# Integrity of markets and duties to clients

Ethical and Professional Standards

## 1 A story: the overheard conversation

- Inside facts often arrive through the job itself
- II(A): do not act on material nonpublic information
- II(B): do not trade or talk to mislead the market
- The facts and the intent decide each case

IN THE LESSON

- Imagine you are sitting in a cafe, and at the next table two bankers are talking.
- One of them says that a listed company will announce a sale of new shares on Thursday, at a price well below today's.
- You did not ask to hear this.
- The fact simply landed in your lap.
- Can you sell your shares in that company before Thursday?
- Standard two says no, if the fact is important and not yet public.
- It also says something second: you must not fake the signals the market relies on.
- A portfolio manager hears inside facts more often than most people, so the Standard asks two things.
- Do not act on facts the market lacks, and do not trade to mislead.

## 2 Standard II on one page

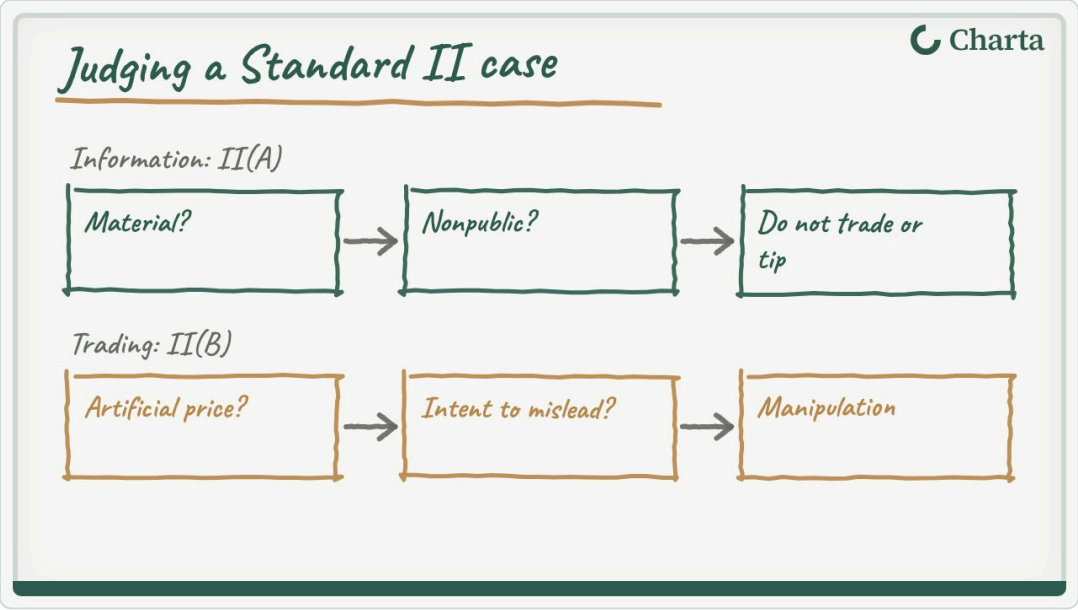
*Larkspur Asset Management: what the Standard asks, and what a breach looks like*

| **II(A) requires** | **no acting on inside facts** |
|---|---|
| II(A) breach | trading after a wall-crossing |
| II(B) requires | no distorting prices or volume |
| II(B) breach | buying at quarter-end to lift value |
| The test for II(B) | intent to mislead |

IN THE LESSON

- Here is the Standard on one page.
- Subsection A is about information.
- Material means a reasonable investor would want to know it, or it would be likely to move the price.
- Nonpublic means it has not been made available to the market.
- If a manager holds a fact that is both, she must not trade on it and must not cause anyone else to trade on it, which includes tipping a friend.
- Subsection B is about trading and talking.
- Nobody may distort prices or trading volume with the aim of misleading others.
- A breach of the first looks like trading after a wall crossing.
- A breach of the second looks like buying at the quarter end to lift a valuation.
- For subsection B the test is intent to mislead.

## 3 Judging a Standard II case




IN THE LESSON

- When a case lands in front of you, walk it through two short chains.
- The top chain is for information.
- First ask whether the fact is material.
- Would a reasonable investor want it, or would it move the price?
- Then ask whether it is nonpublic.
- Has the market really been told?
- If the answer to both is yes, you do not trade, you do not tip, and you do not cause anyone else to trade, until the fact is out.
- The bottom chain is for trading.
- Does the trade or the claim push a price or a volume to an artificial level?
- And was it done with the intent to mislead?
- If so, it is manipulation.
- Notice that an honest trade can move a price too.
- Intent is what separates the two.

## 4 Example 1: the placement call

*Halden Foods 50.00; placement at an 8% discount; fund holds 100,000 shares*

| | | |
|---|---|---|
| **Placement price** | 50.00 × (1 − 8%) | **46.00** |
| **Fall to the placement price** | 50.00 − 46.00 | **4.00** |
| **Loss avoided by selling now** | 100,000 × 4.00 | **400,000** |
| **Dev's planned buy of 20,000** | 20,000 × 4.00 at stake | **80,000** |
| **Verdict** | wait for the announcement | **Do not trade** |

IN THE LESSON

- Let us try it.
- On a Tuesday, Tessa Marlow of Larkspur takes a call from an investment bank.
- After she agrees to keep it confidential, the banker says that Halden Foods plans to sell new shares at a discount of eight per cent to the market price of fifty, to be announced on Thursday.
- That puts the placement price at forty six, a fall of four.
- Larkspur's fund holds one hundred thousand shares, so selling now would dodge a loss of four hundred thousand.
- On Wednesday, Dev Anand, a junior manager, plans to buy twenty thousand shares for a charity.
- Buying just before the fall would cost it eighty thousand.
- Tessa knows the placement is material and nonpublic.
- She may not sell, and she may not let Dev trade on her knowledge.
- She waits until the announcement.

