Standard II: integrity of capital markets

Level II Ethics

1 Standard II protects trust in prices

- II(A): do not act or cause others to act on MNPI
- II(B): do not distort prices or volume to mislead
- II(A) asks what you knew
- II(B) asks what you meant

IN THE LESSON

- Standard two has two parts.
- Standard two A is about information.
- A member who holds material nonpublic information must not act on it or cause anyone else to act on it.
- Standard two B is about conduct.
- A member must not distort prices or inflate trading volume with the intent to mislead other market participants.
- Notice that the two parts ask different questions.
- For information, we ask what the member knew.
- For manipulation, we ask what the member meant to do.
- Level II tests both through short cases, so for each case we will find the facts, name the standard and the subsection, decide whether there is a breach, and say what the member should do.

2 Two tests for any Standard II case

Information test, II(A)

Material? → Nonpublic? → Acted or tipped?

Conduct test, II(B)

Trade or statement? → Meant to mislead? → Distorts price?

IN THE LESSON

- Here is the order of thought for a case.
- The top row is the information test.
- First, is the fact material?
- Second, is it nonpublic?
- Third, did the member trade, or cause someone else to trade, on it?
- If all three answers are yes, Standard two A is breached.
- The bottom row is the conduct test.
- First, was there a trade or a statement?
- Second, was it meant to mislead?
- Third, did it distort the price or the apparent volume?
- Intent is the heart of that row.
- A big order that moves a price is not manipulation if the buyer simply wanted the shares.
- Keep these two rows in mind as we go through the cases.

3 Material and nonpublic, defined

Two questions decide an inside-information case

Question	Test
Material?	Moves price / matters
Nonpublic?	Not yet disseminated
Both yes?	No trading
Source?	Does not matter

IN THE LESSON

- Two words decide most information cases.
- Information is material if it is likely to affect the price of a security, or if a reasonable investor would want it before deciding whether to buy or sell.
- A fact that is merely interesting is not material.
- Information is nonpublic until it has been disseminated to the marketplace in general.
- A news release, a regulatory filing or a widely accessible announcement is public.
- A private call to a few analysts is not, because only a few people have heard it.
- And the source does not matter.
- If you learn something material and nonpublic, you may not trade on it, whether it came from a leak, a lunch or an honest mistake.

4 From public to nonpublic

- Filing
- Press release
- Open briefing
- Call to a few analysts
- Dinner remark

IN THE LESSON

- Let us place some information along a line.
- The left end is public, the right end is nonpublic.
- At the far left is a regulatory filing, and just beside it a press release sent to the wider market.
- Both have been disseminated.
- Moving right, we reach a briefing that any analyst could attend.
- That is a grey area, and the safe view is that public means available to the market in general, not just to a chosen group.
- Further right is a private call to a few analysts.
- Only a few people have the news, so it is still nonpublic.
- At the far right is a remark overheard at a dinner.
- It is plainly nonpublic, and the member must not trade on it.

5 Case 1: Hana Ito builds a mosaic

Public accounts + her own store counts + a supplier's remark

Public inputs	published accounts	**Public**
Her store counts	2,000 to 1,820 visits	**−9%**
Supplier's remark	a scrap, not a fact	**Not material**
Conclusion	a sell view	**Mosaic: allowed**

IN THE LESSON

- Case one.
- Hana Ito is an analyst covering Larch and Pine, a furniture retailer.
- She reads its published accounts.
- She commissions her own counts of customers in twelve stores, and the weekly visits per store fall from two thousand to one thousand eight hundred and twenty, a drop of nine per cent.
- A supplier also mentions, in passing, that orders feel a little softer.
- None of these private scraps would move the price alone.
- Together they lead her to a sell view.
- Is this a breach?
- No.
- This is the mosaic theory.
- A conclusion built from public information and nonmaterial nonpublic pieces is the analyst's own work, even if the conclusion itself would have been material had management stated it.

