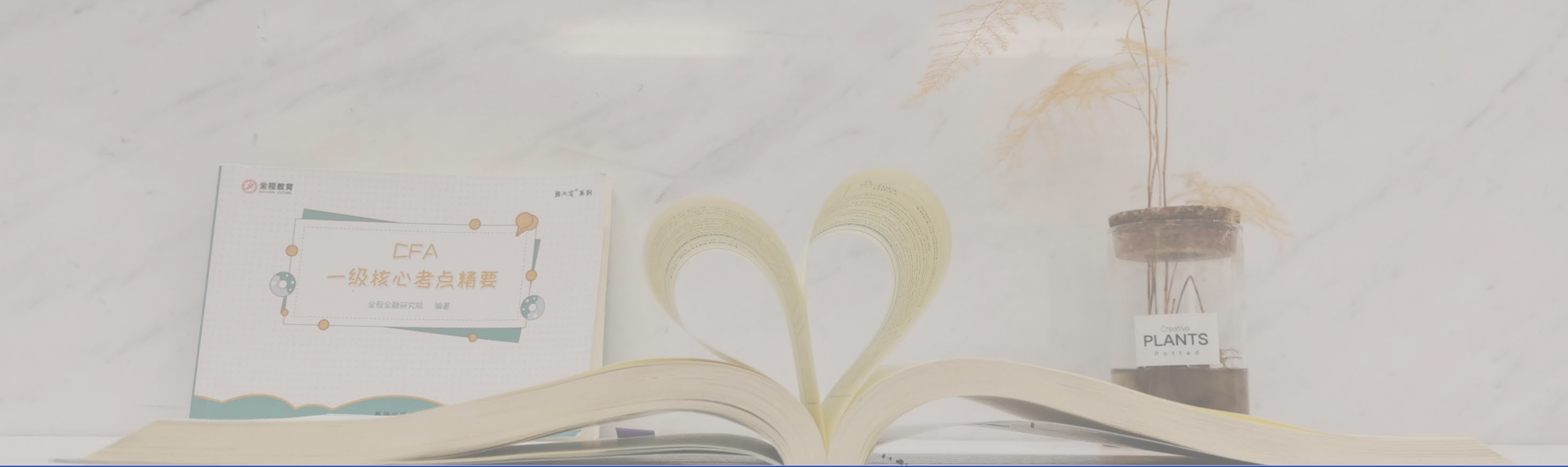

Ethical & Professional Standards

CFA一级培训项目

讲师：Alex Tang

学位证书

- 复旦大学会计学博士
- CFA持证人（2004-2018）
- 中级经济师持证人
- CFRM（注册金融风险管理师）持证人
- RFP（美国注册财务策划师）持证人
- FRM（金融风险管理师）持证人
- CTP（国际财资管理师）持证人
- CAIA（特许另类投资分析师）持证人
- CMA（美国管理会计师）持证人

工作职称

- **金程教育创始人、董事长、首席培训师**
- 南京大学中国机构投资者研究中心专家
- 美国注册财务策划师协会（RFPI）大中华管理中心特聘专家
- 上市公司独立董事
- 吉林大学经济学院研究生校外合作导师
- 上海对外经贸大学金融管理学院CFA/FRM双证班教研顾问
- 西交利物浦大学校外导师

汤震宇 博士

23年授课，10,000+授课课时

汤震宇

出版著作

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- 《新租赁准则解读》（上海财经大学出版社）
- 《CPA会计必背·基础39》（上海财经大学出版社）
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- 《固定收益证券定价理论》（复旦大学出版社）
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Topic Weightings in CFA Level I

Topics	Weights (%)
Quantitative Methods	8-12
Economics	8-12
Financial Statement Analysis	13-17
Corporate Issuers	8-12
Equity	10-12
Fixed Income	10-12
Derivatives	5-8
Alternative Investments	5-8
Portfolio Management	5-8
Ethical and Professional Standards	**15-20**

Ethical & Professional Standards

1. Ethics and Trusts in the Investment Profession
2. Code of Ethics and Standards of Professional Conduct
3. Guidance for Standards I-VII
4. Introduction to the Global Investment Performance Standards (GIPS)
5. Ethics Application

Guide to study Ethics and Standards:

1. Read《中文精读》
2. Recite the standards and identify their specific scope
3. Read all examples in the textbook and identify the specific dissimilarities.

中文精读

1. 投资行业道德标准与信任
2. 道德规范与专业行为准则
3. CFA专业行为准则
4. 全球投资业绩展示标准
5. 职业伦理应用场景

Framework

Module

Ethics and Trusts in the Investment Profession

1. Ethics and professionalism
2. Ethical vs. Legal Standards

Ethics and Trusts

- What's Ethics?
- Role of a code of ethics in defining a profession
- The definition of professions and how professions establish trust
- Why high ethical standards in investment management?
- Describe professionalism in investment management
- Challenges to ethical behavior

What's Ethics?

- Ethics can be described as a set of **shared beliefs** about **what is good or acceptable behavior** and **what is bad or unacceptable behavior**.
  - **Ethical conduct** has been described as behavior that follows moral principles and is consistent with society's ethical expectations.
  - **Ethical conduct** has also been described as conduct that improves outcomes for stakeholders, who are people directly or indirectly affected by the conduct.
    - ✓ **Stakeholders** in the case of investment professionals include their clients, colleagues, employers, and the investment profession as a whole.
    - ✓ Some decisions may bring **positive** results for you, but **negative** consequences for a stakeholder, such as a colleagues. Ethical conduct is behavior that balances your self-interest with the impact on others.

• Role of a code of ethics in defining a profession •

- A code of ethics is a **written set of moral principles** that can **guide behavior** by describing what is considered acceptable behavior.
  - **Having a code of ethics** is a way to **communicate** the values, principles, and expectations of an organization or other group of people and provides a general guide to what constitutes acceptable behavior.
  - Standards of practice serve as **benchmarks for the minimally acceptable behavior** of community members and can help **clarify** the code of ethics.
- A profession refers to a group of people **with specialized skills and knowledge** who serve others and agree to behave in accordance with a code of ethics.
  - A **professional code of ethics** is a way for a profession to **communicate** to the public that its members will use their knowledge and skills to serve their clients in an honest and ethical manner.

The definition of professions and how professions establish trust

- **A profession is an occupational community that has specific education, expert knowledge, and a framework of practice and behavior that underpins community trust, respect, and recognition.**
  - such as doctors, lawyers, actuaries, accountants, architects, and engineers.
- **The requirement to uphold high ethical standards is one clear difference between professions and craft guilds or trade bodies.**
  - Professionals use specialized knowledge and skills to serve their clients and others.
  - Trade bodies do not normally have a mission to serve society or to set and enforce professional conduct rules for practitioners.
- **For a profession to be credible, a primary goal is to establish trust among clients and among society in general.** In doing so, professions have a number of common characteristics that, when combined, greatly increase **confidence and credibility** in professionals and their organizations.

The definition of professions and how professions establish trust

- Common characteristics of professions include [**normalization** of practitioner behavior, **service to society**, **client focus]**, [high entry standards, **a body of expert knowledge**, encouragement and facilitation of continuing education], [monitoring of professional conduct, **collegiality**, recognized overseeing bodies, and encouragement of member engagement].
- **Ways that professions establish trust include:**
  - Professions **normalize** practitioner behavior.
    - ✓ Many governments have recognized that a profession can develop a **more sophisticated system of standards** than a regulator can, via continuous practitioner input and a strong mutual interest within the profession to **maintain good standards** and **adopt best practices**.
  - Professions provide a service to society.
    - ✓ A profession that earns trust may ultimately have **greater flexibility and independence** from government regulators to manage its own affairs, which allows members of the profession to develop **service models** that are both useful to clients and beneficial to members.

The definition of professions and how professions establish trust

- **Ways that professions establish trust include:**
  - Professions are client focused.
    - ✓ At a minimum, professionals must act in the best interest of the client, exercising a reasonable level of care, skill, and diligence.
  - Professions have high entry standards.
    - ✓ The professional will deliver high-quality service of a promised standard, going beyond simply academic credentials.
  - Professions possess a body of expert knowledge.
  - Professions encourage and facilitate continuing education.
    - ✓ The training and education that professionals undertake increase the value of human capital, which can contribute to economic growth and social mobility.

The definition of professions and how professions establish trust

- **Ways that professions establish trust include:**
  - Professions monitor professional conduct.
    - ✓ Members of a profession must be **held accountable for** their conduct to maintain the **integrity and reputation** of an industry.
  - Professions are **collegial**.
    - ✓ They should be respectful to each other, even when they are competing. At least, respect the rights, dignity, and autonomy of others.
  - Professions are recognized oversight bodies.
    - ✓ Continuing membership indicates sustained **competence** in (and updating of) practical skills while maintaining **ongoing compliance** with an ethical code of conduct.
  - Professions encourage the engagement of members.
    - ✓ Professionals should be willing to volunteer to advance the profession and **engage with peers** to develop expertise and ethics.

Why high ethical standards in investment management?

- Investment professionals have a **special responsibility** because they are **entrusted with their clients' wealth**.
  - The **responsibility** to use their specialized knowledge and skills to both **protect** and **grow** client assets makes <u>high ethical standards all the more important</u>.
  - **Investment advice and management** are intangible products, making quality and value received <u>more difficult to evaluate</u> than for tangible products such as a computer.
    - ✓ For this reason, trust in investment professionals takes on an <u>even greater importance than in many other businesses</u>.
  - Failure to act in a highly ethical manner can damage not only <u>client wealth</u> but also <u>impede the success of investment firm and investment professionals</u> because potential investors will **be less likely** to use their services.
  - <u>Unethical behavior</u> by financial services professionals can have **negative effects** for society as a whole.

Why high ethical standards in investment management?

- The financial services industry serves as **an intermediary** between savers and those seeking financing for their business activities.
  - A lack of trust in financial advisors will **reduce** the funds entrusted to them and **increase** the cost of raising capital for business investment and growth.
  - When investors cannot rely on the information they receive from financial services professionals, this adds another layer of risk on top of the investment risks that investors face.
    - ✓ Even the perception of additional risk will **reduce** the amounts invested and **increase** the returns required to attract investor capital.

Why high ethical standards in investment management?

- In addition to reducing the amount of investment overall, unethical behavior (such as providing incomplete, misleading, or false information to investors) can affect the allocation of the capital that is raised.
  - **Misallocation of capital to businesses** other than those with the most potential for growth and societal benefit reduces the growth of an economy and the well-being of its people.
  - When the allocation of investment capital is constrained or inefficient, **the negative consequences** extend to all the participants in an economy.

Describe professionalism in investment management

- Clients of investment professionals **rely on** their expertise, judgment, and ethical principles.
- **Ethical principles** are of great importance because clients often do not have significant knowledge about financial securities, fee structures, or sources of potential bias in investment recommendations.
  - Currently, some financial professionals are held to a suitability standard, while others are held to a fiduciary standard.
    - ✓ **Suitability** refers to the **match** between client return requirements and risk tolerances and the characteristics of the securities recommended.
    - ✓ A **fiduciary** standard is stronger, requiring professionals to use their knowledge and expertise to act in the best interests of the client.

Challenges to ethical behavior

- One challenge to ethical behavior is that individuals tend to **overrate** the ethical quality of their behavior on a relative basis and overemphasize the importance of their own personal traits in determining the ethical quality of their behavior: I am honest and won't tell lies.
- It is claimed that external or **situational influences** are a more important determinant of the ethical quality of behavior than internal personal traits that influence behavior: One situational influence is **social pressure** from others.
  - **Loyalty** to an employer, supervisor, organization, or colleagues can cause individuals to act in unethical ways as they place **more importance on their self-interest and short-term results** than on longer-term results and the ethical quality of their decisions and behavior.
  - The prospect of acquiring **more money or greater prestige** can cause individuals to engage in unethical behavior, but less influential than the loyalty to employer or colleagues.
- Firms with strict rules-based compliance procedures run the risk of fostering a culture that is so focused on **adhering to compliance rules** that individuals only ask themselves what they can do *rather than* what they should do by only checking the box (oversimplify).

Summary

Ethics and Trusts in the Investment Profession

Ethics and Standards

Ethics is shared belief. Code of Ethics is general guide.

Standard of conduct is the minimum acceptable behavior.

Overconfidence, situational influence (short-term, self-interest,

Loyalty to employer/colleagues, strong compliance)

Ethical vs. legal standards

- Ethical standards vs. legal standards
- The framework for ethical decision making

Ethical standards vs. legal standards

- **Not all unethical actions are illegal, and not all illegal actions are unethical.**
  - In some places it may be **illegal** to report one's employer's actions against the best interests of clients by sharing what is considered private company information with authorities, but doing so may be considered **ethical** "whistle-blowing" behavior by some.
  - Acts of civil disobedience that are illegal are also considered by many to be ethical behavior.
  - On the other hand, recommending investment in a relative's firm without disclosure may **not be illegal**, but would be considered **unethical** by many.

Ethical vs. Legal Standards

- The law is **not always the best mechanism** to reduce unethical behavior.
  - Laws typically follow market practices.
  - Regulators' responses typically take significant time, during which the problematic practice may continue or even grow.
  - A new law may be vague, conflicting, and/or too narrow in scope.
  - Laws vary across countries or jurisdictions, allowing questionable practices to move to places that lack laws relevant to the questionable practice.
  - Laws are also subject to interpretation and compliance by market participants, who may choose to interpret the law in the most advantageous way possible or delay compliance until a later date.
- Ethical principles often set a higher standard of behavior than laws and regulations. Ethical conduct goes beyond what is legally required and encompasses what different societal groups or communities, including professional associations, consider to be ethically correct behavior.
- In general, ethical decisions require more judgment and consideration of the impact of behavior on many stakeholders compared to legal decisions—to make considered decisions and reach sensible conclusions.

The framework for ethical decision making

- Ethical decisions will be improved when ethics are integrated into a **firm's decision-making process**.
  - This will allow decision makers and teams to consider alternative actions as well as **shorter-and longer-term consequences** from various perspectives, improving the ethical aspects of their decisions.
- To do this it is first necessary that the firm adopt a code of ethics to guide the process. **Such integration** provides an opportunity to teach, practice, and reinforce ethical decision-making. This is an important part of developing an ethical culture.
- **The support of senior management** for integrating ethics into the decision-making process is also very important in developing a culture and processes that will result in ethical decision-making.
- Using a framework for ethical decision-making helps individuals **identify the important issues** involved, examine these issues **from multiple perspectives**, develop the necessary judgment and decision-making skills required, and avoid **unanticipated ethical consequences**.

The framework for ethical decision making

- **The following ethical decision-making framework is presented as four steps.**
  - **Identify**: Relevant facts, stakeholders and duties owed, ethical principles, conflicts of interest.
  - **Consider**: Situational influences, additional guidance, alternative actions.
  - **Decide and act**.
  - **Reflect**: Was the outcome as anticipated? Why or why not?

The framework for ethical decision making

- **In the first step,** decision makers need to **identify** the facts they have to work with, and the facts they would like to have, before making a decision.
  - Identify stakeholders those affected by the decision
    - ✓ **These stakeholders** may include the employer, clients, colleagues, self, family, and others in the industry, and **the duties to each stakeholder** should be identified.
  - Also help in explicitly identifying **potential conflicts of interest** among the various stakeholders.
  - Identify **the ethical principles** involved in the decision, although greater clarity about those may also be gained throughout the process.

The framework for ethical decision making

- **In the second step,** the framework suggests **situational factors** that may influence decision makers should be identified and considered **along with any personal biases** that may come into play.
  - At this point, decision makers may seek outside guidance which can come from a mentor, colleagues, or friends who have shown good judgment in the past.
    - ✓ Guidance may also be sought from the firm's legal and compliance departments.
    - ✓ This guidance from alternative sources will help to provide variety of perspectives from which the decision under consideration can be viewed, as well as help in developing alternatives that should be considered.
  - Finally, the alternative actions that have been identified are all considered.
    - ✓ Taking into account both the short-term and long-term effects of **each alternative action** and **any potential but unanticipated ethical implications**.

The framework for ethical decision making

- **In the final step,** decision makers should **evaluate** the outcomes of the actions that were taken.
    - In particular, they should consider whether the decisions had their intended results and whether appropriate consideration was given to **ethical principles, situational influences, and duties to clients and other stakeholders.**

Example

Standards of conduct

- Which of the following statements is most accurate? Standards of conduct:

  A. Are a necessary component of any code of ethics.

  B. Serve as a general guide regarding proper conduct by members of a group.

  C. Serve as benchmarks for the minimally acceptable behavior required of members of a group.

- Correct Answer: C

  - Standards of conduct serve as benchmarks for the minimally acceptable behavior required of members of a group. Some organizations will adopt only a code of ethics, which communicates the organization’s values and overall expectations regarding member behavior.

Example

Situational influences

- Which of the following statements is *most* accurate?

  A. Large financial rewards, such as bonuses, are the most powerful situational influences.

  B. When decision making focuses on short-term factors, the likelihood of ethical conduct increases.

  C. Situational influences can motivate individuals to act in their short-term self-interests without recognizing the long-term risks or consequences for themselves and others.

- Correct Answer: C.
  - Situational influences can motivate individuals to act in their short-term self-interests without recognizing the long-term risks or consequences for themselves and others. Large financial rewards are powerful situational influences, but in some situations, other situational influences, such as loyalty to colleagues, may be even more powerful.

Example

Ethical vs. Legal Standards

- Which of the following statements is *most* accurate?
  - A. Increased regulations are the most useful means to reduce unethical behavior by market participants.
  - B. Regulators quickly design and implement laws and regulations to address practices that adversely affect the fairness and efficiency of markets.
  - C. New laws designed to reduce or eliminate conduct that adversely affects the markets can create opportunities for different, but similarly problematic, conduct.

- Correct Answer: C.
  - New laws designed to reduce or eliminate conduct that adversely affects the markets can create opportunities for different, but similarly problematic, conduct.

Summary

- **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. Standards of practice serve as **benchmarks for the minimally acceptable behavior of community members** and can help **clarify the code of ethics.**
- Challenges to ethical behavior include being **overconfident in our own morality**, underestimating the effect of **situational influences**, and **focusing on the immediate rather than long-term** outcomes or consequences of a decision.
- A primary goal of professions is to establish **trust among clients and among society in general**.
- Common characteristics of professions include [normalization of practitioner behavior, **service to society**, **client focus]**, [high entry standards, **a body of expert knowledge**, encouragement and facilitation of continuing education], [monitoring of professional conduct, **collegiality**, recognized overseeing bodies, and encouragement of member engagement].
- 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**.
- 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**.

Summary

Ethical vs. legal standards

Legal is not equal to ethical.

Ethics often sets higher than law. Law is not the best way to reduce unethical.

A framework for ethical decision making allows for different perspectives, considers important issue and its consequence.

Summary

Module: Ethics and Trusts in the Investment Profession

Ethics and professionalism; Overconfidence, situational influence

Law is rule-based; Ethics sets higher than law.

