ETHICS

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STUDY SESSION 1 READINGS

**Reading 1** Ethics and Trust in the Investment Profession

**Reading 2** Code of Ethics and Standards of Professional Conduct *Standards of Practice Handbook*, Eleventh Edition


**Reading 4** Introduction to the Global Investment Performance Standards (GIPS)

**Reading 5** Global Investment Performance Standards (GIPS)
The candidate should be able to:

a. explain ethics;

b. describe the role of a code of ethics in defining a profession;

c. identify challenges to ethical behavior;

d. describe the need for high ethical standards in the investment industry;

e. distinguish between ethical and legal standards;

f. describe and apply a framework for ethical decision making.
2. ETHICS

Ethics refers to the study of making good choices. Ethics encompasses a set of moral principles and rules of conduct that provide guidance for our behavior.

Businesses and financial markets thrive on trust—defined as a strong belief in the reliability of a person or institution.

In a 2013 study on trust, investors indicated that to earn their trust, the top three attributes of an investment manager should be that it

1. has transparent and open business practices,
2. takes responsible actions to address an issue or crisis, and
3. has ethical business practices.

LOS 1.a Explain
Specific communities or societal groups in which we live and work sometimes codify their beliefs about obligatory and forbidden conduct in a written set of principles, often called a code of ethics.

Standards of conduct serve as benchmarks for the minimally acceptable behavior of community members and can help clarify the code of ethics.

CFA Institute is an example of a community with an established code of ethics and standards of conduct.

These beliefs are presented in the Code of Ethics and Standards of Professional Conduct (Code and Standards), which are included in the CFA Institute Standards of Practice Handbook.

LOS 1.a Explain
3. ETHICS AND PROFESSIONALISM

A profession has several characteristics that distinguish it from ordinary occupations. A profession is

1. based on specialized knowledge and skills.
2. based on service to others.
3. practiced by members who share and agree to adhere to a common code of ethics.

In any given profession, the code of ethics communicates the shared principles and expected behaviors of its members.

LOS 1.b Describe
4. CHALLENGES TO ETHICAL CONDUCT

Several challenges can make adherence to ethical conduct difficult.

1. people tend to believe that they are ethical people and that their ethical standards are higher than average.

2. A second challenge is that decision makers often fail to recognize and/or significantly underestimate the effect of situational influences, such as what other people around them are doing. Situational influences are external factors, such as environmental or cultural elements, that shape our thinking, decision making, and behavior.
High ethical standards always matter and are of particular importance in the investment industry, which is based almost entirely on trust.

Clients trust investment professionals to use their specialized skills and knowledge to serve clients and protect client assets. All stakeholders gain long-term benefits when investment professionals adhere to high ethical standards.

The higher the level of trust in the financial system, the more people are willing to participate in the financial markets.

Unethical behavior interferes with the ability of markets to channel capital to the borrowers that can create the most value from the capital, contributing to economic growth.

Both markets and society suffer when unethical behavior destroys trust in financial markets.

LOS 1.d Describe
6. ETHICAL VS. LEGAL STANDARDS

Rules and laws often codify ethical actions that lead to better outcomes for society or specific groups of stakeholders.

Organizations and individuals generally adhere to legal standards, but legal standards are often created to address past ethical failings and do not provide guidance for an evolving and increasingly complex world.

Legal standards are often rule based. Ethical conduct goes beyond legal standards, balancing self-interest with the direct and indirect consequences of behavior on others.
7. ETHICAL DECISION-MAKING FRAMEWORKS

Laws, regulations, professional standards, and codes of ethics can guide ethical behavior, but individual judgment is a critical ingredient in making principled choices and engaging in appropriate conduct.

A framework for ethical decision making can help people look at and evaluate a decision from different perspectives, enabling them to identify important issues, make wise decisions, and limit unintended consequences.

An ethical decision-making framework provides investment professionals with a tool to help them adhere to a code of ethics.

Ethical decision-making frameworks are designed to facilitate the decision-making process for all decisions.

LOS 1.f Describe
7. ETHICAL DECISION-MAKING FRAMEWORKS

The ethical decision-making process includes multiple phases, each of which has multiple components.

1. *In the initial phase, you will want to identify the important facts that you have available to you, as well as information that you may not have but would like to have to give yourself a more complete understanding of the situation.*

2. *In the second phase of ethical decision making, you will take time to consider the situational influences as well as personal behavioral biases that could affect your thinking and thus decision making.*

3. *The next phase of the framework is to make a decision and act. After you have acted on your decision, you should take the time to reflect on and assess your decision and its outcome.*

LOS 1.f Describe
READING 2: CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT
The candidate should be able to:

a describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards;

b state the six components of the Code of Ethics and the seven Standards of Professional Conduct;

c explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard.
Disciplinary Review Committee of CFA Institute Board of Governors has responsibility for the Professional Conduct Program and for enforcement of the Code and Standards.

