee to Joyce, he would have had to disclose this fact to Roger. But because no fee was paid, Standard VI(C) is not implicated. As a result, the best answer is choice A, which is that neither Joyce nor Neville violated the CFA Institute Standards of Professional Conduct.

*Case facts supplied by Tanuj Kholsa, CFA, CAIA.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 3

### CASE STUDY

Wieters runs an investment advisory firm that specializes in equity only asset management. For clients and prospective clients seeking to follow a balanced or fixed-income strategy, Wieters posts on her firm's Facebook page the names of a number of firms that she is familiar with that provide these services. One of the firms replies in the comment section of the post, providing basic performance history information and claiming compliance with the GIPS® standards. Unknown to Wieters, the performance history is misleading and the claim of compliance with the GIPS standards is inaccurate. Has Wieters violated the CFA Institute Code of Ethics and Standards of Professional Conduct?

- A. Yes because Wieters must exercise diligence and have a reasonable and adequate basis for every statement made on her firm's Facebook page.
- B. No, as long as Wieters does not receive referral fees from the adviser for including the adviser's information in the original post.
- C. Yes, if Wieters "likes" the post by the adviser containing the erroneous information.
- D. No because Wieters is not responsible for any information posted by third parties in the comment sections of her firm's Facebook page.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 3

#### ANALYSIS

This case involves CFA Institute Standard I(C): Misrepresentation, which states that CFA Institute members and candidates must not knowingly make any misrepresentation relating to investment analysis, recommendations, or actions. Wieters has the responsibility under Standard I(C) to make sure that any professional communications she puts out are not misleading, whether or not the statements are verbal, written, or posted on social media. In this case, although the misleading statements are posted on the social media platform that Wieters controls, the misleading statement is clearly made by someone else because it is in a comment written by another person.

Therefore, Wieters may not be considered responsible under the CFA Institute Code and Standards for verifying the truthfulness of others information. In providing a list of potential service providers for a style of investment she does not provide, it is not clear whether she is recommending the services of those firms in her post. A recommendation of services would be a step that moves Wieters closer to endorsing the misleading information rather than passively allowing comments by others on her social media account. The payment of referral fees (or no payment of referral fees) is not relevant to the misrepresentation issue. Wieters would be in danger of violating the Code and Standards if she knows the adviser's information to be false and allows it to remain on her Facebook page. It is, therefore, not the case that Wieters is never responsible of any information posted by another person on her page. (In this scenario, the facts are clear that she does not know that the performance history and claim of compliance with the GIPS standards are false.)

Answer C is actually the best answer because if Wieters "likes" the adviser's comment or responds in another way that indicates she explicitly or implicitly endorses, adopts, or approves the content of the comment, that would effectively be a communication made by Wieters. She would then become responsible for the content. By "liking" the adviser's misleading performance information, Wieters becomes the author of a separate and distinct communication that includes misleading statements. To be safe, best practice would be for Wieters to remove from her Facebook page any potentially problematic or unverified statements or comments made by others until she can determine the veracity of those statements.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 4

### CASE STUDY

Andersen is the President and CEO of an asset management firm. Andersen and other senior investment managers of his firm make an in-person pitch to manage the investments of a large pension plan. In response to a request from the pension plan, Andersen lists the key personnel that would be involved in offering these services. But while awaiting for the outcome of the evaluation, one of the key personnel that Andersen identified and who was part of making the in-person presentation to the plan leaves the firm. Andersen should

- A. hire a competent replacement for the person who left and then inform the pension plan of the change.
- B. wait to determine whether the firm wins the business of the pension plan before informing them of the change in staff.
- C. immediately inform the pension plan that one of the key personnel has left the firm.
- D. do nothing because the pension plan is hiring the asset management firm not an individual.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 4

#### ANALYSIS

This case relates to CFA Institute Standard I(C): Misrepresentation, which prohibits any knowing misrepresentation relating to professional activities. In this situation, after making the pitch for the investment management business of the pension fund, there is turnover in Andersen's investment management staff. Andersen has identified the person leaving as a key employee and as a member of the team that made the initial presentation to the pension plan. From Andersen's perspective, he surely has confidence in the abilities of the firm as a whole and will likely replace the person leaving with a competent professional with similar experience and talents so that there is a seamless transition in services to clients.

Nevertheless, the pension plan is clearly concerned about the particular personnel involved in managing its assets because they asked for that information, which makes C the best response. If this was a junior employee, a staff member who had limited effect on the investment decision-making process, or someone who was not listed as a key employee or who was not part of the team making the presentation, then Andersen may not have to provide an update to the pension plan. But given the circumstances outlined in the case, Anderson must tell the pension plan about the departure of a key staff member to avoid a misrepresentation. Waiting until the replacement is found or until the pension plan makes a hiring decision is too late.

*This case was submitted to CFA Institute by an "Ethics in Practice" participant.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 5

### CASE STUDY

Allen Brodeur is CEO and Chairman of the board of Questla, a multibillion dollar company that makes electric cars. Brodeur and Questla disclose to the public and regulators that the company will use Brodeur's personal Twitter account to disseminate information to Questla investors and the investing public. In the midst of media reports that the company was having difficulty producing and delivering its cars to buyers, Brodeur posts a tweet stating that the company is "considering taking Questla private at \$420 a share. Funding is secure."

Some time prior to this tweet, Brodeur had met with a large sovereign wealth fund that expressed general interest in investing in the company and taking the company private. Brodeur and the sovereign wealth fund had not come to any specific agreement or determined a share purchase price. Brodeur was also in discussions with investment banks, but had not yet retained any advisers to assist with going-private transaction. After the tweet, Questla's stock price increased more than 6% on significantly increased volume and closed at \$380 per share, 10% higher than the previous day. When asked about the specific stock price in the tweet, Brodeur admitted that it was not discussed with the sovereign wealth fund but that he chose the price of \$420 because of the number's significance in the marijuana culture and thought his girlfriend "would find it funny." Brodeur's actions are

- A. appropriate because disseminating material information to investors through social media is a valid method for publicizing information.
- B. inappropriate because not all investors use social media, and thus, Brodeur is putting certain investors at a disadvantage and selectively disclosing the information.
- C. inappropriate because the tweet was a misrepresentation of the facts.
- D. appropriate because his tweet only said that he was "considering" taking the company private and thus the tweet contained only speculative, nonmaterial information.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 5

#### ANALYSIS

This case relates to CFA Institute Standard I(C): Misrepresentation, which states that CFA Institute members must not knowingly make any misrepresentation relating to professional or investment activities. Brodeur's tweet was premised on a series of baseless assumptions and was contrary to facts that he knew. Among other things, he (1) had not agreed on any terms for a going-private transaction with the sovereign wealth fund, (2) had never discussed a going-private transaction at a share price of \$420, (3) set the price as an inside joke with his girlfriend, and (4) had not formally retained any legal or financial advisers to assist with a going-private transaction. Unlike market participants reading his tweet, Brodeur knew that his ostensibly "secured" funding was based on a general conversation regarding a potential investment of an unspecified amount in the context of an undefined transaction structure. Because there were many uncertainties that would have needed to be resolved before any going-private transaction could be possible, Brodeur knew or should have known that his statements were false and misleading.

But the tweet can be considered "material" information and not speculative given that the source of the tweet was the company's CEO and Chairman of the board, the subject matter of the tweet was dramatic and elemental, and investors would want to know the information prior to making an investment decision. Disseminating information to investors using social media may be appropriate and ethical under certain conditions. Distribution channels to make information public do not need to guarantee to reach all investors, but they must be designed to effectively make the information public. As long as information reaches all clients or is open to the investing public, the use of social media platforms would be comparable with other traditional forms of communication, such as press releases or email communication. Because the information in this case was misleading, Brodeur's use of social media was not appropriate. Choice C is the best answer.

*This case is based on a 29 September 2018 enforcement action by the US SEC.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 6

### CASE STUDY

Ackerman is a securities contractor working to assist Superior Western Energy (SWE) list its shares on the Australian Security Exchange (ASX). SWE filed a prospectus for an offer of up to five million shares at \$2 each to raise \$10 million. The ASX listing rule applicable at the time required that entities seeking admission to the ASX must meet a "minimum spread requirement" of at least 300 shareholders with a minimum value holding to qualify for listing on the exchange. In their listing application, representatives of SWE informed ASX that the minimum spread requirement of 300 shareholders had been met. These disclosures included as shareholders 31 people or companies arranged by Ackerman. But none of the supposed shareholders were genuine buyers of SWE securities; Ackerman had provided false names and addresses for the investors. The SWE share offer raised more than \$3.5 million, with more than 1.75 million shares being issued. SWE was admitted to the official list of the ASX, and its shares were quoted on that exchange. Over time, the price of SWE shares steadily increased, the company attracted hundreds of investors and shareholders, and early investors achieved an excellent investment return. Ackerman's actions were

- A. unacceptable.
- B. acceptable because SWE proved to be a strong company with excellent performance.
- C. acceptable because no investors were harmed by a technical violation of ASX rules.
- D. acceptable if SWE would have met the minimum spread requirement without the 31 fictitious investors claimed by Ackerman.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 6

#### ANALYSIS

This case relates to CFA Institute Standard of Professional Conduct II(B): Market Manipulation, which prohibits CFA Institute members from engaging in practices that artificially inflate trading volume to mislead market participants. In this case, Ackerman engaged in information-based manipulation by falsely inflating the number of initial investors in the SWE securities. According to the Australian Securities and Investments Commission, the purpose of the minimum requirements for securities to be listed on the ASX is to demonstrate that there is sufficient investor interest in the company to justify its listing. This operates to ensure some level of liquidity at the time the company is initially listed and keeps poorer quality applicants that are not able to attract sufficient investor interest to meet the minimum spread requirement from being admitted to the ASX official list.

Falsifying the number of initial investors, therefore, goes beyond a technical violation of ASX rules and has substantive consequences. The fact that SWE ultimately proved to be a bona fide and solid investment does not mitigate Ackerman's conduct. Even if SWE met the minimum spread requirement without the 31 invented investors, Ackerman's misrepresentations still falsely pumped up the initial interest in SWE securities to circumvent regulatory requirements and drive interest in the investment. Choice A is the best answer.

*This case is based on a 22 October 2018 Enforceable Undertaking by the Australian Securities and Investments Commission.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 7

### CASE STUDY

Dukes is a managing director at a global credit ratings service. She leads and is responsible for the actions of the group that assigns new issue and surveillance credit ratings to commercial mortgage-backed securities. To determine the ratings, Dukes and her group calculate the debt service coverage ratio (DSCR) of each security, a key quantitative metric used to rate commercial mortgage-backed securities. Shortly after the global financial crisis, the ratings agency changed the methodology for calculating the DSCR for certain securities. Dukes' group published future credit ratings without disclosing the change. Using the new methodology, the securities received higher credit ratings than they would have received if the original methodology had been used. Dukes' actions are

- A. inappropriate because she did not have a reasonable and adequate basis for changing the methodology.
- B. appropriate because the new methodology more accurately reflects risk.
- C. inappropriate because she did not disclose the change in methodology to the investing public.
- D. appropriate because no disclosure is necessary because calculating DSCR is only one element in determining the overall rating of the security.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 7

#### ANALYSIS

This case involves the ethical principles applicable to communication with investors. CFA Institute Standard V(B): Communication with Clients and Prospective clients requires CFA Institute members to disclose to investors the basic format and general principles of the investment process they use to analyze investments and promptly disclose any changes that might materially affect those processes. Rating agencies' consistency and transparency are important to investors. Without the consistent application of rating methodologies, ratings may not be readily comparable. Similarly, without transparency, investors can neither assess the methodologies used by the credit ratings agency nor the application of those methodologies, and thus cannot determine what weight to give the rating. Dukes should have disclosed to investors the change in methodology for calculating DSCR.

Although it would be inappropriate to change the methodology without a reasonable and adequate basis, the facts do not indicate that Dukes failed to use diligence or have a reasonable basis for the change. In addition, the facts do not indicate whether the new methodology more accurately reflects risk; however, even if the new methodology does more accurately reflect risk, the change still must be communicated to investors. DSCR is clearly a "key quantitative metric" used to rate the securities because the change in methodology materially affected the credit ratings by moving them higher than the original method. Choice C is the best answer.

*This case is based on a December 2018 enforcement action by the US SEC.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 8

### CASE STUDY

Huang is the CEO and an executive director of GLB Group, a diversified company engaged in the business of securities investment and finance. The company's shares have been listed on the Stock Exchange of Hong Kong (SEHK) for the past two decades. Huang circulates the unaudited financial statements for the past fiscal year to the company's board of directors. The financial statements show a substantial increase in profitability over the previous fiscal year. Shortly after Huang provides this information to the board of directors, dramatic movements are seen in the trading volume and price of GLB stock.

Relying on his obligation under the *CFA Institute Code of Ethics and Standards of Professional Conduct* to keep employer information confidential, act with diligence, and have a reasonable and adequate basis for investment actions, Huang decides to wait for the audited financial statements to be prepared before releasing the statements publicly. Three weeks later, after the audited financial statements are ready, GLB issues a profit alert that states GLB expects a sharp turnaround of its results for the year, mainly attributable to the substantial net gains of its investments. Following publication of the profit alert, the share price of the company jumps 24%. Huang's actions are

- A. inappropriate.
- B. appropriate because the unaudited financial statements are confidential GLB information.
- C. appropriate because he waited for the financial statements to be finalized prior to making a public disclosure.
- D. appropriate if he cautioned the directors not to share the information publicly.
- E. none of the above.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 8

#### ANALYSIS

This case relates to knowledge of regulations relating to the disclosure of corporate information. CFA Institute Standard I(A): Knowledge of the Law states that CFA Institute members must comply with all applicable laws governing their professional activities and, in the event of a conflict, must comply with the more strict law. Because GLB's stock is listed on the SEHK, the rules and regulations governing that exchange are applicable to it and to Huang. Securities Futures Ordinance Section 307 requires that, once information related to fiscal year performance comes to the knowledge of a company, the information must be publicly disclosed to the market as soon as reasonably practicable.

In this case, the disclosure did not take place until several weeks later. Failure to ensure timely disclosure resulted in a breach of SEHK regulations. Huang waited to receive the finalized financial statements before making an announcement, thinking his actions were appropriate in fulfilling his duties under the CFA Institute Code of Ethics and Standards of Professional Conduct. Even if this was a proper interpretation of his responsibilities under the standard, the legal requirement of prompt disclosure, as the stricter rule, trumps the provisions of the applicable CFA Institute standards. Choice A is the best answer.

*This case is based on a November 2018 enforcement action by the Hong Kong Securities and Futures Commission.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 9

### CASE STUDY

Vincent is a 50% owner and managing partner of Paragon Capital, an investment adviser firm, and VP Capital, a broker/dealer. Paragon's only active advisory clients are three registered investment companies (mutual funds), which have their own boards, trustees, officers, and compliance staff separate from Paragon. An investment committee at Paragon that includes Vincent and other Paragon staff recommends and approves all investments made by the mutual funds. Over time, the committee approves multiple investments and reinvestments in promissory notes issued by Aquarius Capital Management based on trade receivables. The mutual funds invest approximately 15% of their net assets in the Aquarius securities.

Vincent and Aquarius both hold ownership stakes in Willow Grove Equity Solutions, a holding company established to invest in other investment adviser firms. Aquarius grants Willow Grove a \$10 million line of credit, which Willow Grove regularly accesses. Aquarius also pays VP Capital, the broker/dealer, fees for referring investors, other than Paragon clients, to invest in the securities issued by Aquarius. These referral fees amount to approximately \$1 million per year. Paragon's regulatory filings and marketing brochures describe Paragon's and Vincent's affiliations with VP Capital and Willow Grove. Paragon provides these documents to the mutual funds' compliance staff each year when they conduct their annual due diligence visits to Paragon's offices. Vincent's actions are

- A. acceptable because the referral fees paid by Aquarius to VP Capital exclude Paragon clients.
- B. unacceptable because Vincent violates his duty of loyalty to Paragon by investing in other investment adviser firms through Willow Grove.
- C. acceptable because Paragon provides disclosure to the mutual funds' compliance personnel about the affiliations with VP Capital and Willow Grove when they conduct due diligence.
- D. unacceptable because Vincent and Paragon's disclosures are incomplete.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 9

#### ANALYSIS

This case relates to the disclosure of conflicts of interest. CFA Institute Standard VI(A): Disclosure of Conflicts requires CFA Institute members to make full and fair disclosures of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their duties to clients. In this case, Vincent's financial interests are aligned with those of Aquarius through their common ownership stakes in Willow Grove. Vincent and Paragon advise their mutual fund clients to invest their money in Aquarius while Aquarius is paying fees and providing credit to firms partly owned by Vincent. In addition, Aquarius is paying referral fees to a brokerage firm partly owned by Vincent. These circumstances give Vincent a material financial interest in supporting Aquarius by having Paragon's mutual fund clients invest in Aquarius. Vincent thus has a conflict of interest related to Paragon's clients' investments in Aquarius promissory notes.

Vincent and Paragon did not provide the advisory clients with sufficient information about the financial ties to Aquarius so the clients could understand those conflicts. Although Vincent and Paragon provide disclosures related to the affiliation between VP Capital and Willow Grove, the disclosures do not cover the nature, magnitude, or extent of the financial ties between Aquarius, Willow Grove, VP Capital, Paragon, and Vincent. Failure to disclose the conflicts renders the due diligence by the mutual funds' compliance staff ineffective. Excluding the mutual funds from the referral fee arrangement does not effectively address the conflicts of interest. The fact that Vincent has ownership interest in multiple investment adviser firms through Paragon and Willow Grove may give rise to loyalty concerns, but there are no facts presented supporting any potential unethical conduct relating to conflicts among the advisory firms. Answer D is the best choice.

*This case relates to a question submitted to the CFA Institute Ethics Help Desk.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Disclosures – Case 10

### CASE STUDY

Hutchins is the chief financial officer of Bloxmore, a publicly-traded real estate investment trust (REIT) that owns several hundred open-air shopping centers. In addition to following generally accepted accounting principles (GAAP) for financial reporting purposes, Bloxmore, like many other REITs, reports same property net operating income (SP NOI) as a supplemental non-GAAP financial measure to help investors and analysts understand and assess the company's operating results. SP NOI represents the NOI of the pool of properties owned by Bloxmore as of the end of both the current reporting period and the same reporting period in the prior year (the "comparison period") for the entirety of both periods. Bloxmore reports SP NOI as a dollar amount and as a percentage by which SP NOI has grown between the current reporting period and comparison period, which is known as the SP NOI growth rate. Because the SP NOI growth rate reflects the growth in the NOI of a static pool of properties, it is a valuable measure of Bloxmore's ability to generate growth from its existing properties over the course of a year, as opposed to growth through the acquisition or construction of new properties.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 10

#### **CASE STUDY (CONTINUED)**

Bloxmore touts its steady and consistent SP NOI growth rate to investors as proof that its business strategies are successful. To maintain steady growth Hutchins uses several accounting methods to incorporate lease termination income into SP NOI. Lease termination income is a one-time negotiated lump sum fee that a tenant pays Bloxmore to exit its lease early. Because this influx of income can spike the SP NOI growth rate, Hutchins amortizes the lease termination income over the period of the remaining term of the original lease. He incorporates the amortized amounts into SP NOI until Bloxmore finds a new tenant for the space. In addition, on a number of occasions, Hutchins reclassifies lease termination income as "Other Income," which is recognized immediately, when additional income is needed to bridge the gap between the company's actual SP NOI growth rate and the its growth rate target. In this way, Hutchins eliminates Bloxmore's income volatility allowing it to achieve its SP NOI growth rate targets. Hutchins actions are

- A. inappropriate.
- B. appropriate because lease termination income should be incorporated in the calculations to make SP NOI an effective comparative measure.
- C. appropriate, as long as all of the income received by Bloxmore is recognized as part of SP NOI in some manner.
- D. appropriate because SP NOI is a non-GAAP financial measure that is optional and does not need to be reported by Bloxmore.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 10

#### ANALYSIS

This case relates to manipulation of accounting practices to misrepresent and falsely report company performance. CFA Institute Standard of Professional Conduct I(C): Misrepresentation prohibits CFA Institute members from making any misrepresentation relating to investment analysis, actions, or other professional activities. In this case, Hutchins uses improper accounting practices to smooth Bloxmore's periodic earnings results, thus making it falsely appear that the company was achieving steady and consistent growth. Although all of the terminated lease income is accounted for, the inconsistent timing of its incorporation into Bloxmore's financial statements misrepresents the nature of the income in order to maintain the narrative of consistent and predictable growth that is central to Bloxmore's investment thesis. Amortizing the lease termination income makes it appear that Bloxmore is continuing to receive rental income as if the lease had never been terminated. Even incorporating lease termination income into SP NOI at all is fundamentally misleading.

Industry practice is to exclude lease termination income from the calculation of SP NOI because it represents a one-time payment that would otherwise skew the SP NOI growth rate as a comparative measure of the growth in SP NOI. Although SP NOI is a non-GAAP measure, investors and analysts rely on it to assess Bloxmore's financial performance and as a valuable measure of a REIT's ability to generate growth from its existing properties over the course of a year, as opposed to growth through the acquisition or construction of new properties. Under GAAP, terminated lease income should be recognized in full when the lease is terminated and the payment received, thus becoming a part of reported GAAP income for that quarter. Hutchins manipulative accounting practices leads to false reporting of Bloxmore's SP NOI growth rate, misleading investors into believing that Bloxmore's growth was strong and steady when in reality it fluctuated greatly. Choice A is the best response.

*This case is based on a US SEC Enforcement Action in August 2019.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Disclosures – Case 11

### CASE STUDY

Greenfield is the chief financial officer of HumanaHealthMD, a biotech firm that researches, develops, and commercializes pharmaceutical drugs for women's health issues. Humana submits a new drug application to government regulators for a promising new drug for treating hormone deficiency. Two meetings scheduled with regulators to discuss the drug are postponed when the regulator states that unspecified deficiencies with the drug make such discussions premature. The public announcement of each meeting postponement results in a decline of more than 10% in the company stock.

When the meeting between regulators and company executives finally happens, Humana presents yet-to-be published preliminary test data with favorable indicators for the drug. The regulators react positively and give Humana preliminary regulatory approval contingent on further studies. After the meeting, six sell-side research analysts covering Humana inquire with Greenfield about the meeting. Greenfield responds by email and indicates that he believes the meeting with regulators was "very positive and productive" and that the company was "pleasantly surprised" by the reaction of the regulators. Greenfield does not share the favorable preliminary test data with the analysts. After the emails to the analysts, the stock price of the company increases 19%. Greenfield's actions are

- A. appropriate because Greenfield does not share the unpublished preliminary test data with the analysts but restricts his comments to the general tenor of the meeting.
- B. appropriate because Greenfield responds to questions from research analysts covering the company.
- C. appropriate because Greenfield communicates with all six research analysts covering the company.
- D. inappropriate.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Disclosures – Case 11

#### ANALYSIS

This case relates to selective disclosure of material nonpublic information. CFA Institute Standard of Professional Conduct II(A): Material Nonpublic Information prohibits CFA® charterholders from causing others to act on material nonpublic information. Information is material if its disclosure would affect the price of a security or if reasonable investors would want to know that information before making an investment decision. Information is "nonpublic" until it has been disseminated or is available to the marketplace in general. In this case, both the positive preliminary test results for the drug and the positive reaction of the regulators about a new drug is information that would have an impact on the price of the security and reasonable investors would want to know about.

Although Greenfield does not share the test results, he does share the fact that meeting with regulators was "positive and productive." Greenfield also shares this information with only a select group of analysts who regularly cover Humana and not the general investing public. The fact that Greenfield is only responding to questions and not affirmatively contacting the select group of analysts is irrelevant. Greenfield and Humana should have issued a public announcement about the nature of the meeting with regulators prior to or simultaneously with disclosing that information to analysts in response to their questions. Choice D is the best response.

*This case is based on a US SEC Enforcement Action in August 2019.*

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# DOCUMENTATION

# CFA INSTITUTE

## ETHICS IN PRACTICE: Documentation – Case 1

### CASE STUDY

Huang is a newly hired client account representative for GWC Asset Management, an investment adviser for high-net-worth clients. Part of Huang's responsibility is to assist each new client complete the extensive documentation needed to open an account. These documents give GWC access to client assets and the discretion to trade on behalf of the client. Because Huang is new to GWC, he is not completely familiar with firm procedures and is afraid of making mistakes with the documents. He uses erasable ink in completing the documentation so he can easily fix any mistakes without having to go back to the client for additional signatures. Huang's actions are

- A. unacceptable under any circumstances.
- B. unacceptable unless disclosed to the clients.
- C. acceptable because he is providing efficient client service.
- D. acceptable if GWC is aware of this practice.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Documentation – Case 1

#### ANALYSIS

This case involves the duty of loyalty to both clients and employer. By using erasable ink, Huang is rendering the key client documents changeable and thus unreliable. Once signed, anyone with access can go back and alter the terms or provisions of the documents. CFA Institute Standard III(A): Loyalty, Prudence, and Care requires members to "act with reasonable care and exercise prudent judgment" and "act for the benefit of their clients." Using erasable ink for legally binding financial documents does not constitute reasonable care and prudent judgment, and it potentially causes harm to the clients. Even if Huang engages in this conduct to try to provide efficient client service (Choice C), he is really trying to protect his own interests and make his job easier while opening the client up to potential harm. Even if he discloses to clients that their documentation can be changed after the fact, he (or anyone with access to the documents) would still have free rein to make any changes. Huang must get client permission regarding the specifics of any changes to these important legal documents to make them effective, making Choice B incorrect.

It is irrelevant whether his employer, GWC, is aware of and acquiesces in the practice because the harm to the client remains (Choice D). In fact, engaging in this conduct without the knowledge of GWC would be a violation of CFA Institute Standard IV(A): Duties to Employers – Loyalty, which prohibits member from causing harm to their employer. Huang's actions, if discovered, would cause great reputational damage for GWC with both the regulator and clients because the firm would have to go back through the process to redo all documentation. Finally, even if a client was aware of and gave permission to use erasable ink (or otherwise gave Huang or GWC permission to make changes to their documents without informing the client of what those changes were going to be), engaging in this conduct would make these documents ineffective and of no value. Huang would be violating the CFA Institute Code of Ethics that requires members to act with integrity, competence, and diligence. Therefore, using erasable ink for client documents is inappropriate under any circumstances (Choice A).

