Omega Financial[8]

Omega Financial, a large financial services firm, makes a market in more than 500 stocks. As a market-maker, the firm executes institutional orders as well as retail orders placed by its private wealth unit, its broker-dealer affiliate, and other third-party broker-dealers.

A page in Omega's compliance manual, which adheres to all legal and regulatory requirements, includes the following information:

> **OTC Stocks in which Omega is a Market-Maker**
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> **Definitions:**
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> Riskless principal transaction: an order in which a firm, after receiving a customer's order, executes the order on a principal basis from another market center.
>
> Net Trade/Trade on a net basis: a principal transaction in which a market maker, after having received an order, executes the order at one price with another broker-dealer or another customer and then sells to (buys from) the customer at a different price.
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> **Compliance Policies:**
>
> | Institutional Orders | Retail Orders |
> |---|---|
> | Riskless principal transactions may be traded on a net basis. | Riskless principal transactions may not be traded on a net basis. They receive the same execution price without mark-up, mark-down, commissions, or fees. |

Consistent with regulatory requirements, Omega discloses the information about riskless principal transactions to all clients and third-party broker-dealers. In addition, Omega informs third-party broker-dealers that it will seek best execution on retail orders.

Omega is developing an automated order-handling system to improve efficiencies in order flow. Anticipated benefits of the new system include much faster execution speeds. Additionally, the system design includes a trading mechanism that will execute portions of certain large orders to reduce market impact. The trading mechanism delays some orders to allow the firm to obtain a better overall price.

Xavier Brown, CFA, is responsible for overseeing the project to ensure its timely completion. Brown enlists the compliance department to review the programming during the initial development phase and identify any potential problems. The compliance department compares the order-handling function of the new system to the third-party software currently in use. They identify a number of potential problems including delays in execution of certain large market orders and embedded mark-ups and mark-downs on stocks in which the firm makes a market. According to the compliance department, changes are necessary to comply with regulatory requirements.

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[8] This case was written by Dorothy C. Kelly, CFA.

Brown directs the programmers to correct the problems and run tests and simulations. The programmers spend the next few months making changes to the system and adding comments throughout the code that clearly explain the purpose of particular functions. After several months, the programmers report that they have corrected all the identified problems and run the necessary tests and simulations. The following month, the firm switches to the automated order-handling system as planned.

Joy Chen, CFA, trades Xydeo stock for Omega. One month following the switch to the new order-handling system, Chen is able to execute a number of principal riskless transactions for both institutional and retail clients at $25.00 per share. When processing the customer buy orders totaling 500,000 shares, the new system automatically uses the best-publicized price of $25.01 and the firm issues client confirmations showing a purchase price of $25.01.

Stephen Smith, CFA, works across from Chen on the trading desk at Omega. His seat is close to a speaker for the company's squawk box, which is used to broadcast information about current analyst recommendations; news about market events; and information about pending block trades.

Smith's young brother-in-law, Adolfo Garcia, recently accepted a position as a broker at a third-party broker-dealer that trades with Omega. Garcia has a modest income and little savings. He is enthusiastic about investments and has enrolled as a CFA candidate. Smith calls Garcia early each morning to talk about the previous day's events. At the end of their conversation, Smith places the call on speakerphone and resumes his work.

In his office, Garcia can hear Omega's squawk box over the speakerphone. Garcia enjoys listening as Omega analysts discuss changes in ratings, economic forecasts, and capital market developments. He is careful not to trade in stocks mentioned explicitly on the squawk box. Rather, he sometimes researches competitors and other firms operating in the same industry. In one case, he immediately shorts the stock of Tefla Corporation after an Omega analyst downgrades a firm in the same industry.

Garcia frequently places large block orders for low-priced small-capitalization stocks at the market price. Once the new system is operational, Smith processes the orders through the new trading-system mechanism, which delays execution of portions of the orders and allows the firm to obtain a better price for Garcia.

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1. For a CFA charterholder, would adhering to Omega's policies regarding riskless principal transactions result in a violation of the CFA Institute Standards of Professional Conduct?
   A. No.
   B. Yes, because Omega disadvantages institutional clients.
   C. Yes, because disclosure of the policy does not relieve Omega of its obligation to treat clients equally.

2. When overseeing the development of the automated-trading system, does Brown violate any CFA Institute Standards?
   A. No.
   B. Yes, because he accepted an assignment for which he was inadequately trained and skilled.
   C. Yes, because he did not ensure that the final system complied with regulatory requirements.

3. With regard to Chen's trades in Xydeo, do the institutional and retail trades both comply with CFA Institute Standards?
   A. Only the retail trades comply.
   B. Only the institutional trades comply.
   C. Neither the retail nor the institutional trades comply.

4. When placing the morning phone call on speakerphone, does Smith violate any CFA Institute Standards?
   A. No.
   B. Yes, his duty to Omega.
   C. Yes, his duty to clients and to Omega.

