CHARTA LEARNING · LESSON NOTES

Standard III: duties to clients, cases and safeguards

Ethical and Professional Standards

1 A story: the key to the safe

- Clients cannot watch what we do, so rules protect them
- Five duties, III(A) to III(E), one per letter
- Level Two gives you a case, not a heading
- Pick the duty, judge the breach, name the action

IN THE LESSON

- Picture a locksmith who is given the key to a family's safe while they travel.
- Nobody watches him.
- He could peek, he could borrow, he could tell a friend what is inside.
- The family has only their trust, and the rules for that trust are what Standard three is about.
- It has five duties, labelled with capital letters.
- A is loyalty, prudence and care.
- B is fair dealing.
- C is suitability.
- D is performance presentation.
- E is preservation of confidentiality.
- In Level One you learned the headings.
- In Level Two you are handed a messy case and must pick the duty, decide on breach, and name the action.

2 Standard III at a glance

The five duties and the question each asks

III(A) Loyalty, Prudence, and Care	Who came first?
III(B) Fair Dealing	Fair chance for all?
III(C) Suitability	Does it fit?
III(D) Performance Presentation	Fair and complete?
III(E) Confidentiality	Kept private?

IN THE LESSON

- Here are the five duties on one page, with the question each one asks.
- Duty A asks: whose interest came first?
- Duty B asks: did every client get a fair chance?
- Duty C asks: does this fit this client and the whole portfolio?
- Duty D asks: are the results shown fair, accurate and complete?
- Duty E asks: is the client's information being kept private?
- When a case arrives, find the question that the facts answer most directly.
- Cases often brush against two duties, so choose the closest one.
- We will go through the duties in order, with one to three cases for each.

3 A way to judge any Standard III case

Four steps, in this order

Find the duty → Find the facts → Judge: breach? → Name the action

IN THE LESSON

- Here is a routine for every case.
- Read the boxes from left to right.
- First, find the duty, using the question we just saw.
- Second, find the facts that matter: who gained, who was told, and who was left out.
- Third, judge.
- Is there a breach, or is this a case where the member has acted properly?
- Do not assume every case contains a breach.
- Several cases in this lesson do not.
- Fourth, name the action: stop, disclose, restore the client, or put a safeguard in place.
- A good exam answer follows all four boxes, and a weak one jumps straight to the word breach.

4 Standard III(A): loyalty, prudence and care

- Client first, then the employer, then the member
- Client commissions belong to the client
- Proxy votes are a client asset: vote with care
- The duty is about process, not a promise of profit

IN THE LESSON

- Now duty A.
- Think of a trustee.
- Loyalty means acting for the benefit of the client, and putting the client ahead of the employer and ahead of oneself.
- Prudence means judging as a careful person would.
- Care means doing the work with proper diligence.
- Two extensions matter in cases.
- First, client brokerage.
- The commissions a client pays belong to the client, so they may buy only research and services that benefit that client.
- Second, proxy votes.
- They are a client asset too, so voting should be informed, though a documented cost and benefit view can justify not voting.
- And note that duty A is about process and loyalty.
- It does not promise a profit.

5 Case 1: what the commissions bought

Paid from client commissions: who benefits?

Research the managers use for clients	Allowed
Marketing team's software licence	Breach
Data terminal for other clients only	Breach
Test: did the payer benefit?	Yes or no

IN THE LESSON

- Case one.
- Dunmore Capital is a fund manager.
- It sends client trades to a broker, Halden, whose commissions are above the lowest rates around, and in return receives three things.
- First, an industry research report that Dunmore's managers use when choosing stocks for those very clients.
- That is acceptable, because the clients who paid get the benefit, provided execution is still good.
- Second, a licence for the software Dunmore's marketing team uses to track prospects.
- That benefits the firm, not the clients, so it is a breach.
- Third, a market data terminal used only for a different client group whose trades paid nothing.
- The payers get no benefit, so that is a breach too.

