CHARTA LEARNING · LESSON NOTES

Standard VI: Conflicts of Interest

Ethical and Professional Standards

1 What a conflict is, and who is owed

- Conflict: could reasonably impair objectivity or duties
- Duties are owed to clients and to the employer
- A conflict can exist even if your advice is honest
- The Standards ask: what do you do about it?

IN THE LESSON

- Imagine a judge at a baking contest whose sister is one of the bakers.
- She may judge perfectly fairly.
- Yet nobody can be sure, and the doubt itself spoils the contest.
- That is a conflict of interest.
- In the Standards, it is anything that could reasonably be expected to impair your objectivity, or to interfere with your duties to clients or to your employer.
- The test is what a reasonable person would expect, not whether you actually behaved badly.
- So a conflict can exist even when your advice is honest.
- The Standards do not pretend conflicts can be wiped out of finance.
- They ask what you do about each one.

2 Standard VI in three parts

Three parts, one idea: put others first, and be open

Part	Core duty
VI(A) Disclosure of Conflicts	Avoid or disclose
VI(B) Priority of Transactions	Clients first
VI(C) Referral Fees	Disclose early

IN THE LESSON

- Here is the whole Standard on one board.
- Part A, disclosure of conflicts.
- The revised wording reads avoid or disclose.
- You should avoid a conflict where that is reasonably possible, and if you keep it, you must disclose it.
- Part B, priority of transactions.
- Clients come first, then the employer, then you.
- Part C, referral fees.
- If you pay or receive anything for a referral, you disclose it before any formal agreement.
- We will meet each part through cases.
- Notice that the Standard does not forbid having interests.
- It forbids hiding them, and it forbids letting them jump the queue ahead of the people you serve.

3 Avoid first, then disclose properly

Part A, step by step

Spot the conflict → Avoid it if reasonable → If kept, disclose → Specific, prominent, plain

IN THE LESSON

- Follow the boxes for part A.
- First, spot the conflict.
- Ask whether it could reasonably affect your objectivity or your duties.
- Second, ask whether you can avoid it.
- An analyst whose family owns the shares can hand the company to a colleague.
- If you can avoid it reasonably, that is the preferred route.
- Third, if you keep the conflict, you move to the last box.
- You disclose it.
- The disclosure must be prominent, specific and in plain language.
- The reader should be able to use it to judge your advice.
- Avoidance is preferred, but it is not mandatory.
- Disclosure is a permitted route, as long as it is done properly.

4 What good disclosure looks like

Would a client be able to use this wording?

Wording	Verdict
Names the stake, on page one	Passes
'Conflicts may arise'	Fails
Precise, but in a last-page footnote	Fails
Dense legal jargon	Fails

IN THE LESSON

- So what separates a disclosure that works from one that does not?
- Look at four wordings an analyst might use.
- The first names the holding, the size, and puts it at the top of the report.
- That passes.
- The second says conflicts may arise.
- That is true of every firm everywhere, so it tells the reader nothing.
- It is generic, and it fails.
- The third is precise but sits in a footnote on the last page.
- Precise yet buried, so it fails on prominence.
- The fourth uses legal jargon that an ordinary client cannot follow, so it fails on plain language.
- A disclosure counts only if a client could actually use it.

5 Case 1: the footnote on page twelve

Tomasz owns the stock he rates a buy

Holding	1,500 × $60	**$90,000**
Share of his portfolio	90,000 ÷ 600,000	**15%**
Disclosure used	generic note, page 12	**Too weak**
Verdict	VI(A)	**Breach**

IN THE LESSON

- Case one.
- Tomasz Berg is an analyst who covers Quillon Foods.
- He personally owns one thousand five hundred shares, worth sixty each.
- That is ninety thousand, and fifteen per cent of his six hundred thousand portfolio.
- His new report rates Quillon a buy.
- On page twelve, the last page, a standard footnote says analysts may hold positions in companies mentioned.
- Is that enough?
- No.
- Standard six A is breached.
- A fifteen per cent holding in the stock he praises could reasonably impair his objectivity, and the generic footnote is neither specific nor prominent.
- He should either hand coverage to a colleague, or state his holding clearly on page one.