CFA Institute Designated Officer, through Professional Conduct staff, conducts inquiries related to professional conduct.
CFA INSTITUTE PROFESSIONAL CONDUCT PROGRAM

Inquiry can be prompted by:

- Self-disclosure by members or candidates
- Written complaints about a member or candidate’s professional conduct
- Evidence of misconduct by a member or candidate
- Report by a CFA exam proctor

LOS 2.a Describe
The Designated Officer may decide:

1. That no disciplinary sanctions are appropriate
2. To issue a cautionary letter
3. To discipline the member or candidate

Sanctions may include condemnation by member’s peers or suspension of candidate’s participation in the CFA Program

LOS 2.a Describe
CODE OF ETHICS

“Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation (“Members and Candidates”) must:

1. Act with integrity, competence, diligence, and respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.

2. Place the integrity of the investment profession and the interests of clients above their own personal interests.

3. Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.

4. Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.

5. Promote the integrity and viability of the global capital markets for the ultimate benefit of society.

6. Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.”

LOS 2.b & c State & Explain
STANDARDS OF PROFESSIONAL CONDUCT

1. Professionalism
   A. Knowledge of the Law
   B. Independence and Objectivity
   C. Misrepresentation
   D. Misconduct

2. Integrity of Capital Markets
   A. Material Nonpublic Information
   B. Market Manipulation

3. Duties to Clients
   A. Loyalty Prudence & Care
   B. Fair Dealing
   C. Suitability (1 a,b,c. 2)
   D. Performance Presentation
   E. Preservation of Confidentiality (1,2,3)

LOS 2.b & c State & Explain
STANDARDS OF PROFESSIONAL CONDUCT

4. Duties to Employers
   A. Loyalty
   B. Additional Compensation Arrangements
   C. Responsibilities of Supervisors

5. Investment Analysis, Recommendations, and Actions
   A. Diligence and Reasonable Basis (1,2)
   B. Communication with Clients and Prospective Clients (1,2,3,4)

6. Conflicts of Interest
   A. Disclosure of Conflicts
   B. Priority of Transactions
   C. Referral Fees

7. Responsibilities as a CFA Institute Member or CFA Candidate
   A. Conduct as Participants in CFA Institute Programs
   B. Reference to CFA Institute, the CFA Designation, and the CFA Program

LOS 2.b & c State & Explain
READING 3. GUIDANCE FOR STANDARDS I–VII

The candidate should be able to:

a demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity;

b distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards;

c recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.
1. Analyze the question: is it asking about:
   
a. The Code of Ethics

b. The Standards
   
   a. Guidance: Violation or NOT of 1 or more standard
   b. Recommended Procedures

   c. GIPS

2. You must be able to identify where an activity violates one or more standards which means that basically you need to have 7 standards and sub standards pretty well memorized.

3. As always – best advice is to practice as many Qs as possible

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

LEVEL I 2018
Standard I (A) Knowledge of the Law

“Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.”

Highlights:

- Relationship between the Code and Standards and Applicable Law
- Participation in or Association with Violations by Others
- Investment Products and Applicable Laws
STANDARD I: PROFESSIONALISM

Guidance

Standard I (A) Knowledge of the Law

➢ Most strict
➢ First, notify supervisor or compliance
➢ May confront wrongdoer directly
➢ Dissociate if necessary
➢ Inaction may be construed as participation
➢ No requirement to report violations to governmental authorities, but this may be appropriate in certain cases

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Recommended Procedures

**Standard I (A) Knowledge of the Law**

- Keep informed, regularly review written compliance procedures, maintain files
- Seek compliance/legal advice as needed
- Encourage firms to adopt code of ethics

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Recommended Procedures

**Standard I (A) Knowledge of the Law**

- Distribute information internally on applicable laws and regulations
- Have written procedures for reporting suspected violations
- Members strongly encouraged to report violations by other members

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Standard I(B) Independence and Objectivity

“Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another’s independence and objectivity.”

Highlights:

- Buy-Side Clients
- Fund Manager and Custodial Relationships
- Investment Banking Relationships
- Performance Measurement and Attribution
- Public Companies
- Credit Rating Agency Opinions
- Influence during the Manager Selection/Procurement Process
- Issuer-Paid Research
- Travel Funding

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Guidance

**Standard I(B) Independence and Objectivity**

- Modest gifts okay
- Distinguish between gifts from clients and gifts from entities trying to influence a member’s behavior
- May accept gift from clients—disclose to employer—get permission if gift is for future performance
Guidance

**Standard I(B) Independence and Objectivity**

- Members responsible for hiring outside managers should not accept travel, gifts, or entertainment that could impair their objectivity
- Investment banking relationships—do not bow to pressure to issue favorable research
- For issuer-paid research, flat fee structure is preferred; must disclose

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Guidance

**Standard I(B) Independence and Objectivity**

- Members working for credit rating firms should avoid influence by issuing firms
- Users of credit ratings should be aware of this potential conflict
- Best practice is for analysts to pay for their own commercial travel to firms being analyzed or to firm events

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Recommended Procedures

**Standard I(B) Independence and Objectivity**

- Protect integrity of opinions—reports should reflect unbiased opinion
- Create a restricted list
- Restrict special cost arrangements
- Limit gifts; clear value limits by firm
- Be careful with IPO share allocations

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Standard I(C) Misrepresentation

“Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.”