*This case is based on facts provided by Nick Pollard, Managing Director of Asia Pacific for CFA Institute, gathered from his industry experiences.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Documentation – Case 2

### CASE STUDY

Mwangi's firm offered its clients several different insurance products. Three of Mwangi's clients initially purchased one type of product (Class A), but later changed their mind and asked to swap the product for another, less expensive type (Class B). To complete the transaction, the law required the clients to execute new sale and purchase documents for the Class B product. The clients wanted to sign the necessary documents at the time they met with Mwangi to switch to Class B, but the documents were not ready. Mwangi advised her clients to wait until all of the paperwork was complete. But when the time came to complete the transaction, Mwangi was unsuccessful in reaching the clients for their signatures. Without the signatures, Mwangi's firm threatened to cancel the swap, which because of other investment purchases, would have placed the clients' accounts into an overdraft position. Under the firm's policies, such shortfalls were to be covered by selling account assets once the debit had been outstanding for two weeks. To keep this from happening, Mwangi forged the clients' signatures on the necessary documents to put the swap into effect. Mwangi's actions were

- A. unacceptable.
- B. acceptable because the clients had already given their permission for the swap.
- C. acceptable with approval from her supervisor.
- D. acceptable if the clients gave her explicit permission to sign the documents on their behalf.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Documentation – Case 2

#### ANALYSIS

This case involves Standard I(A): Knowledge of the Law, which requires CFA Institute members to "comply with all applicable laws, rules, and regulations ... governing their professional activities." To complete the swap from the Class A to the Class B product, Mwangi's clients were legally required to execute new sale and purchase documents, which did not happen because Mwangi forged their signatures. General approval of the transaction by the clients is insufficient to meet the legal requirement for client signatures. Obviously, approval of a supervisor to engage in illegal activities does not relieve Mwangi of her obligation to follow the law. Finally, even if the clients fully understand the circumstances and explicitly approve of Mwangi signing the forms on their behalf, the law requires that actual signatures of the clients must be on the documents. While the intent of the law is meant to protect the clients and the clients are waiving their rights, that still does not allow Mwangi to circumvent the legal requirements. The best response is A.

*This case is based on a disciplinary action by the CFA Institute Professional Conduct Program. Before this incident, the member had an unblemished career in financial services for more than 15 years. The firm confronted the member about the forgeries and she readily admitted what she had done. The member was terminated by her employer for cause and they reported her to the regulatory body. The regulator determined that the member had engaged in conduct unbecoming or detrimental to the public interest and in violation of the regulatory body's member rules. She was suspended, fined, and had to re-take an exam. CFA Institute investigated and imposed a nine-month suspension on the member for violation of Standard I(A): Knowledge of the Law and Standard I(C): Misrepresentation.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Documentation – Case 3

### CASE STUDY

Giddings is responsible for compliance at GWH, a large broker/dealer and investment adviser. In connection with GWH's wealth management business, the company maintains the personally identifiable information (names, addresses, phone numbers, account numbers, balances, and holdings) of hundreds of clients. Giddings adopted a number of policies and restrictions, including a Code of Conduct, that address employees' access to and handling of this confidential information. Marsh, who works for GWH as a client service associate, downloads client data to his personal server located at his residence to facilitate his telecommuting. Marsh's server is hacked and portions of the personal client information downloaded by Marsh are posted for sale on the internet. Did either Marsh or Giddings violate the CFA Institute Standards of Professional Conduct with respect to confidentiality?

- A. Marsh violated the CFA Institute Standards of Professional Conduct.
- B. Marsh did not violate the CFA Institute Standards of Professional Conduct.
- C. Giddings violated the CFA Institute Standards of Professional Conduct.
- D. Giddings did not violate the CFA Institute Standards of Professional Conduct.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Documentation – Case 3

#### ANALYSIS

CFA Institute Professional Standard III(E): Preservation of Confidentiality requires that CFA Institute members and candidates keep information about current, former, and prospective clients confidential unless the information concerns illegal activities, disclosure is required by law, or the client permits disclosure. Although Standard III(E) does not require investment professionals to become experts in information security technology, they must make reasonable efforts to ensure that communication methods and compliance procedures follow practices designed to prevent accidental distribution of confidential information. In this case, the facts presented do not provide enough information to determine whether Marsh or Giddings acted inappropriately to allow confidential GWH client information to end up for sale on the internet.

As you think about your answer choice, there are two main questions that need to be addressed. The first issue is whether Marsh had permission to download client data to his personal server. If he did not, his misappropriation of client information for his own purposes constitutes a violation of Standard III(E). Even if he was not responsible for the distribution of the information, his misconduct facilitated the publication of the information. If Marsh did have permission from GWH to download and use the information from home, the second issue is whether Giddings adopted sufficient compliance policies and procedures reasonably designed to protect client information.

As the compliance officer, Giddings is charged with ensuring the confidentiality of customer information by protecting against any anticipated threats or hazards to the security or integrity of the records. Giddings and GWH must work to protect against unauthorized access or use of client information that could result in substantial harm to clients. Although the facts state that GWH policies and Code of Conduct restricted access and handling of client information, the nature and extent of those safeguards are not provided. The fact that client information was able to be accessed and published calls into question the effectiveness of Giddings compliance efforts. Even if the policies were sufficient, there appears to have been insufficient auditing and/or testing of the effectiveness of the safeguards to keep client information confidential.

*This case is based on a US SEC enforcement case from 2016 against Morgan Stanley Smith Barney and Galen March, an MSSB employee.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Documentation – Case 4

### CASE STUDY

McMaster is the founder and sole director of Dover Financial Services, a financial services business that sells financial products and provides clients with financial product advice. McMaster directs Dover's numerous authorized representatives to incorporate the "Dover Client Protection Policy" as part of the contracts with their clients that set forth the terms for providing financial advice. The protection policy states that it "contains a number of client protections designed to ensure that you (the client) receive the best possible advice and the maximum protection available under the law." The protection policy's terms are intended to excuse Dover and its authorized representatives from various liabilities arising from their failure to act in a client's best interest, relieve Dover and its authorized representatives of their duty to conduct suitability analyses of clients and investments, and inaccurately lead clients to believe that they cannot make claims against Dover or its representatives for securities law violations. McMaster's actions are

- A. appropriate because Dover and McMaster fully disclosed the terms of the Dover Client Protection Policy to clients.
- B. appropriate because Dover and McMaster are free to negotiate the terms of advisory agreements with clients.
- C. appropriate so long as the Dover Client Protection Policy did not misrepresent a client's legal rights.
- D. inappropriate.
- E. none of the above.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Documentation – Case 4

#### ANALYSIS

This case relates to the obligation of investment advisors to act in their clients' best interests. CFA Institute Standard III(A): Loyalty, Prudence, and Care sets forth a duty of loyalty on the part of CFA Institute members for their clients, and requires them to act for the benefit of their clients and place their clients' interests before their own. Other CFA Institute standards require members to provide diligent, independent, and thorough advice as well as have a reasonable and adequate basis for investment action [Standard V(A)], conduct a suitability analysis for any investment recommendation to their clients [Standard III(B)], and not make any misrepresentations relating to investment services [Standard I(C)]. Taken together, these components of the CFA Institute Code of Ethics and Standards of Professional Conduct define the fundamental principles applicable to investment professionals and detail what conduct investors should expect from their financial advisers. The terms of the Dover Client Protection Policy improperly attempt to "disclose away" Dover and McMaster's fundamental ethical (and very likely legal) obligations to clients by limiting liability for failures to act in the client's best interest or provide appropriate advice.

Although in general clients and advisers are free to negotiate the terms of advisory agreements, it is improper for advisers to use the client agreement to create a significant imbalance in the rights and obligations of the adviser or limit the fundamental ethical obligations of loyalty, prudence, and care to their clients. Disclosure does not cure such conduct. Furthermore, the Dover Client Protection Policy was deceptive in that it misrepresented the client's right to bring legal action for ethical and regulatory violations and falsely gave the impression that a client would benefit from its terms. Choice D is the best answer.

*This case is based on a June 2018 regulatory action by the Australian Securities and Investments Commission.*

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# EMPLOYMENT ISSUES

# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 1

### CASE STUDY

Nickoli is an investment counselor with HHI Capital Management. A colleague at her local CFA Society encourages Nickoli to leave HHI and join her at Vesuvius Asset Advisers. Nickoli eventually agrees and determines to leave at the beginning of the new year. Over the course of a few weeks prior to tendering her resignation, she mentions to her clients that they will likely be working with a new investment counselor in the new year because she will be leaving HHI in the coming weeks. Her clients express their surprise, and when pressed for details about why she's leaving, Nickoli shares that she is frustrated by and disagrees with the structure and direction of the firm, she disagrees with and does not have confidence in the current leadership, she does not believe the firm will be able to attract and retain good people, and other HHI employees have been mistreated and will also be leaving soon. Several of Nickoli's HHI clients indicate that they would like information about Vesuvius and may be interested in switching their accounts. After submitting her resignation, Nickoli immediately relays the names of those clients to Vesuvius, and after the first of the year, she begins soliciting them to transfer their accounts from HHI to her new firm. Nickoli's conduct is

- A. acceptable because she is looking out for her clients' best interest and believes Vesuvius provides better service.
- B. acceptable because she provides her opinion of HHI in response to questions from clients.
- C. acceptable because she did not solicit clients until after she left HHI.
- D. unacceptable because she made disparaging remarks about HHI to clients while she was still with the firm.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 1

#### ANALYSIS

Answer D is the best response because this case relates to CFA Institute Standard IV(A): Duty to Employer – Loyalty, which states that CFA Institute members and candidates "must act for the benefit of their employer and not...otherwise cause harm to their employer." Although a departing employee is generally free to make arrangements or preparations to change firms before terminating the relationship, those preparations must not conflict with the employee's continuing duty to act in the best interests of the current employer and not otherwise undermine, disparage, or cause harm to the current employer. In this case, Nickoli decided to leave HHI and join Vesuvius several weeks before she submitted her resignation and notified the firm. During that time, Standard IV(A) obligated her to continue to act in the employer's best interest and not engage in any activities that would conflict with this duty until her resignation became effective.

Nickoli violated her duty of loyalty to HHI by making disparaging and harmful statements about the firm to its clients in the weeks prior to submitting her resignation and by promoting Vesuvius to HHI clients while she was still employed by HHI. Although she did not make actual solicitations until after she left HHI, Nickoli used the final weeks of her employment with HHI to contact and gauge which of the firm's clients may be interested in receiving information about Vesuvius and possibly transferring their accounts from HHI. And although an investment professional should protect the client's best interest, even if Nickoli believes the clients will be better off with her at Vesuvius, the clients' relationship is with HHI. She is a representative of HHI, so she cannot malign the firm while still employed, even in response to questions.

*This case was based on a disciplinary case by the CFA Institute Professional Conduct Program. The member in question received a Private Censure.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 2

### CASE STUDY

Ianetta is the chief compliance officer for Rocky Mountain Investments (RMI). He is responsible for establishing and maintaining appropriate regulatory compliance policies, including a document retention policy. RMI's policies require retaining and archiving the emails of the firm's personnel. RMI has rapidly expanded over the years, and Ianetta determines that the firm should move to a new and less expensive email archive provider. But during the transition, several thousand emails are temporarily inaccessible. In addition, the new system does not capture emails from accounts hosted on an external server, and it does not archive emails sent from a third-party provider's application ("cloud" email). Do Ianetta's actions comply with the CFA Institute Code and Standards?

- A. No because the record retention system Ianetta implemented is inadequate.
- B. Yes, as long as the inaccessible emails are able to be recovered.
- C. Yes because emails sent and received outside RMI's email system are not required to be retained.
- D. Yes, if the emails are more than five years old.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 2

#### ANALYSIS

The issue in the case involves record keeping. CFA Institute Standard V(C): Record Retention states that CFA Institute members must "develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients." Emails to and from firm personnel are important records of the firm's business. As the firm's chief compliance officer, Ianetta has the responsibility to develop policies and procedures to meet the record retention requirements for RMI. The emails of firm personnel must be preserved regardless of what email service or platform is used to generate them. The requirement is not limited to only emails sent and received through the firm's internal server.

Guidance for Standard V(C) recommends that records be retained up to seven years in the absence of regulatory requirements. It is not clear what regulatory regime RMI is subject to if any, but best practice would be to keep seven years of the email records. The facts state that during the transition to the new email archive service provider, the records (emails) were temporarily unavailable, although it is not clear for how long. But even if the records are not available for a short time, it would be unacceptable. Lack of access to records for any amount of time could certainly cause issues with clients and regulators who may be wanting to review emails to substantiate investment recommendations, confirm communications, examine client/adviser discussions, and so on. Therefore, by not adequately fulfilling his responsibility to maintain appropriate records for RMI, Ianetta is in violation of Standard V(C), so the best answer is A.

*The facts of this case are based on a 2013 enforcement action by the US Financial Industry Regulatory Authority.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 3

### CASE STUDY

Kuznetsov is a portfolio manager for a large investment firm that encourages its employees to sell proprietary investment products to their clients. Kuznetsov complies with this directive and within a year becomes the firm's top seller of these investment vehicles. He receives stellar performance reviews and a large bonus. But Kuznetsov eventually determines that the firm's investment products are underperforming and more expensive than other outside investment options that are suitable for his clients and present a better chance for growth.

So, he sharply cuts back on purchasing the firm's investment products for his clients. Although his supervisor puts increasing pressure on him to resume selling the firm's products, Kuznetsov refuses. He complains several times to management that he is being pressured to place the firm's interest above his client's interests. He surreptitiously records several conversations with his supervisor and makes copies of client records that document what he considers to be his supervisor's inappropriate conduct. When management ignores his complaints and his supervisor begins giving Kuznetsov poor performance reviews, he files a complaint with the local regulator against his supervisor and his firm, providing the recordings and copies of client files as evidence. After the firm becomes aware of Kuznetsov's actions, he is fired. Kuznetsov's actions are

- A. inappropriate because he failed to keep client information confidential.
- B. appropriate because he is protecting client interests.
- C. inappropriate because he violated his duty of loyalty to his employer by taking his dispute with his supervisor to the regulator, exposing the employer to financial and reputational harm.
- D. inappropriate because he could have met his ethical obligation by dissociating from the unethical activity of his supervisor.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 3

#### ANALYSIS

This case involves CFA Institute Standard IV(A): Duties to Employer – Loyalty, which states that CFA Institute members "must act for the benefit of their employer and not...divulge confidential information or otherwise cause harm to their employer." But the interests of an investment professional's employer are secondary to protecting the interests of clients. Circumstances may arise in which investment professionals can engage in conduct contrary to their employer's interests in order to comply with their duties to clients. In pressuring Kuznetsov to sell more expensive and less profitable investment products to his clients, the employer is acting contrary to client interests.

In general, Kuznetsov's conduct in recording his conversations with his supervisor, copying client records, and reporting the employer to the regulator are justified because he is attempting to protect his clients' interests by calling out his employer's unethical (and possibly illegal) conduct. (However, certain jurisdictions may have laws against surreptitiously recording conversations without the other party's consent.) Dissociating from the conduct may have removed him from the situation, but it would not be effective in this case because it would not necessarily prevent Kuznetsov's employer from taking advantage of its clients and reassigning their accounts to employees who would engage in the misconduct. His "whistleblowing" activity is not a violation of the CFA Institute Code of Ethics and Standards of Professional Conduct in these circumstances (Answer B).

*This case is based on a US SEC enforcement action from 2015.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 4

### CASE STUDY

Clifford, a senior partner at an investment advisory firm, hires McDougal as a junior analyst on a temporary basis with the understanding that if her work performance is satisfactory after three months she will be hired full time. At the end of the three months, although McDougal's research work is satisfactory, she has had a number of conflicts with several male employees at the firm. Clifford tells McDougal that because of firm restructuring, a full-time position is no longer available, and McDougal is not given a position after her temporary employment contract expires. McDougal files a complaint with securities regulators and CFA Institute alleging various securities violations against Clifford and the firm.

After an investigation, the complaint was found to be meritless. As part of the investigation, Clifford was able to prove that McDougal had been hostile to firm employees, used inappropriate language, and made threats against Clifford when she was not hired on full time. Clifford also produced emails and messages that McDougal sent to firm clients that falsely claimed Clifford was going to lose his CFA® designation because of the investigation by regulators and CFA Institute. After McDougal's complaint against Clifford and the firm was dismissed, the firm once again advertised a position for a full-time junior research analyst. Choose the best response from the following choices:

- A. Clifford violated the CFA Institute Standards of Professional Conduct.
- B. McDougal violated the CFA Institute Standards of Professional Conduct.
- C. Although Clifford's actions may be inappropriate, he did not violate the CFA Institute Standards of Professional Conduct.
- D. Although McDougal's actions may be inappropriate, she did not violate the CFA Institute Standards of Professional Conduct.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 4

#### ANALYSIS

This case relates to CFA Institute Standard I(D): Misconduct, which states that CFA Institute members 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. In this case, McDougal's conduct clearly violates this standard. Certainly, the combination of making false allegations to regulators against your employer, filing a meritless complaint with CFA Institute, using inappropriate language in the workplace, making misrepresentative and disparaging comments to firm clients, and threatening your supervisor all can be considered professional conduct involving dishonesty, fraud, and deceit as well as conduct that reflects adversely on professional reputation, integrity, and confidence. Clifford's conduct, however, falls into a gray area. Although he did not hire McDougal after promising to do so and uses the excuse of a seemingly fictitious corporate restructure when informing her about her termination, those actions may not rise to the level of "misconduct" contemplated by the standard. McDougal's research work may have been adequate, but her not fitting in well with colleagues or the firm culture could very well be a valid reason not to offer her a full-time position. Although she may have had conflicts with some male colleagues, there is no indication that her failure to receive a full-time position was because of her gender. Finally, although Clifford's claim that the junior research analyst position was eliminated may have been false, some may see using the excuse of a phantom work restructuring as a gracious way for Clifford and the firm to disentangle themselves from an unwanted employee. In any event, McDougal's subsequent conduct seems to show that Clifford made the right call on any future employment. Because McDougal's conduct clearly violates Standard I(D), choice B is the best answer.

*This case is based on a recent CFA Institute Professional Conduct Investigation.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 5

### CASE STUDY

Mikalev recently retired from his position as the head of mergers and acquisitions at a large international bank. Two weeks into his retirement, he discovered that he still had access to his bank's online business journal subscription, Bloomberg market data feeds, and online data room, which contains highly sensitive documentation about a client's upcoming acquisition. Mikalev had been in the very early stage of working on the acquisition when he left the investment bank.

Mikalev enjoys his continued access to the newspaper and Bloomberg and, if he ever considered going back to work in the industry, the information helps him to stay abreast of market trends. Of course, remembering his firm's annual compliance training, he does not communicate or trade on the information related to the imminent acquisition by his former client. Mikalev's actions are

- A. appropriate as long as he does not trade on the material nonpublic information.
- B. inappropriate because he should not have access to material nonpublic information from his firm.
- C. inappropriate because he should not access any of the firm's resources.
- D. appropriate, even if he trades on the material nonpublic information, because he is no longer bound by his firm's standards and compliance policies.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 5

#### ANALYSIS

This case relates to duty to employer, confidentiality of client information, and potentially trading on material nonpublic information. Because Mikalev has retired from his position and no longer works for the firm, it would be improper for him to have access to confidential client information. CFA Standard III(E): Confidentiality requires that client information must be kept confidential and shared only under specific circumstances, which are not present in this case. Not trading on the information does not absolve Mikalev of violating the confidentiality standard.

Trading on the client information would not only be a violation of the confidentiality standard but also Standard II(A): Material Nonpublic Information, which prohibits CFA Institute members from trading on material nonpublic information, such as the information related to the client's planned acquisition. Such action is prohibited regardless of the fact that Mikalev no longer works for the firm.

It is possible that the firm allows employees who have retired to have access to general firm resources, such as journal subscriptions and Bloomberg data that do not include confidential client or material nonpublic information, as "retirement benefit" in gratitude for their past service. But there is no indication from the facts of this case that Mikalev's firm has given permission or is even aware that he is using firm resources. Without a clear indication of permission by the firm, Mikalev should not use any of the resources, make the firm aware that he mistakenly continues to have access, and proactively request that his access be removed. Answer C is the best choice.

*This case is based on facts submitted by an Ethics in Practice reader.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 6

### CASE STUDY

Clemence is a wealth management adviser for DeLaurier Strategic Advisors, where she is responsible for financial planning, portfolio management, estate planning, and general wealth management for more than 400 retail clients. She met many of these clients through her spouse, who is a well-known attorney, and her sister, who is a physician. Clemence decides to resign her position with DeLaurier to take a position at another firm where she will not be expected to generate new advisory clients but will take on more research and investment management responsibilities. She leaves DeLaurier on good terms, providing her supervisor with all the background and information that DeLaurier needs to transition her clients seamlessly to a new account manager. All of her clients have insufficient assets under management to become clients of Clemence's new firm.

On the day Clemence leaves DeLaurier, she hastily downloads an Excel file listing DeLaurier clients, potential clients, and former clients and sends it to her personal email address. The list includes client names, assets under management, addresses, and phone numbers. Clemence's intention is to contact her clients as a courtesy to inform them of her new position, thank them for being clients, and express her confidence that DeLaurier will continue to provide them with competent and professional service even though she has left the firm. Clemence's actions are

- A. inappropriate.
- B. appropriate because she does not use DeLaurier's client list to benefit her new firm.
- C. appropriate because she is protecting the interests of her clients.
- D. appropriate as long as she only contacts clients who are personal friends to inform them of her new position.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 6

#### ANALYSIS

Clemence has violated her duty of loyalty to her employer by copying the client list and taking it with her to use after she leaves DeLaurier. CFA Institute Standard IV(A): Duties to Employers—Loyalty requires that CFA Institute members act for the benefit of their employer and not divulge confidential information or otherwise cause harm to the employer. The client list is the property of DeLaurier. It contains proprietary confidential information about DeLaurier clients that Clemence is improperly using for her own purposes, however benign those purposes may be. It is clear that Clemence is not motivated to use the client list and information it contains to benefit her new firm and is working with DeLaurier to protect the interests of her former clients and to make them feel comfortable in continuing to use DeLaurier as their financial advisor.

Clemence may contact her former clients who are friends through personal channels, such as social media or a personal contact, but she cannot use DeLaurier's property to facilitate this communication. As an alternative, she could ask DeLaurier's permission to take her clients' contact information so that she might send them a final "thank you" correspondence. In hastily trying to get information regarding her clients, Clemence has actually overreached and taken much more information than intended. She has not only taken information about her clients but also that of the firm's former, current, and potential clients. Choice A is the best answer.

*This case is based on a CFA Institute Professional Conduct enforcement action from 2018 that resulted in a Private Censure.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Employment Issues – Case 7

### CASE STUDY

Harris, a CFA® charterholder, is the chief financial officer of a large aircraft manufacturer and serves on its investment committee, which has the responsibility of choosing retirement investment options for its employees. One of the retirement options is to purchase additional company stock. Harris becomes aware of an internal investigation that discovered design problems with the company's newest aircraft, which causes it to become unstable during takeoff under certain conditions. Company engineers are working furiously on a fix for these problems. Harris knows, however, that if these problems become public, the information will significantly decrease the value of the company stock. Nevertheless, he does not disclose the information outside the company, and he continues to vote to make company stock purchase a retirement option for employees. Eventually, two of the company's aircraft crash because of the design problems, resulting in a significant loss of life. The company's stock price decreases significantly, and thousands of employee retirement funds suffer. In the context of the CFA Institute Code of Ethics and Standards of Professional Conduct, Harris's actions are

- A. appropriate because he believes the company will rectify the design problems before the information becomes public.
- B. inappropriate because he did not protect the interests of company employees by removing the company stock purchase as a retirement option.
- C. appropriate because he refrains from causing others to make investment decisions based on inside information.
- D. inappropriate because he failed to raise the design problems to the attention of aviation industry regulators.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Employment Issues – Case 7

#### ANALYSIS

This case relates to duty to employer and material nonpublic information. As chief financial officer, Harris is a company insider and has a duty of loyalty to his employer that includes keeping company information confidential. CFA Institute Standard IV(A): Loyalty requires CFA members to "act for the benefit of their employer and not ... divulge confidential information..." The design problems with the aircraft are confidential company information. But guidance for Standard IV(A) in the Standards of Practice Handbook makes it clear that CFA Institute members can go against this standard and divulge confidential employer information in the form of whistleblowing under certain circumstances. Protecting the lives of the general public by drawing attention to consumer product problems is arguably a valid reason for whistleblowing on corporate misconduct. Is Harris justified in whistleblowing in this case? No misconduct on the part of the company is alleged in the facts. Although there are dangerous design problems, it does not appear that the company is trying to conceal them but rather, it is working diligently to resolve the problems. Steps the company has taken to warn those using the aircraft or otherwise remediate problems are not provided. More facts are likely needed to determine whether or not whistleblowing is justified in this case.

In addition to the consumer protection issues, there is the investment aspect of the information. Clearly, the design flaw is material information that a reasonable investor would want to know about but it is not public information. Harris, who is in possession of this information given his position, has a duty under CFA Institute Standard II(A): Material Nonpublic Information not to disclose or cause others to act on this information. Voting to prevent employees from investing on company stock, because he knows the stock price may be devalued in the future would indirectly cause others to act on the material nonpublic information in his possession. Standard II(A) prohibits trading on material nonpublic information even if it is to benefit clients or, in this case, employees of the firm. Thus, choice B would not be a correct response. An argument could be made for any one of the other choices being the correct response, but further information would be needed to make the best choice.

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# ERROR CORRECTION

# CFA INSTITUTE

## ETHICS IN PRACTICE: Error Correction – Case 1

### CASE STUDY

Walsh, CFA, is the Chief Financial Officer of TrueTech Corporation, a leading semiconductor manufacturer in the United States. For the past few months, Walsh has led the TrueTech team in talks to buy a majority stake in Veridy Corporation, a smaller, privately owned semiconductor company that has a patented technology that could potentially cut the chip manufacturing costs of TrueTech by almost 40%. After intense negotiations, TrueTech is able to close the deal with Veridy late on a Friday night. Walsh wants to share the good news with his wife, so he takes out his phone and types "Finally! TrueTech has acquired a majority stake in Veridy. The deal is sealed!" But instead of sending the message to his wife, he accidentally posts it on his personal Facebook page. The next morning (a Saturday), he wakes up and discovers the blunder. Did Walsh violate any part of the CFA Institute Code of Ethics or Standards of Professional Conduct?

- A. No, this was an honest mistake.
- B. Yes, but Walsh does not need to do anything to rectify the matter because the posting was unintentional.
- C. Yes, Walsh should immediately disclose his actions to TrueTech and Veridy.
- D. Yes, Walsh should post the merger information on the company website and make a public announcement about the transaction.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Error Correction – Case 1

#### ANALYSIS

This case involves Standard IV(A): Loyalty, which states that CFA Institute members must not "divulge confidential information or otherwise cause harm to their employer." Even though his action was unintentional, Walsh violated his duty of loyalty to his employer because he disclosed confidential information about TrueTech outside the company. The honest mistake does not exonerate him from violation. Walsh is also in danger of violating Standard II(A): Material Nonpublic Information, which states that CFA Institute members must "not act or cause others to act" on material nonpublic information. Walsh inadvertently leaked material nonpublic information to the select group of people who are his friends on Facebook. But there is no indication from the facts given that any of Walsh's Facebook friends who received the merger information tried to take advantage of that information. Walsh should take steps to attempt to rectify his mistake. Although Walsh should notify TrueTech and Veridy of his error, that does not go far enough. The most appropriate course of action is for Walsh to publicly disseminate the news of the merger as quickly as possible so that the information is available to all investors. Answer D is the best choice.