Ethical conduct balances self-interest with direct and indirect consequences of behavior on others

Module

Code of Ethics and Standards of Professional Conduct

1. Proceedings and the hearing panel
2. Code of Ethics

Proceedings and the hearing panel

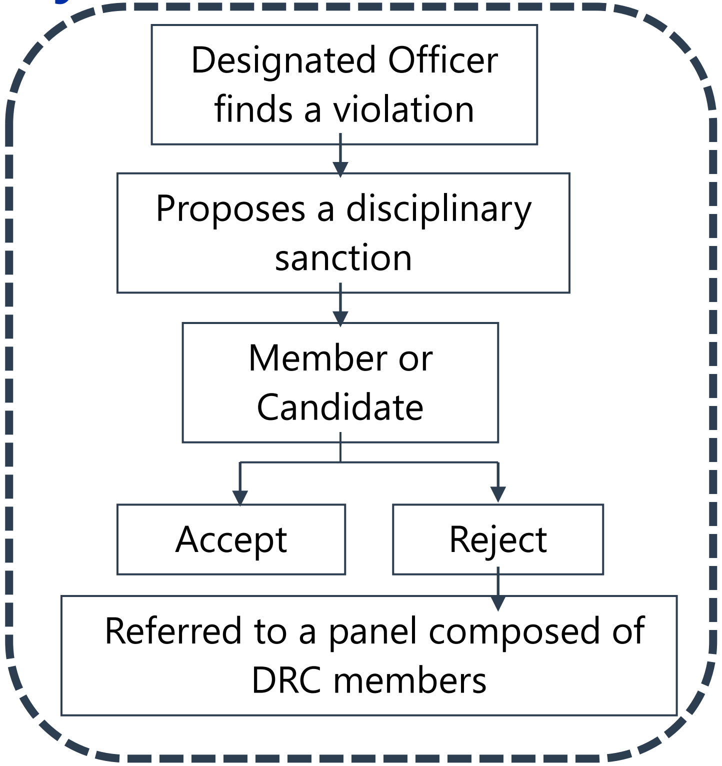
- Proceedings
- The Panel

Proceedings

- The CFA Institute **Board of Governors** maintains oversight and responsibility for the **Professional Conduct Program (PCP).**
- PCP and **Disciplinary Review Committee (DRC)** are responsible for enforcement of the Code and Standards. Professional Conduct inquiries come from a number of sources.
  - Self-disclosure on annual Professional Conduct Statements of involvement in civil litigation or a criminal investigation, or that the member or candidate is the subject of a written complaint.
  - Written complaints about professional conduct received by the Professional Conduct staff.
  - Evidence of misconduct by a member or candidate that the Professional Conduct staff received through public sources, such as a media article or broadcast.
  - A report by a CFA exam proctor of a possible violation during the examination.

Proceedings

- **Once an inquiry is initiated, <u>Professional Conduct staff</u> may requests <u>(in writing)</u> an explanation from the subject member or candidate and may:**
  - Interview the subject member or candidate
  - Interview the complainant or other third parties
  - Collect documents and records relevant to the investigation
- **<u>The Designated Officer</u> may decide:**
  - That no disciplinary sanctions are appropriate
  - To issue a cautionary letter
  - To discipline the member or candidate



The Panel

- If the member or candidate does not accept the charges and proposed sanction, the matter is referred to a panel composed of **DRC** (Discipline Review Committee) members.
- Panels review materials and presentations from Professional Conduct staff and from the member or candidate.
- The panel's task is to determine whether a violation of the Code and Standards or testing policies occurred and, if so, what sanction should be imposed.
- Sanctions imposed by CFA Institute may have significant consequences; they include **public censure**, **suspension of membership and use of the CFA designation**, and **revocation of the CFA charter**. Candidates enrolled in the CFA Program who have violated the Code and Standards or testing policies may be **suspended or prohibited** from further participation in the CFA Program.

Summary

Code of Ethics and Standards of Professional Conduct

Proceedings and the hearing panel

Code of Ethics

- Comparisons of AMC and Code and Standards
- Ethics & Professional Standards

Comparisons of AMC and Code and Standards

- **AMC**
  - The Asset Manager Code of Professional Conduct (AMC), which is designed, in part, to help asset managers comply with the regulations **mandating codes of ethics for investment advisers**.
  - AMC was drafted **specifically for firms**.

- **Code and Standards**
  - Aimed at **individual investment professionals** who are members of CFA Institute or candidates in the CFA Program.

Ethics & Professional Standards

- Members of CFA Institute ("Members and Candidates") must:

  • Act with **integrity**, competence, diligence, 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.

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

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

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

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

  • Maintain and improve their professional **competence** and strive to maintain and improve the competence of other investment professionals.

Summary

Code of Ethics and Standards of Professional Conduct

Integrity, credit, care and independence, competence

Summary

Module: Ethics and Trusts in the Investment Profession

Ethics and Standards; Overconfidence, situational influence

Law is rule-based; Ethical conduct balances self-interest with direct and indirect consequences of behavior on others

Module

Guidance for Standards I–VII

I. Professionalism

II. Integrity of Capital Markets

III. Duty To Clients

IV. Duty To Employers

V. Investment

VI. Conflicts of Interest

VII. Responsibility as Members

P.S.: Cases in this reading are quoted from <Standards of practice handbook> 2015 Eleventh edition.

Module

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

I(A).
Knowledge of the law

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard I (A): Content

- **Content**

1. 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.
2. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation.
3. Must not knowingly participate or assist in any violation of such laws, rules, or regulation.
4. Must dissociate from any violation of such laws, rules, or regulations.

Standard I (A): Guidance

- **Guidance - Code and Standards vs. local law**

5. Must know and **should** know the laws and regulations related to their professional activities in all countries in which they conduct business.
6. **Must** comply with law directly governing. However, **Not should have detailed knowledge of or be expert** on all laws that could **potentially** govern his activities, **not expert** on compliance.
7. Always adhere to the **most strict** rules and requirements (law or CFA institute Standards) that apply. Members and candidates must not engage in conduct that constitutes a violation of the Code and Standards, even though it may otherwise be legal.
8. Comply with the last applicable law if transferable applicability.

Workplace (Applicable) Stating that residence law applies.	Residence	Comply with
Less strict	More strict	Last applicable is the residence law, more strict than Code → Adhere to the law of more strict country
More strict	Less strict	Last applicable is the residence law, less strict than Code → Adhere to Code and Standards

Standard I (A): Guidance

- **Guidance - Participation or association with violations by others**

9. Know → attempt to stop the behavior by bringing it to the attention of the employer through supervisor or compliance department → (if unsuccessful) → dissociate and document → even quit without choice.
10. Suspect → Consult→ but can't be absolved from requirements to compliance
11. There is no requirement under Standards to report violations to governmental authorities, but this may be advisable in some circumstances and required by law in others.
12. Inaction combined with continuing association with those involved in illegal or unethical conduct may be construed as participation or assistance in the illegal or unethical conduct.

Standard I (A): Guidance

- **Guidance - <u>Investment Products and Applicable Laws</u>**

13. Members and candidates involved in creating or maintaining investment services, investment products, packages of securities and derivatives should be mindful of <u>**where** these products or packages will be sold as well as their places of origination (the place of sales and origination).</u>
14. The applicable laws and regulations of the countries or regions of origination and expected sale should be <u>understood **by those responsible for the supervision of**</u> the services or creation and maintenance of the products or packages.

Standard I (A): Guidance

- **Guidance - Investment Products and Applicable Laws**

15. Should make reasonable efforts to review whether associated firms that are distributing products or services also abide by the laws and regulations.
16. Should undertake necessary due diligence when transacting cross-border business to understand the multiple applicable laws and regulations, in order to protect the reputation of the firm and themselves.
17. Seek appropriate guidance from the firm's compliance or legal departments and legal counsel outside the organization when uncertain about which laws or regulations in conducting business in multiple jurisdictions.

Standard I (A) : Procedures

- **Recommended procedures - For members and candidates**

18. **Stay informed**: Should establish or encourage employers to establish a procedure by which employees are regularly informed about changes in laws, rules and regulations. In many instances, the employer's compliance department or legal counsel can provide such information in the form of memorandums distributed to employees in the organization. Participation in an internal or external continuing education program is a practical method of staying current.

19. **Review procedures:** Should review, or encourage their employers to review, the firm's written compliance procedures on a regular basis to ensure that the procedures reflect current law and provide adequate guidance to employees about what is permissible conduct under the law or the Code and Standards.

Standard I (A) : Procedures

- **Recommended procedures - For members and candidates**

20. Maintain current files: Should maintain or encourage their employers to maintain readily accessible current reference copies of applicable statutes, rules, regulations.

- ✓ Distribution area laws: Should make reasonable efforts to understand the applicable laws – both country and regional – for the countries and regions where their investment products are developed and distributed to clients.
- ✓ Legal counsel: When in doubt about the appropriate action, seek the advice of legal counsel or compliance personnel. If a potential violation exists, should seek the advice of legal counsel.
- ✓ Dissociation: When dissociate, should document the violation and urge their firms to persuade the perpetrators to cease such conduct. May have to quit the job.

Standard I (A): Procedures

- **Recommended procedures - For Firms**

21. The formality and complexity of compliance procedures for firms depend on the nature and size of the organization and the nature of its investment operations.

22. Should encourage firms to consider the following policies and procedures:

    ✓ **Develop or adopt a code of ethics:** The ethical culture starts at the top.

    - Should encourage supervisors or managers to adopt.
    - When in ethical dilemmas, adhering to the Code facilitates solutions and prevent the need of a "whistleblowing" solution publicly alleging concealed misconduct. Asset Manager Code of Professional Conduct, may be used as the basis for the codes

Standard I (A): Procedures - For Firms

- **Recommended procedures - For Firms**

23. Should encourage firms to consider the following: (cont.)

    ✓ **Provide information on applicable laws:**

    - Pertinent information that highlights applicable laws and regulations might be distributed to employees or made available in a central location.
    - Information sources might include primary information developed by the relevant governmental agencies, regulatory organizations and professional associations (e.g., from websites); and association publications (e.g., *CFA Magazine*).

    ✓ **Establish procedures for reporting violations:** Firms might provide written protocols for reporting suspected violations.

Standard I(A): Case 1-2

- **Case 1. (Notification of Known Violations)** Allen found overstatement of earnings in files prepared for regulators, he seeks advice of firm's general counsel, who says it would be difficult for regulator to blame Allen for any wrongdoing involved.
  - **Comment:** As the counsel does not give clear justification for the legitimacy of the situation, Allen **must report** to his supervisor and seek independent legal advice and determine whether the regulator should be notified of the error. Cannot be absolved from requirements to comply with law/regulation in spite of having sought advice of legal counsel.
- **Case 2. (Dissociating from a Violation)** Brown finds his customer concealed losses in foreign branch and the preliminary prospectus has been distributed for the underwriting.
  - **Comment:** It's clear violation, Brown must report to supervisor. If not remedied, he also must dissociate, document the records and seek further legal advice to determine appropriate action.

Standard I(A): Case 3-4

- **Case 3. (Dissociating from a Violation)** Washington finds his employer omits some performance in calculating composite to inflate performance, and is asked to use promotional material that includes erroneous number to solicit business.
  - **Comment:** The employer commits misrepresentation; Washington must dissociate from that and bring the fact to supervisor or compliance dept. If it's not remedied, he should consider whether resignation is appropriate, even consider other employment, because using the erroneous number would be construed as assisting in violation.
- **Case 4. (Following the Highest Requirements)** Collins, a Wall Street analyst works in a developing country with little laws concerning insider trading.
  - **Comment:** Collins should be aware of the risk and adhere to the Code and Standards which is more strict and address material nonpublic information officially.

Standard I(A): Case 5

- **Case 5. (Following the Highest Requirements)** Jameson is a CFA charterholder based in the US and also works as a registered investment advisor in an island nation that prohibits participation in IPOs, he believes the Code and Standards apply and ignores the strict prohibition on IPOs in the island.
  - **Comment:** Jameson must follow the stricter requirements of the local law. By ignoring it, he is in violation of Standard I(A)-knowledge of the law.

Standard I(A): Case 6

- **Case 6. (Laws and Regulations Based on Religious Tenets)** Janney's firm receives expressions of interest from potential clients from the Middle East who are seeking investments that comply with Islamic law. The marketing and promotional materials of the fund can not be determined whether or not the fund is a appropriate investment for an investor seeking compliance with Islamic law. The fund is distributed globally. In Janney's concern, the reputation of the fund is very important and she believes disclosure of whether or not the fund complies with Islamic law could help minimize potential mistakes with placing this investment.
  - **Comment:** Members and candidates will need to be aware of the differences between cultural and religious laws and requirements as well as the different governmental laws and regulations. In their efforts to acknowledge areas with different law systems, Janney and the firm could be proactive in determining the suitability of the new fund in that area.

Standard I(A): Case 7

- **Case 7. (Failure to Maintain Knowledge of the Law)** White uses new technology to communicate with clients and potential clients. She recently began posting investment information to her Facebook page and sends out brief announcements, opinions, and thoughts via her Twitter account. Prior to White's use of these social media platforms, the local regulator had issued new requirements and guidance governing online electronic communication. White's communications appear to conflict with the recent regulatory announcements.
  - **Comment:** White is in violation of Standard I(A)-knowledge of the law because her communications do not comply with the new guidance and regulation governing use of social media. White must be aware of the evolving legal requirements pertaining to new and dynamic areas of the financial services industry that are applicable to her. She should seek guidance from appropriate, knowledgeable, and reliable sources, such as her firm's compliance function, service providers, or outside counsel, if she does not personally follow legal and regulatory trends affecting her professional responsibilities.

Knowledge of the law

- Jane and Joe work for an investment company and even in the same group. Jane, CFA, always shares some latest information in the industry with Joe, who is studying for the CFA level 2 exam. One day Joe discovered that Jane may conduct something that maybe harmful to the company's clients. What should Joe do with this situation?

  A. Do nothing because he takes no supervisory duties and should appreciate the help from Jane

  B. Report to the CFA committee

  C. Disassociate from the misconduct and report to the company's compliance department

- Correct Answer: C.
  - If finding colleagues involved in illegal actions, must dissociate, and report to compliance department or supervisor.

Knowledge of the law

- In situations where the laws of a member or candidate's country of residence, the local laws of regions where the member or candidate does business, and the Code and Standards specify different requirements, the member or candidate must abide by:

   A. Local law or the Code and Standards, whichever is stricter.

   B. The Code and Standards or his country's laws, whichever are stricter.

   C. The strictest of local law, his country's laws, or the Code and Standards.

- Correct Answer: C.
   - To comply with Standard I(A) Knowledge of the Law, a member must always abide by the strictest applicable law, regulation, or standard, <u>when applicable</u>.

Summary

Guidance for Standards I–VII

I(A). Knowledge of the law

Code and standards vs. applicable law

How to deal with violation

Investment product and applicable laws

I(B).
Independence and objectivity

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard I(B): Content

- **Content:**

1. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities.
2. Must not offer, solicit, or accept any gift, benefit, compensation, or consideration <u>that reasonably could be expected to compromise</u> their own or another's independence and objectivity.

Standard I(B): Guidance

- **Guidance**

3. Mainly concerning how to deal with internal and external conflicts.
4. Reject gift that could be expected to compromise their own or another's independence and objectivity. (**Best Practice**)
   - ✓ Ordinarily, modest and normal gift is OK only if its purpose is not to influence independence. Benefits may include gifts, invitations to lavish functions, tickets, favors, job referrals, and so on.
5. Gift from corporate: should evaluate both the actual effect on his independence and objectivity and **in the eyes of clients**.

Standard I(B): Guidance

- **Guidance**

6. Gift from clients: Receiving a gift, benefit, or consideration from a client can be distinguished from gifts given by entities seeking to influence independence to the detriment of other clients. Client's gift should be disclosed, if not → violate I(B).

   - ✓ **When possible**, prior to accepting "bonuses" or gifts from clients, members and candidates should disclose to their employers such benefits offered by clients.
     - If notification is not possible prior to acceptance, members and candidate must disclose to their employers benefits previously accepted from clients.
   - ✓ Disclosure allows the employer of a member or candidate to make an independent determination about the extent to which the gift may affect the member's or candidate's independence and objectivity.

Standard I(B): Guidance

- **Guidance - Buy-Side clients**

7. Buy-Side Clients may try to pressure sell-side analysts.

✓ Institutional clients are the primary users of sell-side research, either directly or with soft dollar brokerage.

✓ Rating downgrade: some portfolio managers may support sell-side ratings inflation → affect the portfolio's performance and manager's compensation.

✓ Portfolio performance is subject to media and public scrutiny, affect the manager's professional reputation.

8. For portfolio managers:

✓ It is improper to threaten or engage in retaliatory practices.

✓ Although most portfolio managers do not engage in such practices, the perception by the research analyst that a reprisal is possible may cause concern and make it difficult to maintain independence.

Standard I(B): Guidance

- **Guidance - Fund manager relationships and Custodial Relationships**

9. Members and candidates responsible for hiring and retaining outside managers and third-party custodians should not accept gifts, entertainment, or travel funding that may be perceived as impairing their decisions.

10. Primary and **secondary fund managers** and **third-party custodians** often arrange educational and marketing events to inform others about their business strategies or investment process.

    ✓ Must review the merits of each offer individually in determining whether they may attend yet maintain independence.

Standard I(B): Guidance

- **Guidance - <u>Investment banking relationships</u>**

11. **<u>Firewall</u>** between research and investment banking should be built to minimize conflicts of interest.

- ✓ Separate **reporting structures** for personnel on the research side and personnel on the investment banking side.
- ✓ **Compensation arrangement** that minimizes the pressures on research analysts and rewards objectivity and accuracy. Compensation should **<u>not link analyst remuneration directly to</u>** investment banking assignments in which analyst may participate as a team member.

12. It is appropriate to have analysts work with investment **bankers <u>only when the conflicts are adequately and effectively managed and disclosed</u>.**

13. Firms should also regularly <u>review policies and procedures</u> to determine whether analysts are adequately safeguarded and to improve the transparency of disclosures relating to conflict of interests.

Standard I(B): Guidance

- **Guidance - Performance Measurement and Attribution**

14. Members and candidates working within a firm's investment performance measurement department may also be presented with situations that challenge their independence and objectivity.
15. As performance analysts, their analysis may reveal instances where managers may appeared to **stray from their mandate**. Or the performance analyst may receive requests to **alter the construction of composite indices** due to negative results for a selected account or fund.
16. The member or candidate must not allow internal or external influences to affect their independence and objectivity as they faithfully complete their performance calculation and analysis related responsibilities.

Standard I(B): Guidance

- **Guidance - Public companies**

17. **Analysts should not be pressured to issue favorable research by the companies they follow.** Can promise to cover the firm, should not promise favorable report about the firm.
18. **Due diligence** in financial research and analysis involves gathering information from public disclosure documents and also company management and investor-relations personnel, suppliers, customers, competitors, and other relevant sources.

Standard I(B): Guidance

- **Guidance - Credit rating agency opinions**

19. Members and candidates at rating agencies should ensure that procedures at the agencies prevent undue influences from a sponsoring company during the analysis.
20. Should **abide by their agencies' and the industry's standards of conduct** regarding the analytical process and the distribution of reports.
21. The rating agencies need to develop **the necessary firewalls and protections** to allow the independent operations of their different business lines.
22. When using information provided by credit rating agencies, Should be **mindful of the potential conflicts of interest**.

Standard I(B): Guidance

- **Guidance - Influence during the Manager Selection/Procurement Process**

23. The need for members and candidates to maintain their independence and objectivity extends to the hiring or firing of those who provide many business services beyond investment management.
24. When serving in a hiring capacity, members and candidates should not solicit gifts, contributions, or other compensation that may affect their independence and objectivity. Solicitations do not have to benefit members and candidates personally to conflict with Standard I(B).
    - ✓ **Requesting contributions to a favorite charity or political organization** may also be perceived as an attempt to influence the decision-making process.
25. Members and candidates serving in a hiring capacity should refuse gifts, donations, and other offered compensation that may be perceived to influence their decision-making process.

