Samuel Telline Case **Scenario**[4]

Samuel Telline, CFA, is a portfolio manager at Aiklin Investments with discretionary authority over all of his accounts. One of his clients, Alan Caper, Chief Executive Officer (CEO) of Ellipse Manufacturing, invites Telline to lunch.

At the restaurant, the CEO reveals the reason for the lunch. "As you know Reinhold Partners has made an unsolicited cash offer for all outstanding shares of Ellipse Manufacturing. Reinhold has made it clear that I will not be CEO if they are successful. I can assure you that our shareholders will be better off in the long-term if I'm in charge." Caper then shows Telline his projections for a new plan designed to boost both sales and operating margins.

"I know that your firm is the trustee for our firm's Employee Stock Ownership Plan (ESOP). I hope that the trustee will vote in the best interest of our shareholders-and that would be a vote against the takeover offer."

After looking through Caper's business plans, Telline says, "This plan looks good. I will recommend that the trustee vote against the offer."

Caper responds, "I remember my friend Karen Leighton telling me that the Leighton Family's Trust is managed by your firm. Perhaps the trustee could vote those shares against the acquisition as well. Karen Leighton is a close friend. I am sure that she would agree."

Telline responds "The Family Trust is no longer managed by Aiklin." He adds "I understand that the Trust is very conservatively managed. I doubt it that it would have holdings in Ellipse Manufacturing." Telline does not mention that although the Family Trust has changed investment managers, Karen Leighton remains an important client at Aiklin with significant personal holdings in Ellipse.

After lunch, Telline meets with Sydney Brown, CFA, trustee of the Eclipse ESOP. He shows her Caper's plan for improvements. "I think the plan is a good one and Caper is one of the firm's most profitable accounts. We don't want to lose him." Brown agrees to analyze the plan. After thoroughly analyzing both the plan and the takeover offer, Brown concludes that the takeover offer is best for the shareholders in the ESOP and votes the plan's shares in favor of the takeover offer.

A few months later the acquisition of Ellipse by Reinhold Partners is completed. Caper again meets Telline for lunch. "I received a generous severance package and I'm counting on you to manage my money well for me. While we are on the subject, I would like to be more aggressive with my portfolio. With my severance package, I can take additional risk." Telline and Caper discuss his current financial situation, risk tolerance, and financial objectives throughout lunch. Telline agrees to adjust Caper's investment policy statement (IPS) to reflect his greater appetite for risk and his increased wealth.

Back at the office, Telline realizes that with the severance package, Caper is now his wealthiest client. He also realizes that Caper's increased appetite for risk gives him a risk profile similar to that of another client. He pulls a copy of the other client's investment policy statement (IPS) and reviews it quickly before realizing that the two clients have very different tax situations. Telline quickly revises Caper's IPS to reflect the changes in his financial situation. He uses the other client's IPS as a reference when revising the section relating to Caper's risk tolerance. He then files the revised IPS in Caper's file.

The following week, an Aiklin analyst issues a buy recommendation on a small technology company with a promising software product. Telline reads the report carefully and concludes it would be suitable under Caper's new IPS. Telline places an order for 10,000 shares

[4] This case was written by Sarah W. Peck, PhD.

in Caper's account and then calls Caper to discuss the stock in more detail. Telline does not purchase the stock for any other clients. Although the one client has the same risk profile as Caper, that client does not have cash available in his account and Telline determines that selling existing holdings does not make sense.

In a subsequent telephone conversation, Caper expresses his lingering anger over the takeover. "You didn't do enough to persuade Aiklin's clients to vote against the takeover. Maybe I should look for an investment manager who is more loyal." Telline tries to calm Caper but is unsuccessful. In an attempt to change the topic of conversation, Telline states, "The firm was just notified of our allocation of a long-awaited IPO. Your account should receive a significant allocation. I would hate to see you lose out by moving your account." Caper seems mollified and concludes the phone call, "I look forward to a long-term relationship with you and your firm."

Aiklin distributes a copy of its firm policies regarding IPO allocations to all clients annually. According to the policy, Aiklin allocates IPO shares to each investment manager and each manager has responsibility for allocating shares to accounts for which the IPO is suitable. The statement also discloses that Aiklin offers different levels of service for different fees.

After carefully reviewing the proposed IPO and his client accounts, Telline determines that the IPO is suitable for 11 clients including Caper. Because the deal is oversubscribed, he receives only half of the shares he expected. Telline directs 50% of his allocation to Caper's account and divides the remaining 50% between the other ten accounts, each with a value equal to half of Caper's account.

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1. When discussing the Leighton Family Trust, does Telline violate any CFA Institute Standards of Professional Conduct?
   A. No.
   B. Yes, relating to duties to clients.
   C. Yes, relating to misrepresentation.

2. When deciding how to vote the ESOP shares, does Brown violate any CFA Institute Standards?
   A. No.
   B. Yes, relating to loyalty, prudence, and care.
   C. Yes, relating to diligence and reasonable basis.