Highlights:

➢ Impact on Investment Practice
➢ Performance Reporting
➢ Social Media
➢ Omissions
➢ Plagiarism
➢ Work Completed for Employer

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Guidance

**Standard I(C) Misrepresentation**

- Standard covers oral, written, or electronic communications
- Do not misrepresent qualifications, services of self or firm, or performance record, characteristics of an investment
- Do not guarantee a certain return
- No plagiarism—written, oral, or electronic communications

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

**Standard I(C) Misrepresentation**

- Firms can assist employees by providing written list of the firm’s available services and a description of the firm’s qualifications
- Maintain records of materials used to prepare research reports, and quote source, except for “recognized financial and statistical reporting services”

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Recommended Procedures

**Standard I(C) Misrepresentation**

- Models and analysis of others at the firm may be used without attribution
- Should encourage firm to establish procedures for verifying marketing claims of third parties recommended to clients

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Standard 1(D) Misconduct

“Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.”

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD I: PROFESSIONALISM

Guidance

Standard 1(D) Misconduct

This Standard covers conduct that may not be illegal, but could adversely affect a member’s ability to perform duties.
STANDARD I: PROFESSIONALISM

Recommended Procedures

**Standard 1(D) Misconduct**

- Adopt a code of ethics to which every employee must adhere
- Disseminate a list of potential violations and associated disciplinary sanctions
- Conduct background checks on potential employees—look for good character and eligibility to work in the investment industry

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD II: INTEGRITY OF CAPITAL MARKETS

CFA Institute

LEVEL I 2018
Standard II(A) Material Nonpublic Information

“Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.”

Highlights:

➢ What Is “Material” Information?
➢ What Constitutes “Nonpublic” Information?
➢ Mosaic Theory
➢ Social Media
➢ Using Industry Experts
➢ Investment Research Reports

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD II: INTEGRITY OF CAPITAL MARKETS

Guidance

Standard II(A) Material Nonpublic Information

➢ “Material”—if disclosure of information would affect a security’s price or if an investor would want to know before making an investment decision
➢ If price effect is ambiguous, information may not be considered material
➢ Extends to info such as upcoming rating change, influential analysis to be released

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Guidance

**Standard II(A) Material Nonpublic Information**

- Information is “nonpublic” until it has been made available to the marketplace
- Information made available to analysts is considered nonpublic until it is made available to investors in general
- “Act” includes related swaps and options, mutual funds with the security

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Guidance

**Standard II(A) Material Nonpublic Information**

- If you possess material non-public information, act as you would if you did not know
- “Mosaic Theory”: no violation when an analyst combines non-material non-public information with public information to reach conclusion
Recommended Procedures

**Standard II(A) Material Nonpublic Information**

- Information barrier or “firewall” is recommended to control interdepartmental communications
- Information barrier includes use of restricted list
- Review employee trades

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

**Standard II(A) Material Nonpublic Information**

- Increase review/restrict proprietary trading while firm is in possession of material nonpublic information
Standard II(B) Market Manipulation

“Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.”

**Highlights:**

- *Information-Based Manipulation*
- *Transaction-Based Manipulation*

**LOS 3.a, b & c Demonstrate, Distinguish & Recommend**
STANDARD II: INTEGRITY OF CAPITAL MARKETS

Standard II(B) Market Manipulation

“Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.”

Highlights:

- Information-Based Manipulation
- Transaction-Based Manipulation

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III:
DUTIES TO CLIENTS AND PROSPECTIVE CLIENTS
STANDARD III: DUTIES TO CLIENTS

Standard III (A) Loyalty, Prudence, and Care

“Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients’ interests before their employer’s or their own interests.”