*This case was written by Tanuj Kholsa, CFA, CAIA, and the facts are not based on any particular case.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Error Correction – Case 2

### CASE STUDY

Foss is an institutional money manager specializing in a quantitative investment strategy. He developed his own quantitative model that he uses exclusively as the investment decision-making tool for client accounts. Foss heavily markets his "comprehensive and exclusive" model to clients and prospective clients as being an effective tool to manage risk. After using the model for several years, Foss discovers an error that inadvertently eliminated one of the key components for managing risk, leading to underperformance as a result of industry overexposure. During that time, several clients raised questions about their portfolio performance, but Foss attributed it to market volatility. Foss revises the model to address the error and begins to promote his "new and improved exclusive and comprehensive quantitative model." Foss's conduct is

- A. unacceptable because the original model resulted in underperformance.
- B. acceptable because factors in quantitative models are proprietary and do not need to be disclosed.
- C. unacceptable because he failed to disclose the error in the model and its impact on client performance.
- D. acceptable because Foss corrected the error and uses the new model.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Error Correction – Case 2

#### ANALYSIS

This case involves CFA Institute Standard I(C): Misrepresentation, which states that CFA Institute members and candidates must not knowingly make any misrepresentation relating to investment analysis, recommendations, or actions. A misrepresentation is any untrue statement or omission of fact that is otherwise false or misleading. Although investment professionals are not required to divulge the proprietary elements of their investment decision-making model, they are prohibited from making statements about the model that are not true. In this case, Foss claimed that his "comprehensive model" would effectively manage risk while at the same time, because of an error, the model omitted a key factor for managing risk. Foss also made misrepresentations to clients by failing to disclose the error and its impact on performance and attributing the model's underperformance to market volatility rather than the error. Correcting the error and using a new model does not address the misrepresentations. Underperforming the market or benchmark is not necessarily of indicative unethical behavior. But the fact that the original model did not effectively manage risk and led to underperformance also may lead to a violation of the CFA Institute Standard V(A): Diligence and Reasonable Basis, which requires CFA members to exercise diligence and thoroughness in analyzing investments and taking investment action. Choice C is the best response.

*This case is based on a US SEC enforcement action.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Error Correction – Case 3

### CASE STUDY

Manley is an investment adviser for a regional bank with a number of discretionary, fee-based accounts for high-net-worth individuals. The bank's internal policies and procedures permit trade error corrections for up to 30 days following a failure to place a trade. The policy is intended to address errors in which an adviser fails to send an order to the trade desk. To rectify the error, the adviser is permitted to buy or sell a security at the current market price, with the price differential charged to the adviser personally through an internal error account.

On many occasions, Manley uses the trade error correction policy to benefit clients who are unhappy with their account performance. Manley identifies a security whose price has increased in the last 30 days. He then tells the trade desk that he had mistakenly failed to buy that particular security some days before when the price was substantially lower than the current market price. Once the request is approved, the trade desk purchases the security and charges the price differential to Manley personally through the error account. Shortly thereafter, Manley sends an order to sell the security and net a profit for the client. Manley then tells the client that he had "flipped" them a profitable trade or has given them a "gift" or "no-risk" trade. Manley's actions are

- A. inappropriate.
- B. appropriate because Manley is acting for the benefit of the client.
- C. appropriate because the bank is not harmed by Manley's actions.
- D. appropriate because Manley has disclosed to the client that he engaged in a no-risk trade on their behalf.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Error Correction – Case 3

#### ANALYSIS

This case relates to professional misconduct. CFA Institute Standard I(D): Misconduct prohibits CFA charterholders from engaging in professional conduct involving dishonesty, fraud, or deceit. Manley engaged in a misleading, fraudulent, and deceptive practice when he misused the bank's policies for error correction to enhance client account performance when no legitimate error had been made. In effect, he personally compensated clients as a way of misleading them about his true ability as an investment adviser as well as about the real performance of their accounts so that they would continue as his clients. The fact that these practices did not cause financial losses for either his clients or the bank does not make the conduct any less deceptive or misleading. Disclosing to clients that he provided them a "gift" or "no-risk" trades also does not mitigate the fraudulent conduct. Choice A is the best response.

*This case is based on a March 2019 enforcement action by the Investment Industry Regulatory Organization of Canada.*

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# INVESTMENTS AND TRADING



# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 1

### CASE STUDY

Meyers Associates is an investment firm providing both advisory and investment banking services. One of Meyers investment banking clients, IWEB (which manufactures and markets data storage products and cloud-based software), wants to raise its stock price to facilitate a private offering, for which it will be using Meyers as its placement agent. George works for Meyers Associates as an investment adviser. To assist IWEB with its plans, George solicits several of his advisory clients to buy IWEB stock, and at the same time solicits other clients to sell IWEB stock, frequently effecting matched orders among his customers. For a 10-day period, these trades represented 48% of the total market volume of IWEB, and the price of the stock increased from \$0.12 to \$0.19 and then stabilized at \$0.18 for the next several days. George's actions are

- A. acceptable if the purchase and sale of IWEB stock fit within each of his advisory clients' Investment Policy Statements.
- B. acceptable because he was acting to promote the interests of his client, IWEB.
- C. acceptable as long as he discloses to his advisory clients Meyer Associates' investment banking relationship with IWEB.
- D. unacceptable.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 1

#### ANALYSIS

This case is about market manipulation. Market manipulation damages the interests of all investors and lowers investor confidence in capital markets by disrupting the smooth functioning and efficiency of those markets. CFA Institute Standard II(B): Market Manipulation prohibits members from "engaging in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants." George's trading of IWEB stock for clients is distorting both the trading volume and the market's price-setting mechanism for that stock for the purpose of misleading investors in IWEB stock. George engages in the trading to assist IWEB with its private offering, not to benefit his advisory clients. Therefore, even if the trades fit within the respective IPS of his clients, the trading is unethical, making Choice A incorrect.

One element of the CFA Institute Ethical Decision-Making Framework is identifying to whom a duty is owed. Oftentimes, there are conflicting duties that must be sorted out. Although George is attempting to benefit one client (IWEB) through the trading, he cannot do so at the expense of his advisory clients because he has a duty to all his clients to treat them fairly. And although investment professionals have a duty to work on behalf of clients, they have a greater duty to protect the integrity of financial markets. Engaging in market manipulation, even to assist clients, is unethical, making choice B incorrect. Choice C is also incorrect. While oftentimes investment professionals can mitigate conflicts of interest through disclosure, disclosure of the potential conflict in working for IWEB in an investment banking capacity, does not allow George to use his advisory client accounts to engage in market manipulation. George's actions are unacceptable, Choice D.

*This case is based on a Financial Industry Regulatory Authority (FINRA) enforcement case from 2016.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 2

### CASE STUDY

Hwang is the founder and lead portfolio manager of Tiger Asia Partners (TAP) and Park is a trader for the firm. TAP is participating in private placements for both Bank of China and China Construction Bank stock, and the placement agents shared confidential information with Hwang and Park about both companies. In the days prior to the private placement, Hwang directed Park to make short sales in each stock. TAP earned \$16.2 million by using the discounted private placement shares they received to cover the short sales. Park's actions were

- A. acceptable because he was following the orders of his superior.
- B. acceptable because he used a short position rather than trading in the bank stock itself.
- C. acceptable if the placement agents did not require a confidentiality agreement covering information about the private placements.
- D. unacceptable because the trade was based on material nonpublic information.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 2

#### ANALYSIS

This case relates to trading based on material nonpublic information (MNPI). CFA Standard II(A): Material Nonpublic Information prohibits members who have MNPI that could affect the value of an investment from acting or causing others to act on that information. Hwang and Park received MNPI about the bank stocks from the placement agents as part of the offering process. Park is not exempted from the requirements of the standards simply because his boss directs that he violate laws or ethical standards, so Answer A is not correct. Park should have advised Hwang that the actions he was being asked to take were unethical and likely illegal and refused the directive to trade. The prohibition on using MNPI goes beyond the direct buying and selling of individual securities and extends to any related derivatives (e.g., swaps or option contracts), mutual funds, other alternative investments, so Answer B is not correct. It would have been advisable for the private placement agents to ask Hwang and Park to sign a confidentiality agreement, establish a "fire wall" around the disclosure of that information, and agree not to trade on the information. But even absent such an agreement, Park is prohibited from trading on MNPI, therefore C is incorrect. Because the trading was based on MNPI, the trade was improper and Park's conduct is unacceptable – Answer D.

*This case is based on an enforcement action by both the US SEC and the Securities and Futures Commission of Hong Kong.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 3

### CASE STUDY

Bouchard is a portfolio manager with discretionary control over the portfolios of more than 400 clients. Bouchard pursues a "medium risk, value" strategy for his clients, and they hire him on that basis. After scrutinizing the risk of potential investments, he makes a risk assessment for each of the securities he recommends based on the risks facing the issuer's business. The majority of securities Bouchard invests his clients' assets in are small-cap companies in the oil and gas sector and in commodities that he considers "medium" risk. As a result, Bouchard's client accounts are concentrated in those sectors. Bouchard's actions are

- A. acceptable if he discloses his investment strategy to his clients.
- B. unacceptable because he does not exercise diligence and thoroughness in executing his investment strategy.
- C. acceptable if he maintains appropriate records to support his investment recommendations and actions.
- D. unacceptable because he does not have a reasonable and adequate basis to support his investment recommendations and actions.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 3

#### ANALYSIS

This case involves CFA Institute Standard V(A): Diligence and Reasonable Basis, which states that members and candidates "must exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions." Under this standard, members must also "have a reasonable and adequate basis, supported by appropriate research and investigation" for making investment recommendations and taking investment action. In this case, there is nothing to indicate that Bouchard's investigation and analysis of the individual securities that he chooses for his clients' accounts is insufficient or inadequate.

The facts state that he "scrutinizes" the risk of potential investment on an individual basis. But in making the investment decisions, he does not appear to exercise diligence or thoroughness because he does not give sufficient weight to factors that go beyond long-term risk of the individual securities themselves. Bouchard does not consider such factors as security concentration in client portfolios, price volatility in the short term, or liquidity risk. Without considering all these factors in their entirety, Bouchard's actions underweight the risk of the securities, likely making them a more risky investment for his clients than the "medium" risk that he has assigned. Because he does not exercise diligence and thoroughness when implementing his investment strategy, disclosing his strategy to his clients or maintaining adequate records for a faulty strategy will not cure the misconduct. In this case, the best choice is B.

*This case is based on an enforcement action by CFA Institute. The member was reprimanded and fined by the regulator and CFA Institute suspended his or her right to use the CFA designation for a period of time.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 4

### CASE STUDY

Marte is an asset manager in Puerto Rico, a US territory. Residents of Puerto Rico receive significant tax advantages by investing in local securities. To capitalize on this advantage, Marte's firm offers clients shares in a closed-end investment fund, organized under Puerto Rico's financial laws and regulations, that holds at least 67% local securities and is permitted to borrow against up to 50% of its assets. The fund is usually leveraged to the extent legally permitted. Many of Marte's clients have a modest net worth and conservative or moderate investment objectives. Marte convinces them to invest 85% or more of their assets in shares of the closed-end fund. Marte's actions are

- A. appropriate because they take advantage of the fund's unique tax benefits for his clients.
- B. inappropriate because the fund uses leverage to boost returns.
- C. appropriate as long as Marte fully discloses the risks and benefits of the fund to his clients.
- D. inappropriate because the fund is an unsuitable investment for his retail clients.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 4

#### ANALYSIS

CFA Institute Standard III(C): Suitability states that CFA Institute members and candidates in an advisory relationship with clients must "determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making investment recommendations or taking investment action." In this case, given the favorable tax advantages of the investment vehicle, investment in shares of the closed-end fund may be suitable and appropriate for his clients at some level. In addition, the fund's use of leverage may not be inappropriate or make the investment unsuitable. That said, Marte should always fully disclose the risks and benefits of his recommendations to his clients.

Choice D is the best response. Given the financial circumstances and investment objectives of his clients, the high concentration of the fund's shares in his clients' accounts combined with the leverage make the weighty investment in the fund unsuitable. Despite the favorable tax advantages, highly concentrated clients bear the increased risk that a single market event affecting the value of the fund's shares would significantly decrease their total account value. This risk is exacerbated by the fact that the closed-end fund is internally leveraged, which could magnify the fund's loss during a market event that causes share values to drop steeply.

*This case is based on a FINRA (Financial Industry Regulatory Authority) enforcement action from 2015.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 5

### CASE STUDY

Smith-Pelley is president and CEO of Capital First Investment Group (CFIG), an investment adviser that is a wholly owned subsidiary of Capital First Bank. CFIG uses the 25 branch offices of the bank for its business locations. One client of CFIG, a longtime bank customer and personally known by Smith-Pelley and the board members of the bank, opened an investment account at CFIG with the stated investment objective of income. Although the client did make a few investments over the course of a year, the client engaged in almost exclusively banking activity in the account that involved hundreds of transactions and consisted of \$90 million in deposits and \$84 million in withdrawals.

The transactions included electronic transfers to and from individuals and entities located in bank secrecy havens or countries identified by the government as presenting a money laundering risk. In addition, Smith-Pelley understood the client to be engaged in a type of international business activity that presented an increased risk of transactions being tainted by corruption or bribery. But because of the client's longstanding relationship with the bank, Smith-Pelley presumed that the transactions had a legitimate business purpose. Smith-Pelley accepted vague descriptions of the transactions as "for services provided," "consulting fees," or "commissions," and he approved the daily Anti-Money Laundering (AML) reports (required by law when transactions trigger red flags of potentially suspicious activity) without further investigation. Smith-Pelley's actions are

- A. appropriate because the non-securities activity in the client's CFIG account was consistent with the type of transactions he had engaged in at the bank for many years.
- B. appropriate because Smith-Pelley is protecting the confidentiality of client information.
- C. appropriate because Smith-Pelley can rely on the clearing firm to report suspicious activity for the account.
- D. inappropriate.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 5

#### ANALYSIS

The facts presented in this case should have raised a number of questions for Smith-Pelley regarding the legitimacy of the client account at CFG. The high velocity of money movement and low volume of investment activity was inconsistent with maintaining a securities account for the purpose of generating income, as stated in the account documents. The transactions in the account were high-risk transactions for money laundering activity and should have raised a greater level of scrutiny. Rather than investigate as required by law, Smith-Pelley did not ask questions because of the client's long-standing relationship with the bank.

Smith-Pelley cannot rely on the clearing firm to meet CFG's independent obligation to review the transactions for suspicious activity. Duty of loyalty to clients and preservation of confidentiality of client information cannot be used as a shield to allow clients to violate the law or otherwise damage the integrity or viability of global capital markets. Smith-Pelley's actions violated Standard I(A): Knowledge of the Law, which states that CFA Institute members and candidates must understand and comply with all applicable laws, rules, and regulations covering their professional activities. Smith-Pelley's failure to adequately comply with the anti-money laundering requirements imposed by law violates this standard. The best choice is D.

*This case is based on a June 2018 enforcement action by the US Financial Industry Regulatory Authority (FINRA).*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 6

### CASE STUDY

Reese works for Calloway Asset Management, an independent financial adviser. Calloway provides advice to its clients about whether they should switch their retirement savings from an occupational pension scheme (such as a defined pension plan) to a self-invested personal pension (SIPP), which allows investing in a wide variety of alternative investments. These investments offer the possibility for greater returns but are typically more high risk, illiquid, and esoteric, such as overseas property. Clients are directed to Reese and Calloway for advice on switching to a SIPP through an "Unregulated Introducer" who facilitates the sale of alternative investments to clients that decide to switch. The Unregulated Introducer, an affiliate of Calloway, actively promotes and introduces clients to the concept of investing in alternative investments and provides information on particular investment vehicles.

If Reese recommends a client switch to a SIPP, the client returns to the Unregulated Introducer to purchase the alternative investments to place in his or her SIPP. The majority of Calloway's, and thus Reese's, clients are referred by the Unregulated Introducer. When determining whether a client should switch to a SIPP, Reese reviews the client's overall financial circumstances, assesses the client's existing pension provision, and evaluates the client's attitude toward risk. But the predominant factor in Reese's evaluation is the customer's desire to use pension funds to purchase alternative investments.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 6

#### **CASE STUDY** (CONTINUED)

Therefore, for almost all of his clients, Reese recommends that they transfer their retirement savings to a SIPP. The Unregulated Introducer receives a commission fee from the alternative investment sponsors if clients purchase an alternative investment for their SIPP. Reese is a shareholder of the Unregulated Introducer and serves as a director on its board. He benefits financially from both the fees paid by clients for the advice from Calloway on whether to move to a SIPP and the commissions paid to the Unregulated Introducer for its role in the sale of the alternative investments. Reese

- A. acted properly when evaluating whether clients should switch their assets to a SIPP.
- B. may assume that his clients are aware of the affiliation between Calloway and the Unregulated Introducer.
- C. must disclose his role as a director and shareholder of the Unregulated Introducer to client's seeking advice from Calloway.
- D. does not need to consider the suitability of particular alternative investments when recommending client's switch their assets to a SIPP.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 6

#### ANALYSIS

This case involves CFA Institute Standard III(A): Loyalty, Prudence, and Care; Standard III(C): Suitability; and Standard VI(A): Disclosure of Conflicts. Under Standards III(A) and VI(A), CFA Institute members have a duty of loyalty to their clients, must act with reasonable care and exercise prudent judgment, must place their clients' interests before their own, and must disclose any conflicts of interest. The suitability standard requires CFA Institute members to make a reasonable inquiry into a client's investment experience, risk and return objectives, and financial restraints to determine whether an investment is suitable in the context of the client's portfolio.

Although Reese did inquire about clients' relevant financial circumstances and tolerance for risk when making a recommendation about switching their assets to a SIPP, the facts indicate that the predominant factor in the recommendation was the client's preexisting desire to purchase alternative assets. Thus, Reese's work was not undertaken with reasonable care and prudent judgment because his evaluations and recommendations were unduly swayed by the client's wishes rather than the financial circumstances, which means choice A would not be correct. Furthermore, knowing that clients will need to sell current investments to invest in a particular alternative asset, such as overseas property, Reese must consider the suitability of that investment when advising clients about whether to move their assets to a SIPP, so choice D is also not correct.

It is clear that the Unregulated Introducer will only benefit financially if Reese recommends clients transfer their pension funds into a SIPP. Accordingly, Reese, by virtue of his relationship with the Unregulated Introducer, has a financial interest distinct from the client's interest in the outcome of the advice he gives. Therefore, a conflict of interest exists between the interests of Reese in the outcome of the advice and the client's interest in that outcome. Reese failed to ensure that his clients were informed of Reese's and Calloway's relationship with the Unregulated Introducer, and that they were informed of the financial benefit to Reese if the clients purchased alternative investments. This lack of disclosure prevented clients from being able to make a fully informed decision about whether to seek advice from Calloway about transferring their pension funds into a SIPP and to use their existing pension funds to purchase alternative investments. Choice C is the best answer.

*This case is based on facts from a recent Decision Notice from the UK Financial Conduct Authority.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 7

### CASE STUDY

Zhang is an investment adviser offering clients fixed-income investment advice through numerous separately managed accounts and two pooled investment vehicles. She charges clients an advisory fee for assets under management (AUM) and does not charge clients based on trading activity. Zhang generally invests her fixed-income portfolios in nonrated, tax-exempt, and thinly traded municipal bonds that are issued to finance the construction of senior living facilities, schools, and prisons. Zhang often holds a controlling institutional position in the bonds held across client accounts. Zhang frequently arranges for authorized cross-trading in these securities to facilitate portfolio management and provide liquidity for terminating clients. By effecting cross trades among clients, rather than trading in the secondary market, Zhang provides selling clients with liquidity in an otherwise illiquid market while maintaining a controlling position in the securities.

At the end of each month, Zhang prices the holdings in each client's portfolio by obtaining bid-side evaluation quotes (bid price) from the various broker/dealers who underwrote each of the bonds. Frequently, Zhang challenges the prices quoted by the broker/dealers as too low and, in certain instances, the broker/dealers revise their quotes to Zhang's proposed alternative price. When arranging cross trades, Zhang selects broker/dealers who are willing to execute cross trades at favorable, predetermined spreads that are narrower than the average bid-ask spread of trades in the same or similar securities executed in the secondary market. The trades are executed at the bid price obtained for month-end valuation purposes. Zhang's actions are

- A. inappropriate.
- B. appropriate because Zhang charges an advisory fee for AUM and thus does not benefit from the cross trades.
- C. appropriate because Zhang is valuing thinly traded securities in her clients' portfolios by using price quotes from the underwriting broker/dealers who are familiar with the securities.
- D. appropriate because Zhang seeks best execution by using broker/dealers who are willing to execute the cross trades at favorable bid-ask spreads that are narrower than spreads in the secondary market.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 7

#### ANALYSIS

This case relates to CFA Institute Standard III(B): Fair Dealing, which requires CFA Institute members to deal fairly and objectively with all clients when taking investment action. Zhang's actions violate this standard. By cross-trading securities at the bid price rather than obtaining and using an average or midpoint between the bid and ask prices, Zhang's actions favored the buying clients over the selling clients. At the same time, Zhang favored the selling clients in those instances in which she successfully challenged the valuations of the securities as too low. Cross-transactions subsequently executed at these higher price levels disadvantaged Zhang's buying clients, who ended up paying more than they would have had the bonds been available for purchase in the secondary market at terms similar to prior trades. Zhang's disclosure of these practices would not help in this case because disclosure does not cure or excuse treating clients unfairly. It is not clear from the facts why Zhang challenged the price of the securities as too low, but this also represents a conflict of interest for Zhang in that a higher valuation presumably benefited her investment performance history. It is also not clear that Zhang inappropriately influenced or manipulated the bond prices quoted by simply asking the brokers to reconsider their initial price. The brokers only occasionally revised the price upward. Zhang did not personally hold a controlling position but held the position by virtue of her many clients' investments.

Although Zhang did not benefit from the cross trades as her fees were based on AUM, Zhang failed to discharge adequately her best price and best execution obligations for her selling clients. Seeking valuation of thinly traded securities using broker–dealer quotes is appropriate; but in this case, Zhang used quotes from the broker/dealers who were the original underwriters of the securities and not the executing broker/dealers who were trading the same or similar securities and who would have a better idea about recent bid–ask trading activity. Finally, even if the bid–ask spreads are narrower, Zhang failed to undertake any assessment as to whether the securities were available on better terms for buying clients in the secondary market. If the prices are too high, the valuation is inappropriate. Choice A is the best answer.

*This case is based on a 10 August 2018 administrative action by the US SEC.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 8

### CASE STUDY

Zachary is a portfolio manager for PTM, a large investment management firm with numerous registered investment companies and other clients. Because of market conditions, client investment objectives, portfolio guidelines, liquidations, redemptions, or other reasons, certain PTM clients occasionally need to sell their positions in residential mortgage-backed securities (RMBS). Zachary believes that the securities PTM is required to sell for some clients are good investments at current market prices. So, he wants to move the securities into other PTM client accounts that he believes will benefit from holding the securities he views as desirable. Zachary arranges with broker/dealers to temporarily sell the securities and repurchase them the next business day. The sales are executed based on a single bid for the securities. The repurchases are executed at a small markup over the sale price. Zachary's actions are

- A. acceptable as long as the RMBS investments are suitable for the clients who purchase those securities.
- B. acceptable as long as the markup on the RMBS resale price is reasonable.
- C. not acceptable because he is not acting in the best interests of his clients.
- D. not acceptable if he does not communicate the trading arrangement to his employer.
- E. none of the above.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 8

#### ANALYSIS

Zachary is not treating all PTM clients fairly when executing the sales and purchases of the RMBS investments for their accounts. CFA Institute Standard III(B): Fair Dealing states that CFA Institute members must deal fairly and objectively with all clients when taking investment action. To meet his responsibilities to his clients, Zachary has a duty to execute trades in a manner consistent with his clients' best interests. He must follow a trading process that seeks to maximize the value of the client's portfolio within the client's stated investment objectives and constraints, and he must primarily consider best prices and consistent liquidity when executing trades.

Zachary prearranges dealer-interposed cross trades in which trading counterparties purchase RMBS from certain PTM advisory accounts; he then resells the securities to other PTM advisory accounts. Zachary's cross trades are not bona fide, arm's-length transactions, and do not involve actual transfer of risk to PTM's broker/dealer counterparties. If risk actually passed from PTM's clients to PTM's broker/dealer counterparties, they would incorporate market-based bid-offer spreads. Instead, only a single bid is used as the selling price. By cross trading RMBS at the single bid quoted, rather than at an average between the highest current independent bid and the lowest current independent offer, Zachary favors the buyers over the sellers in the transactions, even though both are advisory clients of PTM. Even if the RMBS investments are suitable for the PTM clients who purchase them, Zachary's prearranged cross trades are not in the best interest of the selling clients. The size of the markup is not relevant because of the favoritism shown to the clients buying the RMBS. Even if Zachary disclosed the trading scheme to PTM (or to the clients), that would not obviate the need for him to act in the best interest of his clients and to treat all clients fairly. Choice C is the best answer.

*This case is based on a US Securities and Exchange enforcement action from September 2018.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 9

### CASE STUDY

Paulson is a portfolio manager at Isaac Investment Advisers, managing four funds that invest in UK equities. In anticipation of an initial public offering (IPO) by the Shore Group, an online retailer of short-term vacation rentals, Paulson conducts extensive research on the company and meets with Shore Group management. He discusses the company and its future prospects with other market participants to gauge the level of interest in the IPO. Along with this research, Paulson relies on his experience of previous IPOs as well as his expertise gained from investing in the specific sector and the wider market to determine a valuation of the new shares. Paulson then discloses his planned order for the stock, including its price limit and its size, with the firm managing the IPO process for Shore Group.

Afterward, he contacts fund managers at competitor firms to suggest that they coordinate their efforts and cap their orders for an allocation of shares at the same price limit. In an email to another fund manager he states, "Some collective bargaining from the buy side is not a bad thing. The fact is there are relatively few funds with reasonable firepower in the small-cap IPOs. To protect our investors, I think we should do more of this – not be bullied by the brokers who say, 'This is coming at X price! Like it or not.'" Paulson's actions are

- A. appropriate because he is working to get the best stock price for his clients.
- B. inappropriate because he is trading on material nonpublic information obtained by meeting with company management.
- C. appropriate because he conducted thorough due diligence on the Shore Group IPO.
- D. inappropriate because he shares the confidential information of Isaac Investment Advisers with the firm managing the IPO for Shore Group.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 9

#### ANALYSIS

Paulson's actions to coordinate with fellow fund managers to affect the price of the Shore Group's IPO is an attempt at market manipulation. CFA Institute Standard II(B): Market Manipulation prohibits CFA Institute members from engaging in practices that distort prices with the intent to mislead market participants. Paulson's actions to coordinate with fellow fund managers to affect the price of the Shore Group IPO are an attempt at market manipulation. His actions undermine the proper price formation process of the IPO, which would cause harm to market participants. His actions could cause harm to issuers and existing shareholders because they could result in less capital being raised and existing shareholdings being valued at less than they otherwise might have been.