6 Case 2: the bond issue the firm cannot avoid

Hana's firm earned banking fees from Orrin

Bond issue	led by the banking arm	**$400m**
Fee earned	0.6% × 400m	**$2.4m**
Disclosure used	plain box, page one	**Strong**
Verdict	VI(A)	**No breach**

IN THE LESSON

- Case two.
- Hana Sato covers Orrin Rail at a large securities firm.
- The firm's banking arm was lead manager on a four hundred million bond issue for Orrin, and earned a fee of zero point six per cent, which is two point four million.
- The firm cannot sensibly drop either business.
- Hana's report carries a box on its first page, in plain words, saying the banking arm managed Orrin's bond issue and earned about two point four million in fees.
- Is there a breach?
- No.
- The conflict could not reasonably be avoided, and it was disclosed specifically and prominently.
- Avoidance is preferred, but disclosure done well is a compliant answer.

7 Priority of transactions

Who trades first

Clients → Employer → You and your family

IN THE LESSON

- Now part B.
- Picture a queue at a bakery with one tray of fresh bread left.
- The person who ordered first is served first.
- The staff do not take the last loaf for themselves.
- Standard six B works like that queue.
- Transactions for clients come first.
- Transactions for the employer come second.
- Your own personal transactions come last.
- And personal transactions are not only your own account.
- They include trades for your immediate family, and for any account in which you have a beneficial interest, meaning you gain from it.
- Personal investing is not banned.
- It simply ranks behind the people you serve, and must never disadvantage them.

8 Case 3: the father's account held back

Elena leaves her father's account out of a placement

Shares to allocate	to 20 suitable accounts	**100,000**
Equal share each	100,000 ÷ 20	**5,000**
Father's account received	she left it out	**0**
Verdict	VI(B), well meant	**Breach**

IN THE LESSON

- Case three.
- Elena Marsh manages twenty client accounts.
- A placement of one hundred thousand shares suits all of them, so each should get five thousand shares.
- One account belongs to her father.
- He pays full fees, and she manages it on the same terms as every other client.
- To avoid any suggestion of favouritism, she leaves his account out, and gives the others a slightly larger share.
- Her motive is good.
- Is it a breach?
- Yes.
- A fee paying family account must be treated like any other.
- She must neither favour it nor hold it back.
- By excluding him she disadvantaged a client.
- The action is to include his account in the allocation.

9 Case 4: the husband's account

Imogen buys before her firm's recommendation goes out

Shares bought Thursday	joint account	**4,000**
Price rise after release	$25.00 to $27.50	**$2.50**
Gain on the position	4,000 × 2.50	**$10,000**
Verdict	VI(B)	**Breach**

IN THE LESSON

- Case four.
- Imogen Park is an analyst.
- Her firm will add Calloway Tech to its buy list on Friday morning, so clients can act on it.
- On Thursday, she buys four thousand Calloway shares at twenty five dollars in an account she shares with her husband.
- After the release, the price rises to twenty seven fifty.
- Her defence is that she did not trade in her own name.
- That fails.
- Personal transactions include trades in an account where she has a beneficial interest.
- She put her own gain ahead of clients and the employer, a gain of ten thousand dollars.
- The action is to wait until clients have had time to act.

10 Case 5: a personal trade that is fine

Lucia buys 300 shares for herself, with approval

Her purchase	300 × $40	**$12,000**
Client orders pending	in that stock	**None**
Compliance approval	asked before trading	**Given**
Verdict	VI(B)	**No breach**

IN THE LESSON

- Case five shows that personal investing is allowed.
- Lucia Ferreira is a portfolio manager.
- She wants three hundred shares of a retailer at forty dollars, twelve thousand in all.
- Her firm has no client order pending in that stock, it is not on a restricted list, and no rating change is planned.
- She asks compliance first.
- Compliance approves, she trades, and a duplicate confirmation goes to compliance.
- Is there a breach?
- No.
- Clients and the employer were not disadvantaged.
- Their transactions were not delayed or made worse, and the trade went through the proper process.
- Standard six B governs the order and the harm.
- It does not ban owning shares.