Highlights:

- Understanding the Application of Loyalty, Prudence, and Care
- Identifying the Actual Investment Client
- Developing the Client’s Portfolio
- Soft Commission Policies
- Proxy Voting Policies

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Guidance

**Standard III (A) Loyalty, Prudence, and Care**

- Take investment actions in client’s best interests
- Exercise prudence, care, skill, and diligence that a person familiar with such matters would use
- Follow applicable fiduciary duty
- “Client” may be investing public

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Guidance

Standard III (A) Loyalty, Prudence, and Care

➢ Manage pools of client assets according to terms of governing documents
➢ Make investment decisions in context of total portfolio
➢ Vote proxies responsibly and disclose proxy voting policies to clients
➢ “Soft dollars” must benefit client
STANDARD III: DUTIES TO CLIENTS

Recommended Procedures

**Standard III (A) Loyalty, Prudence, and Care**
- Follow rules and laws
- Establish client investment objectives
- Diversify
- Deal fairly with clients—investment actions
- Disclose all possible conflicts
- Vote proxies in best interest of clients and ultimate beneficiaries

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Recommended Procedures

Standard III (A) Loyalty, Prudence, and Care

➢ Keep client information confidential
➢ Seek best trading execution for clients
➢ Place client interests first

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Standard III (B) Fair Dealing

“Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.”

Highlights:

➢ Investment Recommendations
➢ Investment Action

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Guidance

**Standard III (B) Fair Dealing**

- No discrimination against any clients when disseminating investment recommendations or taking investment action
- Fair does not mean equal
- Different levels of service are okay as long as disclosed and do not disadvantage any clients

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Guidance

**Standard III (B) Fair Dealing**

**Investment recommendations:**

- *All clients must have fair chance to act on every recommendation*
- *If client is unaware of recommendation change, advise before accepting trade order*

**Investment actions:**

- *Treat all clients fairly—consider investment objectives and circumstances*
- *Disclose written allocation procedures*
- *Do not disadvantage any clients when distributing “hot” issues*

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Recommended Procedures

**Standard III (B) Fair Dealing**

- Limit number of people aware of upcoming changes
- Shorten time frame — decision to dissemination
- Have pre-dissemination guidelines
- Simultaneous dissemination
- Maintain list of clients and their holdings
- Disclose trade allocation procedures

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

**Standard III (B) Fair Dealing**

- Review accounts regularly to ensure fair client treatment
- If firm offers different levels of service, disclose this fact to all clients
- Deviations from strict pro rata allocation of IPO is sometimes okay (e.g., minimum block sizes)

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Standard III (C) Suitability

1. “When Members and Candidates are in an advisory relationship with a client, they must:

- Make a reasonable inquiry into a client’s or prospective client’s investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.

- Determine that an investment is suitable to the client’s financial situation and consistent with the client’s written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

- Judge the suitability of investments in the context of the client’s total portfolio.”
STANDARD III: DUTIES TO CLIENTS

Standard III (C) Suitability

2. “When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.”

Highlights:

➢ Developing an Investment Policy Statement
➢ Understanding the Client’s Risk Profile
➢ Updating an Investment Policy
➢ The Need for Diversification
➢ Addressing Unsolicited Trading Requests
➢ Managing to an Index or Mandate

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Guidance

**Standard III (C) Suitability**

- When in advisory relationship, gather client information at the outset and prepare IPS
- Update IPS at least annually
- Consider whether leverage (derivatives) is suitable for client
- If managing a fund to an index or other mandate, invest according to mandate

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

**Standard III (C) Suitability**

When formulating IPS for client, know the client’s:

- *Return objectives* (*Capital Preservation, Capital Appreciation, Current Income, Total Return*)

- *Risk tolerance* (*Ability & Willingness*)
Recommended Procedures

**Standard III (C) Suitability**

Determine the client’s constraints: (LLTTU)

- *Liquidity needs*
- *Expected cash flows, investable funds*
- *Time horizon, tax considerations*
- *Regulatory/legal constraints*
- *Unique circumstances/needs*
Standard III(D) Performance Presentation

“When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.”
STANDARD III: DUTIES TO CLIENTS

Guidance

**Standard III(D) Performance Presentation**

- Do not misstate performance or mislead clients about investment performance
- Do not misrepresent past performance
- Provide fair and complete performance information
- Do not state or imply ability to achieve returns similar to those achieved in the past

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Recommended Procedures

**Standard III(D) Performance Presentation**

- Consider audience sophistication when presenting performance
- Use performance of the weighted composite of similar portfolios
- Include terminated accounts as part of historical performance
- Make all disclosures and maintain records

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Standard III(E) Preservation of Confidentiality

“Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client;
2. Disclosure is required by law; or
3. The client or prospective client permits disclosure of the information.”

Highlights:
- Status of Client
- Compliance with Laws
- Electronic Information and Security
- Professional Conduct Investigations by CFA Institute
Guidance

**Standard III(D) Performance Presentation**

- In some cases it may be required by law to report activities to relevant authorities
- This Standard extends to former clients
- Exception: May provide confidential information to CFA Institute for an investigation under Professional Conduct Program

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD III: DUTIES TO CLIENTS

Recommended Procedures

**Standard III(D) Performance Presentation**

- Avoid discussing any information received from a client except to colleagues working on the same project
- Follow firm’s electronic data storage procedures; recommend adoption of procedures if none exist

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD IV: DUTIES TO EMPLOYERS

CFA Institute

LEVEL I 2018
STANDARD IV: DUTIES TO EMPLOYERS

Standard IV(A) Loyalty

“In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.”