## 5 Mosaic theory: public pieces, one conclusion

*Tarn Freight: what went into the analyst's sell note*

| Published accounts | public |
|---|---|
| Port traffic statistics | public |
| Photos of depots from a public road | public, nonmaterial |
| Finance director's off-record remark | material, nonpublic |
| Sell note built on the first three | mosaic: allowed |

IN THE LESSON

- Not every sharp conclusion is inside information.
- Larkspur's analyst, Ravi Sandhu, is studying Tarn Freight, a listed haulier.
- He reads the published accounts, the port traffic statistics, and he even photographs depots from a public road.
- None of that is nonpublic, and none of the small scraps is material on its own.
- Building a view from pieces like that is the mosaic theory, and it is protected.
- Compare that with an off the record remark from the finance director at a lunch, saying a profit warning is coming.
- That one fact is material and nonpublic.
- If Ravi writes his sell note on the first three pieces, it is a mosaic.
- If the remark is part of the reason, it is not, and saying it only confirmed what he already thought does not clean it.

## 6 Example 2: the quarter-end close

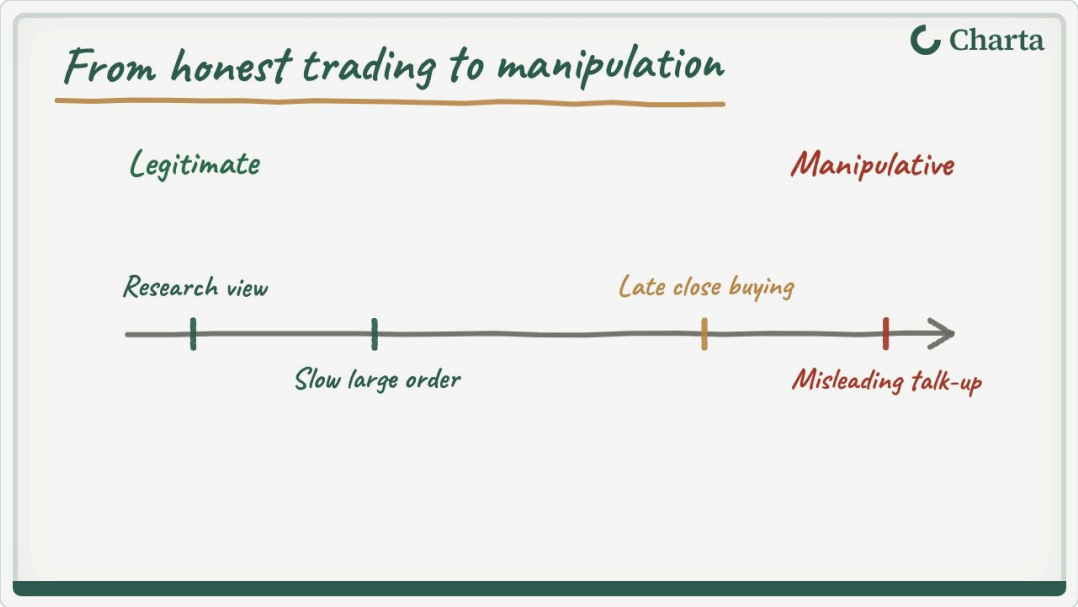
*Quillon, thin stock; fund 40m; holds 400,000; buys 5,000 in last 10 min*

| | | |
|---|---|---|
| **Normal close** | 400,000 × 10.00 | **4,000,000** |
| **Pushed close** | 400,000 × 10.40 | **4,160,000** |
| **Valuation uplift** | 4,160,000 − 4,000,000 | **160,000** |
| **Lift to a 40m fund** | 160,000 ÷ 40,000,000 | **0.40%** |
| **Buying as share of day's volume** | 5,000 ÷ 20,000 | **25%** |

IN THE LESSON

- Now the second subsection.
- Larkspur's mid cap fund holds four hundred thousand shares of Quillon Bearings, a thinly traded stock priced at ten.
- On the last day of the quarter, a trader suggests buying five thousand shares in the final ten minutes.
- Because so few shares change hands, the closing price would jump to ten forty.
- The holding is then valued at four million one hundred sixty thousand, instead of four million.
- That is an uplift of one hundred sixty thousand, which adds point four per cent to the return of a forty million fund.
- The trader would have bought, not because the stock is cheap, but to flatter the quarter's figures.
- That is manipulation under subsection B, because the purpose is to mislead everyone who reads the valuation.