6 Case 2: Tomas Weber at the dinner

Contract = 18% of $400m sales; cancelled next week

Annual sales	stated by the company	**$400m**
Contract share	18% of sales	**$72m**
Material?	large share of sales	**Yes**
Public?	said at a dinner	**No**
Verdict	no trading, no tipping	**Hold off**

IN THE LESSON

- Case two.
- Tomas Weber runs a fund and sits next to the finance director of Alder Grove Foods at a charity dinner.
- Without being asked, the director says the company's largest wholesale contract, worth eighteen per cent of its four hundred million in yearly sales, will be cancelled next week.
- That is seventy two million of sales, which is clearly material, and it is nonpublic.
- Tomas did nothing to get the remark and the director offered it freely.
- Does that matter?
- No.
- The source does not matter.
- Tomas holds material nonpublic information, so Standard two A forbids him to trade on it or to tell anyone who might.
- His proper steps are to refrain, to encourage the company to announce it, and to tell compliance.

7 Case 3: Leila's well-meant warning, drawn

Chart: Share price ($) vs Time

- Warning, sells at 30
- Recall announced
- 30
- 24

IN THE LESSON

- Case three in a picture.
- Along the bottom is time, and up the side is the share price in dollars.
- The line starts flat at thirty dollars.
- Leila Nasser, an analyst at a brokerage, learns that her covered company will announce a product recall next week.
- Her friend and client holds five thousand shares.
- Wanting only to protect him, she tells him to sell.
- The first dashed line is that warning, with the price still thirty.
- He sells at thirty.
- Then at the second dashed line the recall is announced, and the price drops to twenty four.
- The picture shows why the warning is valuable, and why it is unfair to everyone else who held on and took the loss.

8 Case 3: why Leila breached the Standard

Friend holds 5,000 shares: $30 before, $24 after the recall

Value before	5,000 × $30	**$150,000**
Value after	5,000 × $24	**$120,000**
Loss avoided	150,000 − 120,000 (20% fall)	**$30,000**
Leila's verdict	caused another to act	**Breach**

IN THE LESSON

- Now the numbers.
- The friend holds five thousand shares worth thirty dollars, so his position is one hundred and fifty thousand dollars.
- After the recall the shares are worth twenty four dollars, which is a position of one hundred and twenty thousand.
- By selling first, he avoids a loss of thirty thousand dollars, a fall of twenty per cent.
- Leila did not trade a single share herself, and her motive was kind.
- Is she in breach?
- Yes.
- Standard two A bans causing others to act on material nonpublic information.
- This is the well-meant breach that the exam loves: good intentions do not rescue it.
- She should have kept quiet, urged the company to announce, and told compliance.

9 II(B): intent is the test

- Information based: false rumours, misleading claims
- Transaction based: fake volume, pushing the close
- The same act can be fine or a breach
- Ask what the act was meant to do

IN THE LESSON

- Now the second part.
- Imagine a shopkeeper who pays friends to queue outside his shop.
- Passers-by think the shop must be good, look at the queue, and join.
- The queue was never real.
- Market manipulation is the same trick played on a market.
- Standard two B has two forms.
- Information based manipulation spreads false or misleading information to move a price.
- Transaction based manipulation trades to create a false picture, for example by faking volume or pushing a closing price.
- What separates these from honest activity is intent.
- A large order, a published view or a split order may move a price too, but if the purpose is genuine, there is no breach.
- The question is always what the act was meant to do.

10 Two forms, and the honest twins

Same kind of act, different purpose

Act	Breach?
False rumour	Breach
Honest published research	No breach
Buying at the close to lift the mark	Breach
Splitting an order to cut impact	No breach

IN THE LESSON

- Let us set each form beside its honest twin.
- In the information row, the manipulator spreads a rumour known to be false in order to move the price, while the honest twin publishes research that the analyst really believes.
- If the honest research moves the price, that is the market finding it persuasive.
- In the transaction row, the manipulator buys a few shares at the close to push up the final price, or trades between two controlled accounts to look busy.
- The honest twin breaks a large order into pieces to limit its impact on the price, or simply buys a big block because it wants the shares.
- The effect on the market can look the same.
- The intent is what differs.