Standard I(B): Guidance

26. When working to earn a new investment allocation, members and candidates should not offer gifts, contributions, or other compensation to influence the decision of the hiring representative.
    - ✓ The offering of these items with the intent to impair the independence and objectivity of another person would not comply with standard I(B).
    - ✓ Such prohibited actions may include offering donations to a charitable organization or political candidate referred by the hiring representative. (pay to play scandal)

Standard I(B): Guidance

- **Guidance - Issuer-Paid research**

27. Remember that this type of research is fraught with potential conflicts.
28. Analysts' compensation for preparing such research should be limited, and the preference is for **a flat fee that is not linked to their conclusions or recommendations (directly or indirectly)**
29. Must fully disclose potential conflict of interest, including the nature of compensation. If not → misleading investors
30. Conduct a thorough analysis of the company's financial statements based on public information, benchmarking within a peer group, and industry analysis.
    - ✓ Distinguish between fact and opinion.

Standard I(B): Guidance

- **Guidance - Travel Funding**

31. The benefits related to accepting paid travel extend beyond the cost savings to the member or candidate and his firm, such as the chance to talk exclusively with the executives of a company or learning more about the investment options provided by an investment organization.

32. **Best practice:** always use **commercial transportation** rather than accept paid travel arrangements from an outside company.

33. Should commercial transportation be unavailable, may accept modestly arranged travel to participate in appropriate information-gathering events, such as a property tour.

- **Guidance – Social Activities**

34. When seeking corporate financial support for conventions, seminars, or even weekly society luncheons, should evaluate both the actual effect on their independence and whether their objectivity might be perceived to be compromised in the eyes of their clients.

Standard I(B): Recommended Procedures

- **Recommended Procedures**
  - Protect the integrity of opinions – unbiased opinion and adequate system
    - ✓ Establish policies that <u>every research report</u> concerning the securities of a corporate client should <u>reflect unbiased opinion</u>.
    - ✓ <u>Compensation systems</u> should protect integrity in investment decision process by maintaining independence and objectivity of analysts.
  - <u>Create a restricted list for corporate client if not willing to issue adverse opinion</u> and distribute only factual information about companies on the list.
  - Restrict <u>special cost arrangements</u>: When attending meetings at an issuer's headquarters, members and candidates should pay for commercial transportation and hotel charges. ***No corporate issuer should <u>reimburse</u> members or candidates <u>for air transportation</u>***.
  - **Limit gifts - <u>token items only.</u>** Customary and ordinary business-related entertainment is okay as long as its <u>purpose is not to influence independence</u>; <u>based on local customs</u> and <u>whether the limit is per gift or annual total amount.</u>

Standard I(B): Recommended Procedures

- **Recommended Procedures (cont.)**
  - ***Restrict investments***: Firms set up policy related to
    - ✓ Employee purchases of equity or equity-related IPO;
    - ✓ Pre-approval for employee participation in IPO, and prompt disclosure of investment actions taken following the offering;
    - ✓ Restrict acquiring securities in private placements.
  - Review procedures - Implement effective review procedures about personal investment activities to ensure compliance with firm policies.
  - Independence policy: formal written policy to ensure that analysts are not controlled/supervised by any department that could compromise independence.
  - Appointed officer:
    - ✓ To supervise for compliance;
    - ✓ Provide every employee with procedures for reporting violation.

Standard I(B): Case 1-2

- **Case 1. (Travel Expenses)** A mining company invited a group of analysts to mining facilities and arranged for chartered group flights from site to site and 3 night accommodation in the only motel nearby. Taylor accepts this offer but Adams follows his company's policy and pays for his hotel room himself.
  - **Comment:** Adams strictly avoiding the conflict of interest but Taylor is not necessarily violating Standard I(B)-independence and objectivity because what the mining company offers is just **too modest and normal** to compromise the analyst's independence and objectivity even in the clients' eyes.
- **Case 2. (Research Independence)** Dillon made a promise to provide full research coverage of the potential client in a presentation.
  - **Comment:** Dillon may agree to provide research coverage, but must not commit to providing favorable recommendation.

Standard I(B): Case 3

- **Case 3. (Research Independence and Intrafirm Pressure)** After a complete research, Fritz concluded M&M is overpriced but hesitated to issue a report like that because he is afraid to hurt the future business relationship with M&M.
  - **Comment:** Fritz must maintain independence and objectivity and based the report solely on the consideration of company fundamentals. Place on the restricted list for corporate client if unwilling to hurt the relationship

Standard I(B): Case 4

- **Case 4. (Research Independence and Issuer Relationship Pressure)** As in Case 3, Fritz has concluded that M&M stock is overpriced at its current level, but in his consideration, the negative research report might ruin their close relationship which he put effort on in the past several years. A negative report might as well result in management retaliation - for instance, revoke his qualification of participating in conference calls.
  - **Comment**: As in Case 3, the independence and objectiveness of Fritz's analysis should not be affect. Any pressure from M&M is inappropriate. Fritz should reinforce the integrity of his conclusions by stressing that his investment recommendation is based on relative valuation, which may include qualitative issues with respect to M&M's management.

Standard I(B): Case 5

- **Case 5. (Research Independence and Sales Pressure)** Warner is credit analyst whose salary is closely linked to the performance of the corporate bond department. Near the quarter's end, salespeople ask her to push a problematic bond in large inventory which were unable to be sold due to that company announcement of an operating problem.
    - **Comment:** the inappropriate internal pressure and sales-linked salary must not affect Warner's advise. In this case, **she must refuse to push the problematic bond to clients** unless she is able to justify that the market price has already adjusted for the operating problem.

Standard I(B): Case 6

- **Case 6. (Research Independence and Prior Coverage)** The boss asked Jorund must keep the prevailing "buy" recommendation for a specific stock under any circumstances.
  - **Comment**: Jorund must be independent and objective in her investment analysis and not be affected by her boss.
    - ✓ Refuse to cover the company because of this constraint, or
    - ✓ Accept the coverage of the company, reach her conclusions through independent and objective analysis, and if they conflict with her boss's opinion, share the conclusions with her boss or other supervisors in the firm in order to make appropriate recommendations. She must issue only recommendations that reflect her independent and objective opinion.

Standard I(B): Case 7-8

- **Case 7. (Gifts and Entertainment from Related Party)** Grant directed a large portion of his commission business to NY brokerage house and accepted 2 tickets to World Cup, two nights at a nearby resort, meals and transportation via limo to the game. He fails to disclose that to his supervisor.
  - **Comment:**
    - ✓ Grant has violated Standard I (B) by accepting the World Cup tickets which can be considered substantial. This may compromise his independence and objectivity
    - ✓ **Best practice** for monitoring include comparing the cost with others and the performance with others associated with the same mandate.
- **Case 8. (Gift and Entertainment from Client)** Green achieved an annual return for the client that consistently beat the benchmark. As reward, the client offers 2 tickets to London and permit Green to use his flat for a week; Green disclosed the gift to his supervisor.
  - **Comment:** Green does not violate Standard I(B) because she disclosed this information to her employer and public. Members and candidates should disclose to their employers, if they may accept bonuses or gifts from clients.

Standard I(B): Case 9

- **Case 9. (Travel Expense from External Manager)** Penguin was recommended by Wayne as the foreign equity manager for the pension fund because of its proved experience and performance record. After the pension selected Penguin, a reporter challenged that Wayne's recommendation to be based on Penguin's sponsorship for Asian trip that Wayne was one of the members. In fact, <u>the cost of this trip is partially supported by Penguin.</u>
  - **Comment:** Wayne must avoid the Asian trip experience to impede his independence and objectivity in selection of managers.
  - **The best practice: Basic expenses of the trip be paid by his employer and limit the contact with sponsors to informational and educational manner and disclose to public**.

Standard I(B): Case 10

- **Case 10. (Research Independence and Compensation Arrangements)** Herrero is hired to write a research report and the compensation will be a flat fee **plus a bonus based on new investors attracted**.
  - **Comment:** The bonus for attracting investors can reasonably be expected to affect his independence and objectivity. The bonus will induce a positive report regardless of the facts. **Herrero must not accept the payment arrangement with bonus. He should accept only a flat fee not based on the conclusion**.

Standard I(B): Case 11

- **Case 11. (<u>Recommendation Objectivity and Service Fees</u>)** Western funds approaches Wade, trust manager for Central Bank, to promote its family of funds. Western fund promised special interest in the service-fee class of funds. To entice Central bank to promote the class of funds, Western offered to pay the bank a service fee of 0.25 percent. <u>Without disclosing the fee</u> being offered to the bank, Wade asked one of the investment managers to review Western's funds to determine whether they are suitable for Central bank clients. It turns out the funds are appropriate for Central bank clients. Two years later, the funds managed by Western shows underperformed their peers. Wade is <u>counting on the fees to reach his profitability targets and continues to recommend these funds as acceptable investments</u> for Central's clients.
  - **Comment:**
    - ✓ Wade is violating Standard I(B)-independence and objectivity <u>because the objective of his recommended is affected by the fee arrangement.</u>
    - ✓ Wade continuously promote the fund to customer in order to achieve its department's profitability target. He is unwilling to offer other products that may affect the fees received.
    - ✓ Also violate VI(C)-Referral fees; VI(A)-disclosure of conflicts.

Standard I(B): Case 12

- **Case 12. <u>(Recommendation Objectivity)</u>** Thompson is responsible for sensitivity analysis on securitized subprime mortgages. He insists that the analysis should include a scenario run with –10%, -5% and 0% (to project a worst case scenario) for Year 1, Year 2, and Years 3 through Year 5. The manager think these assumptions too dire because <u>there has never been a time in their available database</u> when House Price Appreciation (HPA) < 0. Thompson evaluates the securities in the <u>worst-case scenario on a unlikely but possible environment</u>. <u>Based on the results of the test, he does not recommend the purchase of the securitization</u>. Against the market trends, the manager follows his recommendation and does not invest. The following year, the housing market collapses and the manager's portfolio outperforms its peer group that year.
  - **Comment:** Thompson's actions in running the worst-case scenario against the protests of the portfolio manager are in alignment with the principles of Standard I(B)-independence and objectivity. The pressures from the general trends of the market or manager's desire to limit the analysis to historical norms do not affect Thompson's research.

Standard I(B): Case 13

- **Case 13. (Influencing Manager Selection Decisions)** Adrian, CFA , is a senior portfolio manager for ZZYY Capital Management. To improve the chance of winning an asset manager competition, Adrian make a great monetary contribution and lavishly gift to Ernesto Gomez, UDPBU's leader. These distributions were routinely handled as marketing expenses reimbursed by ZZYY's expense accounts and disclosed to his senior management as being instrumental in maintaining a strong close relationship with an important client.
  - **Comment:** Mandel was in violation of Standard I(B)-independence and objectivity. He contribute of monetary gifts, benefits and other considerations which in order to compromise Gomez's objective.

Standard I(B): Case 14

- **Case 14. (Fund Manager Relationships)** Amie Scott is a performance analyst within her firm with responsibilities for analyzing the performance of external managers. She discovered a change in one of the managers reported composite construction that helps hiding the bad performance into a new residual composite. Due to this change, the manager remains at the top of the performance list. Scott knows her firm has a large allocation to this manager and the fund's manager has a close relationship with the CEO. She needs to deliver her final report, but is concerned with pointing out the composite change.
  - **Comment:** Scott would be in violation of Standard I(B)-independence and objectivity if she did not disclose the change in her final report. The size of the allocation to outside managers and the relationship should not be the reason which can affect Scott's analysis. The report Scott contributed will not be independent if the change is not included in the report.

Standard I(B): Case 15

- **Case 15. (Intra-firm Pressure)** Jill Stein is head of performance measurement for her firm. Many research team members were removed due to their poor quality recommendations during the last quarter. One of the major clients withdrew half of his money because a significant underperformance caused by the subpar research. The sales head requests that <u>Stein remove this account from the firm's performance composite</u>, because the performance decline can be attributed to the departed research team and not the client's advisor.
  - **Comment:** Members and candidates may violate the Code and Standards when internal pressures are inflicted to them. Stein must maintain her independence and objectivity and <u>refuse to exclude specific accounts from the firm's performance composites</u> to which they belong. As long as the managers employed the same strategy, it cannot be excluded because of the poor stock selections that lead to the underperformance and asset withdrawal.

Independence and objectivity

- As a sell-side analyst, Bob Mao, CFA, whose approximately half compensation comes from his firm's Investment-banking division. Bob was asked to write a report about glorious seafood for an Investment-banking client. Bob issued a very positive report on glorious seafood despite concerns about the slowdown in concrete demand. When issuing his report, Bob least likely violates the CFA Institute Standard relating to:

  A. Loyalty, Prudence, and Care.

  B. Loyalty to Employer.

  C. Independence and Objectivity.

- Correct Answer: B.
  - The Standards require members to put client interests ahead of member and employer interests. As Bob's compensation is dependent upon investment banking revenues, Bob may not be objective. When issuing the report, he is in jeopardy of violating Standards relating to I(A) Independence and Objectivity; III(A) Loyalty, Prudence, and Care; and VI(A) Disclosure of Conflicts.

Independence and objectivity

- According to the Standard on independence and objectivity, members and candidates:

  A. May accept gifts or bonuses from clients.

  B. May not accept compensation from an issuer of securities in return for producing research on those securities.

  C. Should consider credit ratings issued by recognized agencies to be objective measures of credit quality.

- Correct Answer: A.
  - Gifts from clients are acceptable under Standard I(B) Independence and Objectivity, but the Standard requires members and candidates to disclose such gifts to their employers.
  - Standard I(B) allows issuer-paid research as long as the analysis is thorough, independent, unbiased, and has a reasonable and adequate basis for its conclusions, and the compensation from the issuer is disclosed.
  - Members and candidates should consider the potential for conflicts of interest inherent in credit ratings and may need to do independent research to evaluate the soundness of these ratings.

Summary

Guidance for Standards I–VII

I(B). Independence and objectivity

Buy-side clients, fund manager and custodial relationships, public companies, manager selection

Performance, investment banking

Issuer-paid research, travel funding, rating agency

I(C). Misrepresentation

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard I(C): Content

- **Content:**

1. Must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.
2. Once finding misrepresentation (e.g. typographical error), correct the error as soon as possible, or violate I (C).

Standard I(C): Guidance

- **Guidance**

3. A misrepresentation is any **untrue statement or omission of a fact** or any statement that is otherwise false or misleading.

   ✓ Must not knowingly omit or misrepresent information or give a false impression of a firm, organization, or security in oral representations, advertising (whether in the press or through brochures), electronic communications, or written materials (whether publicly disseminated or not).

   ✓ Omission of a fact or outcome: Although not every model can test for every factor or outcome, should ensure that the analyses incorporate a broad range of assumptions—from very positive scenarios to extremely negative scenarios.

Standard I(C): Guidance

- **Omissions**

4. **The omission of a fact or outcome is misleading,** especially given growing use of technical analysis. Many members and candidates rely on models and processes to scan for new investment opportunities, to develop investment vehicles, and to produce investment recommendations and ratings. Findings from models shall not be presented as fact.

5. Omissions are also important in regards to what information is provided concerning the **performance measurement and attribution process.**

   ✓ Member and candidates should encourage their firms to develop strict policies for **composite development to prevent cherry picking** — situations in which selected accounts are presented as representative of the firm's abilities. The omission of all accounts appropriate for the defined composite may misrepresent to clients the success of the manager's implementation of its strategy.

Standard I(C): Guidance

- **Guidance - Impact on Investment Practice**

6. Guarantee the investment performance
   - ✓ **Prohibit: Guaranteeing specific return** which is inherently volatile, because it is misleading to investors.
   - ✓ **Not prohibit:** Providing clients with information on investments that have guarantees built into the structure of the product **or** for which an institution has agreed to cover any losses.
7. Members and candidates must not misrepresent any aspect of their practice, including (but not limited to) their **qualifications or credentials**, the qualifications or services provided by their firm, their performance record and the record of their firm, and the characteristics of an investment.
   - ✓ A company is prohibited from saying “we can provide all services you need”. Proper way is to provide **a list of services** available.

Standard I(C): Guidance

8. Investing through outside managers
   - ✓ If invest in areas outside a firm's core competencies through **outside managers**, must disclosed intended use of external managers, members and candidates must not represent those managers' investment practices as their own. For further detail, refer to V(B).
9. Using third-party information
   - ✓ Should exercise care and diligence when using **3rd-party information.**
   - ✓ When it affects the professional's business practices, investment professional should be responsible for the misrepresentation.

Standard I(C): Guidance

- **Guidance - Performance Reporting**

10. Members and candidates may misrepresent the success of their performance record through presenting **benchmarks that are not comparable to their strategy.**
    - ✓ Clients can be misled if the benchmark's results are not reported on a basis comparable to that of the fund's or client's results.
    - ✓ **Best practice**: selecting the most appropriate available benchmark from a universe of available options.
11. The transparent presentation of appropriate performance benchmarks is an important aspect in providing clients with information that is useful in making investment decisions.
12. Standard I(C) does not require that a benchmark always be provided in order to comply. Some investment strategies may not lend themselves to displaying an appropriate benchmark because of the complexity or diversity of the investments included.

Standard I(C): Guidance

13. Some investment strategies may use reference indices that do not reflect the opportunity set of the invested assets.
    - ✓ A hedge fund comparing its performance with a "**cash plus**" basis.
    - ✓ When such a benchmark is used, members and candidates should take reasonable efforts to ensure that they disclose the reasons behind the use of this reference index to avoid misrepresentations of their performance.
14. Members and candidates should discuss with clients on a continuous basis the appropriate benchmark to be used for performance evaluations and related fee calculations.

Standard I(C): Guidance

15. Reporting misrepresentations may also occur when **valuations** for illiquid or non-traded securities are available from more than one source. When different options are available, members and candidates may be tempted to switch providers to obtain higher security valuations.

   - ✓ Members and candidates should take reasonable steps to provide accurate and **reliable** security pricing information to clients on a **consistent** basis.
   - ✓ Consistency in the reported information will limit misperceptions that misrepresented values may have assisted in manipulating investors into continuing to hold certain securities in their portfolios.
   - ✓ Changing pricing providers should **not** be based solely on the justification that the new provider reports a higher current value of a security.

Standard I(C): Guidance

- **Social Media**

16. When communicating through social media channels, members and candidates should provide only the same information they are allowed to distribute to clients and potential clients through other traditional forms of communication.
    - ✓ The online or interactive aspects of social media do not remove the need to be open and honest about the information being distributed.
17. Actions undertaken through social media that knowingly misrepresent investment recommendations or professional activities are considered a violation of Standard I(C).
    - ✓ The perceived anonymity granted through these platforms may entice individuals to misrepresent their qualifications or abilities or those of their employer.

Standard I(C)

- **Guidance – Plagiarism**

18. Plagiarism

- ✓ Definition: Copying or using in substantially the same form materials prepared by others without acknowledging the source of the material or identifying the author and publisher of such material.
- ✓ Applied in: oral communications (e.g. group meetings), visits with clients, use of audio/video media, and telecommunications.
- ✓ Must not copy (or represent as their own) original idea/material without permission. Must acknowledge and identify the source of ideas/material that is not their own. (e.g. a computer model derived from others' idea)

Standard I(C)

- **Guidance – Plagiarism**

19. Forms of plagiarism:

- ✓ Take a study done by others, change name of the author, and release it as ones own.
- ✓ Using excerpts from others' reports (whether verbatim or slight changes in wording) without acknowledgement.
- ✓ Citing "leading analysts" and "investment experts" without naming specific reference.
- ✓ Using charts and graphs without stating sources.