11 Standard VI(C): Referral Fees

- Disclose benefits paid or received for a referral
- Tell the employer, clients and prospective clients
- Before any formal agreement, with nature and value
- Applies even when the client pays nothing extra

IN THE LESSON

- Now part C.
- Think of a plumber who sends you to a tile shop and never mentions the shop pays him for every customer.
- His advice might be sound, but you would weigh it differently if you knew.
- Standard six C asks you to disclose to your employer, clients and prospective clients any compensation or benefit you receive from, or pay to, others for recommending your services or theirs.
- That covers payments in both directions.
- The disclosure must come before any formal agreement, and must give the nature of the benefit and its estimated value.
- The Standard does not ban referral fees.
- It bans keeping them secret, even when the client pays nothing extra.

12 Case 6: told after the client signed

Marta refers Sean to an estate lawyer

Lawyer's first-year fee	paid by Sean	**$4,000**
Marta's referral fee	15% × 4,000	**$600**
Told to Sean	after he signed	**Too late**
Verdict	VI(C)	**Breach**

IN THE LESSON

- Case six.
- Marta Oyelaran is an adviser.
- She refers her client Sean to an estate lawyer, who pays her fifteen per cent of the lawyer's first year fee.
- That fee is four thousand dollars, so Marta will receive six hundred.
- Sean signs the engagement letter with the lawyer on Monday.
- Marta tells him about the payment the following week, saying she did not want to complicate his decision.
- Is that acceptable?
- No.
- Standard six C requires disclosure before the formal agreement, so Sean could weigh her recommendation knowing what was in it for her.
- Telling him afterwards comes too late.
- The action is to disclose first, with the nature and estimated value.

13 Where the first-year fee goes in case seven

Dollars in year one

First-year fee	**13,500**
Firm keeps	**12,150**
Referral fee	**1,350**

Client pays 13,500 whether or not the referral is paid

IN THE LESSON

- Before case seven, look at the picture.
- Ravenscar Advisers takes on a client who invests one million five hundred thousand dollars.
- The firm charges zero point nine per cent a year, so the first bar is the first year fee, thirteen thousand five hundred dollars.
- The firm pays an accountant who introduced the client ten per cent of that first year fee.
- That is the third bar, one thousand three hundred and fifty.
- The middle bar is what the firm keeps, twelve thousand one hundred and fifty.
- The client pays the same thirteen thousand five hundred either way.
- The referral costs the client nothing extra, yet the payment still shapes the introduction, so it must still be disclosed.

14 Case 7: the referral that is handled well

Tariq discloses the accountant's payment to Mia

Mia's first-year fee	1,500,000 × 0.90%	**$13,500**
Accountant's referral fee	10% × 13,500	**$1,350**
Told to Mia	before she signs	**In time**
Verdict	VI(C)	**No breach**

IN THE LESSON

- Case seven.
- Tariq Aziz is an adviser at Ravenscar.
- His employer approved in writing the arrangement to pay the accountant ten per cent of the first year fee.
- Before the client, Mia, signs anything, Tariq gives her a short plain statement.
- It says the accountant will be paid about one thousand three hundred and fifty dollars, which is ten per cent of her first year fee.
- It also says she pays nothing extra.
- Is there a breach?
- No.
- The disclosure came before the formal agreement, and it stated the nature of the payment and its estimated value.
- Employer approval and plain wording make this the model answer.