11 Case 4: Paolo Greco's sell note

Honest sell note; price moves from $50 to $47

Price before	Norwood Tools	**$50**
Price after	after the note	**$47**
Move	47 vs 50	**−6%**
Meant to mislead?	honest, supported view	**No**
Verdict	price move is not the test	**No breach**

IN THE LESSON

- Case four.
- Paolo Greco, an analyst, publishes a sell recommendation on Norwood Tools after careful work on its accounts and market share.
- He believes it.
- The price falls from fifty dollars to forty seven, a drop of six per cent.
- Another analyst complains that Paolo moved the price and calls it manipulation.
- Is that right?
- No.
- Standard two B is about intent to mislead.
- Paolo gave an honest, well supported opinion, and the market responded to it.
- A price move is not the test, and an opinion that later proves wrong is also not manipulation.
- The things to check would be whether he held the shares and wanted to sell into a fall, and whether his statements were misleading.
- On these facts nothing suggests either.

12 Case 5: Sven Olsen marks the close

Fund holds 80,000 shares; 300-share buy at $26.40

Value before	80,000 × $25.00	**$2,000,000**
Value after	80,000 × $26.40	**$2,112,000**
Mark-up	2,112,000 − 2,000,000	**$112,000**
Cost of the buy	300 × $26.40	**$7,920**

IN THE LESSON

- Case five.
- Sven Olsen manages the Cedar Fund, which owns eighty thousand shares of a thinly traded company, last valued at twenty five dollars.
- Five minutes before the quarter ends, he buys just three hundred shares at twenty six dollars forty.
- That sets a new closing price, and the whole holding is now valued at two million one hundred and twelve thousand dollars, a rise of one hundred and twelve thousand.
- The three hundred shares cost only seven thousand nine hundred and twenty.
- His performance report will look better, and his fee may rise.
- The purpose of the purchase was not to own the shares but to move the mark.
- That is transaction based manipulation, a breach of Standard two B.

13 Small buy, big mark-up, in thousands

Thousands of dollars

Cost of the buy	**7.9**
Rise in reported value	**112**

300 shares bought at $26.40 lift 80,000 shares from $25.00

IN THE LESSON

- Here are the two amounts as bars.
- Along the bottom are two bars, and the height of each is an amount in thousands of dollars.
- The first bar is what the order cost: just seven point nine thousand dollars, a very short bar.
- The second bar is how much the reported value of the fund's holding went up: one hundred and twelve thousand.
- It is more than fourteen times taller.
- That gap tells us the order was not an investment.
- Someone who simply wanted shares does not pay so little to make so much on paper.
- A compliance officer looking at an order placed near the close, in a thin stock, from a manager whose fee depends on the quarter end value, would start asking questions.

14 Case 6: Maya Fernandez and the rumour

Holds 10,000 shares at $20; false posts lift price to $23

Shares held	bought at $20	**10,000**
Price after posts	up from $20	**$23**
Rise	23 vs 20	**15%**
Her gain	10,000 × (23 − 20)	**$30,000**
Verdict	false statement to move price	**Breach**

IN THE LESSON

- Case six.
- Maya Fernandez holds ten thousand shares in a small company, bought at twenty dollars.
- She writes several posts on an investor forum, under a false name, saying a takeover offer is coming.
- She has no source.
- The price rises to twenty three dollars, a gain of fifteen per cent, and she sells everything for a profit of thirty thousand dollars.
- This is information based manipulation: a false statement made to move the price, with her own position as the motive.
- Standard two B is breached.
- The false name makes it worse, but even under her own name it would be a breach.
- The correct action would have been to say nothing false, and to sell, if she wished, at the market.