## 7 From honest trading to manipulation




IN THE LESSON

- Here is the idea on one line.
- On the left is legitimate trading, and on the right is manipulation.
- Near the left end is a trade made because the manager has a genuine research view.
- Next to it is working a large order slowly across several days, so the order does not shove the price around.
- That does move the price, but its purpose is to limit the effect, not to deceive anyone, so it is fine.
- Moving right, we find buying late in the day to lift a period end valuation, which we just saw.
- At the far right sits talking up a holding with misleading claims, so that others buy and push the price.
- Remember the test the exam uses.
- A price move alone proves nothing.
- What decides the case is whether there was intent to mislead.

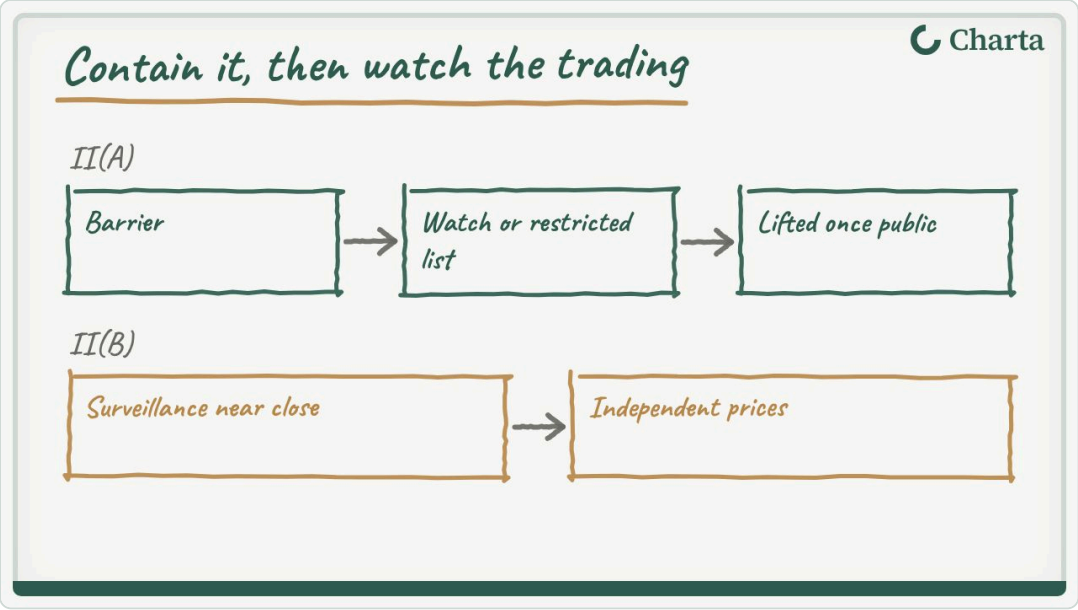
## 8 A story: the fire doors

- Do not rely on restraint: build the doors
- Contain the information the moment it arrives
- Watch the trading, especially near the close
- Take pricing out of the manager's hands

IN THE LESSON

- Think of the fire doors in an office building.
- Nobody relies on every worker being brave and clear headed in a fire.
- The doors close by themselves, and the building stays safe whatever people do.
- Good compliance procedures work the same way.
- A firm managing money will sooner or later hold inside information, and at some quarter end it will be tempted to flatter a valuation.
- If the system depends on each person's restraint, it will fail one day.
- So the firm builds the doors.
- The information is contained from the moment it arrives, the trading is watched, and the manager does not set the prices her own holdings are valued at.

## 9 Contain it, then watch the trading




IN THE LESSON

- Follow the top row first, from left to right.
- These are the controls for subsection A.
- The first box is the information barrier.
- It separates the people who hold the information from the people who trade, with separate offices and systems, and any contact across it is cleared by compliance and recorded.
- Once the firm is over the wall on an issuer, the name goes onto a watch list or a restricted list.
- The third box says the restriction is lifted when the information is public.
- The bottom row is for subsection B.
- Surveillance flags clusters of orders near the close, above all at period ends.
- And holdings are priced by an independent source, so a manager has neither the means nor the motive to mark her own book.

## 10 What Larkspur should put in place

*Standard II: control and the risk it closes*

| II(A) information barrier | compliance clears contact |
|---|---|
| II(A) watch or restricted list | added once over the wall |
| II(A) staff and firm trading | closer review or restricted |
| II(A) expert network calls | screened by compliance |
| II(B) close and valuation | surveillance, independent price |

IN THE LESSON

- Here is the same thing as a checklist, with each control tied to the risk it closes.
- The information barrier closes the risk that a fact held in one team reaches a trader, and compliance clears any contact across it.
- The watch list or restricted list closes the risk that someone trades the name once the firm is over the wall.
- Staff and firm trading in that name gets closer review, or is restricted.
- Calls with expert networks are screened by compliance, because an expert may let slip something confidential.
- For subsection B, surveillance of orders near the close, and prices from an independent source, close the risk of flattering a quarter end.
- A control with no risk attached to it is only paperwork.