15 Cases one to four at a glance

Issue and verdict, cases 1 to 4

Case	Verdict
1 Generic footnote, last page	Breach
2 Bank tie, plain on page one	No breach
3 Father's account held back	Breach
4 Joint account, ahead of clients	Breach

IN THE LESSON

- Let's collect the first four cases in one table.
- Case one, the generic footnote on the last page, is a breach of part A, because the disclosure was neither specific nor prominent.
- Case two, the bond issue disclosed in a plain box on page one, is no breach.
- Part A allows a conflict to be kept if it is disclosed well.
- Case three, the father's account left out, is a breach of part B, even though the motive was good.
- Equal treatment means neither favouring nor holding back.
- Case four, the joint account bought ahead of the firm's recommendation, is a breach, because personal trades include accounts where you have a beneficial interest.

16 Cases five to seven at a glance

Issue and verdict, cases 5 to 7

Case	Verdict
5 Precleared, after clients	No breach
6 Referral told after signing	Breach
7 Told before signing	No breach

IN THE LESSON

- And the last three.
- Case five, the precleared purchase after the clients were looked after, is no breach.
- Personal investing is allowed when clients and the employer are not disadvantaged.
- Case six, the referral fee disclosed to Sean after he signed, is a breach of part C, because the timing was wrong.
- Case seven, the referral fee disclosed to Mia before she signed, with nature and estimated value, is no breach, even though she paid nothing extra.
- Notice the pattern across all seven.
- The answer almost always turns on one of three questions.
- Was the disclosure specific and prominent, did the client or employer come first, and did the disclosure come early enough?

17 Five traps in Standard VI

- Footnote boilerplate is not disclosure
- Avoidance is preferred, yet disclosure is allowed
- Family and shared accounts count as personal
- Holding a family client account back is a breach
- Referral fees: tell before, even if no extra cost

IN THE LESSON

- Let's pause on the traps.
- One.
- Footnote boilerplate is not disclosure.
- If it is generic or buried, it counts as no disclosure at all.
- Two.
- Avoidance is preferred, but it is not always required.
- Disclosure is a permitted route when it is done well.
- Three.
- Family and shared accounts count as personal transactions, so they rank behind clients.
- Four.
- The mirror image of that rule.
- Holding a fee paying family client account back is also a breach, even when well meant.
- Five.
- Referral fees must be disclosed before the agreement, even when the client pays nothing extra.
- Those are the five traps.

18 Prevention beats a report afterwards

- Firm and member both have practices to use
- Best controls act before the trade is made
- Firm: trading policy and referral approval
- Member: specific, prominent disclosure in each report
- Trap: preferring the report after the event

IN THE LESSON

- Now the second outcome, practices and procedures that stop breaches before they occur.
- Think of a smoke alarm and a fire report.
- A report that arrives the next morning tells you what burned.
- An alarm gives you a chance to act while the fire is still small.
- Compliance works the same way.
- Good firms write a policy so that a conflict is caught before the trade is made, not recorded after it.
- Some of the practices belong to the firm, such as a personal trading policy and referral approval.
- Others belong to the member, such as the way an analyst discloses holdings in each report.
- The trap in this topic is preferring the after the fact report.

19 Preclearance, step by step

A personal trade

Request before trading → Compliance checks → Approve or refuse → Duplicate confirmation

IN THE LESSON

- Here is the control at the heart of a personal trading policy.
- Follow the boxes in order.
- The employee sends a request, before any trade is placed.
- Compliance then runs its checks.
- It looks at client orders in progress, at rating changes about to go out, and at the restricted and watch lists, none of which the employee may know about.
- Compliance decides to approve or to refuse.
- A sensible approval is valid only for a short window, so it cannot be saved up for later.
- Last, a duplicate confirmation of the trade goes to compliance, to verify that the employee traded what was approved.
- That last box is a check on the control.
- The control itself is the second and third boxes.