6 Case 2: splitting the commission bill

200,000 shares at 4 cents. Rate elsewhere: 1.5 cents

Commission paid	200,000 × 0.04	**8,000**
Cost at the lowest rate	200,000 × 0.015	**3,000**
Premium for bundled services	8,000 − 3,000	**5,000**
Research for client portfolios	benefits the payers	**3,500**
Marketing software	benefits the firm	**1,500**

IN THE LESSON

- Case two puts numbers on the same idea.
- Dunmore trades two hundred thousand shares through Halden at four cents a share.
- That is eight thousand dollars.
- The lowest rate available elsewhere is one and a half cents, which would cost three thousand.
- So five thousand dollars is the premium that pays for the bundled services.
- Of that five thousand, thirty five hundred dollars is research used in managing the clients' portfolios, and fifteen hundred pays the marketing software.
- The research part is defensible.
- The fifteen hundred dollars of the clients' money is spent on the firm, which is a breach.
- The action is to pay for the software from the firm's own pocket, and to disclose the soft dollar practice.

7 Case 3: the proxy nobody voted

15,000 shares at 6. Company has 750,000,000 shares

Value of the stake	15,000 × 6	**90,000**
Share of the company	15,000 ÷ 750,000,000	**0.002%**
Cost of voting	agent and translation	**2,500**
Cost as share of the stake	2,500 ÷ 90,000	**2.8%**
Verdict	documented cost-benefit	**no breach**

IN THE LESSON

- Case three is a no breach case.
- Marta Quist manages a client fund that holds fifteen thousand shares of a foreign company, worth six dollars each, so ninety thousand dollars.
- The company has seven hundred and fifty million shares, so the stake is two thousandths of one per cent.
- The vote is routine.
- Voting would need a local agent and translations costing twenty five hundred dollars, nearly three per cent of the position, and the client could not change the outcome.
- Marta's firm has a written proxy policy, disclosed to clients, that weighs cost against benefit.
- She records that voting costs more than it could achieve, and does not vote.
- That is consistent with duty A.
- A reasoned, documented choice is the point, not a vote at any price.

8 Standard III(B): fair dealing

- Fair does not mean identical
- Disclosed tiers open to all are allowed
- Recommendation changes reach clients without favouritism
- Oversubscribed issue: pro rata, own order dropped

IN THE LESSON

- Duty B is about sharing.
- Picture a baker who sells the last twelve loaves of the day.
- Fair dealing does not say every customer must get the same thing.
- It says nobody is served last every time, and nobody gets a head start by favour.
- In practice, three rules.
- First, different service levels, such as a premium tier with more meetings, are allowed if they are disclosed and open to all who pay for them.
- Second, changes in recommendations must reach clients without favouritism.
- Third, when an offering is oversubscribed, it is shared pro rata among suitable accounts, the member's own order is dropped, and family accounts that are managed like any other stay in.

9 Case 4: the downgrade phone calls

Price 80. 12 premium clients phoned; 138 others later

Clients called first	12 of 150	**8%**
Price when the note arrives	80 less 7%	**74.40**
Loss per share to a late seller	80 − 74.40	**5.60**
Loss, 5,000 shares	5,000 × 5.60	**28,000**
Verdict	head start by favour	**breach**

IN THE LESSON

- Case four.
- Tamsin Capital downgrades a food company from buy to sell.
- The price is eighty dollars.
- The adviser, Kofi Mensah, wants to protect the twelve premium clients, so he phones them straight away.
- The other hundred and thirty eight clients, out of a hundred and fifty, get the written note the next day, when the price has slipped seven per cent, to seventy four dollars forty.
- A small client with five thousand shares sells after the note and gives up twenty eight thousand dollars that the premium clients avoided.
- Kofi meant well, and a premium tier is allowed.
- But a premium tier is about service, not about earlier news.
- This is a breach of fair dealing.
- The action is to release changes to all clients together.