## 11 Example 3: matching controls to risks

*Larkspur's credit team joins a lender committee at Harrow Steel*

| | | |
|---|---|---|
| **Lender committee seat** | barrier around credit team | **II(A)** |
| **Harrow Steel shares** | restricted, all accounts | **II(A)** |
| **Expert network call** | screened by compliance | **II(A)** |
| **Orders near quarter-end** | surveillance flag | **II(B)** |
| **Thin holdings' prices** | independent source | **II(B)** |

IN THE LESSON

- Let us propose controls for a real looking case.
- Larkspur's private credit team has taken a seat on a lender committee at Harrow Steel, and its equity team holds Harrow's shares.
- The equity team also uses an expert network, and the mid cap fund holds thin stocks.
- Compliance matches each risk to a control.
- The committee seat gets a barrier around the credit team.
- Harrow's name goes onto a restricted list covering all accounts, because Larkspur is one small office and the weekly investment meeting is attended by both teams, so the information could travel.
- Expert calls are screened.
- Orders near the quarter end are flagged.
- Thin holdings are priced by an independent source.
- Each control has a risk behind it.

## 12 Example 4: what surveillance flags

*Quillon Bearings at quarter-end; the flag level is an example set by Larkspur*

| | | |
|---|---|---|
| **Day's volume in Quillon** | | **20,000** |
| **Fund's buying, last ten minutes** | | **5,000** |
| **Share of day's volume** | 5,000 ÷ 20,000 | **25%** |
| **Larkspur's flag level** | last ten minutes, period-end | **10%** |
| **Result** | 25% is over 10% | **Flagged** |

IN THE LESSON

- To see how a surveillance rule works, return to Quillon Bearings at the quarter end.
- The day's total volume in the stock is twenty thousand shares.
- The fund's buying in the last ten minutes is five thousand shares, which is twenty five per cent of the day's volume.
- Suppose Larkspur's rule, an example set by the firm, flags any order in the last ten minutes of a period end day that is above ten per cent of the day's volume.
- Twenty five is over ten, so the order is flagged, and compliance asks the trader for the reason before the close is accepted.
- A much smaller purchase, under the flag level, would pass quietly.
- The rule does not ban buying.
- It makes sure someone asks why.

## 13 Watch list or restricted list?

*The reach depends on how far the information could travel*

| **Strong barrier, team isolated** | **watch list may be enough** |
|---|---|
| Information could reach traders | restricted list, all accounts |
| Staff brought over the wall | restricted until public |
| Personal and firm trades | closer review or restricted |

IN THE LESSON

- One question the exam likes is how far a restriction should reach.
- The answer is that it depends on how far the information could travel inside the firm.
- If the barrier is strong and the team that holds the information is truly isolated, a watch list may be enough.
- The name is monitored quietly and trading is reviewed.
- If the information could reach the traders, for example in a small office with shared meetings, the name goes on a restricted list covering every account, including staff and the firm's own trading.
- Staff who have been brought over the wall stay restricted until the information is public.
- And personal and proprietary trades in the name get closer review, or are restricted.

## 14 Mistakes to avoid on Standard II

- Thinking an unasked-for tip is safe to use
- Letting a colleague trade after a wall-crossing
- Calling a view a mosaic when one inside fact is in it
- Judging manipulation by price move, not by intent
- Letting managers mark their own thin holdings

**IN THE LESSON**

- Let us gather the common mistakes from Standard two.
- One: thinking a tip is safe to use because you never asked for it.
- How it arrived does not matter.
- Two: trading, or letting a colleague trade, after a wall crossing, on the grounds that the colleague did not know.
- Three: calling a conclusion a mosaic when one inside fact is part of the reason for it.
- Four: judging manipulation by the size of the price move, instead of by the intent behind the trade.
- Five: letting the manager mark her own thinly traded holdings, with no independent price.
- Keep these five in mind, because the exam builds its wrong answers from them.

## 15 A story: the trustee's promise

- Clients cannot watch what we do, so duties protect them
- III(A) loyalty, prudence and care; III(B) fair dealing
- III(C) suitability; III(D) performance presentation
- III(E) preservation of confidentiality

**IN THE LESSON**

- Imagine a neighbour asks you to look after her savings while she travels.
- She cannot watch what you do, and she cannot check the prices.
- All she has is trust.
- Now a chance appears that would pay you well and cost her a little.
- What do you do?
- That small moment is what Standard three is about.
- Clients rarely see what is done for them, so five duties protect them.
- Subsection A is loyalty, prudence and care.
- B is fair dealing.
- C is suitability.
- D is performance presentation.
- And E is confidentiality.
- Today we apply each one to a short Larkspur case, then see what a firm should put in place.