15 Case 7: Ines Calder splits a block

Sell 600,000 shares; the stock trades 2,000,000 a day

Block to sell	for a client	**600,000**
Daily volume	typical	**2,000,000**
Slice per day	over 6 days	**100,000**
Share of volume	100,000 / 2,000,000	**5%**
Verdict	limits impact	**No breach**

IN THE LESSON

- Case seven is a no breach case with a tempting look.
- Ines Calder must sell six hundred thousand shares for a client.
- The stock normally trades two million shares a day.
- Selling all at once would push the price down against her client.
- So she sells one hundred thousand shares a day for six days, which is five per cent of daily volume.
- A compliance reviewer sees repeated sales and wonders about manipulation.
- But the purpose is clear: to get a better price for the client by limiting market impact.
- She is not creating a false picture, and she follows the firm's written execution policy.
- There is no intent to mislead, so there is no breach of Standard two B.

16 Cases one to four: the rulings

Judge each by the tests, not by the feeling

Case	Ruling
1 Mosaic from scraps	No breach
2 Dinner remark, trades	II(A) breach
3 Warns a friend, well meant	II(A) breach
4 Honest sell note	No breach

IN THE LESSON

- Let us line up the first four cases.
- Case one, Hana and the mosaic: no breach, since the conclusion came from public information and nonmaterial scraps.
- Case two, Tomas at the dinner: breach if he trades or tips, because the information was material, nonpublic and the source did not matter.
- Case three, Leila and her friend: a breach by tipping, even though her motive was kind.
- Case four, Paolo's sell note: no breach, because an honest opinion has no intent to mislead, whatever it does to the price.
- Two of the four are no breach, and one of the breaches was well meant.
- Notice how the answers came from the tests and not from how the situation felt.

17 Cases five to seven: the rulings

Trades and statements: what was the purpose?

Case	Ruling
5 Buys at the close	II(B) breach
6 False forum rumour	II(B) breach
7 Split block sale	No breach
Extra: wash trades between funds	II(B) breach

IN THE LESSON

- Now the last three, with one more.
- Case five, Sven buying at the close: a breach of Standard two B, because the purpose was to lift a mark, not to own shares.
- Case six, Maya and the rumour: a breach, since a false statement was used to move a price she then sold into.
- Case seven, Ines and the split block: no breach, because limiting market impact is a legitimate strategy.
- The fourth line is a quick extra.
- Two accounts under one manager trade the same stock back and forth with no change of real ownership, to look busy.
- That is a wash trade, a breach of Standard two B.
- Three of these four are breaches, and the one that is not looks very similar to the rest.

18 Mistakes: the traps in Standard II

- A few analysts told: still nonpublic
- Tipping counts: not trading yourself is no shield
- A kind motive does not cure a breach
- Intent, not price movement, decides II(B)
- One material nonpublic fact ends the mosaic

IN THE LESSON

- Here are the traps.
- First, confusing nonpublic with secret.
- Telling a few analysts is not public dissemination, so the news is still nonpublic.
- Second, believing that not trading yourself keeps you safe.
- Causing another to act is also banned.
- Third, thinking that a good motive cures a breach.
- Fourth, judging manipulation by the size of the price move instead of by intent.
- Fifth, mixing up the mosaic theory with inside information.
- Once a single material nonpublic fact enters the work, the mosaic defence is gone.

19 Prevention: why firms build controls

- Firms must stop MNPI leaking to people who trade
- Controls are written, enforced and monitored
- The Standard requires results; firms choose the tools
- Required: no misuse. Best practice: the methods

IN THE LESSON

- Now to the second outcome: stopping a breach before it happens.
- Think of a bank vault.
- We do not rely on every employee being honest at every moment.
- We add locks, logs and two keys.
- A firm that both advises companies and trades securities faces the same problem.
- Its bankers hold inside information, while its traders and analysts act on the market.
- The Standards require reasonable procedures, and supervisors are responsible for them, but exactly how a firm designs them is left to the firm.
- So we separate what is required, such as not trading on inside information, from what is good practice, such as the particular lists and records a compliance team keeps.