Highlights:

➢ Employer Responsibilities
➢ Independent Practice
➢ Leaving an Employer
➢ Use of Social Media
➢ Whistleblowing
➢ Nature of Employment

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD IV: DUTIES TO EMPLOYERS

Guidance

**Standard IV(A) Loyalty**

- Place client interests first but consider effects on firm integrity and sustainability
- Members encouraged to give employer a copy of the Code and Standards
- No incentive or compensation structure that encourages unethical behavior

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD IV: DUTIES TO EMPLOYERS

Guidance

**Standard IV(A) Loyalty**

- If planning to engage in independent practice, notify employer of services provided, expected duration, and compensation
- Do not proceed without consent from employer

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD IV: DUTIES TO EMPLOYERS

Guidance

**Standard IV(A) Loyalty**

- Act in best interest of employer until resignation is effective
- Employer records on any medium (e.g., cell phone, PDA, home computer) are property of the firm
- Simple knowledge of names of former clients is okay; don’t solicit prior to leaving
- No prohibition on use of experience or knowledge gained at former employer

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD IV: DUTIES TO EMPLOYERS

Guidance

**Standard IV(A) Loyalty**

- Whistleblowing permitted only if it protects client or integrity of capital markets
- Not permitted for personal gain

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Standard IV(B) Additional Compensation Arrangements

“Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer’s interest unless they obtain written consent from all parties involved.”
Guidance

Standard IV(B) Additional Compensation Arrangements

- Compensation and benefits covers direct compensation by the client and other benefits received from third parties
- For written consent from “all parties involved,” email is acceptable
Recommended Procedures

**Standard IV(B) Additional Compensation Arrangements**

- Written report to employer with details of proposed compensation in addition to normal compensation and benefits
- Details of incentives verified by offering party
- Include nature of compensation, amount, and duration of agreement

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD IV: DUTIES TO EMPLOYERS

Standard IV(C) Responsibilities of Supervisors

**Highlights:**
- *System for Supervision*
- *Supervision Includes Detection*
STANDARD IV: DUTIES TO EMPLOYERS

Guidance

**Standard IV(C) Responsibilities of Supervisors**

- Supervisors must take steps to prevent employees from violating laws, rules, regulations, or the Code and Standards
- Supervisors must make reasonable efforts to detect violations
- Should enforce non-investment rules as well (e.g., mandatory vacations)
Recommended Procedures

**Standard IV(C) Responsibilities of Supervisors**

Adequate compliance procedures should:

- **Be clear and understandable**
- **Designate a compliance officer**
- **Have checks/balances; permitted conduct**
- **Have procedures for reporting violations**
Recommended Procedures

**Standard IV(C) Responsibilities of Supervisors**

Supervisor and compliance officer should:

- Distribute procedures; update periodically
- Continually educate staff
- Review employee actions
- Promptly initiate procedures once a violation has occurred
Recommended Procedures

**Standard IV(C) Responsibilities of Supervisors**

Once a violation has occurred, a supervisor should:

- *Respond promptly*
- *Conduct a thorough investigation*
- *Place appropriate limitations on the wrongdoer until investigation is complete*
STANDARD V:
INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTION
Standard V(A) Diligence and Reasonable Basis

“Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.”

Highlights:

- Defining Diligence and Reasonable Basis
- Using Secondary or Third-Party Research
- Using Quantitatively Oriented Research
- Developing Quantitatively Oriented Techniques
- Selecting External Advisers and Subadvisers
- Group Research and Decision Making
Guidance

**Standard V(A) Diligence and Reasonable Basis**

- Make reasonable efforts to cover all relevant issues when arriving at an investment recommendation
- Level of diligence will depend on product or service offered

**LOS 3.a, b & c Demonstrate, Distinguish & Recommend**
Guidance

Standard V(A) Diligence and Reasonable Basis

Using secondary or third-party research:

- Determine soundness of the research—review assumptions, rigor, timeliness, and independence of analysis
- Encourage firm to adopt policy of periodic review of quality of third-party research regarding assumptions, timeliness, rigor, objectivity, and independence
Recommended Procedures

**Standard V(A) Diligence and Reasonable Basis**

- Establish policy that research and recommendations should have reasonable and adequate basis
- Review/approve research reports and recommendations prior to external circulation
Recommended Procedures

Standard V(A) Diligence and Reasonable Basis

➢ Establish due diligence procedures for judging if recommendation has met reasonable and adequate basis criteria
➢ Develop measurable criteria for assessing quality of research
Recommended Procedures

**Standard V(A) Diligence and Reasonable Basis**

- Consider scenarios outside recent experience to assess downside risk of quantitative models
- Make sure firm has procedures to evaluate external advisers they use or promote, including how often to review

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

**Standard V(A) Diligence and Reasonable Basis**

- Written procedures of acceptable scenario testing, range of scenarios, cash flow sensitivity to assumptions and inputs
- Procedure for evaluating outside information providers including how often
- No need to dissociate from group research that the member disagrees with

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Standard V(B) Communication with Clients and Prospective Clients

“Members and Candidates must:

➢ Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

➢ Disclose to clients and prospective clients significant limitations and risks associated with the investment process.