IPOs play a vital role in helping companies raise capital in the financial markets and are predicated on natural market forces determining pricing. Issuers and investors expect the prices to be fair and reflective of genuine market demand. When investors attempt to undermine this price formation process by artificially driving down the price of an IPO, the efficiency, functioning, and stability of the financial markets are threatened. Paulson has a duty to protect the integrity of capital markets even over his responsibilities to his clients. Meeting with company management is a normal part of the due diligence process.

The facts of the case do not indicate that he received material nonpublic information in meeting with company management. The research Paulson conducts appears to show that he exercised diligence, independence, and thoroughness in analyzing the Shore Group IPO. Sharing the price limit and order size with the firm running the Shore Group IPO is part of the process to determine at what price to offer an IPO by gauging demand from institutional investors. Because the responses do not address market manipulation, choice E is the best response.

*This case is based on a February 2019 Enforcement Action by the Financial Conduct Authority.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 10

### CASE STUDY

Gain is a commodities trader with a number of retail clients, including Laube who opens a retail forex account with Gain. Laube's forex account is self-directed, and Gain does not advise Laube on any trades. Laube signed Gain's standard customer agreement, which contains provisions relating to margin requirements and liquidation in the event of margin deficits. The agreement authorizes Gain, at his discretion, "to liquidate, without notice, any or all open positions in an account with insufficient margin." Laube initially purchases two 100,000 US dollar/Swiss franc (USD/CHF) positions, bringing his margin requirement to \$4,000. Then Laube purchases two additional 100,000 USD/CHF "pending limit" orders if the trading prices reach a specified level. Because each order has a different limit price, one order will execute before the other. Shortly after placing these limit orders, Laube goes on an extended vacation. While on vacation, the execution on the first limit order triggers, bringing the margin requirement to \$6,000. Later, when the limit price is reached, the second order executes, bringing Laube's margin requirement to \$8,000. After the trades, while Laube is still on vacation, his account balance drops to only \$6,900. Without notice, Gain liquidates all positions in Laube's account, realizing a loss of \$37,000 from the liquidation. Gain's actions are

- A. appropriate because Gain followed the policy and procedures set forth in Laube's client agreement.
- B. inappropriate because Gain has a duty to act in the best interest of Laube by protecting his financial position.
- C. inappropriate because Gain could have met the margin requirement by liquidating only one forex contract.
- D. inappropriate because the margin and liquidation policies in the client agreement are misleading.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 10

#### ANALYSIS

This case relates to the duties of loyalty, prudence, and care owed to clients in relation to advisers' duties to other clients and the markets. Generally, CFA Institute Standard III(A) imposes on CFA Institute members a duty of loyalty, prudence, and care to act in the clients' best interests. The conduct that fulfills this responsibility, however, depends on the nature of the relationship with the client. In this case, Laube self-directs his trades, which are simply executed by Gain who does not provide investment advice. Laube freely contracts with Gain regarding the consequences of insufficient margins in his account, and these policies and procedures are clearly set forth in the client agreement. There is no indication in the facts that Gain misled Laube about the margin requirements or the liquidation procedures. Margin requirements allow commodity traders to ensure their own financial integrity, which, in turn, contributes to the financial integrity of the entire marketplace.

Gain's responsibility to protect his own financial position and that of his other customers may supersede any duties he owes to Laube when Laube defaults on his margin requirements. Given the limited nature of the relationship between Laube and Gain, Gain is not obligated to actively monitor Laube's account to protect Laube's financial interests. Doing so would require Gain to continuously monitor a potentially deteriorating market or to take on additional risk management measures that Gain has not agreed to and that Laube has not contracted for. Gain also is not obligated to use a less drastic alternative by closing only one forex contract and does not breach a duty to Laube by liquidating all open positions when the parties have contractually agreed that total liquidation to meet a margin deficit may be done at Gain's discretion without notice. Although the contractual provision authorizing liquidation without notice does not waive Laube's right to be dealt with in good faith, the margin and liquidation provisions are not an attempt by Gain to waive his duty of loyalty, prudence, and care. They simply set forth the parameters of the relationship. Gain and Laube are each free to negotiate the nature and extent of the relationship. Although Laube suffered significant trading losses from liquidation of his account, Gain liquidates Laube's open positions for business reasons, to protect the integrity of the market, and in accordance with the terms of the customer agreement. Choice A is the best response.

*This case is based on a 2017 US Commodities Futures Trading Commission decision.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 11

### CASE STUDY

Danaher works as a corporate bond broker for AFB Financial (AFB), an interdealer broker that only trades dealer to dealer. Danaher and AFB's other brokers are paid entirely by commissions and deal only with large banks, institutions, and other dealers, not with retail investors. AFB does not take positions in any securities and executes trades in a matched principal capacity. One of Danaher's biggest and most demanding accounts is that of NOVA Capital. NOVA is represented by Elliott who works on NOVA's corporate bond trading desk. NOVA requires a capital reserve for bond positions that age more than 180 days (aged inventory) and charges that reserve against Elliott's inventory book. Aged inventory cash reserves affect the profit and loss calculations of Elliott's proprietary account and, as a result, reduce Elliott's compensation.

At Elliott's request, Danaher agrees to occasionally purchase bonds from NOVA and sell back the same bonds later in the day. Danaher understands that these trades allow Elliott to "reset the clock" to avoid aged inventory reductions in the profits of the proprietary account he manages for NOVA and to avoid negative effects to his compensation. Danaher does not immediately reverse the trades but holds these securities for four to six hours during the day. He also does not sell NOVA's bond positions to another firm before selling them back to Elliott and NOVA at the original price. Danaher's actions are

- A. inappropriate.
- B. appropriate because he is executing the trades in the time and manner requested by his client.
- C. appropriate because the four to six hours between trades creates market risk.
- D. appropriate because Elliott and NOVA are sophisticated institutional clients that are expected to have full knowledge and understanding of their trading strategy.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 11

#### ANALYSIS

This case relates to misconduct, violation of the law, and loyalty to clients. The CFA Institute Standards of Professional Conduct prohibit members from engaging in any professional conduct involving dishonesty, fraud, or deceit (Standard I(D)), require members to refrain from participating in legal or ethical violations (Standard I(A)), and require members to place their client's interests before their own interest (Standard III(A)). In this case, NOVA is a client of AFB, and Danaher is AFB's employee handling that account. Danaher understands that Elliott, NOVA's representative who is responsible for managing the firm's account with AFB, is engaged in a fraud against his employer.

Although there would be no issues with a customer buying and selling the same security on the same day, provided the customer assumed market risk, such risk is not established by how long a party holds a position. In this case, there was no market risk because Danaher never sold NOVA's positions to another firm before selling them back to NOVA at the same price. To placate Elliott, Danaher agrees to assist Elliott in fraudulently updating the "age" of Elliott's corporate bond inventory on NOVA's books so that Elliott will not be financially penalized. These trades are not truly at the request of the client but rather are executed on behalf of a duplicitous employee. Furthermore, in meeting this request, Danaher knows that NOVA will have to pay AFB commissions for non-bonafide transactions in which there was no beneficial change in ownership. Danaher personally benefits from these transactions because he receives a portion of AFB's commissions on the trade as compensation. By assisting in this fraud against NOVA, Danaher fails to protect the interest of his client. The fact that NOVA is a sophisticated investor that fails to discover its own employee's deceitful and fraudulent activity, does not excuse Danaher's misconduct. Choice A is the best choice.

*This case is based on a June 2019 Financial Industry Regulatory Authority Enforcement Action.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 12

### CASE STUDY

Khatri plays on a local cricket team with a number of friends from University, including Patel, his brother-in-law and an attorney, and Ahuja, who owns a software company called ZeroPower (ZP). Patel does the legal work for ZP. Over the years, Khatri, Patel, and many other friends in their circle invest in Ahuja's company. A large global IT company makes an offer to buy ZP at a substantial premium over the company's current share price. Patel works with lawyers from the acquiring firm to assist in their due diligence.

One weekend, during a particularly intense period of negotiations, while Khatri, Patel, and Ahuja are playing in a cricket tournament, Patel speaks repeatedly with representatives of the acquiring firm on his cell phone between cricket matches. Khatri partially overhears Patel's discussions. Although it is not explicit that an acquisition of ZP is being considered, Khatri hears Patel mention repeatedly the name of the acquiring firm. Khatri guesses that ZP is likely to be acquired by the firm because he sees Patel and Ahuja huddled in private conversation several times over the course of the weekend. On Monday Khatri calls his broker and increases his investment in ZP by 5,000 shares. One week later, ZP announces its acquisition by the large IT firm and its share price increases by 30%. Khatri's actions are

- A. acceptable because Khatri's investment was based on his own speculation.
- B. acceptable because Khatri is not an insider of ZP or the acquiring firm.
- C. acceptable because Khatri received the information in a public environment.
- D. acceptable because Khatri used the Mosaic Theory to make his decision to increase his investment in ZP stock.
- E. none of the above.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 12

#### ANALYSIS

This case relates to material nonpublic information. CFA Institute Standard of Professional Conduct II(A): Material Nonpublic Information prohibits CFA Institute members from taking investment action based on material nonpublic information in their possession. The prohibition in this standard is not limited to only those who have information because they are "insiders" but applies to anyone who is in possession of material nonpublic information. In this case, Khatri comes into possession of material nonpublic information by overhearing confidential information from Patel's phone calls and seeing Patel's interactions with Ahuja that are prompted by those calls. Although the information about the acquisition of ZP was not explicitly stated, and some degree of deduction was required by Khatri, he knew or should have known that this information was confidential, nonpublic, and material. Patel should have been more careful to keep his phone conversations more private, but that does not allow Khatri to use material nonpublic information gleaned from eavesdropping on those conversations. Khatri's actions are not an example of using the Mosaic Theory (investing based on cumulative nonmaterial or public information) because he uses of confidential, material information that is improperly obtained. Therefore, E is the best response.

*This case is based on a July 2019 US SEC Enforcement Action.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 13

### CASE STUDY

Santos trades digital coins on cryptocurrency exchanges for both his own account and as an investment strategy for clients who have indicated an interest in such speculative trading and for whom it is appropriate. The cryptocurrency exchanges are unregulated markets. Santos is a member of "EasyCoin," a chatroom in which coin traders gather that has thousands of members. EasyCoin is a private chatroom accessible by invitation only and is overseen by an anonymous moderator. Generally, the chatroom moderator announces a date, time, and exchange for members to initiate trading. At the set time, the moderator informs the chatroom of the particular cryptocurrency to be traded. Traders, including Santos, buy that digital coin creating a surge in the price with the intention of attempting to sell before the price collapses. Over the past several months, 47 different cryptocurrencies have been promoted on EasyCoin and generated \$357 million in trades. Santos often profits from the rise in the price of the cryptocurrency by timing his trades correctly, but occasionally he buys and holds the digital coin too long and the price drops steeply before he can sell, causing him to lose money for himself and his clients. Santos actions are

- A. acceptable because Santos, unlike the moderator of the EasyCoin chatroom, is not actively organizing the trading of the digital coin.
- B. unacceptable because Santos is engaged in market manipulation.
- C. acceptable because he voluntarily engages in this speculative trading based on information in a private chatroom.
- D. unacceptable because speculative trading cryptocurrency in unregulated markets for client accounts is unethical.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 13

#### ANALYSIS

The facts of this case are addressed by CFA Institute Standard II(B): Market Manipulation, which states that CFA Institute members must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants. In this case, Santos, at the direction of the moderator in the EasyCoin chatroom, engages in trading with the intent to give the impression of price movement in a financial instrument. The fact that the financial instrument is a cryptocurrency trading in an unregulated market and not a conventional security trading in a public market does not affect the applicability of the standard. Although Santos is not organizing the run-up of the price for digital coin, his actions in trading the coin at the behest of the EasyCoin chatroom moderator at a particular time and on a particular market make Santos a participant in the manipulation scheme. Trading in speculative investments on behalf of himself or his clients is acceptable if appropriate and warranted by clients' financial circumstances and risk tolerance. But engaging in fraud on the market through market manipulation is a violation of Standard II(B). The best answer is B.

*This case is based on a story in the 6 August 2018 issue of the Wall Street Journal.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 14

### CASE STUDY

Cherrington is a registered representative with a US broker/dealer who has a number of individual clients, including his mother. Cherrington trades mutual fund shares for his mother's account, which has a long-term investment horizon. All of these funds have similar long-term risk and return objectives. Cherrington split \$731,265 in investment funds in his mother's account among 42 different mutual funds in 11 fund families. For the majority of mutual fund purchases, he sold the funds within 92 to 274 days of purchasing them. Cherrington earned \$24,747 in sales charges for these trades but discounted the fees 10% because it was his mother's account. Cherrington's actions are

- A. unacceptable because Cherrington treated clients unfairly by discounting the fees in his mother's account.
- B. acceptable because mutual funds are safe long-term investments.
- C. unacceptable because the trades resulted in unsuitable investments.
- D. acceptable because Cherrington diversified his mother's investments among funds with a strategy that matched her long-term strategy and outlook.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 14

#### ANALYSIS

This case relates to Standard III(C): Suitability, which requires CFA Institute members to determine that an investment is suitable for a client's financial objectives, mandates, and constraints before taking any investment action. In this case, Cherrington is trading mutual fund shares in funds with a similar long-term risk and return objectives as his mother's account, which would seem to make these investments suitable for his mother's account. But although mutual funds are generally safe and conservative investments, the short-term nature of the trades conflicts with his mother's long-term investment horizon. In addition, the new mutual funds' objectives and risks were similar to the funds that were sold, such that the \$24,747 in sales charges, even discounted by 10%, outweighed any marginal benefit from the new mutual funds. Finally, splitting his mother's investment funds into 42 different mutual funds in 11 fund families generated higher sales charges because his mother was unable to take advantage of savings from breakpoints that likely were available for larger investments. For all of these reasons, Cherrington's investments for his mother's account were unsuitable. Clients can be charged different fees; they do not have to be equal for all accounts. Fee discounts can be made for many reasons, and Cherrington may have given other similar or even more generous discounts. A discounted fee does not necessarily mean that clients are being treated unfairly. Choice C is the best answer.

*This case is based on a 24 August 2018 disciplinary proceeding by the Financial Industry Regulatory Association.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 15

### CASE STUDY

Antron is a commodities trader for a regional bank. He often places customer orders for precious metal futures contracts. Then shortly after placing a customer order, he will place a significantly larger order on the other side of the trade for his personal account. So for example, when a customer order is a "sell" order, Antron places a much larger "buy" order from his personal account. Typically, Antron's orders for his personal account are placed slightly lower than best price, reducing the likelihood of his order being filled immediately. As soon as the customer order is executed, Antron cancels his personal trade order. Antron's actions are

- A. unacceptable.
- B. acceptable because his clients' trades are always executed prior to his personal trades.
- C. acceptable if he discloses that he is engaging in a trading strategy for his personal account that is opposite that of his client account.
- D. acceptable because he is acting in the best interests of his clients.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 15

#### ANALYSIS

Antron is engaged in a market manipulation scheme in violation of CFA Institute Standard II(B): Market Manipulation, which prohibits CFA Institute members from engaging in practices that distort prices with the intent to mislead the market. By trading in this manner, Antron is engaging in the practice of "spoofing": His personal orders, which he routinely cancels, are fake or spoof orders entered with the intent to send false signals to market participants. So for example, by placing spoof orders to buy, Antron sends market participants a false signal of greater demand, creating the impression that the price would likely rise and tricking market participants into executing against his genuine customers' orders to sell. This causes his customers' genuine sell orders to be filled sooner, at a better price, or in larger quantities than might otherwise occur. (The risk that the spoof orders could mislead other market participants into believing there was genuine interest in purchasing or selling the specified number of contracts represented by Antron's spoof orders was so obvious that Antron must have been aware of it.)

Although Antron's spoofing practice is boosting returns for his clients' trades, he is doing so at the expense of the integrity of the market. The order of trading between client orders and those for his personal account is irrelevant. In fact, his personal trades are never executed—an integral part of the spoofing scheme. And because Antron is not following a legitimate trading strategy, disclosure of his strategy to his clients does not legitimize or permit his market manipulation scheme. Choice A is the best answer.

*This case is based on a US Commodities Futures Trading Commission enforcement action from February 2019.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 16

### CASE STUDY

Cho, an accountant in a fund management company, lives with his fiancée Wang, an investment banker with a global bank. In view of their proximity, Wang cautioned Cho that her work involves confidential material and advised him not to divulge what he may pick up from her work to anyone.

During a weekend holiday, Cho overheard an acquisition deal which Wang was working on. He decided to buy small quantities of the derivatives of the target stock instead of the stock of the target company. The profit from the transaction would help defray expenses of their impending marriage. Both the derivative and the stock did not come under the restricted list of Cho's employer; and Cho was not yet married to Wang. He went ahead with the purchase, but to his disappointment, the transaction netted him a loss instead. Cho's actions are

- A. acceptable because he bought the derivatives instead of the stock.
- B. acceptable as long as he does not divulge the acquisition information to others.
- C. acceptable only because he suffered a loss.
- D. acceptable because he is merely engaged to Wang.
- E. none of the above.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 16

#### ANALYSIS

Cho was clearly in possession of material nonpublic information when he overheard Wang's conversation. CFA Institute Standard II(A): Material Nonpublic Information says that CFA Institute members who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information. Although Cho bought the derivatives instead of the stock, he is deemed to have acted upon the information.

Even though Cho did not divulge the information to others, thus causing others to act, his decision to act on the information was a clear violation of Standard II(A). Although the transaction did not yield a profit, the loss Cho suffered is irrelevant. The intent was clear. He wanted to profit from the transaction. And he acted upon it.

Whether Cho obtained the information from a total stranger or from his fiancée is also irrelevant. Cho came into possession of material nonpublic information, and he should not have acted on it. Wang could have exercised tighter control on her communications to maintain confidentiality. A firewall should have been erected between her work and her personal life at home as well as on holiday. Although her investment actions would no doubt have been subject to close pre- and post-trade monitoring, Wang could have offered her fiancée's portfolio for scrutiny.

When Cho came into possession of material nonpublic information, he should have communicated this to designated supervisory and compliance personnel in his company. The same should have been done on Wang's part. Cho must not take investment action on the information or knowingly engage in any conduct that may induce others to privately disclose material nonpublic information. Choice E is the only response.

*This case was written by Vineet Vohra, CFA, and Chan Fook Leong, CFA, and is based on a December 2018 Enforcement Action by the US Securities and Exchange Commission.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Investments and Trading – Case 17

### CASE STUDY

Eller is the head trader for a large, global investment adviser and broker/dealer firm. Eller executes the majority of customer orders internally but routes a significant portion of orders to other, outside broker/dealers for execution. Over a period of five years, Eller and the firm routed to outside venues 15.8 million orders that involved 5.4 billion shares worth more than \$141 billion. Eller and the firm do not inform clients that trades are sometimes executed using outside venues. Eller's actions are

- A. appropriate as long as Eller obtained best execution for the clients wherever the trade was executed.
- B. inappropriate because Eller is misleading clients regarding a material aspect of the investment process.
- C. appropriate because order execution venue diversification is an insignificant and routine aspect of the investment process.
- D. inappropriate because using outside broker/dealers to execute client trades could distort market prices.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 17

#### ANALYSIS

The execution of trades is a material aspect of the investment process. Investors can use the execution venue information provided by the firm to make strategic choices about their broker/dealer relationships and tactical routing decisions. Investors may also not want their orders routed to outside venues because it exposes important information about their investment strategy. In addition, listing outside trade executions as having occurred within the firm gives the misleading impression that the firm is a more active trading center than it actually is. Using outside broker/dealers is not, in and of itself, unethical and does not necessarily lead to distorting the market. Eller's ability to obtain best execution for these trades does not absolve him of misleading the firm's clients regarding a material aspect of the investment process. By providing inaccurate information to clients about how their trades were executed, Eller violated CFA Institute Standard I(C): Misrepresentation, which prohibits CFA Institute members from making any misrepresentation relating to investment actions. The best choice is B.

*This case is based on a US SEC enforcement action and penalty.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Investments and Trading – Case 18

### CASE STUDY

Marcos, a baggage handler for a regional airline, learns about investing by reading books during breaks at work and participating in online seminars produced by the mutual fund family that sponsors the airline's retirement account. He also obtains a few investment-related certificates, including the Investment Foundations® certificate from CFA Institute. He begins to manage the retirement accounts of a few friends and other airline employees who hear of his investing hobby by word-of-mouth. For a nominal flat fee of \$300, Marcos "takes over" the employees' airline retirement accounts, selects their investments, and makes their trades. With his colleagues' permission, Marcos trades directly in their accounts by logging into their accounts, having the broker/dealer's "activation code" for a trade sent to the employee, and then getting the employee to text him the code so he can complete the trade. Some of his fellow employees add Marcos's email address to their account profiles so that the activation codes are sent directly to his email.

Marcos uses a market timing strategy for the mutual funds he selects. He invests his fellow employees' assets in a single mutual fund available through the airline retirement platform and sells everything when he believes that the price is right. He then invests the assets in a bond fund while waiting to choose the next investment. When Marcos is added to a Facebook group for airline employees to post interesting "selfie" photos, he posts a picture of the retirement statement of one of his friends that shows close to \$1 million in assets. None of the account holder's identifying information is shown. This drives more airline employees to seek out Marcos to manage their retirement investments. Marcos starts his own Facebook group, which grows to 9,000 members, in which he promotes his investment prowess, answers questions about retirement investing, and posts information about the airline retirement plan. Eventually Marcos manages more than \$110 million in assets for 934 fellow employees collecting more than \$280,000 in fees. Marcos's actions are

- A. appropriate because he is not an investment adviser but is informally assisting fellow employees.
- B. appropriate because he has the full permission of his colleagues to manage their retirement accounts in this manner.
- C. inappropriate because he is violating the Code of Ethics and Standards of Professional Conduct applicable to those who have earned the CFA Institute Investment Foundations certificate.
- D. inappropriate.
- E. none of the above.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Investments and Trading – Case 18

#### ANALYSIS

This case relates to knowledge of the law. CFA Institute Standard of Professional Conduct I(A): Knowledge of the Law states that CFA Institute members must understand and comply with all applicable laws, rules, or regulations governing their professional activities. Although Marcos is managing money for a group of friends and colleagues, he is engaged in activities that make him an investment adviser. He is advertising his services through his Facebook group, providing investment advice, making investment decisions, and trading on behalf of individuals for a fee. There is no indication that he has registered with the appropriate authorities as an investment adviser or taken any of the steps required of investment advisers, such as maintaining trading records, creating written client agreements, evaluating suitability of investments, and so forth. Although he has the permission of his "clients" to manage their investments, he has not properly registered as an investment adviser. And even though it would be advisable and beneficial for any investment adviser to comply with the CFA Institute Code of Ethics and Standards of Professional Conduct, those earning the Investment Foundations certificate from CFA Institute are not required to abide by the Code and Standards. Choice D is the best response.

*This case is based on a US SEC enforcement action from September 2019.*

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# OUTSIDE ACTIVITIES

# CFA INSTITUTE

## ETHICS IN PRACTICE: Outside Activities – Case 1

### CASE STUDY

Stansfield, CFA, works as a portfolio manager at Pitt Asset Management (PAM) based in New York. He has been actively involved with theatre since his college days and performs occasionally as a stand-up comedian at a comedy club after work hours. He is not compensated for his performances, but he is hoping to leave his job to launch an entertainment career. Audience members often show their appreciation for Stansfield's act by giving him nominal tips. One night, Elaine Bennet, a broker at Newman Brokers, a firm that PAM often trades with and in sizeable volumes, stops at the comedy club with a group of friends while Stansfield is performing. Bennet and her friends thoroughly enjoy Stansfield's comic routine and, as a token of appreciation, the group tips him \$5,000. Stansfield should

- A. accept the money and thank Bennet and her friends for their generosity.
- B. accept the money but disclose it to his supervisor at PAM.
- C. accept the money but seek approval from his supervisor before continuing to perform at the club if he anticipates further additional compensation.
- D. not accept the money but thank Bennet and her friends for their compliments on his performance.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Outside Activities – Case 1

#### ANALYSIS

This case potentially involves violations of the CFA Institute standards related to independence and objectivity and/or conflicts of interest. If Stansfield accepts the tip, it could be construed as gift to influence his conduct because some may find it implausible that an audience member would give such a generous tip irrespective of how much he or she might have enjoyed the comic sketch. The large tip he receives from Bennet and her friends after they attend his performance could be seen as an attempt by Bennet to influence Stansfield's/PAM's choice of brokers. But a key step of the CFA Institute Ethical Decision-Making Framework asks those facing an ethical dilemma to identify relevant facts.

A number of relevant facts need to be determined to make an informed decision about the appropriate course of action for Stansfield. Does Bennet know Stansfield and know that Stansfield works for PAM or are they strangers? Does Stansfield have decision-making authority in choosing brokers on behalf of PAM (and if so does Bennet know this) or is Stansfield not involved in the decision about which brokerage firm to use? Does Stansfield know Bennet and who she works for? Was the tip primarily from Bennet or did it represent a collection from the whole group of friends? Do her friends work at Newman as well? Is one of them particularly wealthy and generous with struggling new entertainers?

Assuming that the tip came primarily from Bennet, Bennet knew Stansfield worked at PAM and believed Stansfield to have influence over PAM's brokerage decisions, and Stansfield knew Bennet and who she worked for, then best practice would be for Stansfield to politely reject the tip because it could be perceived to influence his fairness and objectivity when allocating trades. Although the information is incomplete, with these assumptions, the best response would be D. In working at the comedy club, Stansfield did not violate Standard IV(B): Additional Compensation Arrangements, which states that CFA Institute members must not accept any "compensation... that competes with or might reasonably be expected to create a conflict of interest with their employer's interest" without written consent. Stansfield's appearances at the comedy club did not interfere or compete with his day job at PAM, and he normally received tips that were minimal in value.

*This case is based on facts provided by Tanuj Khosla, CFA, CAIA.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Outside Activities – Case 2

### CASE STUDY

Gordon is an investment representative at Wallsend Financial Services, a mutual fund dealer. Wallsend requires its employees to disclose outside business activity for review and approval by the firm. While working for Wallsend, Gordon serves as a director on four outside boards. Gordon gets approval from Wallsend for three of the boards positions, but the fourth is for a charity called *Born in the 50s* to help homeless children that is run by his father. Gordon does not submit the position for approval because it is a volunteer role that he has taken only temporarily to help his father. Wallsend eventually discovers Gordon's service on the *Born in the 50s* board. Wallsend is in the process of reducing their workforce, and after confirming that Gordon failed to disclose his involvement on the additional board, they terminate him for violation of their policy. Now unemployed, Gordon receives his Professional Conduct Statement (PCS) from CFA Institute. Is Gordon required to disclose the internal investigation by Wallsend concerning his nondisclosed service as a director on the *Born in the 50s* board?