10 Case 5: the oversubscribed offering

Allotted 9,000. Orders: A 8,000, B 6,000, father 4,000

Rosalind's own 2,000	member comes last	**dropped**
Client orders	8,000 + 6,000 + 4,000	**18,000**
Fill rate	9,000 ÷ 18,000	**50%**
Clients A and B	50% of 8,000 and 6,000	**4,000, 3,000**
Father's account	kept in, 50% of 4,000	**2,000**

IN THE LESSON

- Case five.
- Rosalind Vance manages money at Tamsin Capital.
- A new share issue is hot, and she is allotted nine thousand shares.
- Suitable orders come in from client A for eight thousand, client B for six thousand, and her father's account for four thousand.
- His account pays fees and is managed like any other.
- She also entered two thousand shares for herself.
- Her own order is dropped, because the member comes last.
- The three client orders total eighteen thousand.
- Nine thousand divided by eighteen thousand is fifty per cent.
- So A receives four thousand, B three thousand and her father two thousand.
- Dropping her father from the list to look careful would be the well meant mistake, and it would breach fair dealing towards a paying client.

11 What each account receives

Shares received (thousands)

Client A	**4**
Client B	**3**
Father's account	**2**

Each account is filled at 50% of its order

IN THE LESSON

- Look at the picture.
- The vertical axis counts shares received, in thousands.
- There are three bars, one for each client account, and each bar is half the size of that account's order.
- Client A ordered eight thousand and receives four thousand.
- Client B ordered six thousand and receives three thousand.
- The father's account ordered four thousand and receives two thousand.
- Every account is filled at the same fifty per cent rate.
- The smallest order is cut by the same share as the largest, so nobody is favoured for size, for fees or for closeness to the manager.
- Where is Rosalind's own bar?
- There is none, because her order was dropped before the sharing began.

12 Fair or not?

Which of these is fair dealing?

Disclosed premium tier, open to all	**Allowed**
Different trades, different mandates	Allowed
Biggest clients told of a change first	Breach
Sharing rule picked after demand is known	Breach
Highest fee payer served first	Breach

IN THE LESSON

- Here is a sorting table, with the answers.
- A disclosed premium tier, open to every client who meets the fee level, is allowed.
- Two clients with different mandates receiving different trades is allowed too, because their mandates differ.
- Now the breaches.
- Telling the biggest clients about a change in recommendation first is a breach.
- Deciding how to share an oversubscribed issue only after seeing who is in a hurry is a breach.
- So is serving the highest fee payer first.
- Notice that every breach gives somebody a head start that the others cannot know about, while every allowed practice is open and disclosed.

13 Mistakes on duties A and B

- 1. Disclosure does not cure a conflict
- 2. Not every high commission is a breach
- 3. Fair is not identical
- 4. A well meant head start is still a breach

IN THE LESSON

- Four traps so far.
- One.
- Thinking that disclosure cures a conflict.
- Telling clients about a perk does not turn a choice that favours the member into a loyal one.
- Two.
- Thinking every higher commission is wrong.
- Research that benefits the clients who paid is fine.
- Three.
- Treating fair as identical, and so banning every premium tier.
- Four.
- Being kind to the wrong people.
- Phoning the most affected clients first, or dropping a family account from an offering to look careful, are well meant actions that still breach.
- The test is always whether the process was open and equal, not whether the intention was good.

14 Standard III(C): suitability

- Know the client: objectives, risk, constraints
- Written IPS, reviewed at least yearly
- Judge each holding within the whole portfolio
- A client's request does not make a trade suitable

IN THE LESSON

- Duty C is the tailor's duty.
- A good suit for one person is a poor suit for another.
- Suitability means knowing the client: their objectives, risk tolerance and constraints, written in an investment policy statement, spoken as I P S.
- The member reviews it at least once a year, and again after any material change in the client's life.
- Two lessons from the cases.
- First, each holding is judged in the context of the whole portfolio, not on its own.
- A volatile asset may be perfectly suitable if the portfolio as a whole stays within the client's limits.
- Second, an unsuitable idea does not become suitable because the client asks for it.
- The member explains, and follows firm policy.