➢ Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.

➢ Distinguish between fact and opinion in the presentation of investment analyses and recommendations.”

Highlights:

➢ Informing Clients of the Investment Process
➢ Different Forms of Communication
➢ Identifying Risk and Limitations
➢ Report Presentation
➢ Distinction between Facts and Opinions in Reports

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Guidance

**Standard V(B) Communication with Clients and Prospective Clients**

- Include basic characteristics of the security
- Inform clients of any change in investment processes
- Suitability of investment—portfolio context
- All communication covered, not just reports
Recommended Procedures

**Standard V(B) Communication with Clients and Prospective Clients**

- The inclusion or exclusion of information depends on a case-by-case review
- Maintain records

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Standard V(C) Record Retention

“Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.”

**Highlights:**

- *New Media Records (email, texts, blogs, twitter)*
- *Records Are Property of the Firm*
- *Local Requirements*

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD V: INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

Guidance

**Standard V(C) Record Retention**

- Maintain records to support research, and the rationale for conclusions and actions
- Records are firm’s property and cannot be taken when member leaves without firm’s consent
- If no regulatory requirement, CFA Institute recommends retention period of 7 years

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

**Standard V(C) Record Retention**

- Responsibility to maintain records generally falls with the firm
- However, individuals must retain documents that support investment-related communications
Recommended Procedures

**Standard V(C) Record Retention**

- When member changes firm, must recreate records from public sources and new firm’s information (can’t rely on memory or materials from old firm)
STANDARD VI: CONFLICTS OF INTEREST

LEVEL I 2018
STANDARD VI: CONFLICTS OF INTEREST

Standard VI(A) Disclosure of Conflicts

“Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.”

Highlights:

➢ Disclosure of Conflicts to Employers
➢ Disclosure to Clients
➢ Cross-Departmental Conflicts
➢ Conflicts with Stock Ownership
➢ Conflicts as a Director

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD VI: CONFLICTS OF INTEREST

Guidance

**Standard VI(A) Disclosure of Conflicts**

Disclose to clients:
- *All matters that could impair objectivity*—allow clients to judge motives, biases
- *For example, between member or firm and issuer, investment banking relations, broker/dealer market-making activities, significant stock ownership, board service*

Disclose to employers:
- *Conflicts of interest*—ownership of stock analyzed/recommended, board participation, financial and other pressures that may influence decisions
- *Also covers conflicts that could be damaging to employer’s business*

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD VI: CONFLICTS OF INTEREST

Recommended Procedures

**Standard VI(A) Disclosure of Conflicts**

- Disclose compensation arrangements with employer that conflict with clients’ interests
- If firm does not permit disclosure, consider dissociating from the activity
- Firms are encouraged to include compensation information in promotional materials
STANDARD VI: CONFLICTS OF INTEREST

Standard VI(B) Priority of Transactions

“Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.”

Highlights:

➢ Avoiding Potential Conflicts
➢ Personal Trading Secondary to Trading for Clients
➢ Standards for Nonpublic Information
➢ Impact on All Accounts with Beneficial Ownership

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD VI: CONFLICTS OF INTEREST

Guidance

Standard VI(B) Priority of Transactions

➢ “Beneficial owner”—has direct/indirect personal interest in the securities
➢ Client, employer transactions take priority over personal transactions (including beneficial ownership)
➢ Family member accounts that are client accounts must be treated as other client accounts

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Recommended Procedures

Standard VI(B) Priority of Transactions

Firm’s compliance procedures should:

- *Limit participation in equity IPOs*
- *Restrict purchase of securities through private placements*
STANDARD VI: CONFLICTS OF INTEREST

Recommended Procedures

**Standard VI(B) Priority of Transactions**

- Establish blackout/restricted periods
- Establish reporting procedures and prior clearance requirements
- Disclose policies on personal investing to clients, upon request
STANDARD VI: CONFLICTS OF INTEREST

Standard VI(C) Referral Fees

“Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.”
STANDARD VI: CONFLICTS OF INTEREST

Guidance

**Standard VI(C) Referral Fees**

- Disclosure allows clients and employers to evaluate full cost of service and any potential biases
- Disclosure is to be made prior to entering into any formal agreement for services
- Disclose the nature of the consideration

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
STANDARD VI: CONFLICTS OF INTEREST

Guidance

**Standard VI(C) Referral Fees**

➢ Encourage firm to have clear policy regarding referral compensation
➢ Firms that do not prohibit should have clear approval process
➢ Members should update referral compensation disclosure to employer at least quarterly
STANDARD VII:
RESPONSIBILITIES AS A CFA INSTITUTE MEMBER
OR CFA CANDIDATE

CFA Institute

LEVEL I 2018
Standard VII (A) Conduct as Members and Candidates in CFA Program

“Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.”