- A. No, it was an internal matter at Wallsend, and no client was involved.
- B. No, Gordon was a volunteer and his firing was unjustified and likely driven by Wallsend's workforce reduction motive.
- C. No, this was not a question of Gordon's professional conduct or activities.
- D. Yes, Gordon should disclose this matter on his PCS.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Outside Activities – Case 2

#### **CASE STUDY (CONTINUED)**

Gordon ultimately decides not to disclose the matter to CFA Institute because he believes he was wrongfully terminated. But he receives a notice of investigation from the regulator concerning his violation of Wallsend's internal policy. Gordon decides to just settle with the regulator. He receives a one-month suspension and a fine for violating the rules pertaining to outside business activity. CFA Institute discovers Gordon's settlement with the regulator through its monitoring efforts and initiates its own investigation. As a CFA charterholder, Gordon is required to cooperate in the Professional Conduct investigation, but Gordon wants to resign his membership to avoid the CFA Institute investigation.

- A. Even if Gordon resigns, he was a member and charterholder at the time of the conduct and thus CFA Institute has jurisdiction over him.
- B. If Gordon refuses to cooperate, CFA Institute can impose a Summary Suspension followed by a Revocation of Gordon's CFA® charter.
- C. If Gordon cooperates with the Professional Conduct investigation, he will be able to tell his side of the story and contribute evidence in support of his position.
- D. All of the above apply.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Outside Activities – Case 2

#### ANALYSIS

This case addresses issues related to the disclosure, investigation, and sanctioning of member misconduct by the Professional Conduct division of CFA Institute. Regarding whether Gordon must disclose Wallsend's internal investigation on his PCS, the correct answer is yes, thus in the first set of multiple-choice answers, choice D is the right decision. Choice A is incorrect because even if it was an internal matter at Wallsend and no client was harmed, the PCS contains six questions and the second question requires a yes response if you have been "the subject of any investigation (internal or external) in which your professional conduct or activities were questioned or at issue." Choice B is also incorrect because the issue is not whether Gordon was justified in his actions or whether his employer had an ulterior motive, the issue is whether there was in fact an internal investigation by his employer involving his professional conduct or activities. And "C" is incorrect because although Gordon may disagree that the temporary volunteer work for his father constitutes a professional activity that needs to be reported, his employer obviously thought it was an activity that needed to be reported. Therefore, the Wallsend investigation needed to be disclosed regardless of its merits

Regarding the second set of multiple-choice answers, choice D is again the right decision because this time, answers A, B, and C are all true. Under the CFA Institute Rules of Procedure, CFA Institute has jurisdiction over Gordon because he was a member and a charterholder at the time of the conduct. If Gordon refuses to cooperate, CFA Institute will proceed with a Summary Suspension, which will lead to a printed Notice of Disciplinary Action followed by a Revocation. Finally, if Gordon cooperates with the Professional Conduct investigation, he will be able to tell his side of the story and contribute evidence in support of his position.

*This scenario is based on a real case handled by the Professional Conduct division at CFA Institute. A Disciplinary Review Committee found that the member violated the following Standards: I(A): Knowledge of the Law, IV(A): Loyalty, and VI(A): Disclosure of Conflicts. The member in the actual case did in fact disclose the matter on the PCS and in a timely manner. Therefore, there was no violation of Standard VII(A): Conduct as Participants in CFA Institute Programs, which makes it a violation to misrepresent information on a PCS.*

#### ABOUT CFA INSTITUTE

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Outside Activities – Case 3

### CASE STUDY

Myers is a founder of and partner at Redbrick, a \$3 billion hedge fund focused on environmental, social, and governance investments. In support of upcoming state elections, he donated \$2,000 to DeFrietas, one of the candidates. As a passionate climate advocate and an avid proponent of responsible investment, Myers supported DeFrietas' backing of environmental policies to reduce air pollution and mitigate the effects of climate change. Myers also thought that his political contribution might be beneficial for Redbrick because DeFrietas was running for a position that had influence over which hedge funds received investments from the state's pension plans. Myers informed all Redbrick limited partners (LPs) about the contribution and clarified that he had used personal rather than company funds for the political contribution. Myers' actions are

- A. appropriate because he provided full disclosure about his political contribution to his clients.
- B. appropriate because he used personal funds and the amount of his donation is insignificant relative to the size of the fund.
- C. appropriate because his donation supports a candidate whose environmental policies align with his beliefs.
- D. inappropriate because making donations to try to win investments from the state pension fund violates the CFA Institute *Code of Ethics and Standards of Professional Conduct*.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Outside Activities – Case 3

#### ANALYSIS

This case relates to CFA Institute Standard I(B): Independence and Objectivity, which states that CFA Institute members must not offer any gift, benefit, compensation, or consideration that reasonably could be expected to compromise another's independence and objectivity. Managers may try to gain lucrative allocations from government-sponsored pension funds by making requested donations to the political campaigns of individuals directly responsible for the manager hiring decisions. This activity would be prohibited by Standard I(B). In this case, Myers seems to have both proper and improper motivations for making a political contribution to DeFrietas. On the one hand, Myers supports DeFrietas' positions on protecting the environment and wants to further those goals. The standard is not meant to prevent participation in the political process through financial or other support for candidates by investment professionals. On the other hand, Myers recognizes that financial support of DeFrietas could benefit Redbrick by currying favor with someone who may be in a position to determine whether to invest in Redbrick's fund.

The source of the funds—personal or from Redbrick—is irrelevant if the donation was meant to influence DeFrietas. Similarly, disclosure to clients does not address or mitigate the issue of the contribution's effect on the independence and objectivity of the hiring decision maker. The question is whether the donation is reasonably designed to improperly affect DeFrietas' independence and objectivity and to benefit Myers or Redbrick directly. Many factors would go into this determination, including the size of the donation, Myer's intent in making the donation, and how influential DeFrietas' position would be in making the hiring decision. As Myers' actions could be perceived as inappropriate, the safest course of action would be to avoid any potential conflict by not donating to the DeFrietas campaign and by seeking to support environmental protection policies in some other way.

In the United States, "pay-to-play" scandals and similar events have led to numerous laws, rules, and regulations at the state and federal level governing political contributions. Under US law, it is unlawful for investment advisers, including hedge funds and private equity firms, to provide compensatory advisory services to a government client for a period of time following a political contribution by the firm or one of its "covered associates" to political candidates or officials in a position to influence the selection of advisers to manage public pension funds or other government client assets. Small contributions are exempted by the rule. CFA Institute members should take care to ensure that their conduct in making political donations complies with the law so as not to risk a violation of CFA Institute Standard I(A): Knowledge of the Law.

*This case was submitted by Anna Sembos, CFA, who serves as volunteer with Compliance Connection, an extension of the CFA Institute Global Monitoring Program.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Outside Activities – Case 4

### CASE STUDY

Ziegenthaler is an analyst and trader for a large global asset management firm. The president and CEO of the firm is a legendary figure in the investment industry and appears regularly on global financial television programs as a commentator. Videos of these appearances routinely show the CEO sitting in the firm's trading room with the traders' workstations featured in the background. Ziegenthaler's workstation and computer screen are often clearly visible during the CEO's television appearances.

In addition to working as an analyst for the firm, Ziegenthaler is a passionate supporter of an animal rights organization that protests the use of animal fur and hides by the fashion industry. During the CEO's next television appearance, and unnoticed by the program's producers, Ziegenthaler pulls up a graphic anti-fur poster on her computer screen so that it can be seen by viewers. Several of the firm's clients, including members of the family of a prominent fashion house, are offended by the graphic and complain to the firm. Ziegenthaler's actions are

- A. inappropriate because she was using employer resources without permission.
- B. inappropriate because her actions reflected poorly on her professional reputation or integrity.
- C. appropriate because she is free to express her personal views on a topic unrelated to work.
- D. appropriate because her actions did not cause financial harm to her employer.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Outside Activities – Case 4

#### ANALYSIS

This case relates to the professional conduct of an investment professional and her duty to her employer. CFA Institute Standard of Professional Conduct IV(A): Loyalty (to employer) requires CFA Institute members to act for the benefit of their employer and not cause harm to their employer. In addition, Standard I(D): Misconduct states that CFA Institute members must not commit any act that reflects adversely on their professional reputation or integrity. As a general matter, investment professionals are free to voice and act on their political beliefs outside of their work environment. Standard I(D) is not meant to curtail freedom of expression or address conduct (or even acts of civil disobedience) in support of personal beliefs as long as that conduct does not reflect poorly on the member's professional reputation or competence.

Ziegenthaler's beliefs related to animal rights, in and of themselves, are not related to her professional competence and do not reflect poorly on her reputation or integrity. But in this case, Ziegenthaler surreptitiously uses resources and a platform made available to her through her employer to express and promote her views. These actions caused her employer at least some reputational harm with its clients, as evidenced by their complaints. As a result, Ziegenthaler's actions are inappropriate. Choice A is the best answer.

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Outside Activities – Case 5

### CASE STUDY

Simpson is a portfolio manager employed by a large global investment bank, managing an investment fund restricted to environmental, social, and governance (ESG) friendly investments. Outside of work, he participates in civil disobedience demonstrations organized by the Extinction Rebellion, a sociopolitical movement that uses nonviolent resistance to protest against climate breakdown, biodiversity loss, and ecological collapse. Simpson is arrested on charges of unlawful assembly, impeding public transit, and disorderly conduct at several demonstrations held in the financial district of the city where he works. He is ultimately convicted of several criminal offenses. Simpson has signed a standard employment contract with the bank that allows them to terminate the contract of any employee who is convicted of a criminal offence. Under the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards), Simpson's actions

- A. violate the Code and Standards because he has violated his employment contract with the bank.
- B. do not violate the Code and Standards because he is engaged in conduct promoting the ultimate benefit of society.
- C. violate the Code and Standards because he is arrested for misconduct in the financial district.
- D. do not violate the Code and Standards because his conduct is consistent with the mandate of the fund he manages.
- E. none of the above.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Outside Activities – Case 5

#### ANALYSIS

This case relates to what constitutes professional misconduct. CFA Institute Standard I(D): Professional Misconduct prohibits CFA Institute members from engaging in any professional conduct involving dishonesty, fraud, or deceit or from committing any act that reflects adversely on their professional reputation, integrity, or competence. Generally, Standard I(D) is not meant to cover legal transgressions resulting from acts of civil disobedience in support of personal beliefs because such conduct does not reflect poorly on the member's or candidate's professional reputation, integrity, or competence. The fact that Simpson is arrested in the financial district is not a sufficient nexus to his professional activities to render his actions a violation of the Code and Standards.

The Code of Ethics requires members to promote the integrity and viability of global capital markets for the ultimate benefit of society. But Simpson's climate protests are not related to the global capital markets. Misconduct with the supposed intent of benefiting society would not be shielded by the Code of Ethics. It is also irrelevant that Simpson's climate protests are somewhat in line with his professional activities in managing an ESG fund. Finally, Simpson's arrest does not seem to be an automatic violation of bank policies. Although Simpson's employment contract gives the bank the option of firing him for criminal activity, the bank can apparently use discretion in retaining employees depending on the nature and circumstances of the conviction. Furthermore, the Code and Standards are not automatically violated with every violation of an employer's employment policies, unless the violations relate to underlying conduct addressed in the Code and Standards. In this case, choice E is the best response.

*This case relates to a question submitted to the CFA Institute Ethics Help Desk.*

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# PERFORMANCE REPORTING

# CFA INSTITUTE

## ETHICS IN PRACTICE: Performance Reporting – Case 1

### CASE STUDY

Young is CEO, portfolio manager, and sole owner of Stewardship Investment Advisers (SIA), a registered investment adviser with more than \$154 million assets under management and over 250 discretionary accounts. For several years, Young has distributed marketing materials to clients and potential clients that contain gross-of-fee performance for returns on SIA's managed portfolios. Young believes that gross-of-fees calculations are the most relevant because management fees are negotiable and can vary by client. Young includes a footnote at the end of the brochure disclosing that advisory fees would have to be netted out to show actual performance. The marketing material also includes a table that compares percentage increases in the S&P 500 Index with percentage increases in SIA's performance. SIA's performance includes the reinvestment of dividends. Young believes that the S&P 500 is the most appropriate and understandable benchmark because it is commonly reported in the financial press and recognizable by his clients. Has Young engaged in misconduct by using gross-of-fee returns or showing the S&P 500 performance? Decide what you believe is the correct answer and use the Ethical Decision-Making Framework to help explain your choice.

- A. Young is guilty of misconduct in showing gross-of-fee performance.
- B. Young is NOT guilty of misconduct in showing gross-of-fee performance.
- C. Young is guilty of misconduct in providing the S&P 500 as a benchmark.
- D. Young is NOT guilty of misconduct in providing the S&P 500 as a benchmark.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 1

#### ANALYSIS

This case involves the presentation of performance history. CFA Institute Standard III(D): Performance Presentation states that "when communicating investment performance information, members must make reasonable efforts to ensure that it is fair, accurate, and complete." The goal is to provide credible performance information to clients and prospective clients and to avoid misstating performance or providing misleading performance information. Absent legal or regulatory provisions prohibiting such conduct, presenting gross-of-fee performance results is acceptable as long as there is clear disclosure that relevant fees must be deducted to get the actual performance history. It is unclear from the facts presented whether Young's footnote is prominent or clear enough to be sufficient to meet this standard. Best practice would be to present both gross and net-of-fee performance history, or in some other way, prominently show the effect of the fees so that the performance information meets the "fair, accurate, and complete" requirement of Standard III(D).

Similarly, presenting a table that includes the S&P 500 performance as a benchmark for returns may be appropriate under certain circumstances. But when it is used as a benchmark for firm performance history that includes reinvested dividends, as in this case, it would not be an "apples-to-apples" comparison and would likely be misleading because the S&P 500 performance history does not include reinvested dividends. If Young wants to use the commonly reported S&P 500 returns over time as his benchmark, he should ensure the SIA's returns are calculated in a comparable way. At minimum, there should be prominent disclosures of any differences between the benchmark's and the firm's returns. It is unclear from the facts presented whether Young has made the necessary disclosures regarding the benchmark. So, to judge whether there has been any misconduct, a thorough examination of the presentation material would be necessary to determine whether Young is presenting performance that is fair, accurate, and complete or whether his presentation misstates performance and is misleading.

*This case is based on CFA Institute Professional Conduct enforcement action.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Performance Reporting – Case 2

### CASE STUDY

Smith is a portfolio manager at an alternative asset management firm, AltInvest LLC. At the direction of her boss, she makes a one-time allocation of the expenses incurred by the Private Credit Opportunities fund to the Private Credit Special Situations fund. Her boss wants to temporarily boost the end-of-year results of the Private Credit Opportunities fund, which has been underperforming. Her boss explains that the Private Credit Special Situations fund closed recently and just entered its long investment period, thus investors in the fund would not yet expect it to deliver good results. In contrast, the investment period of the Private Credit Opportunities fund ended years ago, and its harvesting period is soon coming to an end. Boosting the performance of the Private Credit Opportunities fund also should help attract investors to the Private Credit Opportunities II fund. The consolidated performance results of AltInvest are not affected by the reallocation of expenses between these two funds. Smith's actions are

- A. inappropriate.
- B. appropriate because the consolidated performance results of AltInvest are not affected by the reallocation of expenses.
- C. appropriate because the chosen way of reporting is only temporary.
- D. appropriate because Smith followed the directions of her boss.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 2

#### ANALYSIS

This case relates to CFA Institute Standard III(D): Performance Presentation, which states that CFA Institute members must make reasonable efforts to ensure that the investment performance results communicated to their clients are fair, accurate, and complete. Smith's actions are inappropriate because reallocation of expenses between the two funds renders a misrepresentation and is not a fair, accurate, and complete presentation of the two funds' performance, even though the consolidated results of AltInvest are not affected. Developing and maintaining clear and accurate communication with clients regarding the performance of their investments is critical because it allows clients to make well-informed decisions about their investment portfolios, including about whether to withdraw their money from underperforming funds or whether to invest in follow-on funds. Any misrepresentation of performance, however temporary, affects investors' assessment of their investments and subsequently their investment decisions. In this case, Smith made the allocation of expenses at the direction of her boss, who had determined that the temporary boost of the Private Credit Opportunities fund's end-of-year results would benefit AltInvest. But the interests of an investment professional's employer are secondary to protecting the interests of clients. In asking Smith to make the reallocation of expenses between the two funds, her employer is acting contrary to Smith's clients' interests. Following the direction of a supervisor does not excuse unethical behavior or actions contrary to a client's best interests. Choice A is the best answer.

*This case was written by Anna Sembos, CFA, who serves as volunteer with Compliance Connection, an extension of the CFA Institute Global Monitoring Program.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Performance Reporting – Case 3

### CASE STUDY

Jergens is the portfolio manager for the Volare Investment Management (VIM) fund, a registered collective investment scheme (CIS) organized under the laws of South Africa. VIM's 2018 regulatory disclosure and marketing material for the fund, as produced by Jergens, presents annual investment performance data for the 2010-16 period that is accurate and calculated correctly. The performance history is that of a composite of separate accounts that followed the strategy used by the VIM fund prior to the assets being moved over to the CIS environment in 2017. In presenting the fund's performance history, Jergens' actions are

- A. appropriate because the investment performance is accurate.
- B. inappropriate because the investment performance is misleading.
- C. appropriate as long as the performance calculations are net of fees.
- D. inappropriate if Jergens was not the manager of the composite of segregated accounts from 2010.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 3

#### ANALYSIS

This case relates to CFA Institute Standard III(D): Performance Presentation, which states that CFA Institute members must make a reasonable effort to ensure that investment performance information is fair, accurate, and complete. Although the performance information presented by Jergens is calculated correctly and includes technically accurate data, Jergens' failure to indicate clearly that the performance data applied to a period prior to registration of the VIM fund as a CIS had the potential to mislead investors into believing that the CIS fund had a long track record. To meet the "fair, accurate, and complete" requirement of the standard, Jergens should disclose that the 2010–16 performance history was that of a prior but similar entity and that the VIM fund, as a CIS, has been in existence only since 2017. Performance can be presented either net or gross of fees, as long as there is sufficient disclosure to inform investors about how the performance is calculated and what affect fees may have on the return figures. It is not inappropriate to present performance of a fund, account, or composite of accounts when the managers have changed, as long as the change of investment personnel during the period being presented is disclosed. Choice B is the best answer.

*This case is based on an April 2018 Enforcement Action by the South African Financial Sector Conduct Authority.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Performance Reporting – Case 4

### CASE STUDY

Prosper Funding (Prosper) is a marketplace lender that enables borrowers to obtain unsecured consumer loans and allows investors to purchase securities linked to the performance of those loans. Prosper creates individual account pages for each investor on its website, which provides information on the consumer loans, gives the annualized net return (ANR) performance of each investor's account, and includes a link through which they can invest in Prosper securities. Prosper calculates the ANR for each investor using an automated process developed some years ago by personnel no longer with the firm. ANR results are reported prominently on each investor's online account page.

After several years, Prosper implements a "debt sale program" through which eligible nonperforming, charged-off consumer loans linked to Prosper securities are sold. Because of an unforeseen effect of a previous, unrelated change to the original coding in the program, Prosper reports an ANR to its clients that excludes the impact of the worst-performing securities that they previously held but that have since been sold to third-party debt purchasers. Periodically, Prosper reviews all of the computer processes used by the company, and through that review, it becomes clear that current employees lack an understanding of the ANR calculation process. The review is always general and at a high level, and thus Prosper does not identify the error in the ANR calculation. Because of the error, Prosper reports to a majority of its investors that their investments are earning up to double the returns they actually had earned.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 4

#### **CASE STUDY** (CONTINUED)

When certain affected investors raise questions about the accuracy of the ANR calculations they received, Prosper's customer service department handles the complaints and confirms the reported figures were calculated erroneously because of a flawed computer program. The customer service employees do not elevate any of these complaints to Prosper's product, engineering, or compliance departments. Prosper has also solicited new investors for its securities based on the miscalculated ANR by sending hundreds of emails that highlight their ANR performance (albeit erroneous) and has recommended that investors "add funds and build on their solid returns." Prosper does not identify the error for several years and discovers it only after receiving a complaint from a large institutional investor. Prosper notifies investors that it miscalculated and misstated their ANR and provides a current, correct calculation of the ANR to investors at that time.

Choose one of the following Prosper personnel and explain how that employee may have violated the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards) and why.

- A. Employee responsible for the computer program that calculates the ANR.
- B. Customer service employee responding to client complaints about the ANR.
- C. Marketing employee using the ANR performance calculations to solicit investments.
- D. Compliance employee responsible for firm policies and procedures.
- E. CEO of Prosper.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 4

#### ANALYSIS

- A. Prosper's issues begin with ANR performance that is calculated incorrectly and posted to client accounts. The CFA Institute Standard of Professional Conduct III(D): Performance Presentation requires CFA Institute members to make reasonable efforts to ensure that investment performance is presented in a fair, accurate, and complete manner. The ANR is calculated using a computer program that was created many years earlier, and over the years, it has developed a defect that leads to dropping underperforming accounts from the calculation. Although the person currently responsible for calculating the ANR did not create the computer program, that employee does not understand the program's process and has not adequately reviewed the calculation method to ensure that it is accurate, thus allowing the error to continue.
- B. Although the customer service employee responding to client complaints is not responsible for the ANR calculation error, that employee is responsible for acting in accordance with Standard III(A): Loyalty, Prudence, and Care to protect client interests once the issue has been raised. That employee failed to elevate any of the investor complaints to Prosper's personnel responsible for the calculation and apparently simply recalculated the ANR using the same flawed code. The customer service employee did not engage with or investigate the client complaints with sufficient reasonable care, diligence, competence, or professionalism, as required by Standard V(A): Diligence and Reasonable Basis and the Code of Ethics.
- C. The marketing employee using erroneous ANR performance is not responsible for the calculation error. Team members should be able to rely on the work of others in their firm (in this case, those calculating the ANR) to fulfill their responsibilities in an appropriate manner to produce accurate work. But in this case, the marketing employee is ultimately responsible for distributing misleading information that misrepresents the true performance of the securities, which violates Standard I(C): Misrepresentation. Once the marketing employee becomes aware that the information is inaccurate, that employee must take steps to remediate the error and distribute accurate and complete information.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 4

#### ANALYSIS (CONTINUED)

- D. The compliance employee has a responsibility to review the firm's policies and procedures to ensure that they meet relevant regulatory and ethical requirements. Prosper only sporadically reviews all the computer programs and processes used by the company, uses employees to calculate the ANR performance that lack an understanding of the ANR calculation process, and conducts only a high-level review that would not catch the error in the ANR calculation. Similar to the customer service employee, the compliance employee did not exercise sufficient care, diligence, competence, or professionalism as required by Standard V(A): Diligence and Reasonable Basis and the Code of Ethics to ensure that an adequate compliance program was in place to address errors or properly investigate problems once discovered.
- E. The Prosper CEO likely has no direct involvement with the calculation and presentation of performance, addressing client complaints, or creating and implementing compliance procedures. But the CEO does have overall responsibility to ensure that the firm complies with the law (Standard I(A): Knowledge of the Law) and protects client interests (Standard III(A): Loyalty, Prudence, and Care) as well as overall supervisory responsibility for firm employees (Standard IV(C): Responsibilities of Supervisors). The CEO is allowed to delegate this responsibility. But the Code and Standards require those with supervisory responsibility to make reasonable efforts to ensure that those under their supervision comply with applicable laws and the Code and Standards. The breakdown of the policies and procedures of the firm designed to accurately calculate performance, adequately address complaints, and implement an appropriate compliance program are all red flags indicating a potential failure of the CEO to properly supervise employees of the firm.

*This case is based on an April 2019 US SEC Enforcement Action.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Performance Reporting – Case 5

### CASE STUDY

Smithson, the CEO of Bolton Investment Management, uses JOLF LLP to audit its financial records, including checking the accuracy of client account records and verifying historical performance information. The annual cost of the audit is typically \$10 million. Over time, Smithson hires JOLF to also provide consulting services to Bolton in a number of areas, including consulting on information-technology security, regulatory compliance, compliance with the CFA Institute Global Investment Performance Standards (GIPS®), and other "ad hoc accounting advice." Eventually, Bolton pays JOLF close to \$50 million per year for these other services. Smithson's actions are

- A. acceptable because JOLF's consulting work for Bolton improves the audit by enhancing JOLF's knowledge of Bolton's business.
- B. acceptable only if Bolton makes a determination that JOLF's historical knowledge of the firm will uniquely inform its consultant work.
- C. acceptable only if Bolton discloses its use of JOLF as both its auditor and as a consultant for other financial services.
- D. not acceptable.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Performance Reporting – Case 5

#### ANALYSIS

This case relates to independence and objectivity and conflicts of interest. An independent financial audit of a firm's financial records can provide confidence to clients, investors, and counterparties that the firm is in good financial health and is not engaged in financial fraud. When an auditor has a thorough knowledge of a firm's business, this knowledge can help the auditor to perform a comprehensive, in-depth, and accurate audit, which will benefit both the firm and its stakeholders by enhancing the effectiveness of the audit. But there may be the appearance of a conflict of interest and a concern that the auditor's objectivity may be impeded if it also earns large consulting fees from the same client. If accounting firms sell extra services based on their knowledge of the company they are auditing, will independence related to the audit be compromised?

There may be a perception that an auditor is more likely to provide a favorable assessment of a company's finances to protect a lucrative consulting relationship with the firm. In this case, JOFL collects five times more fees from Bolton for consulting services than for auditing their financial records. Smithson can avoid this conflict by hiring a third-party consultant, rather than JOFL, for these additional consulting services, or at least could restrict the consulting services (and therefore fees) given to JOFL. If Smithson did not want to lose the benefits of having JOFL, a firm intimately familiar with Bolton's business through the audit relationship, provide advice on a number of other issues, Smithson could try to mitigate the conflict by being fully transparent about Bolton's relationship with JOFL, including the nature of the consulting JOFL provides and the fees paid to JOFL by Bolton. In some situations, accounting firms should be able to offer additional services to their auditing clients. But with respect to verification of performance history, CFA Institute guidance on the GIPS standards would prevent JOFL from providing a third-party verification of Bolton's claim of compliance while also providing assistance in the firm's ongoing compliance with the GIPS standards. In regards to the GIPS verification and consulting, choice D is the best response.

For the other consulting services, it does not appear that regulatory rules would prevent JOFL from performing both audit and consulting services. In addition, it does not appear that JOFL's performance of the audit on Bolton is influenced by its consulting work or that mitigation of the conflict through disclosure would not be effective. In these cases, choice C is an acceptable answer. But many accounting firms may determine to refrain from engaging firms for both audit and consulting work to maintain their independence.

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# PERSONAL TRADING

## CFA INSTITUTE

# ETHICS IN PRACTICE: Personal Trading – Case 1

### CASE STUDY

Yang is a research analyst at BAMCO, a registered broker/dealer and investment adviser. While employed with BAMCO, Yang established Prestige Trade Investments Limited and acts as that firm's investment adviser. Yang is responsible for formulating Prestige's investment strategy and directs all trades on behalf of Prestige. Over the course of several days, Yang purchases 50,000 shares of Zhongpin stock and 1,978 Zhongpin call options for his personal account at BAMCO. Shortly thereafter, Yang uses \$29.8 million of Prestige's funds to purchase more than 3 million shares of Zhongpin stock. Yang's actions are

- A. acceptable because Yang's personal investments are not in conflict with the investment advice being given to his clients at Prestige.
- B. acceptable as long as BAMCO is aware of and consents to Yang establishing and working for Prestige as a separate entity.
- C. acceptable as long as Prestige clients are not negatively affected by Yang's prior purchase of Zhongpin securities through his account at BAMCO.
- D. unacceptable.