15 Case 6: a risky holding, a safe portfolio

IPS limit 9%. Now 8%. Add 5% fund: vol 40%, corr 0.2

Old portfolio piece	0.95 × 8 = 7.6	**7.6**
New fund piece	0.05 × 40 = 2.0	**2.0**
Variance	57.76 + 4 + 6.08	**67.84**
Portfolio volatility	square root of 67.84	**8.2%**
Verdict	within the 9% limit	**no breach**

IN THE LESSON

- Case six, another no breach case.
- Simon Okoro advises a retired client whose written policy limits portfolio volatility to nine per cent a year.
- The portfolio is now eight per cent.
- Simon proposes five per cent in a frontier market fund with a stand alone volatility of forty per cent, and an expected correlation with the rest of twenty hundredths.
- A colleague objects that forty per cent is far above nine.
- But suitability is judged for the portfolio.
- The new variance is the square of ninety five per cent of eight, plus the square of five per cent of forty, plus twice the product of the two, times the correlation of twenty hundredths, which comes to about sixty eight.
- Its square root is about eight point two per cent, inside the limit.
- The holding can be suitable.

16 Case 7: the client who insists

Portfolio 1,200,000. IPS limit 5% in speculative holdings

Speculative limit	5% × 1,200,000	**60,000**
Client's order	30% × 1,200,000	**360,000**
Excess over the limit	360,000 − 60,000	**300,000**
First action	hold off, explain, record	**discuss**
If he insists	firm policy: signed note	**acknowledge**

IN THE LESSON

- Case seven.
- Priya Raman advises Aldo, retired, with one million two hundred thousand dollars.
- His written policy sets a moderate risk level, an income aim, and a limit of five per cent in any speculative holding.
- That is sixty thousand dollars.
- A friend tells him about a new digital asset fund and he orders thirty per cent, or three hundred and sixty thousand dollars.
- That is three hundred thousand over the limit.
- Raman must not simply execute the order, and refusing and ending the relationship would be too hasty.
- She holds off, explains how the trade departs from the policy, records the discussion, and if he still insists and firm policy calls for it, takes his signed acknowledgement.
- Only a revised policy would change the limit.

17 Standard III(D): performance presentation

- Fair, accurate and complete
- Include every account, closed ones too
- Label simulated and prior-firm results
- Say whether returns are gross or net of fees

IN THE LESSON

- Duty D is the honest scoreboard.
- Imagine a football club that publishes only its home wins.
- Every figure is true, yet the picture is false.
- Members must make reasonable efforts to ensure that performance information given to clients and prospects is fair, accurate and complete.
- That means including all the accounts that belong in a strategy, including closed ones.
- It means labelling hypothetical, back tested or prior firm results for what they are.
- And it means saying whether returns are before or after fees, called gross or net.
- Claiming compliance with the Global Investment Performance Standards, spoken as G I P S, is recommended, but a firm may claim it only if it truly complies.

18 Case 8: the missing accounts

5 accounts: 3 open at +11%, 2 closed at −4%

Survivors only	(11 + 11 + 11) ÷ 3	**11%**
All five accounts, gross	(33 − 8) ÷ 5	**5%**
Fee	illustration	**1%**
All five accounts, net	5% − 1%	**4%**
Verdict	incomplete, gross not stated	**breach**

IN THE LESSON

- Case eight.
- Ribeira Partners runs a growth strategy with five accounts.
- Three are still open and each earned eleven per cent.
- Two were closed after a poor year, each losing four per cent.
- The brochure shows a return of eleven per cent for the strategy, using only the open accounts, and does not say whether fees are taken out.
- Equal weighting all five gives eleven times three, minus four times two, divided by five, which is five per cent.
- And if the fee is one per cent, the net figure is four per cent.
- The brochure is not fair or complete.
- The action is to include the closed accounts, state whether the figure is gross or net, and show the net figure alongside.