3. The Standard *least likely* to provide guidance for Telline when working with the clients' investment policy statements would be the Standard relating to:
   A. suitability.
   B. fair dealing.
   C. loyalty, prudence, and care.

4. Does Telline violate any CFA Institute Standards when he places the buy order for shares in the technology company for Caper's account?
   A. No.
   B. Yes, relating to fair dealing.
   C. Yes, relating to diligence and reasonable basis.

5. Is Aiklin's policy with respect to IPO allocations consistent with required and recommended CFA Institute Standards?
   A. Yes.
   B. No, because the IPO policy disadvantages certain clients.
   C. No, because the different levels of service disadvantage certain clients.

6. Does Telline violate any CFA Institute Standards in his allocation oflPO shares to Caper's account?
   A. No.
   B. Yes, because the IPO is not suitable for Caper.
   C. Yes, because he does not treat all his clients fairly.

Discussion Questions:

1. Suppose an investment manager involved in a takeover battle sells the entire position after the record date. How should he use the retained shareholder votes? What are the implications for the client, the manager, the firm, and the capital markets? What if the investment manager works for a hedge fund that is short the stock but retains the voting rights of its borrowed shares? What conflicts emerge?

2. What do you think of Caper's behavior towards Telline? Is the customer always right? What short-term and long-term ramifications should Telline consider? What choices does Telline have?

Telline Solutions

1. B is correct. Telline has a duty to preserve the confidentiality of current, former, and prospective clients. Telline violates Standard III (E) Preservation of Confidentiality when he reveals that the firm managed the assets of Leighton Family Trust.

2. A is correct. Brown conducts an independent and careful analysis of the plans' benefits for shareholders as well as the takeover offer. In doing so she puts the client's interests ahead of the firm's. Brown's actions are consistent with Standard III (A) Loyalty, Prudence, and Care; Standard V (A) Diligence and Reasonable Basis; and Standard III (B) Fair Dealing.

3. B is correct. Telline is not likely to receive appropriate guidance on developing or revising investment policy statements from the Standard relating to Fair Dealing. Standard III(B) provides members with guidance on treating clients fairly when making investment recommendations, providing investment analysis, or taking investment action. Telline could obtain guidance from the Standards relating to Loyalty, Prudence, and Care and Suitability. Both Standard III(A) and (C) provide guidance for members in determining client objectives and the suitability of investments.

4. A is correct. Telline determines that the other client does not have the cash available in his account and selling existing holdings does not make sense. Moreover, Telline is careful to consider the investment's suitability for Caper's account. Telline's actions are consistent with CFA Institute Standards III (A) Loyalty, Prudence, and Care and III(B) Fair Dealing.

5. B is correct. The firm violates Standard III(B) Fair Dealing. Under Aiklin's policy, some clients for whom an IPO is suitable may not receive their pro-rata share of the issue. CFA Standards recommend that firms allocate IPOs on a pro-rata basis to clients, not to portfolio managers.

6. C is correct. Telline violates Standard III (B) Fair Dealing by over-allocating shares to Caper. Telline carefully reviews both the proposed IPO and his client accounts to determine suitability. He fails to allocate the IPO shares on a pro-rata basis to all clients for whom the investment is suitable.

Suggested Issues for Discussion Question 1:
Candidates can discuss the potential conflict of having clients, such as Caper and the ESOP plan, with divergent interests. In the situation provided, selling the shares seems to solve the firm's dilemma. By selling the shares, Brown can vote against the acquisition and possibly capture the market's anticipation of a takeover premium in the market price for her clients.
Candidates can discuss the conflicts and implications associated with a practice known as ghost voting or empty voting. Hedge funds that are short sellers receive voting rights when they borrow shares for their positions. The hedge fund managers are then in a position to cast votes designed to favor their clients and adversely affect shareholders. The hedge fund's votes are empty because they do not represent the votes of actual shareholders and may be used in a way that damages shareholders.

Suggested Issues for Discussion Question 2:
Candidates can discuss how they would handle a situation in which a client's demands conflict with acceptable standards or their own ethics and values. In such situations, they face a difficult decision that may have significant ramifications on their careers.
In the short term, Telline risks losing the Caper account, which could negatively affect his pay, his bonus, and possibly his employment at Aiklin Investments. In the long term, how Telline handles Caper and responds to the pressures he is exerting could have a much more lasting effect on Telline and his career. If Telline succumbs to Caper's initial pressures, Caper will likely continue to pressure Telline in the future. Telline might find himself violating not only ethical standards but also applicable law. Ifcaught and convicted, Telline could lose more than his current pay, bonus, and employment. He could serve a prison sentence and be permanently barred from the investment industry.

Telline could choose to mollify Caper or he could seek advice. He might seek advice from his supervisor, his compliance officer, the CFA Ethics Hotline, or his own legal counsel.

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

Standard III. Duties to Clients