Standard I(C): Guidance - Plagiarism

- **Guidance - Plagiarism**

19. Forms of plagiarism : (cont.)

- ✓ Presenting statistical estimates of forecasts prepared by others and identifying the sources without including the qualifying statements or caveats that may have been used.
- ✓ Copying proprietary computerized spreadsheets or algorithms without authorization of the creators.
- ✓ Preparation of research reports based on multiple sources of information without acknowledging the sources. (e.g. ideas, statistical compilations, and forecasts combined to give the appearance of original work).
  - Cannot use undocumented forecasts, earnings projections, asset values, etc.
  - Sources must be revealed to bring the responsibility directly back to the author or the firm involved.

Standard I(C): Guidance - Plagiarism

- **Guidance - Plagiarism**

20. In distributing 3rd-party, outsourced research, may use and distribute reports as long as not representing oneself as the author.

    ✓ May add value for the client by sifting through research and repackaging it for clients.

    - Clients should be fully informed that they are paying for the ability of the member or candidate to find the best research from a wide variety of sources.

    ✓ Should disclose whether the research presented comes from another source, from either within or outside the member's firm.

    - This allows clients to understand who has the expertise.

Standard I(C): Guidance - Plagiarism

- **Guidance - Plagiarism**

21. When citing from mainstream media outlet:
    - ✓ Cannot only cite the information from the intermediary, in case of misunderstanding and potential deviation from the viewpoint of the original author.
    - ✓ **Best practice**: **Either** obtain the information directly from the author and cite only that author **or** use the information provided by the intermediary and cite both sources.

Standard I(C): Guidance

- **Guidance - Work Completed for Employer**

22. Firm may issue future reports without attribution to prior analysts, but a member or candidate cannot reissue a previously released report solely under his or her name.

    - ✓ **May** use other people's work (research, models, etc.) within the same firm without committing a violation.
    - ✓ When the original analyst leaves the firm, research and models developed while employed are the property of the firm. The firm retains the right to continue using the work completed after leaving.
        - The firm may issue future reports without providing attribution to the prior analysts.
        - A member or candidate cannot reissue a previously released report solely under his or her name.

Standard I(C)

Recommended Procedures

- Factual presentations:
  - ✓ Fairly present firm's capabilities.
  - ✓ Provide a written list of available services and a description of qualifications.
  - ✓ By designating which employees are authorized to speak on behalf of the firm.
- Qualification summary:
  - ✓ List of services available, qualifications and experience
  - ✓ Firms periodically review employee correspondence and documents that contain representations of qualifications.

Standard I(C)

Recommended Procedures

- Verify outside information:
  - ✓ Misrepresentation by third party may damage its reputation and integrity of capital market.
  - ✓ Encourage to develop policy to verify.
- Maintain webpage:
  - ✓ Regularly monitor materials posted on the site to ensure current information.
  - ✓ Take precautions to protect the site's integrity, confidentiality and security, and ensure that the site does not misrepresent and provides full disclosure.

Standard I(C)

- **Recommended Procedures**
  - Plagiarism policy:
    - ✓ <u>Maintain copies</u>: Keep copies of all material containing research ideas, new statistical methodologies, and other materials that were relied on in preparing the research report.
    - ✓ <u>Attribute quotations</u>: Attribute to their sources any direct quotations, including projections, tables, statistics, model/product ideas, and new methodologies prepared by persons <u>other than recognized financial and statistical reporting services or similar sources</u>.
    - ✓ <u>Attribute summaries</u>: Attribute to their sources any paraphrases or summaries of material prepared by others. → If attribute other analyst's summaries to support his own analysis, <u>he must acknowledge in his report the reliance on the other analyst's report</u>.

Standard I(C): Case 1-2

- **Case 1. (Disclosure of Issuer-Paid Research)** McGuire is an issuer-paid analyst hired by listed companies to promote their stocks online. He posted profiles with strong buy recommendations of these companies while concealed this contractual relationship and promoted as seemingly independent analyst.
  - **Comment:** McGuire violated Standard I(C)-misrepresentation, Standard VI(A), and Standard I(B) as he failed to disclose his arrangement with the listed companies and misled the investors online.
- **Case 2. (Correction of Unintentional Errors)** Yao is responsible for the marketing material and catches a typographical error that inflates the composite assets.
  - **Comment:** Yao didn't violate Standard I(C)-misrepresentation because he did not knowingly distribute the problematic materials. Yao should make necessary correction as soon as he catch the error.

Standard I(C): Case 3-4

- **Case 3. (Noncorrection of Known Errors)** The firm exaggerates Muhammad's academic degree in its promotional material, for years, Muhammad and the others distributed this material.
  - **Comment:** Although the firm is mainly responsible for this misrepresentation, Muhammad is still in violation of Standard I(C)-misrepresentation due to his distribution of this material.
- **Case 4. (Plagiarism)** Grant read a mining company research report prepared by others, then she made minor further consult and used the main report and circulated as her own report.
  - **Comment:** Grant plagiarized other people's report without acknowledgment, it's a clear violation.

Standard I(C): Case 5

- **Case 5. (Potential Information Misrepresentation)** Abdrabbo advises his to-be retired clients to move part of their investments from equity to bank sponsored CD and money-market accounts so the principal will be guaranteed up to a certain amount.
  - **Comment**: While there is bankrupt risk for the certificates of deposits and money market accounts offered by institution, in the United States, these accounts are insured by the U.S. government through the Federal Deposit Insurance Corporation. Therefore, <u>as long as the amount is within the government-insured limit</u>, <u>using the term "guaranteed" in this context is not inappropriate</u>. Abdrabbo should explain these facts to the clients.

Standard I(C): Case 6

- **Case 6. (Plagiarism)** Swanson is preparing a research report for acquisition, and was given an report prepared by others for reference. Swanson finds the report does not consider all the factors for the purpose and reports this to the supervisor, who tells him to “use Davis report ,change a few words, sign your name, and get it out.”
  - **Comment**: Swanson will violate Standard I(C)-misrepresentation if he does as requested. If Swanson continue Davis report, he might identify the portion of the Davis report that he agree with and add his own analysis and work before sign and distribute it.

Standard I(C): Case 7-8

- **Case 7. (Plagiarism)** Browning is intrigued by Jorrely's new concept of a model during a seminar; he proceeds to test the model, making some minor mechanical adjustments while retaining the concept. He then claims he discovered a new model.
  - **Comment**: Browning is in violation of Standard I(C)-misrepresentation. His work is based on the new concept of Jorrely, even though he made some adjustments. The credit for the innovative thinking, however, must be awarded to Jorrely.
- **Case 8. (Plagiarism)** Zubia includes in his marketing materials plain-language descriptions of various concepts like P/E ratio, standard deviation etc, which come from other sources. He concerns whether he should refer to the original author.
  - **Comment:** Copying verbatim any material without acknowledgment is a violation of Standard I(C)-misrepresentation.
  - **The best practice for Zubia is use his own descriptions or cite the source.**

Standard I(C): Case 9-10

- **Case 9. (Plagiarism)** Schneider learns about a study through a mainstream media. She would like to cite this study in her research.
  - **Comment:** Best practice would be either to obtain the complete study from its original author and cite only that author, or to use the information provided by the media and cite both sources.
- **Case 10. (Misrepresentation of Information)** Ostrowski's firm subscribes research report from a third party and distributes these reports to clients as its own work.
  - **Comment:** Ostrowski is in violation of Standard I(C)-misrepresentation. Ostrowski is clearly misrepresent and mislead the readers by distribute third-party's work and claim its ownership. Ostrowski can use third-party's material if he checked the reasonable basis of these works, but he can not imply that he is the author.

Standard I(C): Case 11

- **Case 11. (<u>Misrepresentation of Information</u>)** Stafford responsible for managing a pool of assets for Open Air Bank, which distributes structured securities to offshore clients. He becomes aware that Open Air is promoting the structured securities as a much less risky investment than IPS. Also, Open Air has obtained an independent rating for the product that significantly <u>overstate</u> the quality of the investment. Stafford communicates his concerns to his supervisor, who responds that Open Air owns the product and is responsible for all marketing and distribution. Stafford's supervisor goes on to say that <u>the product is outside of the U.S. regulatory regime</u> and that all risks of the product are disclosed at P184 of the prospectus.
  - **Comment:** Stafford is capable to recognize the degree of accuracy of the materials that describe the portfolio, and <u>he should continue to pursue the issue</u> under the firm's policies and procedures.

Standard I(C): Case 12

- **Case 12. (Avoiding a Misrepresentation)** Smith concluded that the team cannot effectively distinguish between potentially good and bad investment options with complex construction of bonds. The team refuse to use the highly structured mortgage segment as a part of the core of the fund's portfolio. They will allow some of the less complex securities to be part of the core.
  - **Comment:** Smith is in compliance with Standard I(C)-misrepresentation by avoiding investment that she and her team cannot effectively understand.

Standard I(C): Case 13

- **Case 13. (Misrepresenting Composite construction)** When Palmer is asked to provide the performance number of the fund composite, he avoids mentioning that the fund manager is quite liberal in composite construction and does not fully explain why account are included/excluded. The values reported may not reflect the true ability of the fund manager.
  - **Comment:** “Cherry picking” accounts to include in either published reports or information provided to the rating agencies conflicts with Standard I(C)-misrepresentation.
    - ✓ Palmer’s best practice is helping his firm to build a performance reporting system, ensure the quality of the information being provided.
    - ✓ Moving accounts into or out of a composite is clearly a misrepresentation for investors, which should be avoided.

Standard I(C): Case 14

- **Case 14. (Presenting Out-of-Date Information)** Finch directs the sales team and provides fact sheets which include investment strategy and target distribution rates on funds to clients regularly. He continues to distribute sheets to the team without updates regardless that some data he knows are out of date.
  - **Comment:** Finch is violating Standard I(C)-misrepresentation by providing information that misrepresents aspects of the funds.
    - ✓ By not providing the sales team and ultimately the clients with the updated information, he is misrepresenting the potential risks associated with the funds with outdated fact sheets.
    - ✓ Finch can make distinguish effort to inform clients about this situation, as well as find the appropriate data for clients before they sign the contract.

Standard I(C): Case 15

- **Case 15. (Overemphasis of Firm Results):** Anderson is a chief compliance officer for Optima Company, a firm currently offering eight funds to clients. Seven of the eight had 10-year returns below the median performance. He approves a recent advertisement: “Optima is achieving excellent returns for its investors. One of the fund-the Optima fund <u>has 10-year returns that exceed the sector median by more than 10%.”</u>
  - **Comment:** Select one of the fund in portfolio to represent the whole firm’s ability is not objective. However, according to the given information, it is very difficult to prove Anderson is in violation of Standards. Partially disclose performance may lead to a misrepresentation.

Example

Misrepresentation

- Robert is responsible for the creation and distribution of ABC Company’s marketing materials. In the materials, it says that the asset value of the company is 350 billion, but actually the true value is 35 billion. Before Robert could make necessary change to the data, his subordinates had distributed these materials to their clients without seeking Roberts’ permission. Robert doesn’t know the distribution of the materials. Under this circumstance, does Robert violate any CFA Standards of Professional Conduct?

  A. No.

  B. Misrepresentation.

  C. Misconduct.

- Correct Answer: A.
  - This belongs to typographical error. Robert did not check the numbers before public and it’s not on purpose. So he did not violate misrepresentation.

Summary

Guidance for Standards I–VII

I(C).Misrepresentation

Factors impacting on investment, performance reporting

Social media

Omissions, plagiarism, work completed for employer

I(D).
Misconduct

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
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    - (A) Disclosure of conflicts;
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    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard I(D): Content

- **Content**

1. Members and Candidates must not engage in any professional conduct involving <u>dishonesty, fraud, or deceit</u> or commit any act that reflects adversely on their professional reputation, integrity, or competence.

Standard I(D): Guidance

- **Guidance**

2. Dishonest conduct
   - ✓ Any act that involves lying, cheating, stealing, or other dishonest conduct would violate this standard if the offense reflects adversely on professional activities.
   - ✓ Do not abuse this standard to settle personal, political, or other disputes unrelated to professional ethics.
3. Absence of appropriate conduct and sufficient effort
   - ✓ Member or candidate is expected to conduct the necessary due diligence to understand the nature and risks of investment before making investment recommendations.
   - ✓ If not taking such steps, instead, relying on others, is violation.

Standard I(D): Guidance

- **Guidance**

4. Conduct that damages trustworthiness or competence may include behavior that negatively affects ability to perform professional activities.
    - ✓ E.g. abusing alcohol during business hours. Because it could have a detrimental effect on the ability to fulfill professional responsibilities.
    - ✓ **Personal bankruptcy** may not reflect on the integrity or trustworthiness of the person declaring bankruptcy,
        - But if the circumstances of the bankruptcy involve fraudulent or deceitful business conduct, the bankruptcy may be a violation of this standard.

Standard I(D): Recommended Procedures

- **Recommended Procedures**
  - <u>Code of ethics:</u> Adopt a code of ethics to which every employee should subscribe and make clear that any personal behavior that reflects poorly on the individual, institution, or investment industry will not be tolerated.
  - <u>List of violations:</u> Disseminate a list of potential violations and associated disciplinary sanctions to all employees.
  - <u>Employee references:</u> Check references to ensure good character and eligible for work in the investment industry.

Standard I(D): Case 1-2

- **Case 1. (Professionalism and Competence)** Sasserman have numerous drinks with friends at lunch. He is certainly intoxicated thus compromise his judgment while working in the afternoon.
  - **Comment:** Sasserman's excessive drinking lead to his compromise of investment decisions. Therefore it cause a violation of Standard I(D)-misconduct.
- **Case 2. (Fraud and Deceit)** Hoffman deceitfully increases the health insurance amount due.
  - **Comment:** This is a clear violation as Hoffman's intentional conduct involving fraud and deceit.

Standard I(D): Case 3-4

- **Case 3. (Fraud and Deceit)** Brink, an auto analyst and volunteer of local charities, while handling purchasing agreement of vans. Brink deliberately directs the purchase to his friend dealer at abnormal higher price and splits the surcharge with her friend.
  - **Comment:** Brink violate Standard I(D)-misconduct because of her dishonesty, fraud, and misrepresentation.
- **Case 4. (Personal Actions and Integrity)** Garcia, a mutual fund manager, is also an environmental activist. During nonviolent protests, he has been arrested for trespassing the property of a petrochemical plant.
  - **Comment:** Generally, Code and Standards focus on professional conduct and avoid incidents that may compromise member's or candidates' professional reputation, integrity, or competence. It don't cover acts of civil disobedience in support of personal beliefs. It's not a violation.

Standard I(D): Case 5

- **Case 5. (<u>Professional Misconduct</u>)** When many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen observes that the reported performance of the hedge fund does not reflect this decline. Rasmussen approaches the head of trading about her concern. The response is that the fund is big and successful and she is not qualified to question the fund and this is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, and the officer also tells her to stay away from the issue of the hedge fund's reporting.
    - **Comment:** Rasmussen has come upon an error in compliance practices. She should gather some evidence to confirm her doubt and then follow the firm's procedures to report potentially unethical activity.
    - <u>If all internal communications do not satisfy her concerns, should consider reporting the activity to the appropriate regulator</u>.

Misconduct

- Allen, CFA, was driving to a client's office, when he was pulled over by a traffic policeman. However, he did not believe he had violated any traffic laws. In order to quickly get to his client’s office, Allen offered to buy the police "lunch". The lunch would cost significantly more than the ticket. The alternative was to go to the police station and file a complaint of being wrongly accused that would also involve going to court the next day to present his case. Did Allen most likely violate the CFA Institute Code of Ethics?

  A. No, because the cost of lunch is more than the ticket.

  B. No, because he was wrongly accused.

  C. Yes.

- Correct Answer: C.
  - Allen was effectively trying to bribe the policeman so that he would not issue a speeding ticket. This action violates the Code of Ethics. Despite feeling he was wrongly accused, it is only his opinion, and may not be based on fact or upheld in a court of law. Allen has a responsibility to act with integrity and in an ethical manner as required by the Code of Ethics.

Example

Misconduct

- Which of the following statements about the Standard on misconduct is most accurate?

  A. Misconduct applies only to a member or candidate's professional activities.

  B. Neglecting to perform due diligence when required is an example of misconduct.

  C. A member or candidate commits misconduct by engaging in any illegal activity.

- Correct Answer: B.
  - Failing to act when required by one's professional obligations, such as neglecting to perform due diligence related to an investment recommendation, violates Standard I(D) Misconduct.
  - Acts a member commits outside his professional capacity are misconduct if they reflect poorly on the member or candidate's honesty, integrity, or competence (e.g., theft or fraud).
  - Violations of the law that do not reflect on the member or candidate's honesty, integrity, or competence (e.g., an act related to civil disobedience) are not necessarily regarded as misconduct.

Summary

Guidance for Standards I–VII

I(D).Misconduct

Any dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence

II(A).
Material Nonpublic information

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

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  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard II(A): Content

- **Content:**

1. Members and Candidates who possess material nonpublic information <u>that could affect the value of an investment</u> must **<u>not act</u>** or **<u>cause others to act</u>** on the information.
   - ✓ Trading or inducing others to trade on material nonpublic information erodes confidence in capital markets, institutions, and investment professionals by supporting the idea that those with inside information and special access **can take unfair advantage of the general investing public**.

Standard II(A): Guidance

- **Guidance**

2. Trading or inducing others to trade on material nonpublic information have caused and will continue to cause investors to avoid capital markets because the markets are perceived to be "rigged" in favor of the knowledgeable insider.
3. Must not use such information to：
   - ✓ Directly buy and sell of individual securities or bonds
   - ✓ Influence their investment actions related to derivatives, mutual funds, or other alternative investments.

Standard II(A): Guidance

- **Guidance - What Is "Material" Information ?**

4. Material Nonpublic

   ✓ Information is "**material**" if its disclosure would likely have an impact on the price of a security **or** if reasonable investors would want to know the information before making an investment decision.

   ✓ Information is "**nonpublic**" until it has been disseminated or is available to the marketplace in general.

- MNI?
  - Material?
    - Reliable source?
    - Clear impact?
  - Non-public?

Standard II(A): Guidance

- **Guidance - What Is "Material" Information ?**

5. Substance and specificity determines the materiality

- Company-related information
  - ✓ Earnings
  - ✓ Mergers, acquisitions, tender offers, or joint ventures
  - ✓ Changes in assets or asset quality
  - ✓ Innovations products, processes, or discoveries
  - ✓ New licenses, patents, registered trademarks, or regulatory approval/rejection of a product

Standard II(A): Guidance

- **Guidance - What Is "Material" Information ?**

5. Substance and specificity determines the materiality (cont.)

- Company-related information
  - ✓ Developments regarding customers or suppliers (e.g. the acquisition or loss of a contract)
  - ✓ Changes in management
  - ✓ Changes in auditor notification or the fact that the issuer may no longer rely on an auditor's report or qualified opinion
  - ✓ Events regarding the issuer's securities
  - ✓ Bankruptcies
  - ✓ Significant legal disputes
  - ✓ New or changing equity or debt rating issued by third party

Standard II(A): Guidance

- **Guidance - What Is "Material" Information ?**

5. Substance and specificity determines the materiality (cont.)

- Macro-economy
  - ✓ Government reports of economic trends (employment, housing starts, currency information, etc.)
- Large orders
  - ✓ Orders for large trades before they are executed
- Well known analyst
  - ✓ Reports from well known analyst
- Qualified personnel
  - ✓ Information about trials of a new drug
  - ✓ Additionally, information about trials of a new drug, product, or service under development from qualified personnel involved in the trials is likely to be material, whereas educated conjecture by subject experts not connected to the trials is unlikely to be material.
- Competitors
  - ✓ Competitor's estimation → not MNI

Standard II(A): Guidance

- **Guidance - What constitutes "nonpublic" Information ?**

6. Information is "nonpublic" until it has been disseminated or is available to the marketplace.
   - ✓ Not necessary to wait for the slowest method of delivery.
   - ✓ Once the information is disseminated to the market, it is public information that is no longer covered by this standard.
7. Selective disclosure
   - ✓ Disclosure to a room full of analysts does not necessarily make the disclosed information "public."
   - ✓ Analysts should also be alert to the possibility that they are selectively receiving MNI when a company provides them with guidance or interpretation of financial statements or regulatory filings.
   - ✓ Selective disclosure may violate MNI. If MNI was disclosed selectively, the listed company should issue a press release or reach public dissemination.