## CFA INSTITUTE

### ETHICS IN PRACTICE: Personal Trading – Case 1

#### ANALYSIS

This case involves an investment adviser "front-running" client trades. Front-running involves trading for one's personal account before trading for client accounts. In this case, Yang purchased Zhongpin stock and call options in his personal account at BAMCO before directing the Zhongpin trades of clients at Prestige. Standard VI(B): Priority of Transactions states that "investment transactions for clients...must have priority over investment transactions in which a [CFA Institute] member...is the beneficial owner." Yang's personal investments are tracking with his client investments, so there is no conflict between his personal trading and the investment actions/advice for clients. But the timing of the trades is what is at issue in this case, making Answer A incorrect. Also, the fact that Prestige clients are not harmed by Yang's earlier trades for his personal accounts does not make his actions acceptable.

The issue is Yang's personal benefit derived from trading before his clients, which makes Answer C incorrect. Disclosure is not a cure for front-running. So, even if Yang had told Prestige clients that he would be making personal trades prior to taking investment action on their behalf that would benefit him, the trading in his personal account would not be acceptable. Yang would have to get permission from BAMCO to create and work for Prestige, according to CFA Institute Standard IV(A): Loyalty, but such permission does not allow Yang to engage in unethical activity while at Prestige, making Answer B incorrect. That leaves Answer D as the best answer.

*This case is based on a SEC enforcement action from 2014.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Personal Trading – Case 2

### CASE STUDY

Van Wagenen manages the portfolios of high-net-worth clients. He completes an individualized IPS for each client when opening their account. He then develops a personal asset allocation formula based on each client's risk tolerance, financial goals, and so forth. Over the past two days, the domestic and global equity securities markets fell more than 6%. Fearing a continued drop in the markets, Van Wagenen liquidates his personal investments and moves to cash until the financial markets stabilize. But he keeps his clients' portfolios fully invested pursuant to the directives in their IPS. Van Wagenen's actions are

- A. unacceptable because he is trading ahead of his clients for his personal account.
- B. unacceptable because his personal investment decisions do not match the investment recommendations he has made to his clients.
- C. unacceptable because he is not acting in a diligent and reasonable manner by leaving his clients assets fully invested in a rapidly declining securities market.
- D. acceptable because he is following his client's directives, as detailed in their IPS, by keeping them fully invested.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Personal Trading – Case 2

#### ANALYSIS

The CFA Institute Ethical Decision-Making Framework provides guidance to investment professionals facing ethical dilemmas. The framework calls for identifying the ethical principle at issue, to whom a duty is owed, the relevant facts, and whether there is a conflict of interest to assist in choosing the appropriate course of conduct. In this case, we need more facts before we can properly analyze whether Van Wagenen's actions are acceptable. Specifically, what level of investment discretion have Van Wagenen's clients given him regarding investment decisions and whether the clients' IPSs address how investment decisions are to be made in the face of rapidly changing market conditions. If Van Wagenen has full investment discretion, failing to adjust his client's portfolio in a timely manner means Van Wagenen could be in violation of his duty to act with diligence and a reasonable basis – CFA Institute Standard V(A) – and in violation of his duty to his clients of loyalty, prudence, and care – CFA Institute Standard III(A).

Similarly, if the IPS states that in the event of a significant market downturn, Van Wagenen has the authority to alter the agreed on asset allocation formula prior to formally revising the IPS, that would also be a strong indicator for Van Wagenen to take action. Under those circumstances, Answer C would be the best choice. But if Van Wagenen has limited discretion or the IPS was silent about "emergency" powers to make changes in the portfolio, Van Wagenen's hands may be tied (Answer D). It is also not clear whether Van Wagenen acted diligently in attempting to contact his clients in the face of the volatile markets to determine whether they had any changes to their investment instructions. CFA Institute Standard VI(B): Priority of Transactions states that investment transactions of clients must have priority over personal transactions. This standard does not require that an investment professional's personal investments match those of his clients because there may be differences in the risk tolerances, financial goals, and so on between the adviser and his or her clients (Answer B). Finally, it is not clear that Van Wagenen is "front running" his client accounts because the price of the securities at issue may not be affected by the trades on his personal account (Answer A).

*The facts for this case are not based on a particular case but reflective of current market volatility.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Personal Trading – Case 3

### CASE STUDY

Perkins is the co-owner and chief investment officer of Global Trading Financial (GTF). Perkins' wife is GTF's compliance officer. GTF has several dozen retail clients and total assets under management of \$70 million. All client assets are managed on a discretionary basis. Perkins frequently makes trades for his clients using an omnibus trading account through a broker/dealer, which allows Perkins to buy and sell securities in a block trade on behalf of multiple clients simultaneously. Perkins regularly allocates the securities purchases to individual client accounts after the market closes. Over one six-month period, Perkins allocates 75% of the profitable trades to nine accounts owned or controlled by Perkins and his wife. At the same time, 82% of the unprofitable trades are allocated to the account of the three largest GTF clients. Perkins' actions are

- A. acceptable as long as he discloses the trade allocation practices to his clients.
- B. acceptable as long as he accurately represents whether or not he trades in the same securities as his client.
- C. acceptable as long as he reverses his trade allocation practices to favor the larger clients so that they are not harmed over the long term.
- D. unacceptable.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Personal Trading – Case 3

#### ANALYSIS

This case relates to CFA Institute Standard VI(B): Priority of Transactions, which states that investment transactions for clients have priority over personal transactions. By trading in the firm's omnibus account and then delaying allocation of trades to a specific account until he has an opportunity to observe the security's intraday performance, Perkins is able to cherry-pick the winning trades for accounts in which he has a beneficial interest. This is a violation of Standard VI(B). He allocates the losing trades to client accounts that are large enough to absorb incremental, although steady, trading losses without arousing client suspicion that the losses are due to fraud.

Disclosure is not a cure for this unethical, fraudulent behavior. It is also irrelevant to the priority of transactions issue what Perkins tells his clients about whether he trades in the same securities for his personal accounts as he does for his client accounts. (Although if he claimed not to personally trade in securities being considered for purchase by clients, and did so anyway, that would be further fraud.) Finally, Perkins cannot temporarily favor his personal interests over his clients' interests with the intent of making it up to the clients later. Ethical conduct is not subject to some ledger-keeping exercise. CFA Institute members must, and really all investment professionals should, comply with ethical principles at all times. Choice D is the best answer.

*This case is based on a September 2018 Enforcement Action by the US SEC.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Personal Trading – Case 4

### CASE STUDY

Kapadia is a trader for an asset management company that manages several large global mutual funds. Kapadia executes the equity buy-and-sell orders for the portfolio managers of one of the company's mutual funds. He has discretion to execute the orders at any time during the day depending on market conditions. Prior to executing the orders, Kapadia contacts several close friends and relatives to provide them with information on what securities are set to be traded by the mutual fund. In turn, they make trades that mirror the imminent trades to be executed by Kapadia on behalf of the mutual fund. Kapadia's actions are

- A. inappropriate.
- B. appropriate if he disclosed his actions to his employer or to the mutual fund.
- C. appropriate because he did not share confidential information about individual clients.
- D. inappropriate only if the client was harmed financially by the conduct.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Personal Trading – Case 4

#### ANALYSIS

This case relates to the unethical and often illegal practice of front-running, or trading on advance information for one's personal account prior to trading for client accounts to gain an economic advantage. CFA Institute Standard VI(B): Priority of Transactions states that investment transactions for clients must have priority over investment transactions for personal benefit. In this case, Kapadia facilitated the front-running by his friends and relatives on the trades of his employer's mutual fund. Although Kapadia may not have directly benefited financially, he benefited personally by providing the information to those with whom he had close relationships. This practice is unethical and inappropriate even if the trades of his friends and relatives did not disadvantage the mutual fund by moving the price of the security or causing the fund to lose the price advantage or any profit from its own trades. Kapadia cannot cure this unethical behavior by disclosing his actions to his employer or the fund. Although Kapadia did not share the confidential information of individual clients or individual investors of the fund, he did share confidential information about the fund itself. Choice A is the best answer.

*This case is based on a 2016 enforcement action by the Securities and Exchange Board of India.*

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# PROMOTION AND MARKETING



# CFA INSTITUTE

## ETHICS IN PRACTICE: Promotion and Marketing – Case 1

### CASE STUDY

Svetlana works for a publishing company writing an online financial newsletter that describes her investment philosophy and identifies intriguing investment opportunities. She is paid a salary plus incentive bonuses for every new subscriber. Svetlana routinely states that she makes \$5,000 in investment returns every week, and that if readers followed her advice, they could too. Svetlana often includes success stories from readers, including the story of a reader who turned \$200 into \$1 million in six months using Svetlana's investment techniques. Svetlana's actions are

- A. acceptable because subscribers to her newsletter are not clients.
- B. acceptable because she is not guaranteeing investment success.
- C. unacceptable unless she includes stories of readers who followed her investing philosophy and were not successful.
- D. unacceptable if the investments are unsuitable for her subscribers.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 1

#### ANALYSIS

This case involves potential misrepresentation. CFA Institute Standard I(C): Misrepresentation states that members "must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities." This includes statements relating to past investment performance history. Does Svetlana misrepresent her past performance record and the success of her investments? That is not clear. Her statements regarding her weekly investment returns and the success stories of readers who follow her advice may be true. More facts are necessary. Assuming those statements are true, it is irrelevant whether she is making the statements to clients, potential clients, subscribers to her newsletter, or the investing public. Standard I(C) prohibits any misinformation regardless of the audience, so Answer A is not correct. There is also no requirement that Svetlana include statements in her articles that counterbalance her claims (Answer C). It would be up to the interested person to inquire more deeply about her performance record to gauge its veracity.

Svetlana would be required to respond truthfully to probing questions, such as "how many readers using your investment techniques have lost money?" And because there is no investment advisory relationship between Svetlana and those who may read her articles, she is not required to conduct a suitability analysis of the investments for anyone reading her newsletter (Answer D). (Although best practice would dictate that Svetlana include some general cautionary language in her articles recommending that readers ensure any investments they make are suitable to their financial goals, constraints, and circumstances). Finally, Standard I(C) prohibits members from guaranteeing clients any specific return on investments because most investments contain some element of risk that makes their return inherently unpredictable. But Svetlana does not provide guarantees because she qualifies her statements about expected performance by asserting that readers following her investment philosophy "could" earn regular returns; she doesn't guarantee that they will. Answer B is correct.

*This case is based on facts from a CFA Institute Professional Conduct enforcement action.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Promotion and Marketing – Case 2

### CASE STUDY

Munchee is a US-based business that created an iPhone application (App) for users to review restaurants. The company initiated an initial coin offering (ICO) to sell digital tokens to raise \$15 million in capital to invest in improving the App. The company advertised and promoted the offering on its website, in a white paper, and on social media channels and message boards, such as Twitter and Facebook, particularly in forums aimed at those interested in investing in Bitcoin and other digital assets. In the communications about the offering, Munchee said it would use the proceeds to create an "ecosystem" in which the company, its App users, restaurants, and others could use the tokens to buy and sell goods and services. Munchee explained that it expects the tokens to increase in value as a result of the company's efforts. In addition, increased participation in the ecosystem and the use, or "burning," of tokens would also help increase the value of the tokens. Finally, Munchee stated that it intended for the tokens to trade on a secondary market. Munchee's ICO was

- A. unacceptable because it promoted a virtual and highly speculative investment unsuitable for investors.
- B. unacceptable because it promoted the investment through social media, blog posts, and brief tweets that did not describe the significant limitations and risks associated with buying the tokens.
- C. unacceptable because the tokens were an unregistered security under US securities laws.
- D. acceptable.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 2

#### ANALYSIS

This case involves Standard I(A): Knowledge of the Law, which requires CFA Institute members to "comply with all applicable laws, rules, and regulations . . . governing their professional activities." The fact that the tokens are a virtual currency, highly speculative, and thus unsuitable for many investors does not make it unethical for Munchee to offer them as investments. Munchee is not an investment adviser but an investment issuer. It would be up to investors and their advisers to determine whether an investment was suitable for their portfolio. Similarly, from an ethical standpoint, Munchee is free to promote the tokens in a variety of ways as long as the company provides full and complete information about the investment, responds to inquiries from potential investors, and does not provide any fraudulent or misleading information about the tokens. Munchee can direct those who see brief promotional material about the tokens on social media or Twitter to the company's white paper that presumably contains full and complete information about the tokens. Again, it would be up to an investment adviser, not the issuer, to describe the significant limitations and risks associated with buying the tokens from an investor's perspective.

This case turns on whether the tokens are a security and thus need to be registered according to the US securities laws (US law would be applicable because Munchee is a US-based company selling the products in the United States). In its 11 December 2017 cease-and-desist order against Munchee, the US Securities and Exchange Commission (SEC) found that the tokens were securities as defined by Section 2(a)(1) of the Securities Act and must be registered. According to the test applied by the SEC, a product is a security if it involves the investment of money in a common enterprise with a reasonable expectation of profits that are derived from the entrepreneurial or managerial efforts of others. Upon being contacted by the SEC, the company immediately canceled the sale and refunded the money of buyers who had bought tokens. Because of this prompt action and Munchee's cooperation, the SEC imposed no additional sanctions. In this case, the best answer is C because Munchee is a US company that violated US Securities laws. The laws of another jurisdiction may not require registration of this type of virtual currency as a security. In that case, Answer A could be appropriate.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Promotion and Marketing – Case 3

### CASE STUDY

King is a successful investment adviser with a number of high-net-worth clients who are very happy with him as their adviser. Many of King's clients recommend his advisory services so that their friends and family can achieve the same positive results. King encourages these recommendations as a way to build his business. Each year, King holds an elaborate party for those clients who have referred new clients to his advisory firm to thank them for these referrals. At the party, King distributes nominal gift cards to attendees. In some instances, King offers discounts on advisory fees to clients who have provided him with referrals that prove to be particularly lucrative. Many of the clients attending these celebrations have been referred to King by other clients and they have, in turn, continued the cycle of recommending King to a wider circle of friends and family. King's actions are

- A. acceptable as a proper method for client development.
- B. acceptable as a reward for client loyalty.
- C. acceptable as long as he treats all clients fairly.
- D. unacceptable.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 3

#### ANALYSIS

This case relates to CFA Institute Standard VI(C): Referral Fees, which states that CFA Institute members must disclose any compensation, consideration, or benefit paid to others for the recommendation of services. In this case, King provides an elaborate party; distributes gift cards; and, in some cases, offers discounted advisory fees to those clients who referred particularly lucrative clients to him. These benefits must be disclosed. The facts of the case do not state whether King discloses the benefits that he gives for referrals to the potential incoming clients. The fact that some of the clients later become aware that he pays for referrals when they themselves are paid such fees is insufficient disclosure. If King wanted to hold a party or give gift cards to all his clients to reward their loyalty, whether or not they provided referrals, that would be acceptable. Arguably, King treats his clients fairly because he is offering the opportunity to receive these benefits and fee discounts to all his clients, so long as they make referrals to his business. Whether the clients access these benefits by making referrals is up to them. But regardless of whether King is treating all clients fairly, by not disclosing the benefits and compensation he awards for referrals, he has violated Standard VI(C). Choice D is the best answer.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Promotion and Marketing – Case 4

### CASE STUDY

Mallouk is president and majority owner of Creative Planning, Inc. (CPI), a US-based registered investment adviser with approximately \$36.2 billion in assets under management. To advertise his business, Mallouk purchases several dozen radio advertisements in the local market. CPI's policies and procedures require that the chief compliance officer or president review and approve any marketing materials or advertising concerning the firm or its services before publication or distribution. All of the radio spots are produced by two local radio hosts who have their own show that airs every weekday morning. Mallouk provides the radio station with copy points for the advertisements and approves the 60-second prerecorded advertisement that the pair record. After a few months, one of the radio hosts becomes a client of CPI. During his live radio program, in conjunction with the prerecorded ads, the host regularly mentions his client relationship with CPI, praises his CPI wealth manager by name, and details his satisfaction with the advisory services he received from CPI. Mallouk's actions are

- A. appropriate as long as the content of the advertisements is truthful and accurate.
- B. appropriate as long as Mallouk does not provide any benefit to the radio host to highlight his positive experience with CPI.
- C. appropriate because Mallouk cannot control or preapprove what the radio host says during his program.
- D. inappropriate.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 4

#### ANALYSIS

This case relates to CFA Institute Standard I(A): Knowledge of the Law, which requires CFA Institute members to abide by applicable law. The response to this case turns on the regulations governing CPI's advertising practices. The facts presented do not describe the governing regulations, but the CFA Institute Ethical Decision-Making Framework specifies that investment professionals identify relevant facts when facing an ethical dilemma. If important facts are not known, investment professionals should seek out all information relevant to determining the appropriate course of action. Applicable law is always a relevant and important fact. In this case, the law and regulation applicable to CPI as a US-based adviser stipulates that it is a

fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to, directly or indirectly, publish, circulate, or distribute any advertisement that refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser. [Rule 206(4)-1(a)(1) under Section 206(4) of the Advisers Act]

The radio host's live commentary accompanying the prerecorded spots constitutes an advertisement for CPI that was a testimonial, which is prohibited by applicable law. Mallouk's conduct, therefore, violates CFA Institute Standard I(A). Mallouk also violated his firm's policies and procedures by not reviewing the content of the radio host's commentary. Mallouk and CPI could have directed that the radio host refrain from making a testimonial or providing extraneous commentary to the preapproved ads. Mallouk also could have monitored the station broadcasts or reviewed transcripts of the live spots to ensure that the advertisement met legal requirements. Even if the comments contained truthful and accurate information and the radio host was making those comments of his own volition with no incentive, the type of advertising violated the law. Choice D is the best answer.

*This case is based on an 18 September 2018 enforcement action by the US SEC.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Promotion and Marketing – Case 5

### CASE STUDY

Juniper is a globally famous professional boxer living in Las Vegas, Nevada, with approximately 21 million Instagram followers, 7.8 million Twitter followers, and 13.4 million Facebook followers. Juniper promotes on his social media accounts an initial coin offering (ICO) from Sentara Technologies (Sentara) promoting its STAR cryptocurrency tokens on the Ethereum blockchain. The purpose of the ICO is to raise capital to enable Sentara to complete and operate what it termed the "world's first Multi-Blockchain Debit Card and Smart and Insured Wallet," a financial system that would, purportedly, allow holders of various hard-to-spend "cryptocurrencies" to easily convert their assets into legal tender, and spend these "cryptocurrencies" in "real time" using a Visa- or MasterCard-backed "Sentara Card."

Juniper posted on his Instagram and Facebook accounts a picture of himself holding a Sentara Card at a shoe store with the caption: "Spending bitcoins, Ethereum, and other types of cryptocurrency in Beverly Hills with my Titanium Sentara Card. Join Sentara's ICO next month!" In addition, Juniper recorded a video at a department store in Los Angeles, which purported to show him using the so-called "Sentara Wallet" application on an iPhone and a "Sentara Card" to buy several items at the checkout counter. Sentara subsequently posted the video to YouTube under the headline "Lloyd Juniper Spending Bitcoin with Sentara Card & Sentara Wallet." Although Sentara paid Juniper \$100,000 for this promotion, Juniper did not disclose any information about the payment in his posts. Juniper's actions are

- A. appropriate as a product endorsement typically made by well-known celebrities.
- B. appropriate because Juniper's social media followers are savvy enough to understand that Juniper is being compensated for the posts.
- C. inappropriate unless Juniper discloses the payment.
- D. inappropriate if the ICO is unsuitable for Juniper's social media followers.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 5

#### ANALYSIS

This case relates to conflicts of interest and disclosure of referral fees. CFA Institute Standard VI(C): Disclosure of Conflicts – Referral Fees requires CFA Institute members to disclose any compensation, consideration, or benefit received from others for the recommendation of products and services. As a professional boxer, it is unlikely that Juniper is a CFA® charterholder subject to the CFA Institute Standards of Professional Conduct. Neither could Juniper arguably be seen as an investment professional (nor his social media followers as investment "clients") subject to the general ethical principles or suitability requirements applicable to investment advisers.

But although celebrities often capitalize on their fame by making product endorsements, the STAR tokens, as investment contracts, are regulated by the US SEC pursuant to the US Securities Act. Section 17(b) of the US Securities Act makes it unlawful for any person to "publish, give publicity to . . . (or) circulate any communication which, though not purporting to offer a security for sale, describes such security" in return for payment from an issuer, underwriter, or dealer, "without fully disclosing the receipt . . . of such (payment) and the amount thereof." This provision of US securities law is applicable regardless of the sophistication of the audience for the communication and has the same effect as Standard VI(C) in that it requires disclosure of payments for touting the security. Therefore, Juniper's actions are inappropriate and a violation of US securities laws because he failed to make the proper disclosure. (If Juniper was a charterholder, his actions would have violated Standard VI(C) as well). Answer C is the best choice.

*This case is based on a US SEC Enforcement Action on 29 November 2018.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Promotion and Marketing – Case 6

### CASE STUDY

Salazar works for IFS, a broker/dealer. He is hired by the Public Library District in Harvey, Illinois, to underwrite the issuance of a \$6 million municipal bond offering intended to finance the expansion and renovation of the district's library building. The district has never issued bonds before, and its board of trustees and director (a librarian) have no prior experience with the bond-offering process. The district does not hire an adviser to help select an underwriter for the bonds and does not conduct a competitive selection process or consider other underwriters before hiring Salazar and IFS. This job will be Salazar's first experience serving as a bond underwriter. He discloses this fact to the Harvey Library District and, as a result, agrees to charge the district a reduced fee.

As the sole underwriter of the bond offering, Salazar is responsible for marketing and selling the bonds to investors. Despite the fact that the district's bonds are insured, have an investment-grade rating, and are "bank qualified" (meaning they could be sold to regional or community banks), Salazar has difficulty finding buyers. Investors are confused about the relationship between the Harvey Library District and the City of Harvey, which has a history of regulatory action against it for fraudulent misuse of bond issue proceeds. Although the Harvey Library District is in the same geographic area as the City of Harvey, the district is a sovereign unit of government that is separate from the city and has separate taxing authority, governance, and finance. The regulatory actions against the city are unrelated to the Harvey Library District. Even though the bonds are bank qualified, Salazar does not market the bonds to banks. He also does not contact potential investors until several weeks after the start of the engagement and only a few days before the planned order period. Salazar's marketing efforts and initial order period are also done before the bond insurance had been confirmed.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 6

#### **CASE STUDY (CONTINUED)**

When Salazar is unable to identify any interested investors before or during the initial order period, he postpones the order period by several days. Eventually, Salazar is able to locate a single buyer, another broker/dealer, which offers to buy the bonds at a price of \$115.73 and a 5.05% yield. Although the yield is higher than comparable bonds, Salazar convinces the district to accept the offer. On the same day their offer is accepted, the broker/dealer sells the bonds to a private fund at a price of \$116.15 and a 5% yield for a profit of \$25,260. The private fund sells the bonds to an investment bank at a price of \$122.35 and a 4.3% yield. The investment bank then immediately sells the bonds to six small regional banks at a price of \$124.86 and a 4.0% yield. Salazar's actions are

- A. not acceptable because he has not been chosen as an underwriter under a competitive selection process overseen by a person or entity advising the district on the bond-offering process.
- B. acceptable because he discloses to his client his lack of experience in serving as an underwriter and charges a discounted fee.
- C. acceptable because he fulfills his responsibility as an underwriter by finding a purchaser for the bonds and raising funds for the district.
- D. not acceptable because he fails in his responsibilities as an underwriter.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Promotion and Marketing – Case 6

#### ANALYSIS

This case relates to an investment professional's responsibility to act competently and diligently for his or her clients. The CFA Institute Code of Ethics and Standards of Professional Conduct require investment professionals to act with competence, diligence, and thoroughness in working for the benefit of their clients. In this case, Salazar has the duty to diligently and competently work for the Harvey Library District while serving as an underwriter and to market and sell the bonds to investors to maximize proceeds of the bond issue. The information provided indicates that Salazar failed to exercise this duty because his marketing efforts were insufficient. Specifically, Salazar

- failed to market the bonds immediately and had a short marketing period,
- failed to identify parties interested in buying the bonds or to obtain preliminary orders or "indications of interest" before opening the order period,
- failed to market desirable bank-qualified bonds to banks,
- failed to adequately resolve investors' confusion between the Harvey Library District and the City of Harvey, and
- failed to confirm that the bonds would be insured before his marketing efforts.

These failures resulted in bonds that sold for a lower price and higher yield than comparable bonds. A high yield and low price means that the issuer pays more interest over the life of the bond. The fact that a number of intermediaries sold the bonds on better terms immediately after issue for a healthy profit is evidence that Salazar did not diligently and competently obtain fair market value for the issue. Salazar's inexperience as an underwriter and his discounted fee does not absolve Salazar of his duty to act competently and with thoroughness and diligence in fulfilling the responsibilities for which he was hired. Although the Harvey Library District would have been advised to hire an adviser to provide guidance on the bond issue and conduct a competitive underwriter selections process, it is not the responsibility of Salazar or IFS to decline the underwriting business if the district failed to follow best practices. Choice D is the best response.

*This case is based on a June 2019 US SEC Enforcement Action.*

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# RESEARCH

# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 1

### CASE STUDY

David, an analyst for an asset management firm, attends a presentation for securities analysts at the headquarters of a manufacturing company. The analysts are very impressed with the presentation and ask the CEO many questions. After the meeting, the Head of Investor Relations invites all analysts to a club house for dinner and karaoke. Most of other analysts accept the invitation. Of the choices below, what do you believe David should do?

- A. Accept the invitation.
- B. Accept the dinner but not karaoke.
- C. Accept the invitation but disclose the invitation to his supervisor.
- D. Reject the invitation.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 1

#### ANALYSIS

The ethical principle at issue in this case is independence and objectivity. The question turns on whether David compromises his independence and objectivity as an analyst by accepting an invitation to dinner and karaoke from representatives of the manufacturing company that he is researching. CFA Institute Standard I(B) states that CFA Institute members "must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities" and must not "accept any gift, benefit...or consideration that reasonably could be expected to compromise their... independence and objectivity." So, would dinner and a night of karaoke reasonably be expected to compromise David's independence and objectivity? The appropriate course of action turns on how extravagant the benefit might be. Modest gifts and entertainment in the ordinary course of sociable business interaction may be unlikely to sway an analyst's opinion.

Choice A assumes that the dinner and karaoke is not extravagant and would have no impact on David's opinion of the company. But we need more facts to ensure that is the case. Cultural context should also be considered when making a decision. Dinner and karaoke may be modest and tame in some cultures but more extensive and extravagant in other settings. Awareness of cultural sensitivities and expectations are very important, especially for those who may be working outside of their familiar home region. Choice B attempts to steer a middle ground by having David only accept part of the entertainment, which may lessen the threat of a compromised analysis by reducing the benefit. In practice, this may be awkward to do and the dinner itself could still be extravagant.

