CFA SINGAPORE INSIGHTS

By CFA Singapore Advocacy Team

# Ethics in focus: Trading in unit trusts

The practice of buying and selling such investment products at the expense of the investor merely to generate commissions for financial advisers does little to meet the client's investment objectives

FROM Oct 1 this year, CPF members who make new purchases of products such as investment-linked insurance policies (ILPs) and unit trusts under the CPF Investment Scheme (CPFIS) will pay a lower sales charge of 1.5 per cent. This is halved from the 3 per cent they had to pay previously. By Oct 1, 2019, this charge will be removed entirely and CPFIS members will no longer need to pay such commission. For CPFIS investors who have wrap accounts with financial advisers, the annual wrap fee on assets under management that they pay, capped at 1 per cent previously, was also lowered on Oct 1, 2018 to 0.7 per cent. This will drop further in less than a year to 0.4 per cent on Oct 1, 2019.

The stepwise removal of the CPFIS sales charge and the lowering of the wrap fee for CPFIS members are to reduce the cost of investing for CPF members. The Ministry of Manpower notes that lowering and removing the sales charge weakens the incentive for financial advisers to push sales of products just to earn more commission. Reducing the 0.4 per cent cap on wrap fees, meanwhile, brings such fees on par with those charged by online investment platforms in the cash market.

The practice of buying and selling investment products at the expense of the investor merely to generate commissions for financial advisers is also known as churning.

Churning is an unethical and illegal practice that violates provisions under the Financial Advisers Act, including Section 27 relating to the need to have a basis when making a product recommendation to an investor, the Notice on Recommendations on Investment Products and the Guidelines on Switching of Designated Investment Products.

While there is no quantitative measure for churning, one likely evidence of this is when the adviser recommends or conducts frequent buying and selling activity that does little to meet the client's investment objectives.

Readers may recall nearly a decade ago *The Straits Times* ran a story about low-income Singaporeans who were lured into letting financial advisers churn their CPF savings in exchange for cash rebates. The *modus operandi* was as follows: the financial adviser placed advertisements aimed at individuals who needed money urgently. When a prospect responded to the advertisement, the adviser would ask for the individual's CPF statement, which indicated how much was available for investments. If the prospect was agreeable, the adviser would begin to invest the individual's CPF savings in a unit trust under the CPFIS.

The sales charge for each transaction was 3 per cent of the investment sum, of which the adviser would receive a cut. In turn, the financial adviser gave the individual a cash rebate of 1 per cent of the sum invested. This would continue with the adviser using the individual's CPF funds to repeatedly buy and sell CPFIS products, even when the transactions resulted in losses for the individual. Each buy transaction earned the individual 1 per cent of the investment sum and also earned a fee for the adviser. It took some months before investors realised the transaction costs were eating into their retirement funds.

Unit trusts are typically long-term investments. A financial adviser recommending the sale of a unit trust fund and purchasing another within a short period must substantiate the recommendation with an appropriate basis. Most fund management companies that distribute their unit trust funds in Singapore allow investors to switch into any fund within a fund family without incurring an upfront fee. A financial adviser recommending an investment change should first consider funds within the fund family.

## Practise, practise, practise

Today's case is based on an administrative action taken by the US Securities and Exchange Commission in August 2018. As a guide, the desired ethical behaviour required is based on the CFA Institute Code of Ethics and Standards of Professional Conduct (*https://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n6.1*). All CFA charterholders must adhere to the Code and Standards and renew their pledges every year.

## Case

Zachary Poh is an appointed representative with a licensed financial adviser. He has a number of individual clients, including his mother. Zachary trades units in a unit trust fund for his mother's account, which has a long-term investment horizon. All of these funds have similar long-term risk and return objectives. Zachary split $731,265 in investment funds in his mother's account among 42 different unit trust funds in 11 fund families. For the majority of unit trust fund purchases, he sold the funds within 92 to 274 days of purchasing them. Zachary earned $24,747 in sales charges for these trades but discounted the fees 10 per cent because it was his mother's account. Zachary's actions are:

A: unacceptable because Zachary treated clients unfairly by discounting the fees in his mother's account.
B: acceptable because unit trust funds are safe long-term investments.
C: unacceptable because the trades resulted in unsuitable investments.
D: acceptable because Zachary diversified his mother's investments among funds with a strategy that matched her long-term strategy and outlook.

## Analysis

This case relates to the standard on Suitability, which requires CFA Institute members to determine that an investment is suitable for a client's financial objectives, mandates, and constraints before taking any investment action. In this case, Zachary is trading units in unit trust funds with a similar long-term risk and return objectives as his mother's account, which would seem to make these investments suitable for his mother's account. But although unit trust funds are generally safe and conservative investments, the short-term nature of the trades conflicts with his mother's long-term investment horizon.

In addition, the new unit trust funds' objectives and risks were similar to the funds that were sold, such that the $24,747 in sales charges, even discounted by 10 per cent, outweighed any marginal benefit from the new unit trust funds. Finally, splitting his mother's investment funds into 42 different unit trust funds in 11 fund families generated higher sales charges because his mother was unable to take advantage of savings from breakpoints that likely were available for larger investments. For all of these reasons, Zachary's investments for his mother's account were unsuitable. Clients can be charged different fees; they do not have to be equal for all accounts. Fee discounts can be made for many reasons, and Zachary may have given other similar or even more generous discounts. A discounted fee does not necessarily mean that clients are being treated unfairly.

Choice C is the best answer.

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**The writers are CFA charterholders who volunteer with the Singapore society on advocacy issues with a view towards promoting financial literacy among retail investors and improving overall standards and integrity in the industry.**