ETHICS IN PRACTICE:
Doing Too Much to Make Investments a Success?

CASE STUDY
Corrales manages a hedge fund that seeks out investment opportunities in developing markets. Using assets of the fund's investors, the fund hires local companies to serve as "sub-advisers" to explore and obtain promising investment opportunities and navigate local laws and regulation. The sub-advisers often have very limited experience as financial consultants or advisers but do have close relationships and connections with local high-ranking government officials. The payments made by Corrales, through the sub-advisers, often cover substantial "deal fees" and other expenses that facilitate governmental support of each investment. Corrales does not require the local business partners to provide details of their activities or what specific expenses are covered by the fees. Corrales reports these expenditures to fund investors as operating expenses necessary to the success of the investment. Over several years, the hedge fund is very successful producing an 18% annual rate of return for its investors. Did Corrales actions violate the CFA Institute Code of Ethics and Standards of Professional Conduct?

A. Yes.
B. No because it is acceptable to hire sub-advisers and business consultants to assist in procuring investment opportunities and managing specialized assets.
C. No because the payments to the sub-advisers represent legitimate expenses to ensure the success of investments and protect the interest of investors.
D. No, as long as the sub-advisers provide more detail about the nature and purpose of the payments and this information is disclosed to the hedge fund investors.
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ANALYSIS
To better serve clients, investment professionals may choose to delegate to third parties work that requires particular specialization, knowledge, or expertise. For example, an investment adviser may hire sub-advisers to handle a particular strategy or investment style outside the scope of the adviser's ability or experience. A global adviser may hire a sub-adviser to manage an asset allocation invested in a particular market, and the payments to the sub-adviser would be legitimate investment expenses that could properly be passed on to investors in the fund.

But the facts of this case indicate that Corrales is not hiring a true sub-adviser but essentially paying locally connected officials to secure access to investment deals to ensure the success of the fund's investments. The "sub-advisers" have no financial experience but are close to the government officials, and the "deal fees" are not supported by any documentation that details legitimate investment expenses. The "operating expenses" charged by Corrales to the fund are most likely funding corrupt transactions and bribes through local intermediaries. This practice violates multiple standards:

- **I(A): Knowledge of the Law** because the conduct would violate any type of anti-bribery laws.
- **I(C): Misrepresentation** because he is improperly labeling the expenditures as investment fees.
- **V(A): Diligence and Reasonable Basis** because no reasonable and adequate basis for the "investment" action exists.
- **V(C): Record Retention** because no appropriate records are being kept to support the action.
- **VII(A): Conduct as Participants in CFA Institute Programs** because assuming Corrales is a charterholder, his conduct compromises the integrity to the CFA designation.

This case is based on a US SEC enforcement action from 2017.