Highlights:

➢ Confidential Program Information
➢ Additional CFA Program Restrictions
➢ Expressing an Opinion
STANDARD VII: RESPONSIBILITIES AS CFA INSTITUTE MEMBER OR CANDIDATE

Guidance

Standard VII (A) Conduct as Members and Candidates in CFA Program

Conduct includes:

• Cheating on the exam
• Disregarding rules and policies or security measures related to exam administration
• Giving confidential information to candidates or public
STANDARD VII: RESPONSIBILITIES AS CFA INSTITUTE MEMBER OR CANDIDATE

Guidance

**Standard VII (A) Conduct as Members and Candidates in CFA Program**

Don’t disclose:

- *Formulas tested or not tested on exam*
- *Specific question information*
- *Topic emphasis on the exam or topics tested*
STANDARD VII: RESPONSIBILITIES AS CFA INSTITUTE MEMBER OR CANDIDATE

Guidance

Standard VII (A) Conduct as Members and Candidates in CFA Program

Conduct includes:

• *Improper use of CFA designation to further personal and professional objectives*

• *Misrepresenting the CFA Institute Professional Development Program or the Professional Conduct Statement*
Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

“When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.”
Guidance

**Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program**

CFA Institute membership:

- *Complete PCS annually*
- *Pay membership dues annually*

Failure to comply with above results in an inactive member status
STANDARD VII: RESPONSIBILITIES AS CFA INSTITUTE MEMBER OR CANDIDATE

Guidance

Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

Using the CFA designation:

- Use the marks “Chartered Financial Analyst” or “CFA” in a manner that does not misrepresent or exaggerate the meaning or implications of holding the CFA designation
STANDARD VII: RESPONSIBILITIES AS CFA INSTITUTE MEMBER OR CANDIDATE

Guidance

Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

Reference to the CFA program:

- Candidates may reference participation in CFA program, but do not imply achievement of any type of partial designation
- Okay to say “passed all levels on first attempt,” but do not imply superior ability
Guidance

Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

Improper use of the CFA marks:

- The “Chartered Financial Analyst” and “CFA” marks must always be used either after a charterholder’s name or as adjectives, not as nouns.
Recommended Procedures

**Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program**

- Make sure that your employer is aware of the proper references to the CFA designation and CFA candidacy

LOS 3.a, b & c Demonstrate, Distinguish & Recommend
Reading 4: Introduction to the Global Investment Performance Standards (GIPS)
The candidate should be able to:

a. explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is served by the standards;

b. explain the construction and purpose of composites in performance reporting;

c. explain the requirements for verification.
WHY GIPS WERE CREATED

➢ GIPS make performance measurement among firms comparable, with standardized calculation and reporting practices

➢ GIPS aim to avoid misrepresentation of performance of investment firms and to give clients relevant information to evaluate past performance

➢ Misleading practices included:
  ➢ *Representative Accounts*
  ➢ *Survivorship Bias*
  ➢ *Varying Time Periods*

LOS 4.a, b & c Explain
WHO CAN CLAIM COMPLIANCE

1. Any investment management firm may choose to comply with the GIPS standards. Complying with the GIPS standards is voluntary.

2. Only investment management firms that actually manage assets can claim compliance with the Standards. Plan sponsors and consultants cannot make a claim of compliance unless they actually manage assets for which they are making a claim of compliance.

3. Compliance is a firm-wide process that cannot be achieved on a single product or composite. A firm has only two options with regard to compliance with the GIPS standards: fully comply with all requirements of the GIPS standards and claim compliance through the use of the GIPS Compliance Statement; or not comply with all requirements of the GIPS standards.

LOS 4.a, b & c Explain
WHO BENEFITS FROM COMPLIANCE

The GIPS standards benefit two main groups: investment management firms and prospective clients.

➢ By choosing to comply with the GIPS standards, investment management firms assure prospective clients that the historical “track record” they report is both complete and fairly presented.

➢ Investors have a greater level of confidence in the integrity of performance presentations of a GIPS-compliant firm and can more easily compare performance presentations from different investment management firms.

LOS 4.a, b & c Explain
A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy.

A composite must include all actual, fee-paying, discretionary portfolios managed in accordance with the same investment mandate, objective, or strategy.
Verification is performed with respect to an entire firm, not on specific composites. Verification does not ensure the accuracy of any specific composite presentation. Verification tests:

- whether the investment firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and
- whether the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

Verification must be performed by an independent third party. A firm cannot perform its own verification.

