CHARTA LEARNING · LESSON NOTES

Misconduct, competence and the integrity of capital markets

CFA Level I · Ethical and Professional Standards

You will learn: Judge cases under Standard I(D) Misconduct, Standard I(E) Competence and Standard II Integrity of Capital Markets (material nonpublic information and market manipulation), naming the test the exam would apply.

Running example: Examples use made-up people and firms and made-up figures.

1. I(D) Misconduct

- 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. It is not limited to investment work: private conduct counts when it bears on trustworthiness or competence.
- Test: could a client still rely on you after seeing the conduct? Dishonesty is a violation at any size. Fitness for the job counts too: habitual drunkenness in business hours reflects on competence.
- Not a general morality clause: a traffic offence or an unrelated personal matter does not engage it. Misfortune is not misconduct: an honest bankruptcy is a loss, not a lie.

THREE I(D) CASES

Tomas: real costs 640, claim 760	padding 760 − 640 = 120, a friend's dinner as a client meal	**Violation (dishonest)**
Helen vs Jonas: both bankrupt	Helen's bakery chain failed; Jonas falsified accounts for a loan	**Helen no breach; Jonas violation**
Lucia: often drunk after lunch	missed 3 of her last 5 client calls; no lie, no law broken	**Violation (competence)**

Watch out: Treating I(D) as a morality clause; thinking a small lie is acceptable; thinking you must be working at the time.

2. I(E) Competence

- Members and candidates must act with and maintain the competence necessary to fulfil their professional responsibilities. It makes enforceable the Code's call to maintain and improve competence. What counts depends on the role, and is measured against the job you hold now.
- A gap opens when the role changes or expands, or when a member takes on an unfamiliar product. Close it before taking the work on: employer training, conferences, certification, self-study, or consulting an expert. The Standard names no programme and no number of hours.
- Judged by the knowledge and care brought to the work, not by the result. Thorough work is competent whether the outcome is good or bad; superficial work is not competent even if it makes money.

DEV ANAND (CLIENT PORTFOLIO 500,000) AND ELENA ROSSI

Dev: gain in the year	500,000 × 8%	**$40,000**
Dev: understood the product?	press articles only, luck proves nothing	**Violation**
Elena: hit to the fund	3% holding × 50% fall after an undetected fraud	**1.5%**
Elena: process was sound	thorough, well documented research	**No breach**

Watch out: Thinking a good result proves competence or a bad one disproves it; thinking I(E) sets fixed study hours, or that passing an exam without learning its content is enough. Amara Osei, promoted to supervise four analysts, must close the gap in management and compliance skills.

3. Standard II: two rules, two problems

- Standard II protects trust in market prices. II(A): do not act, or cause others to act, on material nonpublic information. II(B): do not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.
- II(A) is about information (an unfair edge); II(B) is about conduct (a false picture). II(A) can be breached with no wish to deceive: knowledge plus a trade or a tip is enough. II(B) requires intent to mislead.
- Material: a reasonable investor would want it in making a decision, or its release would likely move the price. Nonpublic: not yet disseminated to the marketplace generally, for example by a press release or regulatory filing.

> **Banned only if material AND nonpublic. Public, or not material: may act. Mosaic of public and nonmaterial pieces: may act.**

SORTING FOUR QUICK SITUATIONS

Tip on an unannounced bid	**II(A)**
Wash trades to look busy	**II(B)**
Mosaic from small pieces	**Allowed**
False rumour on own holding	**II(B)**

4. II(A) in cases: private calls, tips and the mosaic

- Telling a few analysts on a private call is not dissemination: it is still nonpublic. So are boardroom talk and a conversation overheard at dinner. How you came to know it does not matter.
- If you receive it by accident: do not trade and do not pass it on (deleting the email does not erase what you know); make reasonable efforts to have it made public; if the company refuses, tell only the firm's supervisory and compliance personnel, and still do not trade.
- Tipping counts as acting: causing others to act is banned, so the tipper is guilty even if they never trade.
- Mosaic theory is allowed: a conclusion built from public information and nonmaterial nonpublic pieces is the analyst's own work, however valuable. The test is where each piece came from.

NINA'S PRIVATE CALL, AND ROSA'S TIP

Nina: guided vs told profit	$100m vs $78m	**shortfall $22m (22%)**
Nina's verdict	moves price; not public	**do not act, urge release**
Rosa's brother: cost	2,000 × $40	**$80,000**
Sale after bid	2,000 × $52	**$104,000**
Gain	104,000 − 80,000	**$24,000 (30%): Rosa in violation**

Watch out: Thinking only the person who trades is guilty; treating valuable research as a violation just because it is material (Kofi's 12 supplier chats plus public accounts are allowed).

5. II(B) Market manipulation

- Information-based manipulation spreads false or misleading information, for example pumping a position you intend to sell. Transaction-based manipulation uses trades to create a false impression: wash trades, matched orders, and marking the close.
- The test is intent, not the size of the price move. A large honest order that moves the price is not manipulation; a small order placed to set a mark may be. Honestly held optimistic research is fine even if wrong.
- Four rulings: big honest buy moves price, no breach; honest optimistic research, no breach; two funds trade back and forth to look busy, violation; false posts then selling, violation.

MIN PARK MARKS THE CLOSE (100,000 SHARES, LAST VALUED AT $18.00)

Value before	100,000 × $18.00	**$1,800,000**
Value after	100,000 × $19.50	**$1,950,000**
Mark-up	1,950,000 − 1,800,000	**$150,000**
Cost of the order	200 × $19.50	**$3,900**

Watch out: Using price movement as the test; forgetting that intent is required for II(B); thinking a small trade is a defence (here the smallness is the evidence).

Key takeaways

- I(D): does the conduct bear on trust? Size and bad luck do not decide it; deceit does.
- I(E): competence is judged by the work, never the outcome, and measured against the role you hold now.
- II(A): do not act or cause others to act on material nonpublic information. Tipping counts.
- A private call to a few analysts is still nonpublic; the mosaic theory is allowed.
- II(B): manipulation needs intent to mislead, by false information or by trades.
- Ask where information came from (II(A)) and what a trade was for (II(B)).

Quick check

1. Thorough research; a hidden fraud sinks the share. Breach of I(E)?
   Answer: No: competence is judged by the knowledge and care brought to the work, not by the result.
2. Overheard takeover news at dinner. May she buy?
   Answer: No: II(A). The news is material and nonpublic however she heard it. Urge release or tell compliance.
3. Small buy at the close to lift the fund's valuation?
   Answer: Manipulation: II(B), intent to mislead.

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