Choice C also attempts to compromise by suggesting David could accept the dinner/entertainment as long as the gift/benefit is disclosed to the employer, seemingly mitigating the potentially problematic conflict of interest. But for disclosure to be effective it must be adequate. There is no indication that David will disclose the benefit to the clients who will read David's research report. They will therefore have no indication that the analyst writing the report was given a nice dinner and potentially fun-filled night on the town by the subject of the report. Best practice would suggest that David reject the invitation (Choice D) to avoid any question about his honesty and integrity.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 2

### CASE STUDY

Sunset Financial Services is a broker/dealer that has historically sold mutual funds and insurance products to individual investors. In 2011, the firm began selling private placements to clients as well. Desmond, vice president of Sunset, is responsible for conducting due diligence on the private placements and placing them on an approved list that Sunset investment advisers can view on the firm's internal website. Desmond relies on third-party due diligence reports to assess the viability and appropriateness of the private placements for Sunset's clients. Gillis is one of Sunset's investment advisers that reviews the internal list of approved private placements and sells several of these investments to his clients. Gillis does not create any sales materials for these private placements but instead relies on sponsor-created sales materials to give to his clients. Has Desmond or Gillis engaged in any misconduct? Decide what you believe is the correct answer and use the Ethical Decision-Making Framework to help explain your choice.

- A. Desmond is guilty of misconduct in selecting the private placements for Sunset to sell.
- B. Desmond is NOT guilty of misconduct in selecting the private placements for Sunset to sell.
- C. Gillis is guilty of misconduct in providing sponsor-created sales material to clients.
- D. Gillis is NOT guilty of misconduct in providing sponsor-created sales material to clients.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 2

#### ANALYSIS

The Ethical Decision-Making Framework includes questions — such as What is the ethical issue involved? To whom is a duty owed? What are the important Facts? — that help investment professionals analyze situations from an ethical standpoint. The ethical issue involved in this case for both Desmond and Gillis relate to diligence and reasonable basis. Desmond bases her evaluation of private placements on third-party due diligence reports without conducting the analysis herself. Gillis gives sponsor-created sales material to clients without producing his own information on the private placements for his clients. Both Desmond and Gillis owe a duty to the clients of Sunset Financial to act with diligence and reasonable basis in investigating the private placement investments and recommending them to clients. CFA Institute Standard V(A): Diligence and Reasonable Basis states that CFA Institute members "must exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions." Determining whether Desmond and Gillis met their responsibilities under Standard V(A) requires examining the relevant facts.

In this case, not much background is provided, making it difficult to tell whether either engaged in misconduct. It is acceptable for Desmond to rely on third-party due diligence reports to evaluate investments as long as she take steps to ensure those reports are from a reputable source and have a reasonable and sound basis. It is not clear what steps Desmond took to evaluate the quality of the third-party due diligence provider. Without a critical evaluation of the third-party due diligence provider, she may have violated Standard V(A). Similarly, it is acceptable for Gillis to rely on Desmond to fulfill her responsibilities to conduct thorough due diligence of potential client investments. Gillis can assume that investments listed on Sunset's approved private placement list have been thoroughly vetted by the firm through Desmond without having to go back and conduct the due diligence himself unless he has reason to question the validity of the process.

It is also not necessarily improper for Gillis to rely on sponsor-created marketing material to provide information to clients, as long as Gillis, compliance, or other personnel at Sunset have thoroughly reviewed the material to ensure that it meets all applicable disclosure requirements and contains no misrepresentations. If Gillis simply forwards the material to clients without such a review, then he could be violating his duty of diligence to clients by potentially disseminating inaccurate or misleading materials to clients. Because of the lack of information provided in the case, an argument could be made that under certain circumstances, any of the responses could be chosen.

*This case is based on a Financial Industry Regulatory Authority (FINRA) enforcement action from 2013.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 3

### CASE STUDY

Robles, a fund manager, visits the main manufacturing plant of a large international cement company. During his visit, the management of the company discloses that the company has purchased additional land and resources at this location that can easily be put to use for low-cost expansion in the future. Management claims that the expansion would result in a capital cost per unit of production nearly 30% cheaper than industry norms. Management tells Robles "confidentially" that the company may consider expansion when the global economic climate improves sufficiently to boost demand for their product. Based on this information, Robles buys stock in the cement company for the fund he manages. Did Robles act unethically?

- A. Yes because Robles traded based on material nonpublic information.
- B. No because Robles did not trade on material nonpublic information.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 3

#### ANALYSIS

CFA Institute Standard II(A): Material Nonpublic Information prohibits members who are in possession of material nonpublic information that could affect the value of an investment from acting on that information. Information is material if it would significantly alter the total mix of information currently available in such a way that the price of the security would be affected. The nature, specificity, exclusivity, and reliability of the source of the information helps determine materiality. Information is nonpublic until it has been disseminated or is available to the marketplace in general. There are three pieces of information that are described in the case that are relevant to Robles's decision to trade: (1) the purchase of excess land and resources at the site of the company's main plant, (2) the calculation that using this additional capacity would reduce the company's production costs to less than industry norms, and (3) the company's expansion plans. Are any of these three pieces of information material nonpublic information?

The first piece of information about acquiring additional production assets would likely be considered material. But it is not clear when the purchase occurred. Was it recent? Is the purchase in the public record? It is possible that the purchase is already publicly known, and the management's disclosure to Robles is nothing new. It is also possible that the purchase just occurred or is imminent and has not been announced publicly, which would make the information nonpublic. The second piece of information about being to produce at much lower costs would be material information. But it is unclear whether this information is known only to the company. Certainly, confidential proprietary manufacturing cost calculations would be nonpublic, but astute analysts with knowledge of the industry may be able to easily make this type of evaluation. In that case, the information may not be confidential. Finally the third piece about the company's expansion plans are very likely to affect the price of the company's stock and would thus be material information. But again, the information is not specific enough. Management tells Robles that the company "may consider" expansion when the global economic conditions "improve sufficiently." The possibility that the company "may consider" expanding is vague and ambiguous. When the economy "improves sufficiently" is also subjective and indefinite. Even if this information is disclosed "confidentially" only to Robles and is not publicly available, it is not clear that general plans about possible expansion at some unknown point in the future rises to the level of material information.

In sum, a portion of the information disclosed to Robles by company management has the potential to be material. It is unclear from the facts of the case that the information is nonpublic. An argument could be made either way. We would need more information to make a determination about whether Robles violated the prohibition against trading on material nonpublic information.

*The facts for this case were submitted by Shreenivas Kunte, CFA Institute Director of Continuing Education and Advocacy, India, Asia-Pacific Region.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 4

### CASE STUDY

Eaton runs a hedge fund that holds the commercial paper (CP) of a listed company. The fund also has a large investment in the equities of that company. Upon maturity of the CP, the company fails to honor the CP and refuses to communicate with Eaton. Based on these facts combined with further research indicating that the company may be having liquidity issues, Eaton sells the fund's equity position. Eaton also shorts the company's stock in his personal account. Did Eaton violate the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards)?

- A. Eaton violated the Code and Standards by selling the fund's equity position in the company.
- B. Eaton violated the Code and Standards by shorting the company's stock in his personal account.
- C. Eaton violated the Code and Standards by both selling the fund's equity position in the company and shorting the company's stock in his personal account.
- D. Eaton did not violate the Code and Standards.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 4

#### ANALYSIS

This case involves CFA Institute Standard II(A): Material Nonpublic Information, which prohibits trading or causing others to trade on material nonpublic information. Information is considered "material" if it is likely to affect the price of a security. It is considered "nonpublic" if it is not widely disseminated. But under the mosaic theory, those who work to uncover and piece together nonmaterial and/or public information to form an opinion about a security can trade based on significant conclusions derived from that analysis. In this case, the fact that a company has defaulted on its commercial paper commitment would likely be a material fact that a reasonable investor would like to know. It is also likely that information regarding the default, at least initially, is not publicly known. The CP is privately traded, and this information may be available only to the holders of the CP.

Eaton becomes aware of the default because his hedge fund owns the CP, and thus he becomes immediately aware of the default when it occurs. The fund is in a unique position to be the first to be aware of the cash flow problems of the company. Does the fund have to wait to trade on the information until it becomes publicly known? This situation is similar to the case in which a customer orders goods from a manufacturer who does not deliver on time. The customer is in the best position to know that the manufacturer defaulted on the contract and thus have an early understanding of the difficulties the company is having. The informational advantage arises from a learned fact as a result of the proximity to the company, not because of any inside information. Intrepid analysts are likely to discover the information eventually. Eaton's hedge fund is the first to do so given their relationship with the company. But even if Eaton's hedge fund is able to trade on the information, Eaton's investment action for his personal account is likely in violation of the standards because he is taking inside information that is confidential to the hedge fund and using for personal gain. The best choice in this case is B.

*This case was submitted to CFA Institute by an "Ethics in Practice" participant.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 5

### CASE STUDY

Soto manages assets for high-net-worth individuals, family groups, foundations, endowments, and similar institutions. Many of his clients have expressed interest in investing a portion of their assets in alternative investments to boost their portfolio return. Soto recommends particular alternative assets, including hedge funds, to his clients and monitors those investments on his clients' behalf. Soto has developed written policies and procedures that he consistently applies when evaluating potential hedge fund investments, but he does not disclose these policies and procedures to his clients. Soto generally meets in-person with the hedge fund managers at the funds' offices to discuss their implemented investment strategy, understand the culture of the manager, have increased access to review documents, and speak with the fund's personnel. Unless he sees a red flag, Soto does not conduct comprehensive background checks on the managers and their key personnel.

Several of the hedge fund managers he chooses as investments for his clients have undisclosed potential conflicts of interests, such as compensation arrangements or business activities with affiliates. When choosing potential hedge fund investments, Soto ensures that the investment style of the fund is suitable for his clients and intermittently checks to verify the fund's commitment to that style over time. Although Soto does not independently verify the funds' relationships with service providers, such as administrators and custodians, he does carefully evaluate the auditors of the fund when he is not familiar with the auditor. Some of the funds that Soto chooses as investments for his clients have multiple changes in key third-party service providers over time. Soto relies on third-party legal consultants to review legal documents to evaluate such issues as redemption terms and restrictions. Soto relies on marketing material prepared by the hedge funds to provide his clients with as accurate as possible information about the investment. What do you think of Soto's actions?

- A. Soto's actions are acceptable under the CFA Institute Code of Ethics and Standards of Professional Conduct.
- B. Soto's actions violate the CFA Institute Code of Ethics and Standards of Professional Conduct.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 5

#### ANALYSIS

This case involves CFA Institute Standard V(A): Diligence and Reasonable Basis, which requires CFA Institute members to exercise diligence, independence, and thoroughness in analyzing investments and making investment recommendations. In choosing hedge fund investments for his clients, Soto must undertake appropriate due diligence in evaluating the funds for potential investment for his clients. Does Soto's actions meet the due diligence and reasonable basis requirement of the CFA Institute Code and Standards? Soto takes many steps to thoroughly evaluate the hedge fund investments, including consistently applying written policies and procedures when engaging in due diligence; holding in-person meetings at the funds' offices to understand the investment strategy, evaluate the manager, meet with key personnel, and make sure the investment is suitable for his clients; investigating the auditor of the fund when it is unfamiliar; having the legal documents of the fund reviewed; and using the funds' own statements and promotional material in an effort to accurately describe the fund to his clients.

But some of Soto's actions may not have been as strong as they could be, leading him to miss potential red flags. Although he adopts due diligence policies and procedures, he does not disseminate those to clients. He does background checks of fund personnel only when he sees a "red flag" leading him to miss potential conflicts of interest on the part of fund personnel. He does not check employment history, legal and regulatory matters, news sources, and independent references of firm personnel. He checks on a fund's strategy and suitability for his clients, but he does not regularly go back to check the fund for style drift. He does not independently verify the relationships with certain fund service providers (administrators, custodians) and looks into the auditor only when he is not already familiar with them, potentially missing business relationship or other conflicts of interests that could undermine their independence. He outsources the legal document review to a third party, which may be appropriate if Soto does not have legal expertise but could be an issue if the third-party review is not thorough or as complete as necessary. Finally, by relying on the marketing material of the fund and not creating his own independent information for his clients, he could be providing false or misleading information prepared by the fund itself. Assessing due diligence is a very facts and circumstances specific exercise. If a client were to challenge Soto's due diligence efforts as insufficient under Standard V(A), whether his diligence is adequate would likely depend on the specific facts of the case.

*This case is based on a 2014 Risk Alert by the US SEC Office of Compliance Inspections and Examinations.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 6

### CASE STUDY

Estevez is a senior research analyst with BIR, a boutique investment research firm that covers micro- and small-cap companies. These companies hire BIR to provide research coverage to promote their stock to investors who otherwise might not be aware of them. Because of BIR's stellar reputation, its research services are in heavy demand by both investors and those companies seeking to get on investors' radar. Estevez helps BIR select the companies that should receive coverage and also oversees a team of junior analysts who conduct the research. Some companies encourage Estevez to select their company for research by providing her a separate bonus if they are included in the BIR research universe. Estevez's actions are

- A. unacceptable because her independence and objectivity in conducting the research are compromised if the research is solicited and paid for by the covered company.
- B. acceptable as long as Estevez does not use material nonpublic information from the company.
- C. unacceptable if Estevez's compensation from BIR is tied to the specific findings of the report.
- D. acceptable as long as her company approves offered payments from covered companies.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 6

#### ANALYSIS

The facts of this case relate to CFA Institute Standard IV(B): Additional Compensation Arrangements, which requires members to obtain written consent from their employer when they accept any gift, benefit, or compensation that might reasonably be expected to create a conflict of interest with their employer. In this case, Estevez receives a benefit from companies that are selected by BIR to receive research coverage. Because Estevez is involved in the process of choosing the companies that BIR agrees to research, that presents a conflict of interest because she might favor those companies that pay her the bonus.

Issuer-paid research itself is not automatically unethical and does not automatically compromise the analyst's independence and objectivity. But this area is fraught with conflicts, so important safeguards must be in place. BIR must adopt strict procedures protecting the inviolability of the analyst's opinion from influence by the company. Such safeguards must also include full disclosure of any conflicts of interests on the part of the analyst conducting the research, full disclosure of any compensation arrangements, including the source of the payment for the research, and policies that disconnect the findings of the research from the level or nature of the payment. In this case, Estevez would have to disclose to her company that she is receiving the benefit from the issuer and BIR would have to disclose to the users of the report that the company paid Estevez the bonus and is paying for the research. The research could be considered independent and objective if Estevez did not use material nonpublic information from the company and if BIR's compensation for the research from the company was not tied to the specifics of the report. But even if that was the case, it would not alleviate the issue of Estevez accepting bonuses from the covered companies without informing her employer. Choice D is the best answer, although it is incomplete because full disclosure is needed as well.

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 7

### CASE STUDY

Gostkowski is an analyst for Banner Investment Management (Banner). Banner's most significant line of business is its repurchase agreements (repo) program, which offers investment advisory clients the opportunity to invest in loan portfolios with portions of loans guaranteed by various government entities, including the US Department of Agriculture (USDA). Banner markets the program as a higher-yield alternative to money market accounts. Banner discloses to clients and regulators that it conducts initial and ongoing due diligence and monitoring of repo counterparties, including the counterparties' financial condition.

As part of these reviews, Gostkowski uses a checklist of the documents he needs to obtain from repo counterparties. The checklist includes certain financial information, including annual audited financial statements. But Banner does not provide any written guidance for Gostkowski regarding its practices for addressing material or problematic information.

During the course of the repo program, Banner begins using Farmers First Financial (Farmers First) as a repo counterparty. Initially, Farmers First provides Gostkowski only unaudited financial statements. Farmers First tells Gostkowski that it is in the process of hiring a new auditor to audit its financial statements and says it will be filing for an extension on submitting the required filings. During his initial due diligence, Gostkowski conducts a background check on Farmers First and its principals. Gostkowski discovers that the Farmers First CEO has not graduated from college, has a poor credit history, has pleaded no contest to assaulting a police officer, has been convicted of two charges of driving under the influence, and has been sued multiple times for breach of contract. Gostkowski does confirm Farmers First's status as an approved USDA lender, but he does not attempt to verify other representations made by Farmers First or contact its references. Gostkowski is informed by Banner's legal counsel that the USDA should honor its guarantee unless Banner had actual knowledge that Farmers First had participated in fraud or misrepresentation.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 7

#### **CASE STUDY (CONTINUED)**

When Gostkowski eventually receives the audited financial statements from Farmers First, they contain discrepancies with the unaudited financial information provided during the initial due diligence. Gostkowski also cannot find evidence that the auditor listed on the Farmers First financial statements exists. Gostkowski conducts an on-site visit at Farmers First's offices and finds no evidence that the firm has five to seven employees, as claimed in its initial disclosures. Gostkowski also cannot locate the purported underlying borrowers for several of Farmers First's loans. The USDA eventually confirms to Gostkowski that a representative sample of the loans purchased from Farmers First were fraudulent and subsequently informs Banner that it will not honor the guarantee. As a result, Banner's investors in the repo programs associated with Farmers First lost millions of dollars. Gostkowski's actions are inappropriate.

- A. appropriate because he collected the financial statements from Farmers First and did background checks on both the company and its principals before Banner engaged with the company.
- B. appropriate because he confirmed Farmers First was a USDA-approved lender and was told by legal counsel that the company's loans were guaranteed by the government.
- C. appropriate because he conducted an on-site visit of Farmers First's offices once he had concerns about the company.
- D. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 7

#### ANALYSIS

This case relates to an investment professional's responsibility to conduct due diligence on investments on behalf of clients and investors. CFA Institute Standard of Professional Conduct V(A): Diligence and Reasonable Basis requires CFA Institute members to exercise diligence, independence, and thoroughness in analyzing investments and to have a reasonable and adequate basis for investment recommendations and action. Banner and Gostkowski have a responsibility to thoroughly investigate Farmers First as a counterparty before allowing clients to invest in the associated repo program.

The facts indicate that Gostkowski took a number of steps to conduct due diligence, including collecting financial statements, conducting background checks, confirming that the firm was USDA approved, checking with counsel on potential liability issues, researching the Farmers First auditor, and trying to investigate the underlying assets (loans) at the heart of the repo investment. But many of these steps were inadequate, raised red flags that were ignored, or happened only after Banner had committed client assets to a fraudulent investment. As a result, the facts are sufficient to indicate that Gostkowski and Banner failed to exercise appropriate due diligence with respect to the Farmers First repo investments. Choice A is the best answer.

*This case is based on a November 2018 Enforcement Action by the US SEC.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 8

### CASE STUDY

Ng launched his independent investment advisory firm last year. His primary investment tool for managing client accounts is an artificial intelligence (AI)-based model that seeks growth investment opportunities while minimizing excessive risk. Over the past decade, Ng honed his quantitative and computer-modeling skills as the lead technologist for a hedge fund. His AI model makes all investment decisions and submits trading requests without any interactions from Ng. To validate the model's operations, he regularly reviews his clients' return performance as well as traditional risk metrics.

Ng is constantly seeking new sources of data for his model. Each new source is back tested against the initial model design and its current sources. Those new sources that strengthen the model's goals are subsequently incorporated into the live model.

Following the addition of the newest data source addressing market sentiment, the model's results became extremely volatile and its risk metrics increased significantly. Ng believes the volatility and increased risk metrics will be short lived and will ease as the model learns to apply the new data effectively. He is partially correct – the return volatility stabilizes over the next six months, but the risk metrics remain above desired values. Ng's decision to use an AI-based model to select investments is

- A. inappropriate if he does not understand the basis for the AI model's investment and trading decisions.
- B. inappropriate if he does not retain the appropriate documentation to support the AI model's investment decisions.
- C. inappropriate if he does not communicate to his clients the continuing updates to the AI model.
- D. all of the above.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 8

#### ANALYSIS

Technological changes are a consistent part of the investment management industry. From the time that computers began replacing calculators and journal ledgers, the industry has used technology to develop practices and techniques that enhance research and trading efficiency. Although artificial intelligence is just the latest iteration of the ongoing advancement of technology, fundamental ethical norms must be applied to its use to ensure that investors' interests continue to be protected.

CFA Institute Standard V(A): Diligence and Reasonable Basis requires CFA Institute members to exercise diligence, independence, and thoroughness as well as have a reasonable and adequate basis supported by appropriate research for taking investment action. In the realm of AI-based decision making, all decisions are made within the programmatic platform. Ng reviews the model's performance and risk metrics, but it is unclear from the facts if his validation of the decisions is grounded in sufficient research.

CFA Institute Standard V(C): Record Retention requires CFA Institute Members to develop and maintain appropriate records to support their investment actions. But in AI-based decision making, the process and information used to arrive at specific decisions are within the programmatic platform. From the information provided, it is unclear what, if any, processes are in place to support appropriate decision-based record retention.

CFA Institute Standard V(B): Communication with Clients and Prospective Clients requires CFA Institute members to describe the basis of the investment process. This information allows clients to make informed decisions about engaging with an investment adviser. With AI, the investment decision-making process continues to "learn" and evolve as data are provided to the programmatic platform.

Ng's introduction of the new sentiment data transforms the initial model used for back testing into the evolved model used in practice. The question, then, is whether the program's "learning" process is considered a significant change to the investment process that needs to be disclosed to clients. Individuals researching investment options certainly rely on many sources of information. But a human's ability to consume data is not as great as that of an AI-based model. The outcome described here of the introduction of a new data source demonstrates the model's potential sensitivity to new factors. It is unclear from the facts if Ng's clients have been informed of these changes.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 8

#### **ANALYSIS** (CONTINUED)

Although the use of AI represents an advancement in investment management, all of these considerations must be addressed in some manner as they relate to ethical practices that protect investors. Choice D is the best answer.

*To better understand these and similar concerns, the CFA Institute Standards of Practice Council (SPC) issued a consultation seeking input from CFA Institute members and other industry participants who are using or researching AI techniques. The SPC will consider the responses received in the development of future guidance on the Code of Ethics and Standards of Professional Practice. The consultation is open until 29 March 2019.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Research – Case 9

### CASE STUDY

Archer is an investment adviser who began his career as a portfolio manager at SR Wealth Management (SRWM). One of his accounts at SRWM was the joint investment account of a young couple. When Archer leaves SRWM to join YC Capital, a competitor, the couple's account is assigned to another adviser at SRWM. Two years after leaving SRWM, Archer bumps into Lucy, the wife of the couple who was his former client, at a social event. She tells Archer that she and her husband are separated and in the process of divorcing. She also shares that she has been unhappy with the new adviser SRWM assigned to manage the couple's joint account after Archer left because it has performed poorly, and the fees seem to have increased substantially.

Archer offers to look over the couple's SRWM account information and statements to see whether there is a problem. He is shocked to see that the investments are not in line with the information in the couple's Investment Policy Statement, and that there seems to be a high level of turnover in the account. Archer asks Lucy to dinner and shares his thoughts about the issues he has found with couple's account. After that, Archer and Lucy begin dating. Shortly after beginning the relationship with Archer, Lucy withdraws the bulk of the assets from her and her estranged husband's SRWM account and opens a personal account at Archer's new firm, YC Capital, with Archer as the portfolio manager. Archer does not disclose to his employer that he and Lucy are in a relationship. Archer's actions are

- A. inappropriate because he violates his duty of loyalty to Lucy's husband as a former client.
- B. inappropriate because he accesses and examines records from his former employer and criticizes a former colleague.
- C. inappropriate because he violates his duty to disclose conflicts of interest by failing to inform his employer about his personal relationship with Lucy.
- D. appropriate.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Research – Case 9

#### ANALYSIS

This case relates to disclosure of conflicts of interest. CFA Institute Standard VI(A): Disclosure of Conflicts requires CFA Institute members to make full and fair disclosure of all matters that could reasonably be expected to interfere with their duties to clients or employers. In this case, Archer's personal relationship with his client is a potential conflict that should be disclosed to his employer because he may have an incentive to neglect other advisory clients in favor of Lucy's account as a way to enhance their relationship.

Archer is not violating confidentiality or any duty to his former employer by examining the investment records of his former client because the client provided those records to him; he did not access them inappropriately. He does not have a duty of loyalty to Lucy's husband, a former client, because he is no longer his investment adviser. Presumably, Archer understands that Lucy is using joint marital assets to open a personal account, without the consent of her current husband. If Archer knows that Lucy is acting in contravention of the law or a court order or is perpetrating a fraud against her husband in using those assets to open the account, Archer would also be violating Standard I(D): Professional Misconduct, which prohibits members from engaging in any professional conduct involving dishonesty, fraud, or deceit. Without further information indicating any fraud, deceit, or dishonesty, choice C is the best response.

*This case is based on facts provided by Tanuj Khosla, CFA, CAIA.*

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# **SUPERVISORY RESPONSIBILITY**

# CFA INSTITUTE

## ETHICS IN PRACTICE: Supervisory Responsibility – Case 1

### CASE STUDY

Rosenthal Collins Group (RCG) is a registered futures commission merchant with a number of branch offices, including one in Memphis, Tennessee. Phillips is hired to be the branch manager of the Memphis office, supervising a number of employees, including Lewis. Phillips allows Lewis to work from home, and as a result, Lewis has no physical office in the Memphis branch of RCG or even access to the building. Unknown to Phillips or RCG, Lewis also works for another futures commission merchant (AFCM). Lewis arranges swap agreements for AFCM, including orders with several cattle feed yards. And through another employee at RCG, he helps open new futures accounts for the feed yards RCG represents. Although the other employee at RCG receives all the commissions for the feed yard accounts, she surreptitiously splits these commissions with Lewis. This commission sharing arrangement is also unknown to Phillips. Phillips actions as a supervisor are

- A. acceptable if RCG did not develop adequate policies and procedures for the detection and deterrence of possible misconduct by its employees.
- B. acceptable if Phillips was not provided adequate training from RCG on its compliance policies and procedures.
- C. acceptable if RGC home office conducted regular audits of the Memphis branch.
- D. unacceptable because Phillips did not diligently perform his supervisory responsibilities.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 1

#### ANALYSIS

This case is about adequately exercising supervisory responsibility. CFA Institute Standard IV(C): Responsibilities of Supervisors states that "[CFA Institute] members must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards." At a minimum, supervisors must make reasonable efforts to detect and prevent legal, regulatory, and policy violations by ensuring that effective compliance systems have been established. They must also understand what constitutes an adequate compliance system and make reasonable efforts to see that appropriate compliance procedures are established, documented, communicated to covered personnel, and followed. Supervisors must alert their superiors and firm management if there is an inadequate compliance system in place and work with them to develop and implement effective compliance tools. If the absence of or inadequacy of the compliance system prevents effective supervisory control, an investment professional should decline to accept supervisory responsibility until the firm adopts reasonable procedures to allow the effective exercise of supervisory responsibility.