Standard II(A): Guidance

- **Guidance – When can use "nonpublic" Information ?**

8. A member or candidate may use insider information provided legitimately by the source company for the specific purpose of conducting due diligence according to the business agreement between the parties for such activities as mergers, loan underwriting, credit ratings, and offering engagements.

Standard II(A): Guidance - Mosaic Theory

- **Guidance – Mosaic Theory**

9. Mosaic theory:

	Material	Non-material
Public	√	√, but unnecessary
Non-public	×	√

- May use conclusions from the analysis of material public and nonmaterial nonpublic information even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company.
  - ✓ A perceptive analyst reaches a conclusion about a corporate action or event through an analysis of public information and items of nonmaterial nonpublic information. → not violate II (A)
  - ✓ Should save and document all the research when applying mosaic theory → Standard V(C).

Standard II(A): Guidance – Social Media

- **Guidance – Social Media**

10. Members and candidates participating in groups with membership limitations should verify that material information obtained from these sources can also be accessed from a source that would be considered available to the public (e.g., company filings, webpages, and press releases).

    ✓ The use of these platforms would be comparable with other traditional forms of communications, such as e-mails and press releases.

    ✓ Members and candidates, as required by Standard I(A), should also complete all appropriate regulatory filings related to information distributed through social media platforms.

Standard II(A): Guidance – Industry Expert

- **Guidance – Industry expert**

11. Members and candidates may provide compensation to individuals for their insights without violating this standard. However, members and candidates are ultimately responsible for ensuring the information they receive does not constitute material nonpublic information.
    - ✓ Members and candidates would be prohibited from taking investment actions on the associated firm until the information became publicly known to the market.
    - ✓ Firms connecting experts with members or candidates often require both parties to sign agreements concerning the disclosure of material nonpublic information.

Standard II(A): Guidance

- **Guidance - Investment Research Reports**

12. **When a well-known or respected analyst issues a report or makes changes to his or her recommendation, that information alone may have an effect on the market and thus may be considered material. Theoretically, such a report would have to be made public before it was distributed to clients.**
13. The analyst is not a company insider, however, and does not have access to inside information. Presumably, the analyst created the report from information available to the public (mosaic theory) and by using his or her expertise to interpret the information. The analyst's hard work, paid for by the client, generated the conclusions.
14. **Simply because the public in general find the conclusions material does not require that the analyst make his/her work public**. Investors who are not clients of the analyst can either do the work themselves or become clients of the analyst for access to the analyst's expertise.

Standard II(A)

Recommended Procedures

- Achieve public dissemination(if public is not possible, communicate only to designated supervisory and compliance).
- Adopt compliance procedures[15].
- Adopt disclosure procedures (policy to disseminate equitably).
- Issue press releases[16].
- Firewall elements[17].
- Appropriate interdepartmental communications (procedures should be formalized and compiled).
- Physical separation of departments (to the greatest extent).
- Prevention of personnel overlap (when as investment banker, not share inside info with research).
- A reporting system[18].
- Personal trading limitations[19].
- Record maintenance[20].
- Proprietary trading procedures[21].
- Communication to all employees[22].

Standard II(A)

Recommended Procedures

15. Adopt compliance procedures.
    - ✓ Should encourage firms to adopt compliance procedures to prevent the misuse of MNI.
    - ✓ Particularly important is improving compliance in such areas as the review of employee and proprietary trading, documentation of firm procedures, and the supervision of interdepartmental communications in multi-service firms.
    - ✓ Compliance procedures should suit the particular characteristics of a firm, including its size and the nature of its business.
    - ✓ Disclosure: members and candidates should encourage the development of and compliance with procedures for distributing new and updated investment opinions to clients.
    - ✓ Recommendations of this nature may represent material market moving information that needs to be communicated to all clients fairly.

Standard II(A)

Recommended Procedures

16. Issue press releases.
    - ✓ Companies should consider issuing press releases <u>prior to analyst meetings and conference calls</u> and scripting those meetings and calls to decrease the chance that further information will be disclosed.
    - ✓ If MNI is disclosed for the first time in an analyst meeting or call, <u>the company should promptly issue a press release or otherwise make the information publicly available.</u>

Standard II(A): Recommended Procedures

- **Recommended Procedures**

17. Firewall

✓ The minimum elements include, but are not limited to, the following:

- Substantial control of interdepartmental communications, preferably through a clearance area in either the compliance or legal department;
- Documentation of the procedures designed to limit the flow of information between departments and of the actions taken to enforce those procedures;
- Review of employee trading through the maintenance of **"watch," "restricted," and "rumor" lists;**
- Heightened review or restriction of proprietary trading while a firm is in possession of MNI.

Standard II(A): Recommended Procedures

- **Recommended Procedures**

18. A reporting system.

- Primary objective of effective firewall procedure:
  - ✓ Establish a reporting system in which authorized people review and approve communications between departments.
- **Inter-department communication** should ***consult a designated compliance officer to determine whether sharing the information is necessary and how much to be shared.***
  - ✓ If sharing is necessary, the compliance officer should coordinate the process of "looking over the wall" so that the necessary information will be shared and the integrity of the procedure will be maintained.
- A single supervisor or compliance officer should decide whether or not information is material and whether it is sufficiently public to be used as the basis for investment decisions.
- Ideally, the supervisor or compliance officer responsible for communicating information to a firm's research or brokerage area would not be a member of that area. (independent)

Standard II(A): Recommended Procedures

Recommended Procedures

19. Personal trading limitations.

- ✓ Firms should **consider restrictions or prohibitions** on personal trading and should carefully monitor proprietary trading.
- ✓ Should require employees to **make periodic reports** (to the extent that such reporting is not already required by securities laws) of their own transactions and transactions made for the benefit of family members.
- ✓ Securities should be placed on a restricted list when a firm has or may have MNI. The broad distribution of a restricted list often triggers the sort of trading the list was developed to avoid.
  - A watch list shown to only the few people responsible for compliance → monitor transactions in specified securities.
  - Watch list in combination with a restricted list is a common means of ensuring effective control of personal trading.

Standard II(A): Recommended Procedures

- **Recommended Procedures**

20. Record maintenance.

✓ Multi-service firms should maintain written records of the communications between various departments. Firms should place a high priority on training and consider instituting comprehensive training programs, particularly for employees in sensitive areas.

21. Proprietary trading procedures

✓ Monitor and restrict proprietary trading when holding MNI

✓ Prohibition on **all** proprietary activity when owning MNI is **not appropriate**. → depend on the **types** of proprietary trading.

- **Market maker** in possession of MNI, withdrawal from market making will be a clear tip to market. Remain passive to market (take only contra side of unsolicited customer's trades).
- **Risk-arbitrage trading:** Best to stop; If not stop, prove the adequacy of their internal procedures, and must demonstrate stringent review and documentation of firm trades.

Standard II(A): Recommended Procedures

- **Recommended Procedures**

22. Communication to all employees.

    - ✓ Written compliance policies and guidelines should be circulated to all employees.
    - ✓ Policies and guidelines should be used in conjunction with training programs aimed at enabling employees to recognize MNI.
    - ✓ Sufficient training to either make an informed decision or to realize they need to consult a supervisor or compliance officer before engaging in questionable transactions.

Standard II(A): Case 1-2

- **Case 1. (Acting on Nonpublic Information)** Staple gets the information of the tender offer for SmartTown from his wife who is the niece of the president and controlling shareholder of SmartTown, and immediately buys the stock.
  - Comment: The info is both material and nonpublic so it is a violation of Standard II(A)-material nonpublic information.
- **Case 2. (Controlling Nonpublic Information)** During the telephone conference call with Bright Company, Peter is advised that the earnings projections have significantly dropped. During the call, several portfolio managers and sales persons walk in and out of Peter's office. As a result, they are aware of the drop. Before the conference call is concluded, the sales person traded the stock of the company for clients and in personnel accounts.
  - Comment: Peter violated Standard II(A)-material nonpublic information as he failed to prevent the transfer and misuse of material nonpublic information and his colleagues who traded also committed violation.

Standard II(A): Case 3

- **Case 3. (Selective Disclosure of Material Information)** In a meeting with the finance director of the manufacturer and the other 10 largest shareholders of that company, Levenson knew a forthcoming strike which will cripple the production and distribution. She concerns whether she could use this information as a basis to change the rating from buy to sell.
  - **Comment:** Levenson must first determine whether the material information is public. If the company has not made this information public (a small-group forum does not qualify as a method of public dissemination), she cannot use the information according to Standard II(A)-material nonpublic information.

Standard II(A): Case 4

- **Case 4. (Determining Materiality)** Fechtman collects information from his doctor who thinks a takeover is imminent and it is good to long stocks. After talking to investment professionals and checking opinions on the company and industry trends, Fechtman decides to accumulate more stock.
    - **Comment:** Although information on an expected takeover bid may be of the type that is generally material and nonpublic, in this case, the source of information is unreliable and could not be considered material. Therefore, Fechtman can trade the stock on the basis of this information.

Standard II(A): Case 5

- **Case 5. (Applying the Mosaic Theory)** Teja is covering furniture industry. He analyzes several furniture makers by studying their financial reports and visiting their operations. He also talks to some designers and retailers to find out which furniture style are trendy and popular. Through his research and analysis he believes SFC is overpriced because its high cost and slow demand due to unattractive design and issues a sell recommendation.
  - **Comment:** Teja's correct conclusion based on public information and on pieces of nonmaterial nonpublic information .Therefore, trading based on Teja's correct conclusion is not prohibited by Standard II(A)-material nonpublic information.

Standard II(A): Case 6

- **Case 6. (Applying the Mosaic Theory)** Clement, a famous auto analyst, after his due diligence with the manufacturer, salesman, banker, labor union and etc, changed his recommendation from buy to sell mainly based on: unsuitable new model, corporate restructure face serious opposition from labor union, depreciation of Korean won resulting in down pressure on profitability margin and bank would take tougher-than-expected stance in upcoming round of credit renegotiations.
  - **Comment:** Clement has not violated Standard II(A)-material nonpublic information in drafting the report. Clement has pieced together a number of nonmaterial or public bits of information that affect Turgot Chariots to calculate the value of the company, . Therefore, it is under the “mosaic theory,”

Standard II(A): Case 7

- **Case 7. (Analyst Recommendations as MNI)** Clement mentioned his changed recommendation <u>before a TV interview</u> to Zito who is the journalist preparing to interview him. Zito sells the stock prior to the interview.
  - **Comment:** Zito knows that <u>Clement's opinions will have a strong influence on the stock's behavior</u>, so when she receives advanced notice of Clement's change of opinion, she knows it will have a material impact on the stock price, even if she is not totally aware of Clement's underlying reasoning. <u>She is not a client of Clement but obtains early access</u> to the material nonpublic information prior to publication. Her actions are thus trades based on material nonpublic information and <u>violate Standard II(A)-material nonpublic information.</u>

Standard II(A): Case 8

- **Case 8. (Acting on Nonpublic Information)** Kellogg manages his own portfolio. He owns shares in NS Bank. A close friend and golf buddy, John, is a senior executive at NS Bank. NS has seen its stock drop considerably. In a conversation about the economy and the banking industry on the golf course, John drops information that NS will announce excellent earnings for the quarter. Kellogg is surprised by this information, and thinks that John knows the law and would not disclose inside information, so he doubles his position in NS. Subsequently, NS announces that it had good operating earnings but had to set aside reserves for anticipated significant losses on its loan portfolio. The combined news causes the stock to go down 60 percent.
  - **Comment**: Kellogg has violated Standard II(A)-material nonpublic information by purchasing additional shares of NS. It is the member's or candidate's responsibility to make sure, before investment actions, that comments about earnings are not material nonpublic information.

Standard II(A): Case 9

- **Case 9. (Mosaic Theory)** John Doll is a research analyst for a hedge fund that also sells its research to a select group of paying client investment firms. Doll has been writing research report recommending Boyce Health, a medical device manufacturer. He recently ran into an old acquaintance at a wedding who is a senior executive at Boyce, and Doll asked about the business. Doll was drawn to a statement that the executive, who has responsibilities in the new products area, made about a product: "I would not get too excited about the medium term prospects; we have a lot of work to do first." Doll incorporated this and other information about the new Boyce product in his long-term recommendation of Boyce.
  - **Comment:** Doll's conversation with the senior executive is part of the mosaic of information. When holding discussions with a firm executive, Doll would need to guard against for obtaining material nonpublic information. Before issuing the report, the executive's statement of the product would need to be weighed against the other known public facts to determine whether it is material or not.

Standard II(A): Case 10

- **Case 10. (Materiality Determination)** Larry Nadler is a trader for a mutual fund. He gets a text message from another firm's trader, which indicates a software company is going to report strong earnings when the firm publicly announces in two days. Nadler completes the purchases by the following morning, a day ahead of the firm's planned earnings announcement.
  - **Comment:** The text message from the other trader would be considered market noise.
  - Unless Nadler knew that the trader had an ongoing business relationship with the public firm, he has not receive material nonpublic information.

Standard II(A): Case 11

- **Case 11. (Using an Expert Network)** Mary McCoy is the senior drug analyst at a mutual fund. Her firm hires a service that connects her to experts in the treatment of cancer. Through various phone conversations, McCoy enhances her understanding of the latest therapies for successful treatment. This information is critical to Mary making recommendations about drugs.
  - **Comment:** McCoy is appropriately using the expert networks to enhance her evaluation process.
  - She has not asked for nonpublic information, such as preliminary trial results.
  - McCoy is allowed to seek advice from professionals within the industry that she follows.

Standard II(A): Case 12

- **Case 12. (Using an Expert Network)** Tom Watson is a research analyst working for a hedge fund. Watson relies on outside experts for information, where new advancements occur frequently. Watson arranges a call to discuss future prospects of a new semiconductor product. **The scientist leading the tests indicates his disappointment with the performance** of the new semiconductor. Following the call, Watson relays the opinion of others at the fund. The fund sells its current position in the company and writes many put options because the market price is on the basis of the perceived success of the new semiconductor.
  - **Comment:** Watson has violated Standard II(A)-material nonpublic information by passing along material nonpublic information.
  - Watson cannot simply rely on the message that the scientist given, he must make his own determination whether information he received through these arrangements reaches a materiality threshold that would affect his trading abilities.

Example

Material nonpublic information

- Dacy CFA, is married to an auditor employed at a large accounting firm. Her husband mentioned that a computer firm he was auditing would receive a qualified opinion. For the information, she did not pay attention. However, she noticed that there were substantial holdings of this company when she reviewed a new client's account later that week. Then she did an internet search for news on the company but did not find anything about its most recent audit or anything adverse. Which of the following actions concerning the computer stock should Dacy most likely take to avoid violating the CFA Institute Standards of Professional Conduct?

  A. Take no investment action.

  B. Complete a thorough and diligent analysis of the company and then sell the stock

  C. Sell the stock immediately as she has a reasonable basis for taking this investment action.

- Correct Answer: A.
  - The information concerning the qualified opinion is nonpublic and material. She would be in violation of Standard II (A) if she took investment action based on the information.
  - She should also make reasonable efforts to achieve public dissemination of the information.

Summary

Guidance for Standards I–VII

II(A).Material nonpublic information

Material, public, Mosaic

Social media, experts, research reports

II(B).
Market manipulation

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard II(B): Content

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

1. Market manipulation includes:

- **Info-based:** Dissemination of false or misleading information
  - ✓ Pump up prices by issuing misleading positive info, then dump.
- **Transaction-based:** Members or candidates knew or should have known that transactions deceive or would be likely to mislead market participants by distorting the price-setting mechanism. It includes:
  - ✓ Artificially affect prices or volume to give misleading impression of price movement, which represent a diversion from the expectations of a fair and efficient market.
  - ✓ Securing a dominant position to exploit and manipulate the price of related derivative and the underlying asset.

Standard II(B): Guidance

- **Guidance**

2. The <u>intent</u> of the action is critical to determining whether it is a violation.
   - ✓ Not prohibit legitimate trading strategies that exploit a diff in market power, info, or other inefficiency.
   - ✓ Not prohibit trade for tax purposes, selling then buying back.
3. <u>To increase liquidity, Futures Exchange</u> made agreements with members to insure the minimum trading volume in exchange for reduction of commission.→ If <u>for the interest of clients and disclosed</u>, **not violate**.

Standard II(B): Case 1

- **Case 1. (Independent Analysis and Company Promotion)** The principal owner of FIS agrees to promote 2 small-caps in exchange for stock and cash compensation, and systematically publishes purportedly independent analyses and inaccurate favoring recommendation in the form of emails, design and online investment newsletter - all of which recommended investment in the 2 companies. The price increases dramatically.
  - **Comment:** The principal owner of FIS violated Standard II(B)-market manipulation by using inaccurate reporting and misleading information **under the guise of independent** analysis to artificially increase the price.
  - Also violate V(A)-diligence and reasonable basis; VI(A)-disclosure of conflicts.

Standard II(B): Case 2

- **Case 2. (<u>Personal Trading Practices and Price</u>)** John Gray would like to reduce his holding of shares in Fame Pharmaceuticals, a small-cap security with limited trading volumes. Gray devises a plan to <u>divide his holdings into multiple accounts</u>. He then creates a rumor campaign on various blogs and social media outlets promoting the company. Gray <u>begins to buy and sell the stock using the accounts to raise</u> the trading volume, public awareness, and the price. He finally reduce his shares of Fame Pharmaceuticals without cut down the stock price.
  - **Comment:** John violated Standard II(B)-market manipulation by fraudulently creating the appearance that there was a greater investor interest in the stocks through the online rumors. In addition, he dumped his stocks with certain trading strategy through several accounts is definitely manipulating the market and cause other investor exposed to excessive risk.

Standard II(B): Case 3-4

- **Case 3. (Creating Artificial Price Volatility)** Murphy issued a pessimistic report extensively on Wirewolf during the company's quarter-end "quiet period", in order to benefit his hedge fund clients who have short position of Wirewolf .The report was mainly based on speculation, not on fact.
  - **Comment:** Murphy tried to benefit his clients through disseminating unfaithful information and causing the stock price volatility; It is a violation of Standard II(B) and V(A) **(diligence and reasonable basis)**
- **Case 4. (Personal Trading and Volume)** In order to liquidate the CD stock at a favorable price, Sekar plans to artificially inflate the trading volume and price of the stock.
  - **Comment:** Sekar's plan involves distortion of both trading volume and price and therefore constitutes violation, therefore constitutes a violation of Standard II(B)-market manipulation.

Standard II(B): Case 5

- **Case 5. (“Pump-Priming” Strategy)** In order to demonstrate best liquidity of a new contract, Gonchar, chairman of the ACME Futures Exchange, enters into agreements with members so that they commit to a substantial minimum trading volume on the new contract for a specific period in exchange for reductions of commission.
    - **Comment:** If ACME fully discloses its agreement with members to boost transactions over some initial launch period, it does not violate Standard II(B)-market manipulation. ACME’s ultimate purpose is benefit its clients with better services rather than harm their clients.