## 16 Standard III on one page

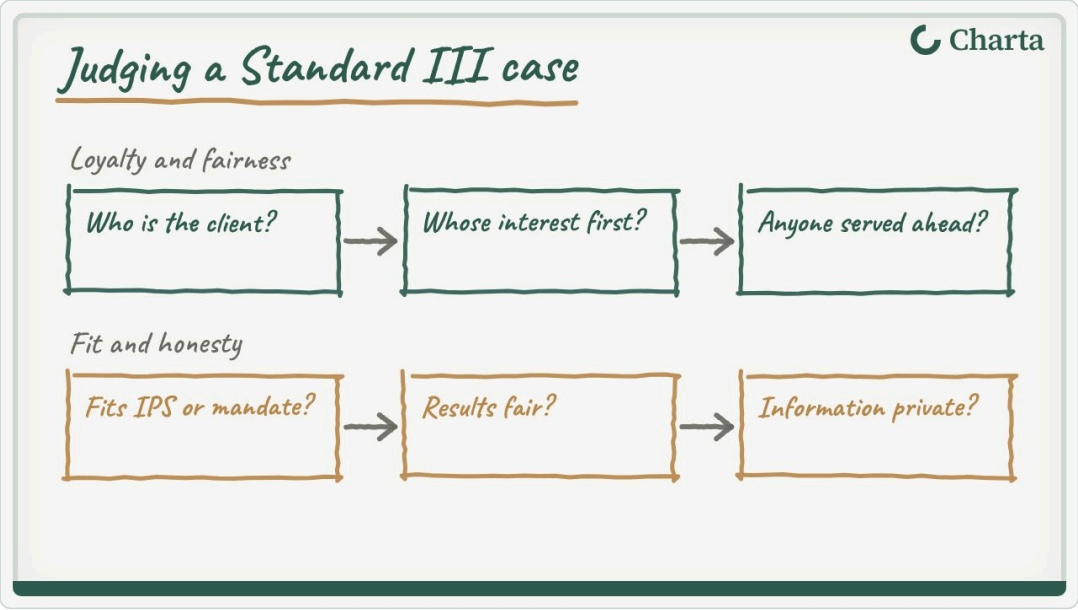
*Each duty, and what a breach looks like at Larkspur*

| | |
|---|---|
| **III(A) Loyalty, prudence, care** | **sponsor's wish put first** |
| III(B) Fair dealing | split decided after results |
| III(C) Suitability | outside the IPS or mandate |
| III(D) Performance presentation | best accounts shown as typical |
| III(E) Confidentiality | client details passed on |

**IN THE LESSON**

- Here are the five duties, with the kind of breach each one catches at Larkspur.
- Loyalty, prudence and care means the client comes first, so a breach is putting a sponsor's wish ahead of the people the money is for.
- Fair dealing means treating clients fairly, so a breach is an allocation decided after the results are known.
- Suitability means judging a position against the client's written policy and the whole portfolio, so a breach is a holding outside the policy or the mandate.
- Performance presentation means results are fair and complete, so a breach is showing the best accounts as typical.
- Confidentiality means client information is protected, so a breach is passing a client's details on.

## 17 Judging a Standard III case




IN THE LESSON

- A short routine helps with any Standard three case.
- The top row is about loyalty and fairness.
- First, who is the client?
- For a pension plan it is the beneficiaries, not the people who hired you.
- Second, whose interest is being put first?
- Third, is any client being served ahead of another, on price, on information or on allocation?
- The bottom row is about fit and honesty.
- Does the position suit the client's written policy, or the stated mandate of a pooled fund?
- Are results being shown fairly and completely?
- And is client information being kept private?
- Often a case touches two duties.
- Choose the one the facts point at most directly.

## 18 Case: the sponsor's request

- Brindle's chairman asks the plan to buy Brindle shares
- The client is the plan's members, not the sponsor's officers
- Prudence: the plan would lean even harder on Brindle
- Decline, explain and keep a record of the request

IN THE LESSON

- Our first case is about loyalty.
- Brindle Engineering sponsors a pension plan that Larkspur manages.
- Brindle's chairman telephones Tessa Marlow and asks her to buy more of Brindle's own shares for the plan, to support the share price.
- Who is the client?
- It is not the chairman, and it is not Brindle's management.
- The client is the plan, which means its members and beneficiaries.
- Buying more of the sponsor would help the sponsor's officers, but it would tie the plan even more closely to the same company that stands behind its pensions, which is hardly prudent.
- So Tessa declines, explains why, and records the request.
- Loyalty runs to the people the money is for.

## 19 Example 5: soft dollars and loyalty

*Brindle plan: soft-dollar credits earned through its commissions*

| | | |
|---|---|---|
| **Credits from the plan's trades** | | **40,000** |
| **Research for plan decisions** | 28,000 ÷ 40,000 | **70%** |
| **Spent on office software** | 12,000 ÷ 40,000 | **30%** |
| **Software spending** | firm's benefit, not client's | **Breach** |
| **Client-directed broker** | honour, warn about cost | **Warn** |

**IN THE LESSON**

- Commissions belong to the client, so they must be used for the client.
- Brindle's plan generates soft dollar credits of forty thousand through the commissions on its trades.
- Larkspur spends twenty eight thousand on research that helps decisions for the plan, which is seventy per cent.
- It spends twelve thousand on office accounting software, thirty per cent.
- Research that helps the client's decisions can be fine.
- Software that only benefits the firm cannot, because it spends the client's money for the firm's own benefit.
- There is also directed brokerage.
- If the plan tells Larkspur which broker to use, Larkspur honours it, but warns the client that the choice may cost it best execution.
- The trap is thinking that the client's instruction removes any need for that warning.