If Phillips knew that RCG had not developed adequate policies and procedures for the detection and deterrence of potential misconduct by RCG employees, it would be incumbent on him to bring this to the attention of RCG, help develop adequate compliance policies, or decline supervisory responsibility. In the absence of adequate compliance policies, it would not be acceptable for Phillips to act as branch manager. A lack of adequate policies would also not be an excuse for failing to detect potential misconduct by RCG employees, including Lewis, which means Answer A would not be correct. Similarly, if RCG did not properly train Phillips on RCG compliance policies that did exist, Phillips should decline supervisory responsibility until he adequately understands RCG policies and procedures and expectations for maintaining his subordinates' compliance with those policies. Lack of training on how to supervise should not be an excuse for inadequate supervision but a catalyst to seek out that training, thus making Answer B not the right choice.

A regular audit of the Memphis branch by RCG home office compliance personnel could be an excellent way to ensure that branch employees are complying with applicable law, regulations, and RCG policies. But it is not a substitute for effective and regular supervision by Phillips, the onsite branch manager, making Answer C incorrect. Although it is not clear from the case what steps Phillips did take to diligently exercise supervisory responsibility, the fact that Lewis worked from home and did not have access to the branch office, suggests that Phillip's "hands on" supervision was minimal at best and obviously ineffective. Answer D is the best choice.

*This case is based on an enforcement action by the US Commodity Futures Trading Commission from 2014.*

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# CFA INSTITUTE

## ETHICS IN PRACTICE: Supervisory Responsibility – Case 2

### CASE STUDY

Manley, Head of Research at a long-short equity fund, leads a team of four analysts. One of the fund's portfolio managers asks Manley to look at a particular small-cap company as a possible investment target. Because there is little information available on the company, Manley assigns the challenging task to Chang, one of the fund's top junior analysts, who spends a week conducting research. Chang builds a cash flow projection model that shows the company is deeply undervalued. Manley briefly reviews the model and publishes a research report on the company with the author listed as the Research Department that recommends a "Buy" at the current price. The fund makes a substantial investment in the company's stock. Later, several brokerage houses come out with research pieces on the company that include cash flow projections that are considerably lower than Chang's model. Over the course of six months, the investment loses 25% of its value. Manley thoroughly reviews Chang's model and discovers two assumptions that eventually proved erroneous as well as an arithmetic mistake. Did either Manley or Chang violate the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards)?

- A. Manley violated the CFA Institute Code and Standards.
- B. Chang violated the CFA Institute Code and Standards.
- C. Manley did not violate the CFA Institute Code and Standards.
- D. Chang did not violate the CFA Institute Code and Standards.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 2

#### ANALYSIS

Many people choose response A, which is the easy answer; the subordinate's work was flawed, so the supervisor must be responsible. And that can be true under some circumstances. But response C – no supervisor violation – could be just as correct given the right facts and circumstances. This case shows how you must identify all the relevant facts before making a decision to analyze a decision from an ethical perspective. Read on for arguments that could be made for each answer.

Case for Response A. Manley violated Standard V(A): Diligence and Reasonable Basis by relying on the erroneous work done by Chang. In addition, as Head of Research, Manley violated Standard IV(C): Responsibilities of Supervisors by failing to supervise Chang, who himself violated the standards (See Response B analysis). Manley only briefly reviewed Chang's work. Finally, Manley misrepresented the author of the research report as that of "the Research Department" when Chang conducted the research.

Case for Response B. Chang violated Standard V(A): Diligence and Reasonable Basis. Chang included two erroneous assumptions in his model. It is not clear from the facts that he had a reasonable and adequate basis or that he thoroughly analyzed the information to create his model. Furthermore, he did not thoroughly check his model because he made an arithmetic mistake that contributed to skewing the model results.

Case for Response C. Manley did not violate the standards because he reasonably relied on the work of one of his colleagues, who had a track record of exercising diligence and thoroughness and conducting appropriate research. Furthermore, there is no indication from the facts that Manley failed to adequately supervise Chang. The facts of the case do not indicate the supervisory steps Manley or the fund have in place to monitor Chang's work. A "brief" review by Manley of the research may be appropriate if other steps are in place (peer review, for example) to check the appropriateness of Chang's analysis. And there is no indication that Chang violated the standards. (See Response D analysis). Finally, it is proper to have the author of the research report listed as the "Research Department" because the work is that of the firm.

Case for Response D. Chang did not violate the standards because there is no indication from the facts that he failed to exercise diligence and thoroughness or that his research was not supported by appropriate research and investigation. Although the two assumptions ultimately proved erroneous, that does not automatically mean that they were inappropriate when initially made by Chang given the facts he was aware of at the time. Being incorrect about an investment recommendation or prediction is common. An inaccurate prediction is not sufficient evidence that a violation of the CFA Institute Code and Standards occurred. It is also not clear from the facts that the arithmetic mistake was material or affected the outcome of the model.

*This case is based on facts written by Tanuj Khosla, CFA, CAIA.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Supervisory Responsibility – Case 3

### CASE STUDY

Olsen is president and CEO of RCS, a registered investment adviser. RCS offered clients an advisory fee between 0.4% and 1.5% of their assets under management based on fee breakpoints described in its fee schedule. The schedule reduced the advisory fee as a client's assets under management increased. RCS's fee schedule was incorporated by reference in client advisory agreements, distributed to clients upon request, and disclosed in RCS's regulatory disclosure filings. RCS's written policies and procedures manual stated that RCS was to conform its client fees and fee billing practices to those described in the regulatory filings in the advisory agreements provided to clients. In certain instances, however, RCS failed to apply the breakpoint discounts. As a result, RCS improperly calculated advisory fees and thereby overcharged certain clients. As president and CEO, Olsen

- A. met his ethical responsibilities if he delegated responsibility for billing and fees to competent personnel in RCS's accounting department.
- B. met his ethical responsibilities if he made certain that appropriate policies and procedures were in place to ensure that RCS properly billed its clients.
- C. met his ethical responsibilities if the erroneous billing was the result of clerical error and inadvertent.
- D. failed to meet his ethical responsibilities.
- E. none of the above



## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 3

#### ANALYSIS

Although the harm to clients and the misconduct of the firm is clear, the facts and answer choices examine this case from the perspective of Olsen's supervisory responsibility. CFA Institute Standard of Professional Conduct IV(C): Responsibilities of Supervisors requires members to make reasonable efforts to ensure that those subject to their supervision or authority comply with applicable law and ethical responsibilities. As president and CEO, Olsen has overall accountability for the conduct of the firm and is ultimately responsible for compliance with applicable legal requirements and fulfilling the firm's ethical duties to clients. As the leader of RCS, he may delegate these responsibilities to competent and knowledgeable subordinates. Whether conduct constitutes reasonable supervision in compliance with Standard IV(C) is determined by the facts or circumstances of each particular case.

Delegation of billing functions to competent personnel alone does not absolve Olsen of his supervisory responsibility. At a minimum, Olsen should have made reasonable efforts to prevent and detect violations by ensuring the establishment of effective compliance systems. At the same time, ignoring or not properly implementing compliance policies and procedures could result in a violation of the Standard because of the failure to supervise. The occurrence of inadvertent errors may not indicate improper structure or application of billing policies and procedures but could be a red flag indicating the existence of ineffective policies or sloppy, error-prone work that should be addressed through adequate supervision. The CFA Institute Ethical Decision-Making Framework calls on those seeking to engage in ethical conduct to identify the relevant facts to determine the appropriate course of action. In this case, although the firm's actions harmed clients and resulted in liability for regulatory violations, the facts given are insufficient to allow a definitive determination of whether the overcharging of clients was a result of inadequate supervision by Olsen. Choice B is the best answer.

*This case is based on a US SEC Enforcement Action from November 2018.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Supervisory Responsibility – Case 4

### CASE STUDY

Stansfield is hired by Roudabush Securities Inc. (RSI) to manage a staff of investment advisers. Delorme, one of the investment advisers Stansfield supervises has been with RSI for more than 30 years and is the sister-in-law of the owner of the firm. Delorme is involved in a pump-and-dump trading scheme with an investment adviser outside of RSI in which Delorme buys or encourages her clients to buy speculative "penny" stocks to boost demand and price of the securities controlled by the outside adviser. In return, Delorme receives compensation from the outside adviser. Stansfield becomes aware of these activities from Delorme's emails, which are flagged by the email monitoring system Stansfield put in place to detect misconduct on the part of his subordinates.

He limits her trading in the last hour of the day and restricts her from trading in certain penny stocks, but he allows her to continue to interact with customers, process orders, and make investment recommendations and decisions for her clients. He tells colleagues that because of Delorme's senior position at the firm, he wants to "be gentle" in terms of restrictions and not take excessively harsh action. But during this time, Delorme continues to act as an accomplice in the stock manipulation scheme. Eventually, two clients complain to RSI about the securities bought for their accounts when they become worthless. The complainants note that the deals had to be handled through a different broker/dealer, apparently because of RSI's trading restrictions on Delorme.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 4

#### **CASE STUDY** (CONTINUED)

Finally, the local regulator notifies RSI that they are investigating Delorme's conduct. RSI policies do not specify whether an employee's supervisor, compliance personnel, or the firm's legal department have responsibility for investigating misconduct. Nevertheless, Stansfield begins an internal investigation into Delorme's conduct. RSI policies do not specify how the results of the investigation are to be documented or reported or who within the firm has responsibility to address potential employee misconduct once discovered. Stansfield's actions with respect to Delorme are

- A. acceptable because he put an effective email monitoring system in place to detect misconduct.
- B. acceptable because he restricted Delorme's activities once alerted of potential misconduct.
- C. acceptable because he takes the initiative to investigate Delorme's activities in the face of ambiguous firm policies.
- D. unacceptable.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 4

#### ANALYSIS

This case relates to effective exercise of supervisory responsibility. CFA Institute Standard IV(C): Responsibilities of Supervisors states that CFA Institute members must make reasonable efforts to ensure that those subject to their supervision comply with applicable laws, rules, and regulations as well as with the CFA Institute Code of Ethics and Standards of Professional Conduct. Effective supervisors enact policies and procedures to encourage compliance and investigate and punish employee misconduct when it arises. In this case, a number of red flags alert Stansfield to Delorme's misconduct, including emails, client complaints, and a regulatory investigation. In the face of these red flags, Stansfield must promptly initiate an assessment to determine the extent of wrongdoing and take steps to ensure that the misconduct does not continue. Stansfield's policies and compliance practices (email monitoring system) successfully reveal Delorme's misconduct, and he initiates an investigation. He does then take some steps to limit Delorme's activity. But because he is deferential to Delorme's seniority, the measures he takes are inadequate, and Delorme works around the restrictions to continue the misconduct.

In addition, RSI's compliance policies are vague and incomplete when it comes to addressing misconduct. They lacked any reasonable coherent structure to provide guidance to supervisors and other staff for investigating possible misconduct, and they lacked reasonable procedures regarding the investigation and handling of red flags. If a CFA Institute member cannot discharge supervisory responsibilities effectively because of an inadequate compliance system, he or she should not accept a supervisory position until an adequate compliance system is put in place. Given the nature of Delorme's misconduct and the clear danger to client interests, Stansfield should have taken stronger action to remove Delorme from the investment management process. Additionally, in the face of RSI's inadequate compliance system, Stansfield should not have accepted supervisory responsibility. Choice D is the best response.

*This case is based on a March 2019 US SEC Enforcement Action.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Supervisory Responsibility – Case 5

### CASE STUDY

Simpson is a senior portfolio manager for Regal Investment Advisors and acts as the firm's compliance officer. Regal has Simpson review the mutual fund transactions of all discretionary client accounts using trade reports generated by Regal's clearing firm. But those reports do not specifically identify when a client is moving assets from one mutual fund to another. Simpson wants to review these particular "mutual fund switch" transactions to ensure suitability of investments and to avoid churning in client accounts. To facilitate this review, Simpson requires each portfolio manager to complete a form and obtain approval from Simpson before initiating a switch transaction. If Simpson approves the switch, the portfolio manager is required to obtain a client's written acknowledgment of the transaction. Simpson's actions are

- A. acceptable because the procedures ensure suitability of mutual fund transactions.
- B. unacceptable because the procedures rely on third-party records to verify Regal's compliance procedures.
- C. acceptable because the procedures require independent confirmation of the trade by a client in writing.
- D. unacceptable because the compliance procedures are not sufficient to detect churning in client accounts.
- E. none of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 5

#### ANALYSIS

This case centers on whether a person in a position of authority effectively exercises supervisory responsibility. CFA Institute Standard IV(C): Supervisory Responsibility requires CFA Institute members to make reasonable efforts to ensure that those subject to their authority comply with regulations, firm compliance procedures, and fundamental ethical principles. At a minimum, members must make reasonable efforts to prevent and detect violations by establishing an effective compliance system. In this case, the compliance procedures are not reasonably designed to ensure the suitability of mutual fund switch transactions and to prevent churning because they rely solely on the portfolio manager to self-report and alert the firm about the transaction.

Regal has no supervisory mechanism in place to initiate a review of mutual fund switches in the event that a portfolio manager fails to complete the required form or otherwise fails to notify Regal of the transaction. This lack would allow unscrupulous portfolio managers to escape supervisory scrutiny by the firm. As a general matter, it would be acceptable and effective for a firm to verify trades using trader reports generated by its clearing firms. But in this case, these reports are incomplete because they do not identify mutual fund switch transactions. Acknowledgment by a client is ineffective if those trades that require acknowledgment are not made known to the supervisor, compliance officer, and client by a portfolio manager who does not follow the firm's compliance procedures to obtain prior approval of the trade. Choice D is the best response.

*This case is based on an enforcement action by the US Financial Industry Regulatory Authority from June 2019. In the case, two portfolio managers took advantage of the inadequate supervisory system to place mutual fund switch trades in which clients incurred unnecessary front-end sales loads of close to US\$400,000 in losses.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Supervisory Responsibility – Case 6

### CASE STUDY

Estevez is the chief compliance officer of a global financial services corporation. He and his staff develop and implement policies and procedures to address antibribery and corruption issues. The policies prohibit employees from providing "anything of value" to government officials to gain an improper business advantage. The policies specifically define "value" to include job offers or employment to individuals at the request of a client, potential client, or official of a government or state owned enterprise. The policy also prohibits employees from hiring anyone as a temporary employee, intern, or in other roles in an attempt to evade the policy. The company uses a questionnaire that requires employees seeking to hire a referral candidate to disclose the source of the referral, identify whether the referral source is a client or prospective client, and disclose whether the potential hire was referred by or related to a government official. The compliance policies require the questionnaire to be submitted to both the compliance and the human resources departments for approval.

On multiple occasions, senior members of the company's Asia-Pacific (APAC) office, seeking to obtain or retain business, attempt to hire relatives of state-owned enterprises and government officials, but these applications are rejected by Estevez as violations of the firm's compliance policies. The firm's APAC officials then direct a regional-affiliated organization to hire the referred individuals. As employees of the affiliate, these referral hires are permitted to do work for the firm. Several months later, the employees, having gained experience, are brought into the firm as lateral hires from the firm's affiliate. Choose the response that best describes how Estevez met his professional responsibilities with respect to the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards). Estevez

- A. drafted comprehensive compliance policies regarding referral hires.
- B. fulfilled his responsibilities because he rejected the APAC officials' attempts to hire individuals in violation of the firm's policies.
- C. properly allowed referred hires to gain experience at an affiliate prior to joining the firm.
- D. did not appropriately meet his professional responsibilities under the Code and Standards.
- E. none of the above.

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## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 6

#### ANALYSIS

This case relates to effective implementation of compliance policies and supervision of employees. CFA Institute Standard IV(C): Responsibilities of Supervisors requires CFA Institute members to make reasonable efforts to ensure that anyone subject to their authority complies with applicable rules and regulations. As chief compliance officer for the firm, Estevez is responsible for developing and implementing effective compliance policies and has effective supervisory responsibility over firm employees. He recognizes that hiring relatives of foreign government officials and other clients in exchange for business could violate antibribery laws. He drafts written hiring policies and a questionnaire to address these types of hires as a way to detect and prevent corrupt hiring practices.

But these policies do not apply to all categories of hires, are easily circumvented, and are not effectively enforced. Although Estevez rejects referred candidates for employment that violate firm policies, senior members of the firm's APAC offices regularly get around the policies by hiring rejected candidates as employees of a regional affiliate that is apparently not covered by the firm's compliance procedures. Referred candidates hired by the affiliate engage in work for the firm and are eventually hired as full-time employees at the firm. The compliance procedures thus do not effectively mitigate known corruption risks and allow APAC employees to award valuable employment opportunities to the relatives of foreign government officials as a personal benefit to the officials in an attempt to improperly influence them to assist the firm in obtaining or retaining business or other benefits. Choice D is the best response.

*This case is based on an August 2019 US SEC enforcement action.*

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## CFA INSTITUTE

# ETHICS IN PRACTICE: Supervisory Responsibility – Case 7

### CASE STUDY

Corix Bioscience is a startup company seeking to begin operations manufacturing and selling cannabidiol (CBD) products. To promote the company, Corix hires Harrelson, an independent research analyst, to write and distribute a research report on the company. Corix informs Harrelson that it has a joint venture with Native American tribes, enabling the company to access tribal lands for farming commercial hemp and cannabis and to sell hemp and cannabis products in retail outlets on tribal lands. Corix also tells Harrelson that the company has obtained a certificate of compliance from regulators that allows the company to transport, process, and export industrial hemp products. Finally, Corix discloses to Harrelson that the prior year's harvest of hemp surpassed expectations in both quality and quantity, resulting in a substantial inventory of product. Based on these statements by the company, Harrelson includes all of this information in a research report and provides a positive analysis of the company.

In reality, Corix does not have agreements with Native American tribes; the company did not seek or obtain regulatory approval; the certificate of compliance is a forgery; and Corix never cultivated, planted, or harvested significant quantities of industrial hemp. Chong, a research analyst at Natures Harvest Investment Management (NHIM), incorporates the information and conclusions from Harrelson's research report as part of his own internal research on Corix and includes a "buy" recommendation. Chong's report is distributed to only portfolio managers at NHIM. Broadus, a NHIM portfolio manager, reviews Chong's research and purchases substantial holdings in Corix for a number of his clients. Corix is ultimately shown to be a sham operation, leading to substantial losses for Broadus's clients. Which of the following characters most likely acted in violation of the CFA Institute Code of Ethics and Standards of Professional Conduct and why?

- A. Harrelson.
- B. Chong.
- C. Broadus.
- D. Harrelson, Chong, and Broadus.
- E. None of the above.

## CFA INSTITUTE

### ETHICS IN PRACTICE: Supervisory Responsibility – Case 7

#### ANALYSIS

This case relates to diligence and reasonable basis in making investment recommendations and taking investment action. CFA Institute Standard of Professional Conduct V(A): Diligence and Reasonable Basis states that CFA Institute members must exercise diligence and thoroughness in analyzing investments and must have a reasonable and adequate basis supported by appropriate research and investigation for any investment recommendation. The issue in this case is whether Harrelson, Chong, and Broadus complied with the requirements of this standard.

By relying on the statements given by Corix and not conducting an independent investigation into the veracity of the information, Harrelson did not exercise diligence and thoroughness in analyzing the company. Chong seemingly relied on Harrelson's research to formulate his "buy" recommendation without conducting his own independent research. Investment professionals who rely on third-party research conducted outside their firm by someone who is not their colleague must make reasonable and diligent efforts to determine whether such research is sound. The facts do not indicate that Chong independently verified the statements, critically assessed Harrelson's research, or had reason to rely on Harrelson's report based on past experience and familiarity with the quality of Harrelson's work. Chong also did not appear to recognize that Harrelson's work was issuer-paid research and thus subject to heightened scrutiny.

Broadus relied on the work of his colleague, Chong, in making the decision to invest in Corix stock for his clients. Investment professionals may rely on the work of colleagues in their firms when making an investment decision, under the assumption that the employer has fully vetted and approved of the diligence, quality, and thoroughness of their fellow colleagues' work. Investment professionals may also rely on others in their firms to determine whether third-party research is sound and use the information in good faith unless there is reason to question its validity or the processes and procedures used by those responsible for the research. Under the facts provided, Broadus had no reason to be concerned that Chong had not adequately conducted internal research on Corix, or that NHIM was negligent in employing Chong as a research analyst. Under these circumstances, Broadus is entitled to rely on the work of his colleague and thereby meet the requirements of the diligence and reasonable basis standard. Since Harrelson and Chong most likely violated the standard and Broadus did not, choice E is the best response.

*This case is based on an enforcement action by the US SEC from August 2019.*

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CFA INSTITUTE  
ETHICS IN PRACTICE

## CASES LISTED BY STANDARD

### I: PROFESSIONALISM

#### I(A): Knowledge of the Law

- Billing and Fees Case 2 - 11
- Billing and Fees Case 7 - 22
- CFA Institute Case 1 - 25
- Disclosures Case 8 - 72
- Documentation Case 2 - 84
- Investments and Trading Case 5 - 121
- Investments and Trading Case 11 - 134
- Investments and Trading Case 18 - 148
- Outside Activities Case 2 - 153
- Outside Activities Case 3 - 156
- Promotion and Marketing Case 2 - 187
- Promotion and Marketing Case 4 - 191

#### I(B): Independence and Objectivity

- Client Relationships Case 4 - 47
- Outside Activities Case 1 - 151
- Outside Activities Case 3 - 156
- Performance Reporting Case 5 - 173
- Research Case 1 - 199

#### I(C): Misrepresentation

- Billing and Fees Case 2 - 11
- Billing and Fees Case 5 - 17
- Client Advice Case 2 - 34
- Disclosures Case 3 - 62
- Disclosures Case 4 - 64
- Disclosures Case 5 - 66
- Disclosures Case 10 - 76
- Documentation Case 4 - 88
- Error Correction Case 2 - 108
- Investments and Trading Case 17 - 146
- Promotion and Marketing Case 1 - 185

#### I(D): Misconduct

- Employment Issues Case 4 - 97
- Error Correction Case 3 - 110
- Investments and Trading Case 11 - 134
- Outside Activities Case 4 - 158
- Outside Activities Case 5 - 160
- Research Case 9 - 217

### II: INTEGRITY OF CAPITAL MARKETS

#### II(A) Material Nonpublic Information

- Disclosures Case 11 - 79
- Error Correction Case 1 - 106
- Investments and Trading Case 2 - 115
- Investments and Trading Case 12 - 136
- Investments and Trading Case 16 - 144
- Research Case 3 - 203
- Research Case 4 - 205

#### II(B): Market Manipulation

- Disclosures Case 6 - 68
- Investments and Trading Case 1 - 113
- Investments and Trading Case 9 - 130
- Investments and Trading Case 13 - 138
- Investments and Trading Case 15 - 142

### III: DUTIES TO CLIENTS

- Performance Reporting Case 4 - 169

#### III(A): Loyalty, Prudence, and Care

- Billing and Fees Case 3 - 13
- Billing and Fees Case 4 - 15
- Billing and Fees Case 6 - 20
- Documentation Case 1 - 82
- Documentation Case 4 - 88
- Investments and Trading Case 6 - 123
- Investments and Trading Case 10 - 132
- Investments and Trading Case 11 - 134
- Personal Trading Case 2 - 178
- Promotion and Marketing Case 6 - 195

CFA INSTITUTE  
ETHICS IN PRACTICE

**CASES LISTED BY STANDARD (CONTINUED)**

**III(B): Fair Dealing**

- Client Relationships Case 3 - **45**
- Documentation Case 4 - **88**
- Investments and Trading Case 7 - **126**
- Investments and Trading Case 8 - **128**
- Investments and Trading Case 15 - **142**

**III(C): Suitability**

- Client Advice Case 4 - **38**
- Client Relationships Case 1 - **41**
- Client Relationships Case 6 - **51**
- Investments and Trading Case 4 - **119**
- Investments and Trading Case 6 - **123**
- Investments and Trading Case 14 - **140**

**III(D): Performance Presentation**

- Performance Reporting Case 1 - **163**
- Performance Reporting Case 2 - **165**
- Performance Reporting Case 3 - **167**

**III(E): Preservation of Confidentiality**

- Client Relationships Case 5 - **49**
- Documentation Case 3 - **86**
- Employment Issues Case 5 - **99**

**IV: DUTIES TO EMPLOYERS**

**IV(A): Loyalty**

- Client Relationships Case 2 - **43**
- Employment Issues Case 1 - **91**
- Employment Issues Case 3 - **95**
- Employment Issues Case 6 - **101**
- Employment Issues Case 7 - **103**
- Error Correction Case 1 - **106**
- Outside Activities Case 2 - **153**
- Outside Activities Case 4 - **158**
- Personal Trading Case 1 - **176**

**IV(B): Additional Compensation Arrangements**

- Research Case 6 - **209**

**IV(C): Responsibilities of Supervisors**

- Supervisory Responsibility Case 1 - **220**
- Supervisory Responsibility Case 2 - **222**
- Supervisory Responsibility Case 3 - **224**
- Supervisory Responsibility Case 4 - **226**
- Supervisory Responsibility Case 5 - **229**
- Supervisory Responsibility Case 6 - **231**

**V: INVESTMENT ANALYSIS, RECOMMENDATIONS,  
AND ACTIONS**

**V(A): Diligence and Reasonable Basis**

- Billing and Fees Case 2 - **11**
- Documentation Case 4 - **88**
- Error Correction Case 2 - **108**
- Investments and Trading Case 3 - **117**
- Personal Trading Case 2 - **178**
- Research Case 2 - **201**
- Research Case 5 - **207**
- Research Case 7 - **211**
- Research Case 8 - **214**
- Supervisory Responsibility Case 2 - **222**
- Supervisory Responsibility Case 7 - **233**

**V(B) Communication with Clients and Prospective  
Clients**

- Billing and Fees Case 1 - **09**
- Disclosures Case 7 - **70**
- Research Case 8 - **214**

**V(C): Record Retention**

- Billing and Fees Case 2 - **11**
- Client Relationships Case 2 - **43**
- Employment Issues Case 2 - **93**
- Research Case 8 - **214**

CFA INSTITUTE  
ETHICS IN PRACTICE

**CASES LISTED BY STANDARD (CONTINUED)**

**VI: CONFLICTS OF INTEREST**

- Disclosures Case 2 - **60**
- Performance Reporting Case 5 - **173**

**VI(A): Disclosure of Conflicts**

- CFA Institute Case 3 - **29**
- Client Advice Case 1 - **32**
- Client Advice Case 3 - **36**
- Client Relationships Case 7 - **55**
- Disclosures Case 9 - **74**
- Investments and Trading Case 6 - **123**
- Outside Activities Case 2 - **153**
- Research Case 9 - **217**

**VI(B): Priority of Transactions**

- Personal Trading Case 1 - **176**
- Personal Trading Case 3 - **180**
- Personal Trading Case 4 - **182**

**VI(C): Referral Fees**

- Disclosures Case 1 - **58**
- Disclosures Case 2 - **60**
- Promotion and Marketing Case 3 - **189**
- Promotion and Marketing Case 5 - **193**

**VII: RESPONSIBILITIES AS A CFA INSTITUTE  
MEMBER OR CFA CANDIDATE**

**VII(A): Conduct as Participants in CFA Institute  
Programs**

- Billing and Fees Case 2 - **11**
- CFA Institute Case 2 - **27**

**VII(B): Reference to CFA Institute, the CFA  
Designation, and the CFA Program**

- CFA Institute Case 1 - **25**