19 Three ways to show the same record

Annual return (%)

Survivors only	**11**
All five, gross	**5**
All five, net	**4**

Same record, shown three ways

IN THE LESSON

- Here is the same record three ways.
- The vertical axis is annual return in per cent.
- The first bar, in green, is the survivors only, eleven per cent.
- It is the flattering one.
- The second bar is all five accounts, before fees, at five per cent.
- The third bar is all five accounts after a one per cent fee, at four per cent.
- Same strategy, same years, and a gap of seven percentage points between the first bar and the last.
- A prospect who sees only the first bar would expect to earn nearly three times as much as one who sees the last.
- That gap is the harm that duty D exists to prevent.

20 Standard III(E): preservation of confidentiality

- Applies to current, former and prospective clients
- Three doors: illegality, the law, client consent
- Inside the firm, share on a need-to-know basis
- The duty does not end with the relationship

IN THE LESSON

- Duty E is the family doctor's duty.
- What a client tells you stays with you, whether the client is current, former or only prospective, and the duty survives the end of the relationship.
- There are three doors through which information may leave.
- The first is illegality: if the client's conduct is or may be illegal, the member may disclose to the proper authorities.
- The second is the law: a valid legal demand, such as a court order or a regulator's request, must be met.
- The third is consent: the client says yes.
- Inside the firm, the rule is need to know, so only the people who must have the information to serve the client see it.

21 Case 9: confidential or not?

Seo and his clients: what may be shared?

Court order for a client's records	Must give
Client consents in writing	Allowed
Dinner chat about a client	Breach
Client's illegal act uncovered	May report
Former client's file to a friend	Breach

IN THE LESSON

- Case nine is a sorting table, with the answer for each.
- A court orders Seo to hand over a client's records.
- Confidentiality gives way to the law, so he must comply.
- A client says in writing that Seo may share her details with her accountant.
- Consent, so that is allowed.
- Seo chats about a client's big inheritance over dinner with a friend.
- Breach, even without a name, if the client could be identified.
- Seo discovers a client is hiding income from the tax authorities.
- He may report it, though the standard does not make him.
- And a former client's file shared with a friend is a breach.

22 Procedures: decide before the result

Allocation chain for duty B

Written procedure first → Time-stamped tickets → Pro rata partial fills → Ratings released together

IN THE LESSON

- Now part two: the practices that stop breaches before they happen.
- Most of them work the same way.
- They take a decision that could be made with hindsight and fix it in writing beforehand.
- Read the allocation chain from left to right.
- First, a written allocation procedure, fixed before any order is placed.
- Second, every order ticket time stamped, so the intended split is on record.
- Third, if only part of the order is filled, the fill is shared pro rata, in round lots.
- Fourth, rating changes released to every client at the same moment.
- Each box removes a point where a manager could favour one account once she knew how the trade turned out.

23 A partial fill, shared pro rata

Order 10,000: 5,000 / 3,000 / 2,000. Filled: 7,000

Fill ratio	7,000 ÷ 10,000	**70%**
Account 1	0.70 × 5,000	**3,500**
Account 2	0.70 × 3,000	**2,100**
Account 3	0.70 × 2,000	**1,400**
Check	sum equals the fill	**7,000**

IN THE LESSON

- Here is the chain at work.
- Ines Varga places one block order for ten thousand shares for three accounts, in the proportions written on the time stamped ticket: five thousand, three thousand and two thousand.
- Only seven thousand shares are filled, and the firm trades in round lots of one hundred.
- The fill ratio is seven thousand over ten thousand, or seventy per cent.
- Account one gets seventy per cent of five thousand, thirty five hundred.
- Account two gets twenty one hundred.
- Account three gets fourteen hundred.
- All three are whole round lots.
- What is not allowed is filling the biggest account first, or the one with the best recent record.
- The rule was fixed before the fill was known.