## 20 Example 6: sharing a block order

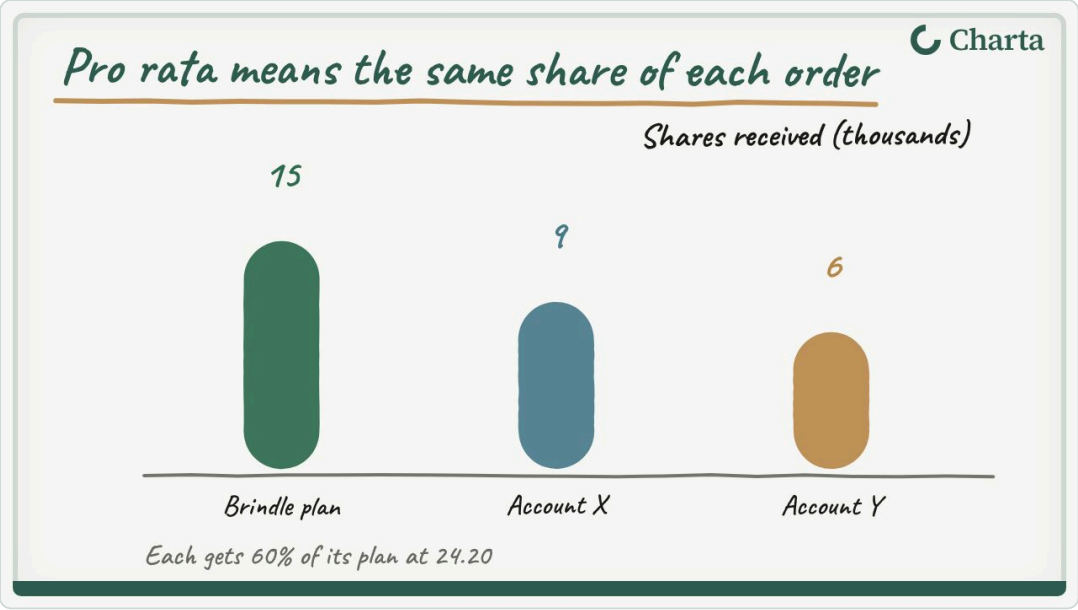
*Pellam Brewing: 50,000 ordered; fills of 10,000 each at 24.00, 24.20, 24.40*

| | | |
|---|---|---|
| **Fill rate** | 30,000 ÷ 50,000 | **60%** |
| **Brindle plan** | 60% × 25,000 | **15,000** |
| **Account X** | 60% × 15,000 | **9,000** |
| **Account Y** | 60% × 10,000 | **6,000** |
| **Average price for all** | 726,000 ÷ 30,000 | **24.20** |

**IN THE LESSON**

- Now fair dealing.
- Tessa places a block order for fifty thousand shares of Pellam Brewing and records the plan before sending it: twenty five thousand for the Brindle plan, fifteen thousand for account X, and ten thousand for account Y.
- Only thirty thousand shares are filled, ten thousand each at twenty four, twenty four twenty and twenty four forty.
- That is sixty per cent of the order.
- Each account receives sixty per cent of what was planned: fifteen thousand, nine thousand and six thousand.
- All pay the average price, twenty four twenty.
- Giving the best fills to the largest client, or deciding the split once the day's prices were known, would favour one account over others in the same situation.
- That is a breach, even if nobody can see it.

## 21 Pro rata means the same share of each order




IN THE LESSON

- Here are those allocations as bars.
- The vertical axis is shares received, in thousands.
- The first bar is the Brindle plan, which received fifteen.
- The second is account X, nine.
- The third is account Y, six.
- The largest client still gets the most shares, because it asked for the most.
- But each account received exactly sixty per cent of what the recorded plan promised it, and each paid the same average price of twenty four twenty.
- Fair dealing does not mean equal shares for everybody.
- It means the same rule for everyone in the same position, fixed before the result is known.
- That is why the bars shrink together and in proportion, not one at a time.

## 22 Example 7: the mandate drifts

*Mid-cap fund, 50m; stated mandate: market value of 2bn to 10bn*

| | | |
|---|---|---|
| **Stated mandate** | mid-cap, 2bn to 10bn | **Mid-cap** |
| **Nettle Bio's market value** | below the 2bn floor | **0.8bn** |
| **Weight bought** | | **12%** |
| **Position size** | 12% × 50m | **6.0m** |
| **Verdict** | outside the stated mandate | **Style drift** |

IN THE LESSON

- Now suitability.
- Larkspur's mid cap fund tells investors that it holds mid sized companies, with a market value of two billion to ten billion.
- It has fifty million in assets.
- Tessa finds a small company, Nettle Bio, with a market value of only point eight billion, and believes in it.
- She buys twelve per cent of the fund, which is six million.
- Her research may be sound, but the position is outside the stated mandate, and investors in a pooled fund rely on that description.
- Drifting away from it is a breach of duty C.
- For a separate account, the same test uses the client's investment policy statement and the whole portfolio.
- The trap is thinking a good investment is automatically a suitable one.

## 23 Example 8: results and secrets

*Five similar accounts; returns 14%, 12%, 10%, 6%, 3%*

| | | |
|---|---|---|
| **All five accounts, average** | (14+12+10+6+3) ÷ 5 | **9%** |
| **Best two accounts, average** | (14 + 12) ÷ 2 | **13%** |
| **Brochure calls this typical** | the best two | **13%** |
| **Overstatement** | 13 − 9 | **4 points** |
| **Client information** | private, exceptions limited | **III(E)** |

IN THE LESSON

- The last two duties are quicker.
- For performance presentation, Larkspur manages five similar accounts, with returns of fourteen, twelve, ten, six and three per cent.
- The average of all five is nine per cent.
- The best two average thirteen.
- A brochure that calls thirteen the typical return overstates it by four points, even though every account shown really earned its figure.
- Selected results presented as typical are a breach of duty D.
- For confidentiality, duty E, information about current, former and prospective clients stays private.
- The exceptions are where the law requires disclosure, where the client permits it, or where it concerns illegal activity.
- So passing a client's details to a friend is a breach, even after the client has left.