5. When listening to the Omega squawk box, does Garcia violate any CFA Institute Standards?
   A. No.
   B. Yes, the standard regarding professionalism.
   C. Yes, the standard regarding material nonpublic information.

6. When shorting Tefla stock, does Garcia violate any CFA Institute Standards?
   A. No.
   B. Yes, because he does not have a reasonable basis for the trade.
   C. Yes, because he is in possession of material nonpublic information.

Discussion Questions:

1. What additional steps, if any, should Brown take to comply with his responsibilities as a supervisor?

2. What is meant by best execution? Why might factors other than price determine best execution?

3. When placing the large block trades for Garcia through the trading mechanism, does Smith violate any CFA Institute Standards?

Omega Solutions

1. A is correct. Mark-ups and mark-downs in net trades are considered fees paid by clients. Standard III(B), Fair Dealing, requires that members treat all clients fairly in light of their investment objectives and circumstances. Treating institutional and retail investors differently is not a violation. According to the Standards, members can differentiate their services to clients but different levels of service must be disclosed and should not negatively affect clients. Omega has made the appropriate disclosures to its clients in compliance with legal and regulatory requirements as well as the Standards.

2. C is correct. Brown is in violation of Standard IV(C), Responsibilities of Supervisors, because he did not ensure that the final system complied with regulatory requirements. According to the Standard, Brown has a responsibility to make reasonable efforts to detect and prevent violations of applicable laws, rules, and regulations. Alerted to potential problems by the compliance department, he had a responsibility to ensure that the modifications corrected the potential problems without introducing new problems.

3. B is correct. Only the institutional trades comply with CFA Institute Standards. All the trades were processed on a net basis. Because the firm disclosed that institutional orders may be executed on a net basis, the institutional trades did not result in a violation. The firm disclosed to clients that in riskless principal trades, retail clients will receive the same execution price without mark-up. Executing the retail orders on a net basis with a $.01 mark- up resulted in a violation of Standards l(C) and IIl(B) relating to misrepresentation and fair dealing.

4. C is correct. Smith violated his duties to both clients and Omega by not protecting confidential information. By providing Garcia access to confidential information such as changes in recommendations and information regarding block trades, Smith provided Garcia the opportunity to front-run, which could cause harm to both Omega and its clients. Thus, Smith's actions violate his duty of loyalty, prudence, and care to his clients and his duty of loyalty to his employer, Standards Ill(A) and IV(A), respectively.

5. B is correct. Garcia violated the Standard of Professionalism by engaging in eavesdropping on confidential information including changes in analyst recommendations and pending block trades. According to Standard l(D) members must not engage in professional conduct involving dishonesty, deceit, or fraud or commit any act that reflects adversely on their professional reputation, integrity, or competence. Garcia engages in deceitful conduct in obtaining information from the squawk box. His actions reflect adversely on his professional reputation and integrity and thus violate Standard I(D). Garcia is not in violation of Standard Il(A), Material Nonpublic Information, although he listens to the material nonpublic information on pending block trades. Possession of such material nonpublic information is not a violation of the Standard, which prohibits acting on the information.

6. C is correct. Garcia is in possession of material nonpublic information and acted on it in violation of Standard II(A). After the analyst's recommendation has been issued and/or distributed publicly, Garcia would be free to make the trade.

Suggested Issues for Discussion Question 1:

Brown has responsibility for seeing that the trading system complies with all regulatory requirements. Thus, Brown should ensure that the compliance department remains involved in the development of the trading system through its completion. Software programmers do not understand, nor can they be expected to understand, the regulatory implications of their programming changes. Rather than oversee the changes himself, Brown could delegate the task to the compliance department.

Brown should establish procedures requiring the compliance department's approval of changes made by programmers. In addition, Brown could establish a procedure where compliance staff reviewed the comments embedded into the programming code to explain the purpose of particular codes and their intended functions.

Finally, Brown should require full-scale testing of the new software by the compliance department before changing to the new system. The tests should examine the system's ability to handle orders in compliance with current regulatory requirements.

Suggested Issues for Discussion Question 2:

Best execution does not necessarily mean best price. Rather, best execution refers to seeking the most favorable total cost for the client under the particular circumstances at that time. Standard considerations include evaluating the broker's financial responsibility, responsiveness, commission rate or spread involved, and the range of services offered.

In some cases, factors other than price may determine best execution. If market impact is a concern, speed of execution and likelihood of execution may take precedence. A higher quoted price may be offset by the diminished likelihood of executing the trade in a timely fashion.

Suggested Issues for Discussion Question 3:

Yes, when using the trading mechanism for the Garcia trades, Smith violates his duty of loyalty, prudence, and care for his client [Standard III(A)]. Omega has informed third-party brokers that their trades will receive best execution-not best price. While delaying portions of the trade may result in a better overall price, Garcia placed an order at the market and has an expectation that the order will be executed without delay.

Reference: Standards of Practice Handbook, 11th edition (CFA Institute, 2014)