20 The information barrier

Normal flow

Deal team knows → Compliance gate → Research and trading stay clear

Crossing the wall

Request cleared → Analyst brought over → Stays until public

IN THE LESSON

- The central control is an information barrier, often called a firewall or Chinese wall.
- Picture the firm in two rooms.
- In one room, the deal team knows about an unannounced bid.
- In the other, the analysts and the traders must not.
- The top row shows how it works: information moves only through a gate staffed by compliance or legal, and the people who stay on the far side never hear it.
- The bottom row shows a person who has to cross.
- A banker needs an analyst's help, compliance clears and records the request, and the analyst is brought over the wall.
- Once over, he stays there, and he may not return to his normal work on that company until the information is public.

21 Lists and records that back up the wall

Who sees which list, and why

Control	Purpose
Watch list	Quiet monitoring
Restricted list	No trading allowed
Rumour list	Spot leaks early
Written records	Proof it worked

IN THE LESSON

- The barrier is supported by lists.
- A watch list holds securities the firm is working on or is monitoring, and compliance quietly checks trading in them.
- A restricted list holds securities where the firm has inside information.
- Employees and often the firm itself may not trade them, and the list itself is shared only with people who need it.
- A rumour list records market talk about companies, so that compliance can see whether leaks are starting.
- Alongside the lists, the firm keeps written procedures, written records of who crossed the wall and when, and records of enforcement.
- If it is not written down, the firm cannot prove that the control worked.

22 Case 8: Rohan Gupta crosses the wall

Unannounced bid; analyst needed; firm trades for itself

1 The request	through compliance	**Cleared, logged**
2 The analyst	brought over the wall	**Stops publishing**
3 The target	added to watch list	**Monitored**
4 Proprietary desk	tighter review	**While held**
5 Bid announced	analyst returns	**Lists updated**

IN THE LESSON

- Case eight.
- Moss Bay Securities is advising a company on an unannounced takeover bid.
- Rohan Gupta, the analyst who covers the target, is asked by a banker to sanity check the valuation.
- Meanwhile the firm's own proprietary desk holds a position in the target.
- The banker's instinct is to ring Rohan directly.
- That would be quick, but it leaves no record, and it bypasses the wall.
- The right path has five steps.
- The request goes through compliance.
- Rohan is brought over and stops publishing on the target.
- The target goes on the watch list.
- The proprietary desk gets tighter review while the firm holds the information.
- When the bid is announced, Rohan returns and the lists are updated.

23 Good practice around the wall

- Staff on one side of the wall at a time
- Cross-wall talk cleared by compliance or legal
- Tighter review of proprietary trading
- Written procedures and written enforcement records

IN THE LESSON

- A wall works only if people behave as if it were real.
- Staff should be on one side of it at a time.
- They should not share a floor, a shared drive or casual chat across the divide.
- Interdepartmental communication on a restricted matter should be cleared through compliance or legal.
- The firm should limit proprietary trading in names it holds inside information about, and review that trading more closely while it does.
- It should write the procedures down, and document how they are enforced, including what happened when someone broke them.
- And an analyst who is brought over the wall stays there until the information is public, because anything he published in the meantime would be formed with that knowledge.

24 If inside information reaches you

The order of response

Receive it → Do not trade or tell → Urge public release → Tell compliance

IN THE LESSON

- Sometimes nobody has done anything wrong to get there.
- An executive simply says too much, and you are listening.
- Standard two A still applies, and there is an order of steps.
- First, you receive the information.
- Second, you do not act on it and you do not pass it on.
- Deleting the email does not erase what you know.
- Third, you make reasonable efforts to have the company make the information public, for example by raising it with the company's management.
- Fourth, if the company will not, you tell your compliance officer or your supervisor, who decides what to do next.
- The one thing you never do is trade first and report afterwards.