LOS 4.a, b & c Explain
The provisions within the 2010 edition of the GIPS standards are divided into nine sections:

1. Fundamentals of Compliance,
2. Input Data,
3. Calculation Methodology,
4. Composite Construction,
5. Disclosure,
6. Presentation and Reporting,
7. Real Estate,
8. Private Equity, and
9. Wrap Fee/Separately Managed Account (SMA) Portfolios. The provisions are further categorized into requirements and recommendations.

LOS 4.a, b & c Explain
The candidate should be able to:

a describe the key features of the GIPS standards and the fundamentals of compliance;

b describe the scope of the GIPS standards with respect to an investment firm’s definition and historical performance record;

c explain how the GIPS standards are implemented in countries with existing standards for performance reporting and describe the appropriate response when the GIPS standards and local regulations conflict;

d describe the nine major sections of the GIPS standards.
9 MAJOR SECTIONS OF GIPS

1. Fundamentals of compliance—issues for firms to consider when claiming GIPS compliance, including definition of firm

2. Input data—must be consistent, for full, fair, comparable performance presentations

3. Calculation methodology—certain methodologies are required; be uniform in methods

4. Composite construction—create meaningful, asset-weighted composites

5. Disclosures—certain info must be disclosed about presentation/policies

6. Presentation and reporting—present investment performance according to GIPS requirements

7. Real estate—provisions also apply to real estate investments, regardless of level of control the firm has over management of the investment

8. Private equity—value according to GIPS Private Equity Valuation Principles, unless open-end or evergreen fund (then follow regular GIPS)

9. Wrap Fee/Separately Managed Account (SMA) Portfolios—a supplement to Sections 0–5 with specific reference to those provisions which don’t apply to Wrap Fee/SMA portfolios and some provisions here that supersede those in Sections 0–5

LOS 5.a,b,c & d Describe & Explain
COMPOSITES: CONSTRUCTION AND PURPOSE

- Composite—grouping of individual discretionary portfolios with same investment strategy, objective, or mandate
- A composite must include all portfolios (current and past) that the firm has managed in accordance with this particular strategy
- Groupings must be pre-identified

LOS 5.a,b,c & d Describe & Explain
PURPOSE OF VERIFICATION

➢ Voluntarily, a firm may hire an independent third party to verify its claim of GIPS compliance

➢ Primary purpose of verification is to provide assurance that compliance with GIPS is on a firm-wide basis
REQUIREMENTS – VERIFICATION OF COMPLIANCE

➢ Must be performed by a third party, on a firm-wide basis
➢ Verifier must attest that firm has complied with GIPS requirements for composite construction, and firm’s processes/procedures are established to present performance in accordance with proper calculation methods, data, and format

LOS 5.a,b,c & d Describe & Explain
GIPS OBJECTIVES

➢ Obtain global acceptance of calculation and presentation standards—fair, comparable format with full disclosure
➢ Ensure consistent, accurate performance data—reporting, marketing, presentations
➢ Promote fair competition
➢ Promote global industry “self-regulation”
GIPS KEY CHARACTERISTICS

To claim compliance, define firm—“distinct” business entity

GIPS—ethical standards for performance presentation—ensure fair representation

Include all actual fee-paying, discretionary portfolios in composites for 5-year minimum, or since inception (add performance results each year—10 years)
GIPS KEY CHARACTERISTICS (CONTINUED)

- Certain calculation/presentation standards are required, along with disclosures
- Input data must be accurate
- GIPS—required and recommended provisions (encouraged)
- No partial compliance allowed
- If GIPS conflicts with local law, follow local law, but disclose conflict
GIPS CLAIM OF COMPLIANCE

Once GIPS requirements are met:

- “[Firm name] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS)”

- No statements referring to calculation methodologies used in a composite presentation being “in accordance with GIPS”

LOS 5.a,b,c & d Describe & Explain
GIPS FIRM’S FUNDAMENTAL RESPONSIBILITIES

➢ Provide compliant presentation to all prospects
➢ Provide composite list/description to all prospects who make a request
➢ On client request, provide compliant presentation and composite description
➢ Joint marketing, separate non-compliant firm

LOS 5.a,b,c & d Describe & Explain
FIRM DEFINITION AND HISTORICAL RECORD

➢ To claim compliance, firm defined as the “distinct business entity” held out to clients

➢ Include all actual fee-paying, discretionary portfolios in composites for a minimum of five years or since firm or composite inception

➢ Must add one year of compliant performance history each year until a 10-year record is presented

LOS 5.a,b,c & d Describe & Explain
Firms that previously represented performance in compliance with a specific Country Version of GIPS (CVG) may claim GIPS compliance prior to 1-1-06.

In cases where country-specific regulations are different from GIPS, follow the country-specific regulations, but disclose the nature of the conflict with GIPS.