24 Procedures for suitability and the IPS

Suitability in practice

Write the IPS →
Review yearly and on change →
Client insists: discuss and record

IN THE LESSON

- Next, the suitability chain.
- Read left to right again.
- The firm keeps a written investment policy statement for each client, covering risk, return and constraints, including liquidity, time horizon, taxes and any special wishes.
- It is reviewed at least once a year, and also before any material change, such as a retirement or the sale of a family business.
- Then comes the third box.
- When a client insists on an unsuitable trade, the member discusses it, explains the effect on risk and income, records the conversation, and, where firm policy calls for it, takes a signed acknowledgement.
- The acknowledgement documents the decision.
- It does not make the trade suitable.

25 Practices matched to each duty

Which practice prevents which breach?

Written proxy policy, quarterly statements	**III(A)**
Allocation set before orders	III(B)
Written IPS, reviewed yearly	III(C)
Composites keep closed accounts	III(D)
Need-to-know data access	III(E)

IN THE LESSON

- Here are the remaining practices, matched to the duties.
- For loyalty, a written proxy voting policy, disclosed to clients, with case by case analysis of non routine proposals instead of automatic votes with management.
- Clients should also receive itemised statements, at least quarterly.
- For performance, composites that include terminated accounts, clear labels on simulated or prior firm results, and a statement of whether returns are gross or net.
- For confidentiality, secure data handling on a need to know basis, with client files not sent to everyone in the firm.
- For fair dealing, the allocation chain we just met.
- And for suitability, the written policy and its yearly review.

26 Mistakes: requirement or best practice?

- 1. Duties are required; practices are recommended
- 2. A signed note does not make a trade suitable
- 3. GIPS is best practice, claimed only if true
- 4. A procedure written after the fact protects no one

IN THE LESSON

- Part two has its own traps.
- One.
- Mixing up what the Standards require with what they recommend.
- The duties themselves are required.
- The practices, such as written policies and signed acknowledgements, are recommended, and the exam asks which one is best.
- Two.
- Thinking an acknowledgement makes a client's unsuitable trade suitable.
- It does not.
- Three.
- Thinking G I P S compliance is a legal requirement.
- It is best practice, and may be claimed only if truly met.
- Four.
- Thinking a procedure fixes a problem after the fact.
- Allocation rules written after seeing the results are not procedures at all.
- A procedure must come first.

27 Recap: Standard III in one page

Remember these

III(A) Loyalty	**client commissions, informed votes**
III(B) Fair dealing	pro rata, no head start
III(C) Suitability	whole portfolio, yearly IPS
III(D) Performance	all accounts, gross or net
III(E) Confidentiality	law, consent, illegality

IN THE LESSON

- Let us pull it together.
- Duty A, loyalty, prudence and care: client first, commissions belong to the client, and not voting needs a documented cost and benefit case.
- Duty B, fair dealing: fair, not identical, with pro rata sharing and no head starts.
- Duty C, suitability: know the client, review the policy yearly, and judge each holding within the whole portfolio.
- Duty D, performance: fair, accurate and complete, with closed accounts included.
- Duty E, confidentiality: kept private unless illegality, the law or consent says otherwise.
- And the safeguards: write the rule down first, time stamp it, share pro rata, review yearly, and keep the data need to know.

28 Try three quick questions

1. Downgrade phoned to best clients a day early, meant well. OK?
   Answer: No: a head start breaches III(B)
2. Small volatile fund keeps portfolio within the IPS. Unsuitable?
   Answer: No: judge the whole portfolio, III(C)
3. Track record shows only accounts still open. OK?
   Answer: No: include closed accounts, III(D)

IN THE LESSON

- Now try three questions yourself.
- Pause after each one.
- Question one.
- A manager phones his most valuable clients about a downgrade the day before the written note goes out, meaning well.
- Acceptable?
- No.
- It is a head start, which breaches fair dealing.
- Question two.
- A retiree's portfolio volatility stays within the policy limit after adding a small, volatile fund.
- Is the holding unsuitable just because the fund is volatile on its own?
- No.
- Suitability is judged across the whole portfolio.
- Question three.
- A firm shows only the accounts still open.
- Acceptable?
- No.
- Closed accounts must be included to be fair and complete, and that is the end of the questions.