



# Ethics Challenge

A more ethical investment profession starts here.

## GSW Securities Limited

John Keeley, CFA, is a mining analyst for GSW Securities Ltd. (GSW), an investment bank based in Toronto. Founded in 2015, GSW wants to become more well-known in the areas of securities underwriting and equity research. This morning, Keeley is meeting with his supervisor, Edward Peterkin, CFA. Peterkin, who joined GSW at the same time as Keeley, is now the Managing Director of its investment banking division. Below are excerpts from their conversation.

*Peterkin:* Keeley, I have good news for you. Arbour Resources (AR) has just hired GSW to be the lead underwriter in its upcoming secondary equity offering. As part of our agreement, I told AR that you would write a research report on the company and recommend it as a “strong buy.” How much do you know about the company?

*Keeley:* I am very familiar with AR because my son has worked for the company as an engineer for the past three years. Recently, he told me that the company has been struggling financially because of the huge environmental permitting costs it has been incurring.

*Peterkin:* I am going to set up a meeting between you and AR's senior management so that they can provide you with first-hand knowledge of what is really happening at their company.

The next day, AR's Chief Financial Officer (CFO) invites Keeley to a three-day conference that the company is sponsoring in Abuesi. Each day during the conference, Keeley plays golf with AR's senior management. In the evening, Keeley attends lavish



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dinners at which AR's senior management discuss the company's future operating strategy and its financial projections. At the conference, AR covers the cost of Keeley's transportation, hotel accommodations, and golf fees.

After returning from the conference, Keeley meets with Peterkin to discuss his observations of AR. Below are excerpts from their conversation.

*Keeley:* Unfortunately, I was not impressed by AR or its management. Every time I asked a question about their current financial condition and position, the CFO gave me an evasive answer. And after reviewing and analyzing AR's recent financial statements, I noticed that they are using complicated accounting methods and techniques that I believe overstate their revenues and earnings. I was so disturbed by what I heard from AR's management and my analysis of their financial statements that I would like to issue a "sell" recommendation on the company instead of a "strong buy" recommendation.

*Peterkin:* I hope you understand that a "sell" recommendation would damage the strong business relationship that our firm has developed with AR and that they would probably use another firm to underwrite their securities offering. AR may also retaliate against you by firing your son and preventing you from attending their analyst meetings and conference calls. Therefore, you should seriously think about the consequences of your actions. Whatever you decide to do, I want to review your research report on AR before it is distributed.

A week later, Keeley submits his research report on AR to Peterkin with a "neutral" recommendation. In his report, Keeley does not discuss AR's accounting methodology, and he does not include his opinion that the company's revenues and earnings are



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overstated. He also does not disclose that his son works for AR or that AR is an investment banking client of GSW.

Three days later, Keeley receives a phone call from Peterkin.

*Peterkin:* I just wanted to let you know that I made some modifications to your research report. First, I changed your “neutral” recommendation to a “strong buy.” I also allowed AR’s CFO to review your report before publishing it widely. The CFO thought that your annual revenue and earnings growth projections of 8% and 5%, respectively, were too low, so I increased them to 12% and 10%, respectively. I then emailed your report to our 10 largest clients to get their reaction to it. Later that same day, after receiving positive feedback from them, I posted your report on GSW’s website. To increase interest in AR’s upcoming secondary offering, I instructed GSW traders to simultaneously purchase and sell large blocks of AR shares and to place buy and sell orders in market for AR shares at the same price to generate greater volumes and have the street take notice that we’re the most active trader in the stock.

Keeley is so angry when he hears about the changes Peterkin made to his report that he immediately calls his wife and instructs her to take a short position in AR shares in her trading account. Because the transaction is in his wife’s account, he does not disclose the transaction to anyone. He then phones his close friend and former colleague, Manuel McBride, an independent financial advisor (IFA) and institutional client of GSW. Keeley recommends to McBride that he either sell or sell short AR shares in all of his clients’ accounts.