Standard II(B): Case 6

- **Case 6. (Pump and Dump Strategy)** Weinberg disseminate a rumor that M&B Railroad Company starts expanding its railway network to reply an anticipation of receiving a large contract for shipping lumber. He did this solely for dumping his M&B shares with higher average price.
  - **Comment:** Weinberg's false information <u>mislead the market and profit himself</u>. It is a violation of Standard II(B)-market manipulation.

Standard II(B): Case 7

- **Case 7. (<u>Manipulating Model Inputs</u>)** Mandeville use selective inputs to create a model with limited downside risk, therefore the rating result is very good. Additionally, Mandeville's compensation from superior is partially based on both the level of rating assigned and the successful sale of new structured investment products but do not related to the long-term performance of the instruments.
  - **Comment**: Mandeville manipulates the inputs of a model to minimize associated risk to achieve higher ratings. <u>This information manipulation for short-term gain, which is in violation of Standard II(B)-market manipulation</u>, Such loss of confidence affects the ability of the capital markets to operate efficiently.
  - Also violate I(D)-Misconduct; V(A)-diligence and reasonable basis.

Standard II(B): Case 8

- **Case 8 (Information Manipulation)** Allen King disseminated a rumor which cause several small and micro cap companies' stock price rise. These companies are included to a portfolio whose manager is an enemy of Allen. The manager sold his position and caused an investigation by the regulator as Allen desired.
  - **Comment:** Allen created a rumor and mislead the market. These actions are clearly violation of Standard II(B)-market manipulation. Even though he did not profit from his rumor, the misleading information is disseminated to the market.
  - Also violate I(D)-Misconduct.

Example

Market manipulation

- Jacky, CFA, a retired portfolio manager, would like to sell 20,000 shares of a small public company that he owned because he is worried about the company's prospects. Then he posts messages on several internet bulletin boards, which read, " I have done some close research on these guys. This stock is going up once the pending patents are released, so now is the time to buy. The stock is a buy at anything below $3." According to the Standards of Practice Handbook, Jacky most likely violated the Code and Standards associated with:

  A. Neither Integrity of Capital Markets nor Conflicts of Interest.

  B. Integrity of Capital Markets, but not Conflicts of Interest.

  C. Integrity of Capital Markets, and Conflicts of Interest.

- Correct Answer: B.
  - Blake violated Standard II(B) regarding the Integrity of Capital Markets by engaging in a practice that is likely to artificially inflate trading volume.

Market manipulation

- Over the past two days, Lorraine Quigley, CFA, manager of a hedge fund, has been purchasing large quantities of Craeger Industrial Products’ common stock while at the same time shorting put options on the same stock. Quigley did not notify her clients of the trades, although they are aware of the fund's general strategy to generate returns. Which of the following statements is most likely correct?
  A. Quigley did not violate the Code and Standards.
  B. Quigley violated the Code and Standards by manipulating the prices of publicly traded securities.
  C. Quigley violated the Code and Standards by failing to disclose the transactions to clients before they occurred.
- Correct Answer: A.
  - Quigley's trades are most likely an attempt to take advantage of an arbitrage opportunity that exists between Craeger's common stock and its put options.
  - She is not manipulating the prices of securities in an attempt to mislead market participants, which would violate Standard II(B) Market Manipulation. She is pursuing a legitimate investment strategy.
  - Participants in her hedge fund are aware of the fund's investment strategy, and thus, Quigley did not violate the Code and Standards by not disclosing this specific set of trades in advance of trading.

Summary

Guidance for Standards I–VII

II(B).Market manipulation

Intent

Info-based, transaction-based

III(A).
Loyalty, Prudence and Care

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard III(A): Content

- **Content:**

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

Standard III(A): Guidance

- **Guidance**

3. Exercise prudence, care, skill, and diligence.
4. Fiduciary (acting for the benefit of another party) requires higher duty to other business duty.
   - ✓ A fiduciary is someone who acts for the benefit of someone else. In a position of trust, fiduciaries owe undivided loyalty to their clients and must place clients' interests before their own.
   - ✓ Prudent man rule: A fiduciary must direct and operate the client's assets according to a higher standard of loyalty and extra care than the standard to which most people are held.
   - ✓ Any pooling of funds must be managed in strict accordance to the trust documents.

Standard III(A): Guidance

- **Guidance**

5. Prudence requires caution and discretion.
   - ✓ The exercise of **prudence by investment professionals** requires acting with care, skill, and diligence in the circumstances that a reasonable person acts in a like capacity and familiar with such matters would use.
   - ✓ In managing a client's portfolio, prudence requires following the investment parameters set by the client and balancing risk and return.
   - ✓ Acting with care requires a prudent and judicious manner in avoiding harm to clients.
6. Standard III(A), is not a substitute for legal or regulatory obligations. The duty required in fiduciary relationships exceeds what is acceptable in many other business relationships because a fiduciary is in an enhanced position of trust.

Standard III(A): Guidance

- **Understanding the Application of Loyalty, Prudence, and Care**

7. Standard III(A) does not render all members and candidates fiduciaries. However, Standard III(A) requires members and candidates to work in the client's best interest no matter what the job function.

   ✓ The conduct may or may not rise to the level of being a fiduciary, depending on the type of client, whether they are giving investment advice, and the many facts and circumstances surrounding a particular transaction or client relationship.

   - A member or candidate who does not provide advisory services to a client, but who acts only as a trade execution professional must prudently work in the client's interest when completing requested trades.
   - The extent of the advisory arrangement and limitations should be outlined in the agreement with the client at the outset of the relationship.

Standard III(A): Guidance

- **Understanding the Application of Loyalty, Prudence, and Care (cont.)**
  - Members and candidates should inform clients that the advice provided will be limited to the propriety products of the firm and not include other products available on the market. Clients who want access to a wider range of investment products would have the information necessary to decide not to engage with Members or candidates working under these restrictions.
  - Recommending the allowable products that are consistent with the client's objectives and risk tolerances.
  - They would exercise care through diligently aligning the client's needs with the attributes of the products being recommended.
  - Besides offering a limited product selection, members and candidates should place the client's interests first by disregarding any firm or personal interest in motivating a recommended transaction
  - Standard III(A) requires them to fulfill the obligations outlined explicitly or implicitly in the client agreements to the best of their ability and with loyalty, prudence, and care.

Standard III(A): Guidance

- **Guidance - Identifying the Actual Investment Client**

8. Determine the identity of the "client" to whom the duty of loyalty is owed.

4 types of clients:

✓ **Individual:** In the context of an investment manager managing the personal assets of an individual, the client is the owner of the asset.

✓ **Beneficiary:** When the manager is responsible for the portfolios of pension plans or trusts, the client is the beneficiaries of the plan or trust. The duty of loyalty is owed to the ultimate beneficiaries.

✓ **Mandate:** Members and candidates managing a fund to an index or an expected mandate owe the duty of loyalty, prudence, and care to the stated mandate.

✓ **Investing public:** The client may be the investing public as a whole, the goals of independence and objectivity of research surpass the goal of loyalty to a single organization.

Standard III(A): Guidance

- **Guidance - Identifying the Actual Investment Client (cont.)**

9. Situations involving potential conflicts of interest with respect to responsibilities to clients may be extremely complex because they may involve a number of competing interests.
   - ✓ Not only put obligations to clients first in all dealings but also endeavor to avoid all real or potential conflicts of interest.
10. Even not have responsibilities of direct investment management, "clients" should also be considered.
    - ✓ Must look at roles and responsibilities when making a determination of who their clients are.
    - ✓ Easily identifiable client relationship: company executive and the firm's public shareholders.

Standard III(A): Guidance

- **Guidance - Developing the Client's Portfolio**

11. The duty of loyalty, prudence, and care to client is especially important because the investment manager typically possesses greater knowledge in investment than the client does. This disparity places the individual client in a vulnerable position; the client must trust the manager.
    - ✓ The manager in these situations should ensure that the client's objectives and expectations of the account are realistic and suitable to their circumstances and that the risks involved are appropriate.
    - ✓ In most circumstances, recommended investment strategies should relate to the long-term objectives and circumstances of the client.

Standard III(A): Guidance

- **Guidance - Developing the Client's Portfolio (cont.)**

12. Particular care must be taken to detect whether the goals of the investment manager or the firm in placing business, selling products, and executing security transactions potentially conflict with the best interests and objectives of the client.
13. Must follow any guidelines set by their clients for asset management.
14. Investment decisions must be judged in the context of the **total portfolio** rather than by individual investment within the portfolio.

Standard III(A): Guidance

- **Guidance - Soft Commission Policies**

15. An investment manager often has discretion over the selection of brokers executing transactions. Conflicts arise when an investment manager uses client brokerage to purchase research services→ "soft dollars" or "soft commissions."

16. Whenever using client brokerage to purchase goods or services that do not benefit the client, should disclose to clients the methods or policies followed in addressing the potential conflict.

    ✓ A member or candidate who pays a higher commission than he or she would normally pay to purchase goods or services, without corresponding benefit to the very client, violates III (A).

Standard III(A): Guidance

- **Guidance - Soft Commission Policies (cont.)**

17. **Directed brokerage**: A client will direct a manager to use the brokerage to purchase goods or services for the client. Because brokerage commission is an asset of the client and is used to benefit that client, not the manager, such a practice does not violate any duty of loyalty.

    ✓ Obligated to seek **"best execution" and "best price",** and assured that the goods or services purchased from the brokerage will benefit the account beneficiaries.

    ✓ "Best execution" refers to a trading process that seeks to maximize the value of the client's portfolio within the client's stated investment objectives and constraints.

    ✓ Should disclose to the client and obtain written consent that the client may not get best execution from the directed brokerage if he insists on trading through that broker.

Standard III(A): Guidance

- **Guidance - Proxy Voting Policies**

18. Voting proxies in an informed and responsible manner.

    - ✓ Proxies have economic value to a client.
        - Must ensure properly safeguard and maximize this value.
    - ✓ An investment manager who fails to vote, casts a vote without considering the impact of the question, or votes blindly with management on non-routine governance issues may violate III(A).
    - ✓ **A cost–benefit analysis** may show that voting all proxies may not benefit the client, so voting proxies may not be necessary in all instances.
        - Members and candidates should disclose to clients their proxy voting policies.

Standard III(A)

Recommended Procedures

- Regular account information[19]
- Client approval[20]
- Firm policies
  - ✓ Follow all applicable rules and laws
  - ✓ Establish the investment objectives of the client
  - ✓ Consider all the information when taking investment actions. (Return objectives and risk tolerance)[21]
  - ✓ Diversify[22]
  - ✓ Carry out regular reviews
  - ✓ Deal fairly with all clients with respect to investment actions
  - ✓ Disclose conflicts of interest
  - ✓ Disclose compensation arrangements
  - ✓ Vote proxies in the best interest of beneficiaries and clients (disclose to clients their proxy-voting policies)[23]
  - ✓ Maintain confidentiality
  - ✓ Seek best execution
  - ✓ Place client interest first

Standard III(A)

Recommended Procedures

19. Regular account information.
    - ✓ Members and candidates with control of client assets should **submit to each client, <u>at least quarterly</u>, an <u>itemized statement</u> showing**
        - The funds and securities in custody plus all debits, credits, and transactions that occurred during the period;
        - Should disclose to the client <u>where the assets</u> are to be maintained, where or when they are moved;
        - Should separate the client's assets from any other party's assets, including the member's or candidate's own assets.
20. Client approval.
    - ✓ If <u>uncertain about the appropriate action</u> to a client, should <u>ask what he or she would expect or demand if he were the client.</u>
    - ✓ <u>If in doubt</u>, should disclose questionable matter <u>in writing</u> to the client and obtain <u>client approval</u>.

Standard III(A)

Recommended Procedures

21. When taking investment actions, must consider the appropriateness and suitability of the investment relative to:
    - ✓ The client's needs and circumstances
    - ✓ The investment's basic characteristics
    - ✓ ***The basic characteristics of the total portfolio.***

22. Diversify:

- ✓ Should diversify investments to reduce the risk of loss ***unless*** diversification is not consistent with plan guidelines or is contrary to the account objectives.

23. Vote proxies
    - ✓ In most cases, should determine:
        - ◻ Who is authorized to vote shares
        - ◻ Vote proxies in the best interests of clients and ultimate beneficiaries.

Standard III(A): Case 1

- **Case 1 (Identifying the Client-Plan Participants).** Wiley serves as trustee for Miller's pension plan and is requested by the Miller's managers to support their anti-takeover action by buying Miller's common stock for the plan. Although he believes the stock is overvalued, he purchases the stock considering maintaining the company's good favor to his firm. And the anti-takeover action succeeds.
    - **Comment:** The trustee must act for the beneficiary's interest (in this case: the plan participants), not the benefit of the management. The guiding principle is the appropriateness of the investment for the plan, not whether the decision benefits Wiley or the company that hired him. So, it is a violation of III(A)-Loyalty, prudence and care.

Standard III(A): Case 2

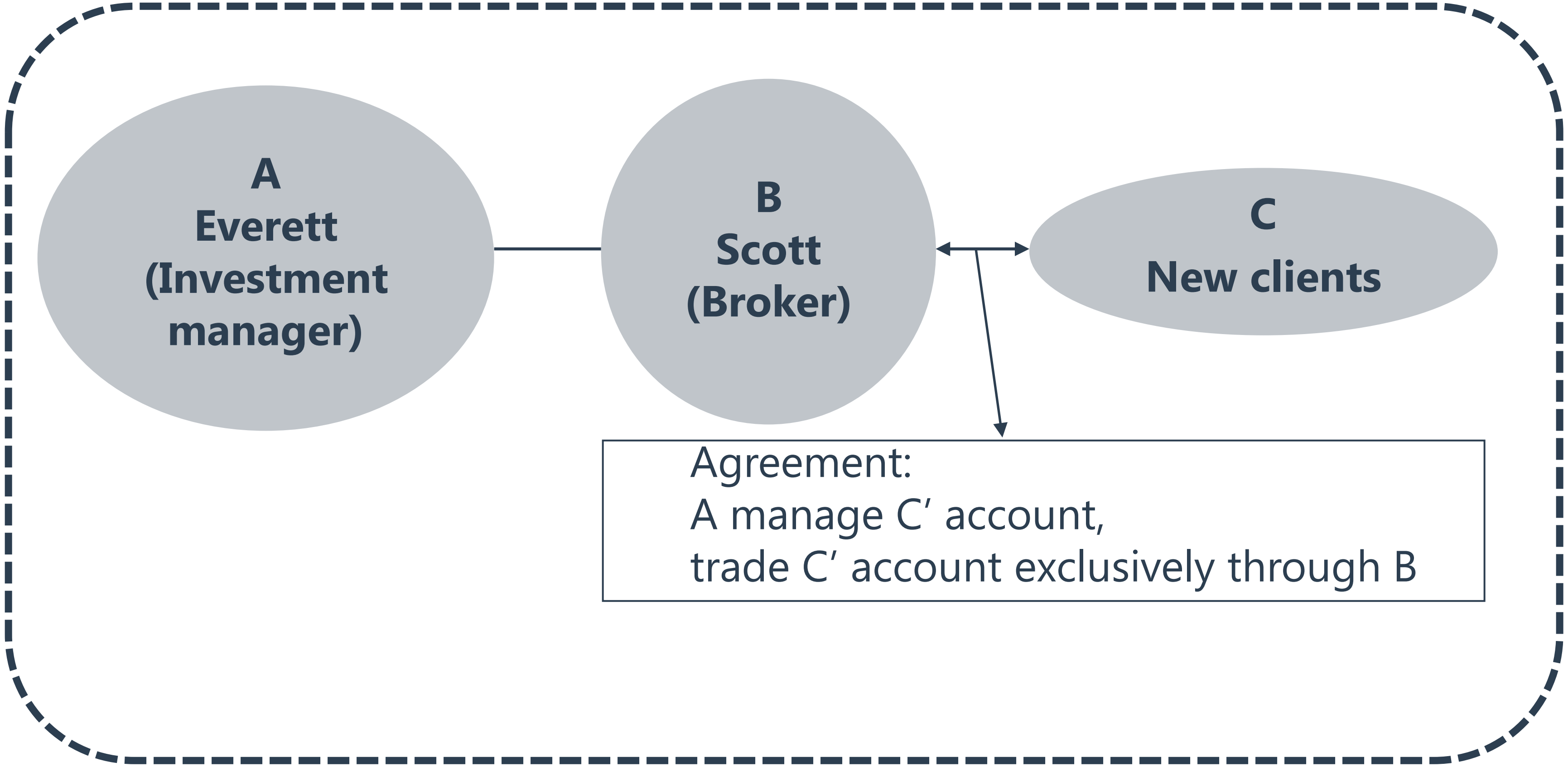
- **Case 2 (Client Commission Practices).** JNI, a successful investment counseling firm for local pension plans, directs large portion of brokerage to Thompson, because of close relationships between the executives of the two firms. Thompson's commission structure is higher despite of the average research services and execution capabilities. In exchange for JNI directing brokerage to Thompson, Thompson absorbs a portion of overhead expenses of JNI.
  - **Comment:** JNI did not obtain best execution for clients and indirectly used clients' brokerage to cover overhead, it is clear violation.

Standard III(A): Case 3

- **Case 3. (Soft dollar)** Everett works as an independent investment advisor for the pension plans of several companies. Her existing client Crayton, has directed Everett to place securities transactions for Crayton's account exclusively through her brokers Scott with many new client accounts. In order to have more new accounts from Scott, Everett also directs transactions to Scott from other clients without their knowledge.
  - **Comment:** Everett has violated Standard III(A)-loyalty, prudence and care. She is obliged to seek best price and execution on all trades unless a written statement from new clients that ask **not** to do so and that they know the consequence, Everett may trade other accounts through Scott only if the accounts receive best price and execution and the practice is disclosed to the accounts.
  - Not disclosing, also violating VI(A) Disclose the conflicts of interest.

Standard III(A): Case 3

- **Case 3. (Case outline)**



Standard III(A): Case 3

- **Case 3. (Soft dollar: Case analysis)**
  - Everett may <u>direct new client trades exclusively through Scott</u> as long as:
    - ✓ Everett receives best price and execution <u>**or**</u>
    - ✓ Receives written statement from new clients that she is not to seek best price and execution and that they are aware of the consequence for their accounts.
  - Everett may <u>trade other accounts</u> through Scott as long as:
    - ✓ Everett receive best price and execution <u>**and**</u> the accounts receive best price and execution.
    - ✓ The practice is disclosed to the clients.

Standard III(A): Case 4

- **Case 4 (Brokerage Arrangements).** Rome is a trust officer for Paget. She has been using Gray, a broker, exclusively for trust account brokerage transactions. When Gray makes a market in stocks, he has been giving Rome a <u>lower price for personal purchases and higher price for sales</u> <u>than trust accounts and other investors</u>.
  - **Comment:** Rome violates III(A)-loyalty, prudence and care by placing her own interests before those of her clients. She uses Gray as the trust account's broker because of the privilege she gets in buying stocks and this breaches the duty of loyalty to the bank's trust accounts.

Standard III(A): Case 5

- **Case 5 (<u>Client Commission Practices</u>).** Parker is an analyst specializing in South American equities. Without knowing its competency, Parker gives the commission business to SouthAM, a research firm who arranges briefing study trip for Parker to South America so she can take the trip for free. Also Parker decides to use the commission dollars to cover her additional five days of hotel expense at the end of the trip.
  - **Comment:** Parker has violated Standard III(A)-loyalty, prudence and care by not exercising her duty of loyalty to her clients. He did not determine whether the commissions charged by SouthAM were reasonable in relation to the benefit of the research and not determine that best execution and prices can be received from SouthAM. And the hotel expenses should not be paid for with commission dollars.

