

Care and Feeding of YOUR Money: An Ethics Case Study for Financial Advisors

Jin Peng - Spring 2024

This material was developed by Jin Peng, Ph.D. and is intended for classroom discussion rather than to illustrate effective or ineffective handling of administrative, ethical, or legal decisions by management. No permission or compensation is needed for classroom use as long as it is acknowledged to be the creative work of the author and the Daniels Fund Ethics Initiative Collegiate Program at UCCS. For public action or electronic posting, please contact the UCCS Daniels Fund Ethics Initiative Collegiate Program at UCCS College of Business at 1- 719-255-5151. (2024)

Care and Feeding of YOUR Money: An Ethics Case Study for Financial Advisors

Jin Peng - Spring 2024

Fixed Income FNCE 4900 (31 students)

International Finance FNCE 6400 (3 students)

DANIELS FUND
ETHICS INITIATIVE
Collegiate Program



College of Business
UNIVERSITY OF COLORADO **COLORADO SPRINGS**

All Chartered Financial Analyst Institute members and candidates must abide by The CFA Institute Code of Ethics and Standards of Professional Conduct.

Violations may result in disciplinary sanctions.

Students will review cases and discuss how they can serve clients fairly and ethically when they face similar situations in their finance professions.



DAN
ETHIC

e for all relevant stakeholders


Ethics & Standards in Finance Industry

- Professions can only exist within an industry when those acting with **transparency, integrity, candor, and trust** reach a critical mass. **CFA Institute** has long championed these values through its Code of Ethics and Standards of Professional Conduct. **CFA Institute** believes that the investment industry should work for the ultimate benefit of society, and that cannot be achieved without the highest possible standards and ethics.
- **Ethics for the Investment Management Professional** A commitment to ongoing ethics education ensures that professionals are prepared to make critical decisions that demonstrate professional and ethical competence.
- **Investment Industry Standards** Through codes, guidelines, and standards, CFA Institute develops and administers practical tools for firms to guide the investment industry to higher standards.
- **Professional Conduct Program** investigates, sanctions, and discloses violations to uphold ethical principles and protect the value of the charter.



Ethics for the Investment Management Professional

- ▶ 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.



Ethics for the Investment Management Professional

- 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 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.



THE CODE OF ETHICS

- 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.



THE CODE OF ETHICS

- 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.



STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

- A. **Knowledge of the Law.**
- B. Independence and Objectivity.
- C. Misrepresentation. (must not knowingly make any misrepresentations)
- D. Misconduct. (must not engage in any professional conduct)



STANDARDS OF PROFESSIONAL CONDUCT

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. (must not engage in practices that distort prices or artificially inflate trading volume)



STANDARDS OF PROFESSIONAL CONDUCT

III. DUTIES TO CLIENTS

- A. Loyalty, Prudence, and Care. (clients' interests before their employer's or their own interests.)
- B. **Fair** Dealing.
- C. Suitability.
- D. Performance Presentation (**fair**, accurate, and complete.
- E. Preservation of Confidentiality.



STANDARDS OF PROFESSIONAL CONDUCT

IV. DUTIES TO EMPLOYERS

- A. Loyalty. (must act for the benefit of their employer)
- B. Additional Compensation Arrangements. (must not accept gifts, gifts, benefits, compensation, or consideration that competes with their employer's interest)
- C. Responsibilities of Supervisors. (ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.)



STANDARDS OF PROFESSIONAL CONDUCT

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

- A. Diligence and Reasonable Basis. (**1.** Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions. **2.** Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.)
- B. Communication with Clients and Prospective Clients.
- C. Record Retention. (must develop and maintain appropriate records)



STANDARDS OF PROFESSIONAL CONDUCT

VI. CONFLICTS OF INTEREST

- A. Disclosure of Conflicts. (must disclose conflict of interests)
- B. Priority of Transactions. (transactions for clients and employers must have priority over his/her own investment transactions)
- C. Referral Fees. (must disclose any compensation)

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

- A. Conduct as Participants in CFA Institute Programs.
- B. Reference to CFA Institute, the CFA Designation, and the CFA Program.



Investment Industry Standards

- ▶ An integral part of the CFA Institute's mission is to develop and administer codes, best practice guidelines, and standards that guide the investment industry and help ensure all investment professionals place client interests first.
- ▶ **Global Investment Performance Standards (The GIPS® standards)** are a set of industry-wide principles that guide investment firms on how to calculate and report their investment results to prospective clients.
- ▶ **ESG Disclosure Standards for Investment Products** will establish disclosure requirements for investment products with ESG-related features.

The purpose is to provide greater product transparency and comparability to investors by enabling asset managers to clearly communicate the ESG-related features of their products.



Investment Industry Standards

➤ Asset Manager Code

helps asset managers practice ethical principles that put client interests first. By helping investors identify asset managers who have committed to high standards of professional conduct, the **integrity** of the investment industry is built.

➤ Diversity, Equity, and Inclusion Code

A diversity of perspectives will lead to better investor outcomes; an inclusive investment industry will better serve our diverse society. CFA Institute is developing a voluntary code to guide DEI, beginning in the United States and Canada and developing regionally differentiated, global coverage over time.




Investment Industry Standards

➤ Pension Trustee Code

sets the standard for ethical behavior for a pension plan's governing body. Adoption of the Code is voluntary and promotes professional excellence among a pension plan's trustees and trust among the plan's stakeholders.


➤ Endowments Code of Conduct

The CFA Institute Investment Management Code of Conduct for Endowments, Foundations, and Charitable Organizations outlines ethical responsibilities for the sound management of longer-term financial assets.



Case Study 1 – Client Advice (Transparency)

- 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.



Case Study 1 – Client Advice (Transparency)

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.



Case 1 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.



Case 1 ANALYSIS

- 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.*



Case 2 – Client Relationships (Fairness)

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.



Case 2 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.



Case 2 Analysis

- 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.



Case 3 – Disclosures (Transparency)

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.



Case 3 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 of 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).



Case 3 Analysis

- ▶ 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).**