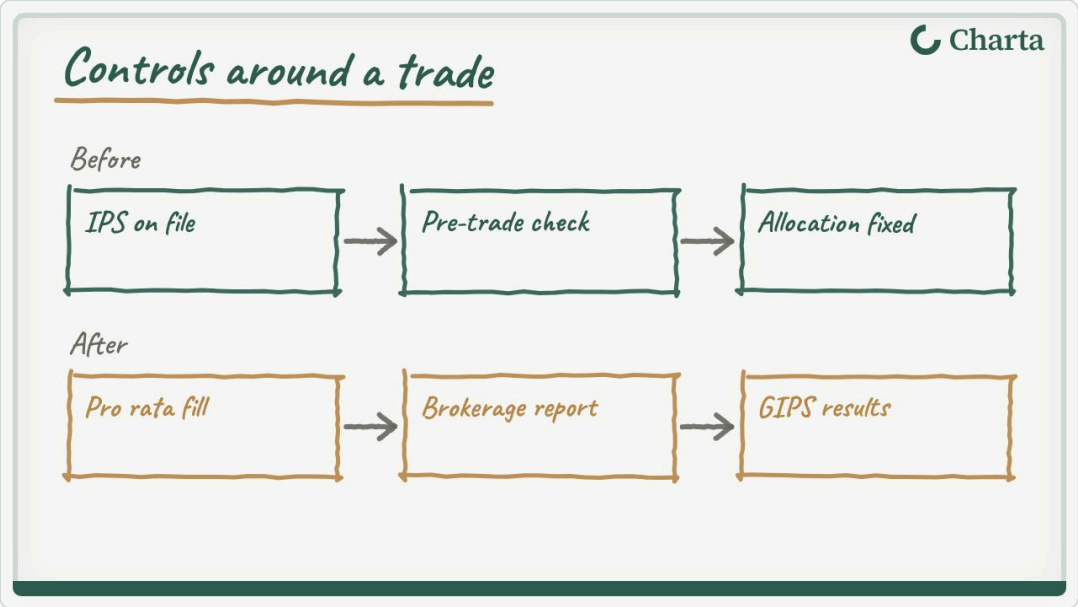
## 24 A story: the seat belt and the black box

- Before the trade: rules written ahead of the decision
- After the trade: records and reports anyone can check
- Fix the rule first, then record that it was followed
- Tie each control to the duty it protects

IN THE LESSON

- A car has two safety systems.
- The seat belt works before a crash, and the black box tells you what happened after.
- Procedures for Standard three are the same.
- Those that work before the trade are rules fixed in writing, ahead of the decision, so that nobody has to make a fair choice in a hurry.
- Those that work after the trade are records and reports, so that anyone can check that the rule was followed.
- Timing is the idea.
- If an allocation is written down before the orders go out, it cannot be bent once the prices are known.
- Keep this picture in mind as we build Larkspur's procedures.

## 25 Controls around a trade




IN THE LESSON

- Read the top row as prevention, and the bottom row as what follows the trade.
- First, every separate account has a written investment policy statement on file, reviewed at least once a year and whenever the client's circumstances change.
- Second, a pre trade check compares each order with the limits in that statement and blocks any order outside them, instead of the breach turning up at month end.
- Third, the allocation is written on a time stamped ticket before the order is sent.
- After the trade, partial fills are shared pro rata at the average price.
- Clients are told how their brokerage was used.
- And performance is presented under the Global Investment Performance Standards, a tested framework that guards against picking the flattering results.

## 26 Standard III: what a firm puts in place

*Standard III: duty and its main control*

| | |
|---|---|
| **III(A) loyalty** | **proxy and soft-dollar policies** |
| III(B) fair dealing | allocation fixed before orders |
| III(C) suitability | IPS, yearly review, pre-trade check |
| III(D) performance | follow GIPS and claim it |
| III(E) confidentiality | access controls on client files |

IN THE LESSON

- This table pairs each duty with its main control.
- For loyalty, a written proxy voting policy and a soft dollar policy, ideally following the Soft Dollar Standards of CFA Institute, with the use of client brokerage reported to clients.
- For fair dealing, a written allocation policy fixed before orders go out.
- For suitability, a written investment policy statement for each separate account, reviewed at least yearly, with pre trade checks on mandate limits.
- For performance presentation, following the Global Investment Performance Standards and claiming compliance.
- For confidentiality, access controls on client files, so that only the people who need a file can open it.