20 A personal trading policy, part by part

Four core controls, and the job each does

Control	Job
Preclearance	Asks first
Blackout periods	Blocks trades
Duplicate confirms	Checks after
Holdings reports	Show positions

IN THE LESSON

- A written policy has several parts, and you should be able to name each and say what it does.
- Preclearance asks compliance before the trade.
- Blackout periods block personal trades around client orders and rating changes, so an employee cannot trade just ahead of the clients or just ahead of a research view.
- Duplicate confirmations send copies of trade records to compliance, which checks afterwards that the rules were followed.
- Holdings reports, given at hiring and periodically after, show what employees already own.
- Two more parts: limits on initial public offerings and private placements, with any permitted participation precleared, which case nine will show, and disclosure of the policy to clients on request.

21 Case 8: counting the blackout

Hallam blocks personal trades for 3 business days

Client fund trade	in the same stock	**Thursday**
Gareth asks on	day 2 of the blackout	**Monday**
Decision	inside the window	**Refused**
Earliest approval	business day 4	**Wednesday**

IN THE LESSON

- Case eight shows a blackout working.
- Gareth Moyo is a portfolio manager at Hallam Funds.
- Hallam's policy blocks personal trades for three business days after a client trade in the same stock.
- Hallam's client fund bought the stock on Thursday.
- On Monday, Gareth asks compliance to approve a personal purchase.
- Count the days.
- Friday is day one, and Monday is day two.
- He is still inside the window of three days, so the request is refused, and the conflict is stopped before the trade.
- The earliest approval is Wednesday, the fourth business day.
- A holdings report that merely noted his trade later would have documented the conflict rather than prevented it.

22 Case 9: the private placement

Anita asks to join a private placement

Her subscription	2,000 × $12.50	**$25,000**
Client fund interest	same company	**Yes**
Policy	limit and preclear	**Applies**
Result	stopped before subscribing	**Refused**

IN THE LESSON

- Case nine is about limits on new issues.
- Anita Rossi is an analyst at Vale Capital.
- She wants to subscribe to two thousand shares in a private placement at twelve fifty each, twenty five thousand dollars.
- One of the firm's client funds is also looking at that company.
- Private placements and oversubscribed offerings are scarce, so an employee's allocation may be taken from clients.
- The firm's policy limits staff participation, and requires any permitted purchase to be precleared.
- Compliance sees the fund's interest, and refuses.
- The control worked because Anita had to ask before she subscribed, and the answer arrived while clients' interests could still be protected.

23 Disclosure practices for analysts

- State holdings, directorships and banking ties
- Specific: name the stake and the board seat
- Prominent: near the front, not the last page
- Repeat it in each report
- Make the firm's policy available to clients on request

IN THE LESSON

- Turn to what an analyst can do personally.
- In every report, the analyst should give specific, prominent statements of the things a reader would want to know.
- Holdings: say what you own and roughly how much.
- Directorships: say if you or a family member sit on the board of a company you cover.
- Banking relationships: say if your firm earns fees from the company.
- Specific means naming the stake and the board seat, not a generic sentence.
- Prominent means near the front of the report, not in the final footnote.
- And the habit must be repeated in each report, not just the first.
- The firm's trading policy should also be made available to clients on request.

24 Tomasz rewrites his Quillon disclosure

From a generic footnote to a usable disclosure

Name the holding	1,500 shares, 15% of portfolio	**Specific**
Place it	box on page one	**Prominent**
Word it	plain sentences, no jargon	**Plain**
Repeat it	every report, updated	**Each time**
Result	reader can judge the rating	**Passes**

IN THE LESSON

- Let's repair case one.
- Tomasz Berg takes the generic footnote and rewrites it.
- First, the holding.
- He names it, one thousand five hundred Quillon shares, about fifteen per cent of his portfolio.
- Second, the placement.
- He puts it in a box on page one, where the reader sees it before the rating.
- Third, the wording.
- He writes in plain sentences, with no jargon.
- Fourth, the habit.
- He repeats it in every report on Quillon, and updates it whenever his holding changes.
- Now a client can judge his buy rating knowing exactly what he owns.
- This rewrite uses the member's own practice, and it needs no rule change at all.

