

INSIGHTS FROM CFA SOCIETY SINGAPORE

By CFA Society Singapore Advocacy Team

The ethics of personal transactions

Portfolio managers must prioritise the interests of clients and employers over their personal financial interests

RETAIL investors can opt for do-it-yourself (DIY) investing where they build and manage their own portfolios. There are benefits. And like with most issues, there are downsides as well. For some retail investors who prefer to leave it to the experts due to various reasons, they can empower portfolio managers to make decisions under a pre-agreed investment mandate.

Discretionary portfolio management is a form of service in which buy and sell decisions are made by portfolio managers for the retail clients' account. If one is currently employing portfolio managers to look after their monies or are thinking of doing so, there are issues to consider.

One aspect a retail investor may want to look into would be whether portfolio managers put investors' interests first. Do portfolio managers prioritise your interest over the investment firm's or the portfolio manager's own interests? Is there assurance or guidance given to portfolio managers with regards to priority of investment transactions?

The Priority of Transactions Standard

CFA Institute, a global association for investment professionals, does provide guidance via its Priority of Transactions Standard. This standard reinforces the responsibility of portfolio managers to give the interests of their clients and employers priority over their personal financial interests.

The standard is also designed to prevent any potential conflict of interest, or the appearance of a conflict of interest with respect to personal transactions. Client interests have priority. Client transactions must take precedence over transactions made on behalf of the portfolio managers' firm or personal transactions.

Avoiding potential conflicts

Conflicts between the client's interests and a portfolio manager's personal interests may occur.

Although conflicts of interest exist, nothing is inherently unethical about individual managers, advisers or unit trust employees making money from personal investments as long as (1) the client (retail and institutional investors) is not disadvantaged by the trade, (2) the portfolio manager does not benefit personally from trades undertaken for clients and (3) the portfolio manager complies with applicable regulatory requirements.

Some situations occur where a portfolio manager may need to enter a personal transaction that runs counter to current recommendations or what the portfolio manager is doing for client

portfolios. For example, a portfolio manager may be required at some point to sell an asset to make a college tuition payment or a down payment on a home, to meet a margin call, and so on. The sale may be contrary to the long-term advice the portfolio manager is currently providing to clients. In these situations, the same three criteria given in the preceding paragraph should be applied in the transaction, so as to not violate the Priority of Transactions Standard.

Impact on accounts with beneficial ownership

Portfolio managers may undertake transactions in accounts for which they are a beneficial owner, only after their clients and employers have had adequate opportunity to act on a recommendation. Personal transactions include those made for the portfolio manager's own account, family accounts (including those of the spouse, children and other immediate family members), and for accounts in which the portfolio manager has a direct or indirect pecuniary interest, such as a trust or retirement account.

Family accounts that are client accounts should be treated like any other firm account, and should neither be given special treatment nor be disadvantaged because of the family relationship. If a portfolio manager has a beneficial ownership in the account, however, the portfolio manager may be subject to pre-clearance or reporting requirements of the employer or applicable law.

Ethics in action: practise, practise, practise

Today's case is based on a September 2018 enforcement action by the US Securities and Exchange Commission. As a guide, the desired ethical behaviour required is based on the CFA Institute Code of Ethics and Standards of Professional Conduct.

Case study: Personal transaction

Phala is the co-owner and chief investment officer of Asean Trading Financial (ATF). Phala's wife is ATF's compliance officer. ATF has several dozen retail clients and total assets under management of S\$770 million. All client assets are managed on a discretionary basis. Phala frequently makes trades for his clients using an omnibus trading account through a broker/dealer, which allows Phala to buy and sell securities in a block trade on behalf of multiple clients simultaneously. Phala regularly allocates the securities purchases to individual client accounts after the market closes.

Over one six-month period, Phala allocates 75

per cent of the profitable trades to nine accounts owned or controlled by Phala and his wife. At the same time, 82 per cent of the unprofitable trades are allocated to the account of the three largest ATF clients.

In the long term, however, Phala does engineer his trade allocation practices to favour larger clients so as to benefit them. He discloses the trade allocation practices to his clients and also accurately represents whether or not he trades in the same securities as his client.

So, are Phala's actions acceptable?

Analysis

This case relates to CFA Institute Priority of Transactions Standard, which states that investment transactions for clients have priority over personal transactions. By trading in the firm's omnibus account and then delaying allocation of trades to a specific account until he has an opportunity to observe the security's intra-day performance, Phala is able to cherry-pick the winning trades for accounts in which he has a beneficial interest.

This is a violation of the Priority of Transactions Standard. He allocates the losing trades to client accounts that are large enough to absorb incremental, although steady, trading losses without arousing client suspicion that the losses are due to fraud.

Disclosure does not absolve Phala from unethical and fraudulent behaviour. It is also irrelevant to the priority of transactions issue what Phala tells his clients, about whether he trades in the same securities for his personal accounts as he does for his client accounts. (Though, if he claimed not to personally trade in securities being considered for purchase by clients, but did so anyway, that would be another incidence of fraud.)

Finally, Phala cannot temporarily favour his personal interests over his clients' interests, with the intent of making it up to the clients later. Ethical conduct is not subject to some ledger-keeping exercise. Investment professionals should comply with ethical principles at all times. Phala's actions are unacceptable.

The writers are CFA charterholders who volunteer with CFA Society Singapore on advocacy issues with a view to promoting financial literacy among retail investors and improving overall standards and integrity in the industry. Should you have comments and feedback, do write to the CFA Society Singapore advocacy committee: advocacy@cfasocietysingapore.org