Standard III(A): Case 6

- **Case 6 (Excessive Trading).** Knauss is a portfolio manager for high-net-worth individuals, and her investment management fee mostly depends on trading commissions. So she engages in extensive trading within the firm's minimum commission level and adds asset classes for the clients regardless that the trading exceeds what is necessary to achieve the client's investment objectives.
    - **Comment:** Knauss has violated Standard III (A)-loyalty, prudence and care because she is using the assets of clients to benefit her firm and herself by collecting more trading commissions and management fee.

Standard III(A): Case 7

- **Case7 (Managing Family Accounts).** Dill works in an asset management firm and manages many client's account as well as his family. To assist Dill build client base, his brother opened a new account with normal fee-paying. Dill recently finds an IPO is a suitable investment for his clients including his brother. To avoid conflict of interest , he does not allocate any shares to his brother's account.
  - **Comment:** Dill is not acting for the benefit of his brother's regular fee-paying account as well as his other accounts.
  - By not allocating the shares proportionately for all appropriate accounts, Dill is disadvantaging specific clients. Dill would have been correct in not allocating shares to his brother's account if that account was being managed outside the normal fee structure of the firm. Dill has violated standard III(A)-loyalty, prudence and care.
  - **Also violating III(B) fair dealing.**

Standard III(A): Case 8

- **Case 8 (Identifying the Client).** Donna Hensley has been hired by a law firm to testify as an expert witness. She is concerned that her work may have negative consequences for the law firm. But the testimony is intended to represent impartial advice . If the law firm is Hensley's client, how does she ensure that her testimony will not violate the required duty of loyalty, prudence, and care to one's client?
  - **Comment:** In this situation, the law firm represents Hensley's employer and the aspect of client is not well defined. When acting as an expert witness, Hensley is bound by the standard of independence and objectivity. Hensley must not let the law firm influence the testimony she is to provide in the legal proceedings.

Standard III(A): Case 9

- **Case 9 (Identifying the Client):** Jon Miller is a mutual fund portfolio manager. Wanda Spears is a private wealth manager in the same city as a friend of Miller. Spears mentions to Miller that her new client is an investor in Miller's fund. She states that the two of them now share a responsibility to this client.
  - **Comment:** Spears' statement is not totally correct. Because she provides the advisory services to her new client, she alone is bound by the duty of loyalty to this client. Miller's responsibility is to manage the fund not any particular fund investors. His actions should not be influenced by the needs of any particular fund investor.

Standard III(A): Case 10

- **Case 10 (Execution Only Responsibilities)** Sulejman is a candidate in the CFA program and works as a broker only actualizing trading decisions made by clients without offering any investing advice. He is concerned whether he has a fiduciary duty to clients so he emails to CFA Ethics to seek guidance on this issue.
  - **Comment:** Sulejman takes execution-only responsibilities in his work. Given this job function, the requirement of the Code and Standards for loyalty, prudence and care clearly do not impose a fiduciary duty.

Loyalty, prudence and care

- David Jason, CFA, is a portfolio manager and holds shares of Barcaly Limited and Mayer Ventures in all client portfolios. There are upcoming annual general meetings scheduled for the same day for both companies. The management of Barclay proposes to change its financial year-end from September to December, while Mayer Ventures proposes to enter into a high-risk venture. The proxy voting policy clause in all client investment management agreements managed by David states, “When voting proxies provides a cost benefit to the client, the manager must vote a proxy.” Regarding the proxy votes for Mayer and Barclay, David would least likely violate CFA Institute Standard III (A) Loyalty, Prudence, and Care if he votes:

A. With management.

B. Only the Mayer proxy.

C. Only the Barclay proxy.

Loyalty, prudence and care

- Correct Answer: B.
  - Standard III (A) Loyalty, Prudence, and Care states: it is a member's or candidate's duty to vote proxies on behalf of clients in an informed and responsible manner.
  - However, if a cost-benefit analysis shows voting all proxies may not benefit the client, voting all proxies may not be necessary. The member or candidate is responsible for informing all clients if this is the policy of the fund manager. The member or candidate must takes steps to disclose this proxy voting policy to clients.
  - Voting the Barclay proxy does not appear to offer a benefit because the issue is not of a critical nature, while voting the proxy for Mayer involves a material issue and is a benefit that should be voted on.

Summary

Guidance for Standards I–VII

III(A).Loyalty, prudence and care

Fiduciary duty, who's clients

Development of portfolio, soft dollar, proxy voting

III(B).
Fair dealing

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard III(B): Content

- **Content:**

1. Must deal fairly and objectively with all clients when:
   - ✓ Providing investment analysis
   - ✓ Making investment recommendations
   - ✓ Taking investment action
   - ✓ Engaging in other professional activities.

Standard III(B): Guidance

- **Guidance**

2. Fairly ≠ equally

   ✓ Fairly: Not to discriminate against any clients when disseminating recommendations or taking investment action.

   ✓ Equally: Not required to treat all clients exactly the same, e.g. reach all clients exactly the same time, by e-mail or telephone.

3. Report types: Initial detailed report, brief update report, by addition to or deletion from a recommended list, or simply by oral communication.

4. **Premium level service is okay**, if not disadvantage or negatively affect other clients. Such services should be disclosed to clients and available to everyone (should not be selective).

5. Trade: Equitable system, pro rata on order size, not on account size.

Standard III(B): Guidance

- **Guidance - Investment Recommendations**

6. The conduct involves members and candidates whose primary function is the preparation of investment recommendations to be disseminated either to the public or within a firm for the use of others in making investment decisions.
7. **The criterion:** The primary responsibility is the preparation of recommendations to be acted on by others, including those in the member's or candidate's organization.
8. An investment recommendation is any opinion in regard to purchasing, selling, or holding a given security or other investment.
    - ✓ Recommendation may be disseminated in different types. (refer to 3. report types)
    - ✓ A recommendation distributed to anyone outside the organization is considered a communication for general distribution.

Standard III(B): Guidance

- **Guidance - Investment Recommendations**

9. Ensure that information is disseminated in a manner that all clients have a **fair opportunity** to act **on every recommendation**.
   - ✓ Should encourage their firms to design an equitable system to prevent selective or discriminatory disclosure
   - ✓ Should inform clients about what kind of communications they will receive.
10. **Material changes** in prior recommendations should be communicated to all current clients; **particular care** should be taken that the information reaches those clients who have acted on or been affected by the earlier advice.
   - ✓ Clients who do not know the changed recommendation and who place orders contrary to a current recommendation should be advised of the changed recommendation before the order is accepted.

Standard III(B): Guidance

- **Guidance - Investment Action**

11. Treat all clients fairly in light of investment objectives and circumstances.
12. When making investments in new offerings or in secondary financings, should distribute the issues to **all** customers who are suitable for the investment and consistent with the policies of **allocating** blocks of stock.
13. If the issue is oversubscribed, should be prorated to all subscribers.
    - ✓ Should be taken **on a round-lot basis to avoid odd-lot distributions**.
    - ✓ If the issue is oversubscribed, should forgo any sales to themselves or immediate families in order to free up additional shares for clients.

Standard III(B): Guidance

- **Guidance - Investment Action (Cont.)**

14. If the investment professional's **family-member accounts** are managed similarly to the accounts of other clients of the firm, these accounts should not be excluded from buying such shares.
15. Must make every effort to treat all individual and institutional clients in a fair and impartial manner.
16. **Disclose** to clients and prospective clients the **documented allocation procedures** in place and how the procedures would affect them.
17. Should not take advantage of their position to the detriment of clients.

Standard III(B): Recommended Procedures

- **Recommended Procedures**
  - Develop firm policies
    - ✓ An investment advisor who is a <u>sole proprietor and handles only discretionary accounts might not disseminate recommendations to the public</u>, but should have <u>formal written procedures</u> to ensure that all clients receive fair investment action
  - Consider the following points <u>when establishing compliance procedures</u>:
    - ✓ **<u>Limit the number of people who are privy</u>** to the fact that a recommendation is going to be disseminated
    - ✓ **<u>Shorten the time frame</u>** between decision and dissemination[18]
    - ✓ Publish guideline for pre-dissemination behavior
    - ✓ Simultaneous dissemination[19]
    - ✓ Maintain a list of clients and their holdings
    - ✓ Develop and document trading allocation procedures[20]
  - **Disclose trade allocation procedures[21]**
  - Establish <u>systematic account review procedures</u> to detect whether trading in one account is being used to benefit a favored client
  - Disclose <u>the level of services available</u>

Standard III(B): Recommended Procedures

- **Recommended Procedures**

18. Shorten the time frame between decision and dissemination

✓ If a detailed recommendation is still in preparation, should publish a short summary including the conclusion in advance.

- In large firms with extensive review process, the long passage of time is not within the control of the analyst. Should communicate to customers and firm personnel by an update or "flash" report.

19. Simultaneous dissemination

✓ Should not give favored clients info when such action may disadvantage other clients.

✓ Discuss with some clients after email dissemination, okay.

Standard III(B): Recommended Procedures

- **Recommended Procedures**

20. Develop and document trade allocation procedures: develop a guiding principles that ensure

✓ Fairness to advisory clients, both in priority of execution of orders and in the allocation of the price in execution of block orders or trades,

✓ Timeliness and efficiency in the execution of orders,

✓ Accuracy of the records as to trade orders and client account positions.

21. Disclose trade allocation procedures

✓ Trade allocation procedures must be fair and equitable.

✓ ***Disclosure of inequitable allocation methods does not relieve the member or candidate of this obligation.***

Standard III(B): Recommended Procedures

- **Recommended Procedures**

22. Should develop or encourage their firm to develop written allocation procedures, with particular attention to procedures for block trades and new issues.

    - ✓ Document orders and time stamped
    - ✓ ***FIFO basis***
    - ✓ Develop a policy to calculate execution prices and "partial fills" in a block trade for efficiency
    - ✓ ***Same commission, same price***
    - ✓ ***Pro rata on basis of order size***
    - ✓ Obtain advance indications of interest, allocate securities by client (not portfolio manager), and provide a method for calculating allocations when allocating for new issues.

Standard III(B): Case 1-2

- **Case 1 (Selective Disclosure).** Ames, a famous IT analyst, while at luncheon with several of <u>his best clients</u>, mentions the buy recommendation scheduled to be sent <u>early</u> next week to all firm's clients.
  - **Comment:** It's a violation by disseminating recommendation early thus favors only few clients.
- **Case 2 (Fair Dealing between Funds).** Rivers finds that the pension fund entrusted to the bank has significantly underperformed the bank's commingled fund with similar investment objective and portfolios, and questions this. The result is that the bank <u>discriminated various clients by favoring the commingled fund</u>.
  - **Comment:** The bank's policy did not treat all clients fairly and violated her duty to her clients by giving priority to the commingled fund. **In this case, disclosure of the bank's policy would not change the fact that the policy is unfair.**

Standard III(B): Case 3-4

- **Case 3 (Fair Dealing and IPO Distribution).** Morris convinces Arena to do the financing which he believes sure hot issue and arrange some options for himself. When the issue is oversubscribed, Morris fills all the orders (including his own) and cuts back the institutional blocks.
  - **Comment:** Morris has violated Standard III (B)-fair dealing by not treating all clients fairly. He shouldn't have taken any himself and have prorated the shares among all clients.
  - Also violating **VI(A) Disclosure of Conflicts, and VI(B) Priority of Transaction.**
- **Case 4 (Selective Disclosure).** SIWM publicly indicates a conservative earnings forecast for the quarter. Robert, an analyst, believes the earning will be much higher than what the firm reported. After extensive research and discussion, he releases his report to all clients using the same statistic as SIWM while privately recommends a "good buy" to his large clients as the profit is being understated.
  - **Comment:** Roberts has violated Standard III (B)-fair dealing by not treating all clients fairly . Because he did not share his opinion regarding the potential for a significant upside earnings surprise with all clients.

Standard III(B): Case 5

- **Case 5 (Fair Dealing and Transaction Allocation).** Preston is trying to retain his biggest client Colby who threatens to leave if no performance improves. Then Preston purchases MBSs for several accounts including Colby's without allocating trades in time. Several days later, he notices a big increase in some MBSs so he intentionally allocates the profitable trades to Colby and spreads the losing trades among other accounts.
  - **Comment:** Preston violated Standard III(B)-fair dealing by not dealing clients fairly in taking investment actions. Preston should have allocated the trades prior to executing the orders or she should have had a systematic approach to allocation, such as pro rata, as soon as practicable.

Standard III(B): Case 6

- **Case 6 (Additional Services for Select Clients).** Weng uses email to issue a new recommendation to all his clients and then calls his 3 biggest clients to discuss the recommendation in detail.
  - **Comment**: Weng has not violated Standard III (B)-fair dealing because he distributes the recommendation to all clients at the same time. It's appropriate to provide additional service to Weng's larger clients because they pay bigger fees or have a large amount of assets under Weng's management.

Standard III(B): Case 7

- **Case 7 (Minimum Lot Allocations):** Hampton is a private wealth manager and find an appropriate bond for her five clients of whom three want US$10,000 each and two want US$50,000 each. The minimum lot size is US$5,000 and under her firm's policy that odd-lot allocation below the minimum should be avoided for liquidity. As Hampton will receive only $55,000 of the offering so she distribute each $20,000 for the two and $5,000 for the three.
  - **Comment:** Hampton has not violated Standard III(B)-fair dealing , even though the distribution is not on a complete pro rata basis. Because Hampton ensured that each client received at least the minimum lot size of the issue. This approach guarantee that the clients can efficiently sell the bond later.

Standard III(B): Case 8

- **Case 8 (Excessive Trading)** Ling Chan manages the accounts for many pension plans whose investment portfolio strategy are similar but not identical, including the plan of his father's employer. To minimize the brokerage cost of his father's pension plan, he purposely trades more frequently in the other accounts to ensure enough brokerage to receive free research for use by all the pensions.
    - **Comment:** Chan is violating Standard III(B)-fair dealing because his trading actions are disadvantaging other clients.
    - All clients should incur their fair portion of the costs for the research.
    - This does <u>not mean that additional trading should occur</u> if a client has not paid an equal portion of the commission; trading should occur only as required by the strategy.
    - Also violating III(A) Loyalty, prudence and care.

Standard III(B): Case 9

- **Case 9 (Limited Social Media Disclosures)** Burdette is a junior auto industry analyst for FIM company. Recently, Burdette is completing a report on the financial impact of Sun Drive Auto, Ltd.'s new solar technology for compact automobiles, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, <u>Burdette sends a quick tweet to FIM Twitter followers</u> summarizing her "buy" recommendation for Sun Drive Auto stock.
  - **Comment:** Burdette has violated Standard III(B)-fair dealing by sending the recommendation to the FIM Twitter followers first before sending to all clients. And Burdette should make sure she has received enough training on FIM's policies, procedures and the appropriate use of social media if social networks before engaging in such activities.
  - Also violating **IV(C) Responsibility of supervisors.**

Standard III(B): Case 10

- **Case 10 (Fair Dealing between Clients)**Rove works as a performance analyst for AB Investment Management and is describing to firm's chief investment officer two new reports. Based on similar investment strategies clients have, his first report details the securities from several clients including the percentage of the portfolio, while the second compares portfolios' monthly performance. Any outliers would be submitted to CIO for review.
    - **Comment:** Rove's two recommended reports comply with Standard III(B)-fair dealing and contribute to monitoring the fair treatment and effectiveness of the firm's advisers dealing with clients' portfolios.

Fair dealing

- Michael, CFA, purchased a large block of stock at varying prices during the trading session. Michael reviewed her purchase prices to determine prices that should be assigned to each specific account after the stock realized a significant gain in value before the close of the trading day. According to the Standards of Practice Handbook, Michael's least appropriate action is to allocate the execution prices:

  A. On a first-in, first-out basis with consideration of bundling orders for efficiency.

  B. Across the participating client accounts pro rata on the basis of account size.

  C. Across the participating client accounts at the same execution price.

- Correct Answer: B.
  - According to Standard III (B) best practices include allocating pro rata on the basis of order size, not account size.
  - All clients participating in the block trade should receive the same execution price and be charged the same commission.

Example

Fair dealing

- Which of the following actions is most likely a violation of the Standard on fair dealing?

  A. A portfolio manager allocates IPO shares to all client accounts, including her brother's fee-based retirement account.

  B. An investment firm routinely begins trading for its own account immediately after announcing recommendation changes to clients.

  C. After releasing a general recommendation to all clients, an analyst calls the firm's largest institutional clients to discuss the recommendation in more detail.

- Correct Answer: B.
  - The firm must give its clients an opportunity to act on recommendation changes. Firms can offer different levels of service to clients as long as this is disclosed to all clients.
  - The largest institutional clients would likely be paying higher fees for a greater level of service. The portfolio manager's brother's account should be treated the same as any other client account.
  - Also violating VI(B) Priority of transactions.

Summary

Guidance for Standards I–VII

III(B).Fair dealing

Fair is not equal, same opportunity to trade

Fair allocation and its policy, family client is client first

III(C). Suitability

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard III(C): Content

Content

1. When in an advisory relationship with a client, must:
   - ✓ Make a reasonable inquiry into a client or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action, must reassess and update regularly.
   - ✓ Determine that an investment is suitable to the client's financial situation and consistent with written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
   - ✓ Judge the suitability in the context of the client's total portfolio.
2. When responsible for managing a portfolio to a specific mandate, strategy, or style, must only make investment recommendations or take investment actions that are consistent with the stated objectives and constraints of the portfolio.

Standard III(C): Guidance

- **Guidance - Developing an Investment Policy**

3. In an advisory relationship, must gather client information at the inception of the relationship.
   - ✓ Information includes the client's financial circumstances, personal data (such as age and occupation) that are relevant to investment decisions, attitudes toward risk, and objectives in investing.
   - ✓ Information should be **incorporated into a written investment policy statement (IPS)** that addresses the client's risk tolerance, return requirements, and all investment constraints

- **Guidance - Understanding the Client's Risk Profile**

4. One of the most important factors to be considered in matching appropriateness and suitability of an investment with a client's needs and circumstances is measuring that client's tolerance for risk.

- **Guidance - Updating an Investment Policy**

5. Updating the IPS should be repeated at least annually and also prior to material changes to any specific investment recommendations.

Standard III(C): Guidance

- **Guidance - The Need for Diversification**

6. An investment with high relative risk may be suitable in the context of the entire portfolio **or** when the client's stated objectives contemplate speculative or risky investments.
7. The manager may be responsible for only a portion of the client's total portfolio, or the client may not have provided a full financial picture.
   - ✓ Members and candidates can be responsible for assessing the suitability of an investment only on the basis of the information and criteria actually provided by the client.

- **Guidance - Managing to an Index or Mandate**

8. Responsibility is to invest in a manner consistent with the stated mandate.
9. Those who manage pooled assets to a specific mandate are not responsible for any individual investor.
   - ✓ Only those who have advisory relationship are responsible for individual clients.

Standard III(C): Guidance

- **Addressing Unsolicited Trade Requests**

10. Unsolicited trades request that a member or candidate knows are unsuitable for a client.

- The member or candidate should refrain from making the trade until he or she discusses the concerns with the client.
  - ✓ Unsolicited request may be expected to have only a minimum impact on the entire portfolio because the size of the requested trade is small or the trade would result in a limited change to the portfolio's risk profile.
    - ☐ Necessary client approval for executing unsuitable trades.
    - ☐ At a minimum, the client should acknowledge the discussion and accept the conditions that make the recommendation unsuitable.
  - ✓ Unsolicited request expected to have a material impact on the portfolio, the member or candidate should use this opportunity to update the investment policy statement.
    - ☐ Some clients that decline to modify their policy statements while insisting an unsolicited trade be made.
      - Members or candidates will need to evaluate the effectiveness of their services to the client and ultimately determine whether they should continue the advisory arrangement with the client.
      - Some firms may allow for the trade to be executed in a new unmanaged account.