25 Case 9: Omar Haddad hears at a meeting

Fund holds 50,000 shares at $12; leak at a trustee meeting

Position	50,000 × $12	**$600,000**
Information	unannounced share issue	**Material**
Public?	heard at a meeting	**No**
Action	hold, urge, tell	**No trade**

IN THE LESSON

- Case nine.
- Omar Haddad is an analyst at a pension fund that holds fifty thousand shares of Dune Bank, bought at twelve dollars, a position of six hundred thousand dollars.
- At a trustee meeting, a trustee who is a director of the bank mentions that a large and unannounced share issue is coming.
- Omar thinks of selling the position.
- Should he?
- No.
- The information is material and nonpublic, and the source does not change that.
- His correct steps are to hold the position, ask the bank to make the news public, and tell the fund's compliance officer.
- This is a no breach outcome, but only because he follows the steps.
- Selling first and reporting later would be a breach of Standard two A.

26 Watching for manipulation

Red flags a compliance team scans for

Pattern	Possible issue
Orders near the close	Marking the close
Orders cancelled before fill	False demand
Trades, no change of owner	Wash trades
Coordinated accounts	A ring

IN THE LESSON

- Against manipulation, a firm monitors its own trading and what its staff publish.
- Compliance looks for patterns.
- Orders placed near the close, especially in thinly traded stocks, may be marking the close.
- Orders cancelled before they execute may be a trick to give the market a false impression of demand.
- Trades with no change in ownership, such as the same shares moving between two related accounts, are wash trades.
- And coordinated activity between several accounts, or between staff and outsiders, may be a ring.
- The firm should also review research and communications about securities, such as forum posts or newsletters, so that misleading statements are caught early.
- Each flag is only a prompt to ask what the activity was for.

27 Member practices that prevent breaches

Five habits for the individual member

1 Ask the two questions	material? nonpublic?	**Before acting**
2 Unsure? Ask compliance	before the trade	**Not after**
3 Keep source notes	show the mosaic	**In writing**
4 Refuse to move a price	or a mark	**Say no**
5 Report concerns	to supervisors	**Raise it**

IN THE LESSON

- The firm cannot do everything, so the member also needs habits.
- Before acting on any item of information, ask the two questions: is it material, and is it nonpublic?
- If either is unclear, ask compliance before trading, not after.
- Keep a record of the sources of your analysis, so you can show that your conclusion is a mosaic.
- Do not be talked into a trade by a manager or a client for the purpose of moving a mark or a price.
- And if you see a colleague doing something that looks like manipulation, raise it with supervisors or compliance.
- Each step is cheap, and each makes a later breach less likely.

28 Recap: Standard II and its controls

- II(A): material and nonpublic means no trade, no tip
- Mosaic of public and nonmaterial scraps is allowed
- II(B): intent to mislead decides manipulation
- Barrier, lists, records, tighter proprietary review
- Received MNPI: urge release, tell compliance

IN THE LESSON

- Let us recap.
- Standard two A: if information is both material and nonpublic, the member must not trade, or cause others to trade, whatever the source and whatever the motive.
- The mosaic theory allows a conclusion built from public information and nonmaterial scraps.
- Standard two B: manipulation turns on intent, so false rumours and trades meant to fake activity or push a close are breaches, while a split order or an honest research note is not.
- For prevention, the central control is the information barrier, backed by watch, restricted and rumour lists, written procedures and enforcement records, and closer review of proprietary trading.
- A member who receives inside information urges release and tells compliance, and never trades.

29 Try three quick questions

1. Analyst tells a friend to sell before bad news; she does not trade. Breach?
   Answer: Yes: causing another to act, II(A)
2. A large sale is split over days to limit impact. Manipulation?
   Answer: No: legitimate, no intent to mislead
3. An analyst is brought over the wall. When may she publish again?
   Answer: Only once the information is public

IN THE LESSON

- Now try three questions yourself.
- Pause after each one.
- Question one.
- An analyst tells a client friend to sell ahead of an unannounced bad news item, but does not trade herself.
- Is that a breach?
- Yes.
- Causing another to act on material nonpublic information is a breach of Standard two A, even when well meant.
- Question two.
- A trader splits a very large sale over several days to limit market impact.
- Is that manipulation?
- No.
- The purpose is a better price, not a false picture.
- Question three.
- An analyst moves over the wall to help on a deal.
- When may she go back to publishing on the target?
- Only after the information has become public.
- Remember that rule when you practise.