CASE STUDY cryptocurrency

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.

TEST YOURSELF
Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

Santos’ actions are:
acceptable because Santos, unlike the moderator of the EasyCoin chatroom, is not actively organizing the trading of the digital coin.

0%
unacceptable because Santos is engaged in market manipulation.

50%
VV acceptable because he voluntarily engages in this speculative trading based on information in a private chatroom.

14%
unacceptable because speculative trading cryptocurrency in unregulated markets for client accounts is unethical.

36%

Soft Dollar Expenditures

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. This Resource explores Murdoch's use of soft dollar credits.

CASE STUDY

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 memorandum 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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

Murdoch's actions are:

appropriate because rental payment on office space is an acceptable use of soft dollars.

appropriate because IOM disclosed that it would use soft dollars for overhead expenses.

appropriate because Murdoch may charge (and increase) rental rates for use of his property to the extent that the market will bear.

VV inappropriate.

none of the above.

ANALYSIS

This case relates to CFA InstituteStandard 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.

Reference:

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

Raising Capital with Digital Assets

Munchee is a US-based business that created an iPhone application (App) for users to review restaurants. This Resource follows the company's rollout of its initial coin offering (ICO) and asks us to determine whether that process was ethically sound.

CASE STUDY

Munchee 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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

Munchee's ICO was:

unacceptable because it promoted a virtual and highly speculative investment unsuitable for investors.

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.

unacceptable because the tokens were an unregistered security under US securities laws.

acceptable.

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 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 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. After 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.

Entertainment After Investor Presentation

Ethics In Practice ethical decision making

OVERVIEW

This Resource asks us to evaluate when and whether it is ethical to accept gifts or entertainment from companies you may be researching for investment.

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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

Of the choices below, what do you believe David should do?

Accept the invitation

Accept the dinner but not karaoke

Accept the invitation but disclose the invitation to his supervisor

Reject the invitation

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 professional conduct 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.

New Professional Opportunities

Ethics In Practice ethical decision making

OVERVIEW

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. This Resource follows her decision to leave her firm.

CASE STUDY

Clemence met many of her clients through her spouse, who is a well-known attorney, and her sister, who is a physician. She 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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

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 position

E None of the above

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.

Mortgage-Backed Securities Credit Ratings

Ethics In Practice ethical decision making

OVERVIEW

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. This Resource explores how she responded to a new process in her field.

CASE STUDY

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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

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 inappropriate because she did not disclose the change in methodology to the investing public

C appropriate because no disclosure is necessary because calculating DSCR is only one element in determining the overall rating of the security

D none of the above

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.

Investing in Firm's Funds

Ethics In Practice
OVERVIEW

Miriam works as an investment adviser for JVC Wealth Managers. This Resource asks us to evaluate whether it is ethical to invest client assets into JVC's accounts.

CASE STUDY
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.

TEST YOURSELF
Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

Marian'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 nacceptable 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.

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.

Elderly Investors

Ethics In Practice

OVERVIEW

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. This Resource follows Kinner and Abbott during a recent visit and asks us to determine whether Kinner's actions are ethically sound.

CASE STUDY

Abbott 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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

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.

ANALYSIS

This case involves CFA Institute Standard III(E): Preservation of 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.

Reference:

This case is based on new guidance on providing services to vulnerable clients under CFA Institute Standard of Professional Conduct III(E): Preservation of Confidentiality, which was released by CFA Institute in March 2019. To learn more, please read the updated guidance on www.cfainstitute.org.

Different Service for Different Clients?

Ethics In Practiceethical decision making

OVERVIEW

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. This Resource explores Korloff's decision about how to treat this high net-worth client.

CASE STUDY

This client's 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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

What should Korloff do?

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

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.

Material Nonpublic Info or Not?

Ethics In Practiceethical decision making

OVERVIEW

Robles, a fund manager, visits the main manufacturing plant of a large international cement company. This Resource follows him during his visit and asks us to determine whether his actions are ethically sound.

CASE STUDY

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.

TEST YOURSELF

Take the quiz below to complete this Resource. Answer carefully: you can only take the quiz once.

Did Robles act unethically?

The correct answer was:

A It is unclear because we do have enough information about Robles' choice11%

B Yes because Robles traded based on material nonpublic information86%

C No because Robles did not trade on material nonpublic information4%

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.

Reference:

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

Capitalizing on Tax Benefits

Ethics In Practiceethical decision making

OVERVIEW

Marte is an asset manager in Puerto Rico, a US territory. Residents of Puerto Rico receive significant tax advantages by investing in local securities. This Resource explores how Marte's firm capitalizes on this benefit.

CASE STUDY

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.

TEST YOURSELF

Martes' 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

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.

But choice D is actually 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.

Reference:

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

--