## 27 Example 9: from incident to control

*Larkspur's review found five incidents*

| | | |
|---|---|---|
| **Allocation after the close** | time-stamped tickets | **III(B)** |
| **Cash limit breached unseen** | pre-trade check vs IPS | **III(C)** |
| **Credits paid for software** | soft-dollar policy, report | **III(A)** |
| **Only best accounts shown** | follow GIPS | **III(D)** |
| **Client files open to all** | access controls | **III(E)** |

IN THE LESSON

- Let us propose fixes for a Larkspur review that found five problems.
- A trader allocated a partly filled order after the close.
- The fix is a written allocation policy with time stamped tickets, which protects fair dealing.
- An account breached its cash limit unnoticed.
- The fix is a pre trade check against the investment policy statement, which protects suitability.
- Soft dollar credits paid for accounting software.
- The fix is a soft dollar policy with reports to clients, which protects loyalty.
- The firm showed only its best accounts in a brochure.
- The fix is to follow the Global Investment Performance Standards.
- And client files were open to all staff, so the fix is access controls.
- Each fix is matched to one duty.

## 28 Example 10: a pre-trade check at work

*Separate account 40m; written policy caps one holding at 5%*

| | | |
|---|---|---|
| **Cap on one holding** | 5% × 40m | **2.0m** |
| **Current holding** | | **1.7m** |
| **After the proposed buy of 0.5m** | 1.7m + 0.5m | **2.2m** |
| **Share of the account** | 2.2m ÷ 40m | **5.5%** |
| **Verdict** | room is 2.0m − 1.7m | **Block; 0.3m ok** |

IN THE LESSON

- Here is a pre trade check with numbers.
- A Larkspur separate account has forty million in assets, and its written policy statement caps any one holding at five per cent.
- Five per cent of forty million is two million.
- The account already holds one point seven million of one stock, and a trader proposes buying another point five million.
- After the buy it would hold two point two million, which is five point five per cent of the account, above the cap.
- The system blocks the order and tells the trader that only point three million of room is left.
- The check does not depend on anyone remembering the limit.
- It catches the breach before the order goes out, which is better than finding it at month end.

## 29 Example 11: a hot issue policy

*Requests: plan 20,000; X 10,000; Y 10,000 (no new issues); staff 5,000*

| | | |
|---|---|---|
| **Shares offered to Larkspur** | | **24,000** |
| **Requests, suitable accounts** | 20,000 + 10,000 | **30,000** |
| **Share each receives** | 24,000 ÷ 30,000 | **80%** |
| **Plan and account X** | 80% of each request | **16,000 / 8,000** |
| **Unsuitable and employee accounts** | ruled out; staff last | **0** |

IN THE LESSON

- Last, a hot issue, which is a new offering expected to trade at once above its offer price.
- Larkspur receives twenty four thousand shares, but its accounts have asked for much more.
- The Brindle plan requests twenty thousand and account X requests ten thousand, and both are suitable for it.
- Account Y requests ten thousand, but its policy statement rules out new issues.
- And a Larkspur employee account asks for five thousand.
- The written policy offers the issue only to suitable accounts, so Y is out, and puts employee accounts last, so that account gets nothing.
- The suitable requests total thirty thousand, so each suitable account receives eighty per cent: sixteen thousand and eight thousand.
- Staff are never served ahead of clients.

## 30 Recap: the lesson in five lines

- II(A): no acting on material nonpublic information
- II(B): no trading to mislead; intent decides
- Firm: barrier, lists, surveillance, independent prices
- III: client first, fair shares, suitable, honest, private
- Fix the rule before the decision, then record it

**IN THE LESSON**

- Let us pull the lesson together.
- First, subsection two A forbids acting on material nonpublic information.
- Second, subsection two B forbids trading or talking to mislead, and the test of manipulation is intent.
- Third, a firm contains information with a barrier and lists, screens expert calls, flags orders near the close, and prices holdings independently.
- Fourth, Standard three puts the client first, which for a pension plan means its beneficiaries, shares trades fairly, fits positions to the policy or mandate, presents results honestly and keeps client information private.
- Fifth, firms fix the rule before the decision and record that it was followed, through allocation policies, pre trade checks, soft dollar policies, and the performance standards.

## 31 Try three quick questions

1. Placement at 5% below 80; fund holds 50,000 shares. Loss avoided by selling first? May she sell?
   **Answer:** 80 × 5% = 4.00; 4.00 × 50,000 = 200,000. No: material and nonpublic.
2. Block order of 40,000 fills 10,000. An account was allocated 16,000. What does it receive?
   **Answer:** Fill rate 10,000 ÷ 40,000 = 25%; 25% × 16,000 = 4,000 shares.
3. Cap 8% of 25m. Holding 1.7m; buy 0.4m. Allowed?
   **Answer:** 2.1m ÷ 25m = 8.4%, above 8%. No: the pre-trade check blocks it.

**IN THE LESSON**

- Now try three quick questions.
- Pause after each one.
- Question one.
- A manager is wall crossed on a placement at a five per cent discount to a price of eighty.
- Her fund holds fifty thousand shares.
- What loss would selling first avoid, and may she sell?
- The fall is four, times fifty thousand is two hundred thousand, and the answer is no, she may not sell, because the fact is material and nonpublic.
- Question two.
- A block order for forty thousand shares fills only ten thousand.
- An account was allocated sixteen thousand before the order.
- What does it receive?
- The fill rate is a quarter, so it receives four thousand shares.
- Question three.
- A policy caps one holding at eight per cent of twenty five million.
- The account holds one point seven million and a trader wants to add point four million.
- Allowed?
- It would be two point one million, eight point four per cent, so the check blocks the order.