CHARTA LEARNING · LESSON NOTES

Standard III: duties to clients, loyalty, prudence, care and fair dealing

CFA Level I · Ethical and Professional Standards

You will learn: Name the five duties in Standard III and match a case to the right one, then apply loyalty, prudence and care (III(A)) and fair dealing (III(B)) to cases on pension plans, soft dollars, brokers, proxy votes, recommendation changes and oversubscribed offerings.

Running example: Examples use made-up people and firms, mostly Harbor Peak Asset Management and its manager Maya Okafor, with made-up figures.

1. The five duties of Standard III

- Clients cannot watch what is done for them, so five duties protect them: put the client first, treat clients fairly, fit the advice to the person, show results honestly, keep their secrets.
- III(A) Loyalty, Prudence, and Care: client first. III(B) Fair Dealing: none served last. III(C) Suitability: the advice fits the whole client, judged against the whole portfolio and written objectives. III(D) Performance Presentation: results fair, accurate and complete. III(E) Preservation of Confidentiality: client information stays private, even after the relationship ends.
- To judge a case ask four questions in order: who is the client; whose interest comes first; is anyone served ahead of another; which duty is it really about.
- Matching: trades sent to a broker for a personal perk is A; biggest clients told first is B; risky stock for a retiree who needs income is C; worst accounts left out of a performance figure is D; a former client's details passed on is E.

2. III(A) Loyalty, prudence and care

- Loyalty: act for the client, not for yourself or your employer. Prudence: judge as a careful person would handle their own affairs. Care: reasonable diligence, not guesses. Members must act for the benefit of clients and place their interests before their employer's or their own.
- The order is a ranking, not a balance: the client, then the employer, then yourself. When interests clash, the client wins. Disclosure does not turn a self-serving choice into a proper one.
- The duty is about process, not a promise of profit. A bad outcome alone is not a breach; a careless process is. Keep records of why a decision was made and follow the firm's policies.
- Identify the client first. For a pension plan the client is the beneficiaries, not the sponsor company or the executive who appointed you. Test: whose money is at risk?

CASE 1: FINANCE DIRECTOR ASKS MAYA TO PUT 10M OF A 200M PLAN INTO THE SPONSOR'S OWN BONDS

Amount moved	10m of 200m	**5%**
Yields	sponsor bonds 4.0% vs others 4.6%	**gap 0.6%**
Yield given up	0.6% of 10m	**60,000 a year**
Verdict	request helps the company, not the beneficiaries	**decline**

Watch out: Putting the employer first because it pays you; believing disclosure fixes a self-serving choice; treating the person who hired you as the client; reading prudence as a promise of profit.

3. Soft dollars, brokers and proxy votes

- Commissions are the client's money. Soft dollars (commissions that also pay for research) are allowed only if the clients whose commissions paid benefit. Research for another client's account, or the firm's own running costs, is a breach.
- Best execution is the client's interest. Choosing a broker for a personal perk is a breach whether or not it is disclosed.
- Votes attached to shares belong to the clients, so voting in their interest is part of the duty. Not voting needs a documented cost-benefit reason that the cost exceeds the benefit. Convenience is not a reason.

CASE 3: JUN CHOOSES BROKER Y FOR A 500,000 SHARE ORDER

Broker X, best price	fill at 20.00	**20.00**
Broker Y, with two free tickets	fill at 20.03	**20.03**
Extra cost to the client	0.03 × 500,000	**15,000**
Verdict	disclosure in a newsletter footnote does not cure it	**breach**

Watch out: Case 4, skipping proxy votes: holding 40,000 of a 400m company is 0.01%; voting costs 3,000 (3,000 ÷ 40,000 = 7.5% of the holding). A written note and yearly review makes skipping defensible; never voting anywhere, with no note, is a breach.

4. III(B) Fair dealing

- Members must deal fairly and objectively with all clients when providing analysis, making recommendations, taking investment action or engaging in other professional activities. Fair does not mean identical: clients differ in mandates, sizes and needs.
- Allowed: a disclosed premium tier open to every client who qualifies; different trades for different mandates. Breach: biggest clients told of a change first; sharing a limited opportunity after demand is known; serving the highest fee payer first. Each gives someone a head start the others cannot know about.
- A change of recommendation: decide and keep the gap short, release to all entitled clients through one process, then speak with holders. Holders do not go first, even with good intentions.
- Fair means a fair opportunity to act, not the same second for everyone.

CASE 5: DOWNGRADE OF RIDGEWAY (PRICE 50), 15 OF 240 LARGEST CLIENTS PHONED FIRST

Clients called early	15 of 240	**6.25%**
Price when others hear (note 2 days later)	50 down to 46	**−8%**
Smaller client, 10,000 shares	4 × 10,000	**40,000 lost**
Verdict	no fair chance to act for the others	**breach**

5. Sharing an oversubscribed offering

- When more is requested than is available, fair dealing needs a method set before the issue arrives, disclosed to clients and applied to everyone. The common choice is pro rata: each client gets the same percentage of what they asked for.
- Fairness means an equal rule, not equal shares. Giving everything to the highest fee payer, or choosing case by case afterwards, cannot be defended.

> **Allocation rate = shares available ÷ total requested; each client gets rate × request**

CASE 6: 300,000 SHARES OFFERED

Requests	Ana 600,000 + Bo 400,000 + Cho 200,000	**1,200,000**
Allocation rate	300,000 ÷ 1,200,000	**25%**
Ana / Bo / Cho	25% of each request	**150,000 / 100,000 / 50,000**
Total allocated	all 300,000 used	**300,000**

Watch out: Thinking fair means identical; warning holders first; deciding how to share a limited offering afterwards; requiring every client to hear in the same second.

Key takeaways

- Standard III has five duties, A to E: loyalty, fair dealing, suitability, performance presentation, confidentiality.
- Priority is the client, then the employer, then yourself; a conflict settled in your favour is a breach even if disclosed.
- For a pension plan the client is the beneficiaries; ask whose money is at risk.
- Soft dollars must benefit the clients whose commissions paid; not voting proxies needs a documented cost-benefit case.
- Fair dealing means fair, not identical: no client systematically ahead of others.
- Release news to all entitled clients with a short gap; share scarce offerings by a rule set in advance.

Quick check

1. Free tickets from a broker, disclosed in small print. Acceptable?
   Answer: No: a conflict settled for yourself breaches III(A), disclosed or not.
2. Disclosed premium tier, open to all who qualify. Acceptable?
   Answer: Yes: fair does not mean identical.
3. Largest clients phoned before the note goes to all. Acceptable?
   Answer: No: a head start breaches III(B).

Summary notes for the Charta whiteboard lesson. Examples use made-up figures. Watch the full lesson at charta-learning.com.