25 Referral arrangements under control

Referral arrangements

Employer approves in advance → Client told before signing → Fees reported every quarter

IN THE LESSON

- Referrals need their own controls, and the employer has the key role.
- Follow the boxes.
- First, the employer approves each arrangement in advance, so nothing starts without a manager knowing.
- Second, the member tells the client before the client signs, with the nature of the benefit and its estimated value.
- Third, the employer receives updates at least every quarter, showing the fees paid and the fees received.
- That final box gives the employer a way to see whether the arrangement has grown, or whether a payment has been made without disclosure.
- Compare case seven with case six.
- The difference was approval and early disclosure, and the quarterly report gives the employer a way to check both.

26 From preventing a breach to only recording it

- Preclearance
- Blackout periods
- Duplicate confirmations
- Quarterly holdings report
- Annual list

IN THE LESSON

- This picture ranks controls by timing.
- The line runs from controls that prevent a breach on the left, in green, to ones that only record it on the right, in red.
- Start at the left end.
- Preclearance stops a trade before it is made, which is why it is the strongest.
- Next, blackout periods block trades in a window around client orders and rating changes.
- Moving right, duplicate confirmations show compliance what was done, after the trade.
- Further right, quarterly holdings reports show positions weeks later.
- At the far end, an annual list tells the firm about a breach long after the harm has happened.
- When asked for the best control, choose the one furthest to the left.

27 Case 10: the report that arrived too late

Marlow's policy only asks for a quarterly report

Sale by the analyst	day before a downgrade	**14 Feb**
Report due, 30 days after quarter	end of March + 30	**30 Apr**
Days from sale to report	14 Feb to 30 Apr	**75 days**
Best fix	preclear, with blackout	**Prevent**

IN THE LESSON

- Case ten is the trap in action.
- Viktor Lund is head of research at Marlow Securities.
- Marlow's policy asks analysts only to file a holdings report within thirty days of each quarter end.
- An analyst sold her holding on the fourteenth of February, the day before she downgraded the stock.
- Compliance learned of it on the thirtieth of April, when her report arrived.
- That is seventy five days after the sale.
- Viktor is asked whether tighter reporting, perhaps monthly, would fix this.
- It would not, because any report is after the fact.
- The best change is preclearance, with a blackout around rating changes, which would have refused the sale before it happened.

28 Recap: Standard VI in one board

Rule and practice, one line each

Avoid, or disclose plainly	**VI(A)**
Clients, employer, then you	VI(B)
Referral fees: tell first	VI(C)
Preclear and blackout	Prevent
Approve referrals, report	Quarterly

IN THE LESSON

- Time to pull it together.
- For the rules, part A: avoid a conflict where reasonably possible, otherwise disclose it specifically, prominently and in plain language.
- Part B: clients first, employer second, you last, with family and beneficial interest accounts counted as your own, and fee paying family accounts treated equally.
- Part C: disclose referral fees before the agreement, with nature and estimated value, even when the client pays nothing more.
- For the practices: use preclearance, blackouts, duplicate confirmations, holdings reports, limits on new issues, disclosure in every report, and employer approval with quarterly updates of referrals.
- Choose the control that acts before the trade.

29 Try three quick questions

1. Analyst owns the stock; generic last-page note. Enough?
   Answer: No: specific and prominent
2. Referral fee disclosed after client signs, no extra cost?
   Answer: No: before, with nature and value
3. Quarterly holdings report or preclearance, to stop trades?
   Answer: Preclearance: before the trade

IN THE LESSON

- Now try three questions.
- Pause after each one.
- Question one.
- An analyst owns shares in a company she covers, and the report has a generic note on the last page saying analysts may hold positions.
- Is that enough?
- No.
- Disclosure must be specific and prominent.
- Question two.
- An adviser tells a client about a referral payment the day after the client signs, and says it costs the client nothing extra.
- Acceptable?
- No.
- It must be disclosed before the formal agreement, even when there is no extra cost.
- Question three.
- To stop trading ahead of rating changes, is a quarterly holdings report better than preclearance?
- No.
- Preclearance catches the conflict before the trade, and a report only records it afterwards.