Standard III(C): Recommended Procedures

- **Recommended Procedures**

11. Investment policy statement.

    ✓ Include needs, circumstances, performance benchmarks and objectives, and review at least annually;

    ✓ An appropriate suitability determination will not prevent some investments or investment actions from losing value.

    ✓ Update investors' objectives and constraints periodically

Standard III(C): Recommended Procedures

- **Recommended Procedures**

12. Regular updates.

    ✓ Objectives and constraints should be maintained and reviewed periodically to reflect any changes in the client's circumstances.

    - Changes in either factor may result in a fundamental change in asset allocation.

    ✓ Should regularly compare constraints with capital market expectations to arrive at an appropriate asset allocation.

    ✓ Annual review is reasonable unless business or other reasons, such as a major change in market conditions, dictate more frequent review.

    ✓ ***Should document attempts to carry out review if circumstances prevent it.***

Standard III(C): Recommended Procedures

- **Recommended Procedures**

13. Suitability test policies.

    ✓ Should require the investment professional to ***look beyond the potential return*** of the investment and include the following:

    - An analysis on the *impact on the portfolio's diversification*,
    - A comparison of the investment risks with the client's assessed risk tolerance, and
    - The fit of the investment with the required investment strategy.

Standard III(C): Case 1-2

- **Case 1 (Investment Suitability-Risk Profile).** Smith recommends investing 20% of both his 2 clients' portfolios in zero dividend yield small-cap hi-tech issues. One of them having a large asset base is willing to invest partly aggressively while the other only wants to achieve a steady return with low volatility.
  - **Comment:** The two clients have different financial circumstances and objectives. Smith's recommendation is not suitable for steady one. It's a violation.
- **Case 2 (Investment Suitability-Entire Portfolio).** Walters suggests his client to use covered call options in the equity portfolio to improve the performance in a portfolio perspective. He educates his client about all possible outcomes, including tax consideration, downside risk etc.
  - **Comment:** Walters has considered the characteristics of the client's entire portfolio and thoroughly explained the investment to the client. It's not a violation.

Standard III(C): Case 3-4

- **Case 3 (IPS Updating).** A manager learns in a meeting with client that the client has just inherited a larger sum of money which will increase his net worth fourfold.
  - **Comment:** The client's financial circumstances have definitely changed, so the manger must **update the IPS** and discuss with client to determine how to adjust the investment objectives, high equity ratio, tilted to low-yield, growth-oriented issues.
- **Case 4 (Following an Investment Mandate).** Perkowski buys zero-dividend stock he believes undervalued for his high-income mutual fund.
  - **Comment:** Perkowski has violated Standard III (C) because zero-dividend stock is absolutely not suitable for high-income mutual fund.

Standard III(C): Case 5

- **Case 5 (IPS Requirements and Limitations).** Gubler, a manager of insurance company, has an IPS mandate for highly liquid investments. Recently he is attracted by a VC seed fund which has a fairly long lock-up period and after extensive analysis he invests 4% in the seed fund, leaving the portfolio's total equity exposure still well below its upper limit.
  - **Comment:** Gubler is violating Standard III(A)-loyalty, prudence and care, as well as Standard III(C)-suitability because of the liquid conflict between IPS and practice.

Standard III(C): Case 6

- **Case 6 (<u>Submanager and IPS Reviews</u>).** As business grows in large, Ostrowski wants to find a submanager to help manage the fund. He uses the CFA Institute model "request for proposal" to design a questionnaire for his search and receives seven back by deadline. For the least impact on firm's bottom line, Ostrowski chooses the one that charges the lowest fees.
  - **Comment:** Ostrowski violates Standard III(C)-suitability by making the decision on fee structure only. He should compare clients' risk profile with the investment strategy and ensure the appropriateness of the manager's service.
  - Violating III(C) Suitability → **violating III(A) Loyalty, Prudence and Care**.
  - Violating III(C) Suitability → **violating I(D) Misconduct**.
  - Violating **V(A) Diligence and Reasonable Basis**.

Standard III(C): Case 7

- **Case 7 (Investment Suitability-Risk Profile):** Snead manages funds with long-term investment objectives. In order to improve his short-term performance for more reward, he changes the investment strategy and purchases several high-beta stock which are contrary to clients' IPS and leads to clients' doubt because of no notice of change in their objective or strategy.
  - **Comment:** Snead violated Standard III(C)-suitability by investing in high-beta stocks for clients with long-term objectives. He made this change for his own purpose not for the benefit of the clients.
  - Also violating III(A)-Loyalty, Prudence and Care; VI(A)-Disclosure of conflicts.

Standard III(C): Case 8

- **Case 8:(Investment Suitability)** Shrub owns and operates an investment advisory firm, Conduit. To attract more clients, Shrub offers lower-than-normal fees to his friend Reed whose company EI has two top-performing funds. So clients quickly invest with Conduit to access to EI fund while no one is turned away by Conduit for the sake of expanding its assets.
  - **Comment:** Shrub has violated Standard III(C)-suitability because the risk profile of the fund may not be suitable for every client. Shrub needs to establish an IPS for each client and recommend investments accordingly. And he should fully discuss the risks of a planned purchase and provide reasons why it might not be suitable for a client before executing their requests that may not align with their IPS.
  - Violating III(C) Suitability → **violating III(A) Loyalty, Prudence and Care**.
  - Violating III(C) Suitability → **violating I(D) Misconduct**.
  - Violating **V(A) Diligence and Reasonable Basis**.

Suitability

- Shirly, CFA, manages equity accounts for government entities with conservative and risk averse portfolios. Shirly decides to add to their holdings a new, thinly-traded, leveraged derivative product which she believes has the potential for high returns based on the clients' objective to maximize returns with the lowest possible risk. Shirly relies upon comprehensive research from an investment bank that has a solid reputation for top quality research to make her investment decision. Shirly positions her accounts so that each has a 10% allocation to the derivative product after her review of that research. Did Shirly most likely violate any CFA Institute Standards of Professional Conduct by purchasing the derivative for her clients?

  A. No.

  B. Yes, related to Suitability.

  C. Yes, related to Loyalty, Prudence and Care.

Example

Suitability

- Correct Answer: B.
  - B is correct as Shirly is in violation of Standard III (C) since she did not consider issues such as the limited liquidity or any potential leverage of this new product when she invested a substantial percentage of her client's portfolios in these instruments.

Suitability

- The Standard regarding suitability most likely requires that:

  A. An advisor must analyze an investment's suitability for the client prior to recommending or acting on the investment.

  B. A member or candidate must decline to carry out an unsolicited transaction that she believes is unsuitable for the client.

  C. When managing a fund to an index, a manager who is evaluating potential investments must consider their suitability for the fund's shareholders.

Suitability

- Correct Answer: A.
  - According to Standard III(C) Suitability, a member or candidate who is in an advisory relationship with a client is responsible for analyzing the suitability of an investment for the client before taking investment action or making a recommendation.
  - If a member or candidate believes an unsolicited trade is unsuitable for a client, the appropriate action is to discuss the trade with the client. The advisor may follow her firm's policies for obtaining client approval if the requested trade would not affect the risk and return of the client's portfolio materially.
  - If the trade would have a material effect, the advisor should discuss with the client whether the IPS needs to be updated.
  - When managing a fund to an index or stated mandate, the manager is responsible for ensuring that potential investments are consistent with the fund's mandate.
  - Suitability for individuals would be a concern for an advisor who recommends the fund to clients, but not for the manager of the fund.

Summary

Guidance for Standards I–VII

III(C).Suitability

Develop and update IPS, risk, diversification

Unsolicited trade, index or mandate

III(D).
Performance presentation

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard III(D): Content

- **Content:**

  1. When communicating investment performance information, must make reasonable efforts to make sure that it is fair, accurate, and complete.

Standard III(D): Guidance

- **Guidance:**

2. The presentation should be **fair, accurate, complete**
3. Prohibit misrepresentations of past performance or reasonably expected performance
   - ✓ **Not state or imply to obtain what was achieved in the past**
4. Include terminated portfolio as part of performance history.
5. The performance of weighted rate of return rather than a single performance.
6. **If the presentation is brief,** must
   - ✓ Make available to clients and prospects, on request, the detailed information supporting that communication.
   - ✓ **Best practice:** brief presentations include a reference to the limited nature of the information provided.

Standard III(D): Recommended Procedures

- **Recommended Procedures**

7. **Apply GIPS standards.**

   ✓ For members and candidates who are showing the performance history of the assets they manage, compliance with the GIPS standards is the best method to meet their obligations under Standard III(D).

   ✓ Should encourage firms to comply with the GIPS standards.

Standard III(D): Recommended Procedures

- **Recommended Procedures**

8. **Compliance without applying GIPS standards.** Can also meet obligations under Standard III(D) by:
   - ✓ Considering the knowledge and sophistication of the audience to whom a performance presentation is addressed,
   - ✓ Presenting the performance of the weighted composite of similar portfolios rather than using a single representative account,
   - ✓ Including terminated accounts as part of performance history with a clear indication of when the accounts were terminated,
   - ✓ Including disclosures that fully explain the performance results being reported.
     - ☐ Simulated performance using models?
     - ☐ Performance record from prior entity?
     - ☐ ***Is performance gross of fees (investment management fee), net of fees, or after tax?***
   - ✓ Maintaining the data and records used to calculate the performance being presented.

Standard III(D): Case 1-2

- **Case 1 (Performance Calculation and Length of Time).** Taylor communicates his clients that "You can expect steady 25% annual compound growth of the value of your investments over the year." In fact, Taylor's performance only achieves the annual return of 25% only for the past year.
  - **Comment:** Taylor dishonestly **overstates** his performance, it is a violation.
  - Also **violates I(C)-Misrepresentation** which prohibits assurances or guarantees regarding an investment.
- **Case 2 (Performance Calculation and Asset Weighting).** Judd, a senior partner of ACM, circulates a performance sheet and claims compliance with the GIPS. But his composites are not asset weighted which is a violation of GIPS.
  - **Comment:** It's a false claim of GIPS compliance and violates Standard III (D)-performance presentation.

Standard III(D): Case 3-4

- **Case 3 (Performance Presentation and Prior Fund/Employer).** McCoy is recently recruited by a new company. The new company prepared a marketing campaign in which includes McCoy's equity performance achieved at his old company and the advertisement did not identify the old source.
  - **Comment:** McCoy has violated Standard III(D)-performance presentation by distributing material performance misrepresentations regarding the historical performance of the new company.
  - Generally, the standard does not prohibit showing past record so long as it is fully disclosed where the performance comes from and the person's role in it.
- **Case 4 (Performance Presentation and Simulated Results).** Davis produced performance results from 1990-95 based on historical data and simulated performance results for the period from 1996-2003. Then he includes all these in advertisement to clients and does not indicate that the simulated results.
  - **Comment:** Davis violated Standard III(D)-performance presentation by failing to clearly identify simulated performance results.

Standard III(D): Case 5

- **Case 5 (Performance Calculation and Selected Accounts Only).** In a presentation, Kilmer constructed the composite with balanced objective, and arbitrarily excluded accounts under certain asset level <u>without disclosing the fact of exclusion and includes non-balanced accounts to boost return</u>. He also manipulates the accounts that make up the composite over time.
  - **Comment:** Kilmer violated Standard III(D)-performance presentation. He misrepresents the facts in the promotional material sent to prospective clients, and fails to include disclosure.
  - Also violating I(C)-Misrepresentation; I(D)-Misconduct.

Standard III(D): Case 6

- **Case 6 (Performance Attribution Changes)** When Purell is reviewing the performance attribution reports for clients, he finds that the current attribution methodology indicates that stock selection contributed negatively to the calculated return. After several different scenarios, Purell discovers that calculating attribution by comparing each stock with its industry and then rolling the effect to the sector level can better reflect manager's stock selection. So he uses the revised methodology in the report instead.
  - **Comment:** Revising the attribution methodology without noticing clients violates Standard IIII(D)-performance presentation.
  - Purrell modifies the attribution methodology only for the benefit of his firm to perceively improve their investment strategy, which is disadvantaging the clients. If Purell thinks the new methodology works better than the original one, he should report both to the clients and explain why the new one is preferred.

Standard III(D): Case 7

- **Case 7 (Performance Calculation Methodology Disclosure)** While developing a new performance report for clients, Singh found the system calculated both time-weighted and money-weighted returns and wondered which one should be adopted. She asked the head of client services and was told <u>not to label the return value</u> so the firm can use whichever is greater.
  - **Comment:** Following these instructions would result in violation of Standard III(D)-performance presentation. The inconsistent return values Singh provides would be incomplete and fail to give sufficient information to the clients in judging the firm's performance.

Standard III(D): Case 8

- **Case 8 (Performance Calculation Methodology Disclosure)** REI manages an equity fund which trades once a week and publishes the performance report based on the higher of the last trading day or last business day of the month determined by the firm. As the fact sheet did not specify the exact date, Clark, the performance analyst is concerned and ask her supervisor if the frequent change is appropriate.
  - **Comments:** Clark's actions comply with Standard III(D)-performance presentation. She has shown concern about these changes, which are not presenting accurate and complete performance.

Example

Performance presentation

- Smith, CFA, is responsible for performance presentations at his investment firm. The following is the presentation that Smith uses to state his firm:
  - uses actual and simulated performance results;
  - deducts all fees and taxes;
  - bases the performance on a representative individual account.

  Based on the above information, which of the following is the most appropriate recommendation to help Smith comply with meet the CFA Institute Standards of Professional Conduct in his performance presentations? He should present performance based on:

  A. A weighted composite for all similar portfolios.

  B. A gross of fee basis.

  C. Actual not simulated results.

Performance presentation

- Correct Answer: A.
  - In order to meet their obligations under Standard III (D), members should present the performance of the weighted composite of similar portfolios rather than using a single representative or all accounts, so this is the best selection of the options provided.

Summary

Guidance for Standards I–VII

III(D).Performance presentation

Past not guarantees future return

Brief with detailed on request

III(E).
Preservation of confidentiality

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard III(E): Content

- **Content:**

1. Must keep information about current, former, and prospective clients <u>confidential unless</u>:
   - ✓ The information concerns <u>illegal activities</u> on the part of the client;
   - ✓ Disclosure is <u>required by law</u>; or
   - ✓ The client or prospective client <u>permits disclosure</u> of the information.

Standard III(E): Guidance

- **Guidance**

2. Require preservation of the confidentiality of information communicated by clients, prospective clients, and former clients[4]. III(E) is applicable when:
   - ✓ Receiving information because of special ability to conduct a portion of the client's business or personal affairs, and
   - ✓ Receiving information that arises from or is relevant to that portion of the client's business that is the subject of the special or confidential relationship.
3. If disclosure is required by law or the information concerns illegal activities by the client, may have an obligation to report the activities to the appropriate authorities.

- **Guidance - Status of Client**

4. Must continue to maintain the confidentiality of client records even after the client relationship has ended. ***If a client or former client expressly authorizes the disclosure***, may follow the terms of the authorization and provide the information.

Standard III(E): Guidance

- **Guidance - Compliance with Laws**

5. As a general matter, must comply with applicable law.

   ✓ If applicable law requires disclosure of client information in certain circumstances, members and candidates must comply with the law.

   ✓ ***If applicable law requires maintaining confidentiality***, even if the information concerns illegal activities on the part of the client, should not disclose.

   ✓ When in doubt, should consult with compliance personnel or legal counsel before disclosing confidential information about clients.

Standard III(E): Guidance

- **Guidance - Electronic Information and Security**

6. Many employers have **strict policies** about how to electronically communicate sensitive client information and store client information on personal laptops, mobile devices or portable disk/flash drives.

7. Standard III(E) does not require members or candidates to become experts in information security technology, but they should have a **thorough understanding of the policies of their employers**. The size and operations of the firm will lead to differing policies for ensuring the security of confidential information maintained within the firm.

8. Members and candidates should encourage their firm to conduct **regular periodic training on confidentiality procedures** for all firm personnel, including portfolio associates, receptionists, and other non-investment staff who have routine direct contact with clients and their records.

Standard III(E): Guidance

- **Guidance - Professional Conduct Investigations by CFA Institute**

9. Requirements of III(E) are not intended to prevent from cooperating with an investigation by the CFA Institute Professional Conduct Program (PCP).
10. When permissible under applicable law, shall consider the PCP an extension of themselves when requested to provide information about a client in support of a PCP investigation into their own conduct.

    ✓ Encouraged to cooperate with investigations into the conduct of others.

    ✓ Any information turned over to the PCP is kept in the strictest confidence.

    ✓ Will not be considered in violation of this standard by forwarding confidential information to the PCP.

Standard III(E): Recommended Procedures

- ## Recommended Procedures

11. The simplest, most conservative and effective way to comply with III(E) is to avoid disclosing any information received from a client ***except to authorized fellow employees who are also working for the client.***

12. In some instances, may want to disclose information from clients that is outside the scope of the confidential relationship and does not involve illegal activities. Before making such a disclosure, should ask the following:
    - ✓ In what context was the information disclosed? If disclosed, is the information relevant to the work?
    - ✓ Is the information background material that, if disclosed, will enable better service to the client?

13. Communication with clients: Members and candidates should be diligent in discussing with clients the appropriate methods for providing confidential information. It is important to convey to clients that not all firm-sponsored resources may be appropriate for such communications.

Standard III(E): Case 1-2

- **Case 1 (Possessing Confidential Information).** Connor, an advisor for Medical Centre, learns the Center's internal expansion plan during the routine investment advising meeting. Then he is approached by a potential donor for the Center who wants to find out the expansion plan of the Center first and does not want to speak to the Center.
  - **Comment:** The plan is confidential. Connor must not divulge the plan without the permission of the Center.
- **Case 2 (Disclosing Confidential Information).** Moody is a treasurer for HIW, a charity which looking for prospects to donate more fund. He learns from an advisory customer about his intention to give US$50,000 to charity for income taxes reduction. So Moody recommends HIW to call his customer for the donation.
  - **Comment:** Moody violated Standard III(E)-preservation of confidentiality by revealing confidential information about his client.

Standard III(E): Case 3-4

- **Case 3 (Disclosing Possible Illegal Activity).** Samuel is the manager for Garcia Company's pension plan and is approached by government officer for potential illegal activities of Garcia management. Samuel consults her employer's general counsel and is advised that Garcia probably has violated tax regulations.
  - **Comment:** Samuel should inform her supervisor to remedy the violation. If not successful, should seek legal advice for appropriate action. She may have a duty to disclose the evidence of the continuously legal violations and resign.
- **Case 4 (Disclosing Possible Illegal Activity).** Bradford manages money for a family-owned firm as well as the family members and officers. During his work, Bradford finds some questionable practices of the CFO and believes the CFO is embezzling money from the firm.
  - **Comment:** Bradford should check with the compliance department or appropriate legal counsel to determine whether it is appropriate to report the CFO's financial records.

Standard III(E): Case 5

- **Case 5 (Accidental Disclosure of Confidential Information)** The investment officer Moody established a new group page on a social media platform for her clients and instructed clearly on the platform that all comments posted would be to the public, so any personal or confidential communication is not preferred. Later when Moody posted a new strategy, one client responded directly on the page about his major change in financial situation and others in the group could all read the details.
  - **Comment:**
    - ✓ Moody has given instructions on the publicity of the platform and advised no confidential information disclosed on it. She cannot predict client's accidental disclosure of confidential information. So if she deleted the information at once, she would comply with Standard III(E)-Preservation of confidentiality.
    - ✓ Further training is needed and Moody could give clients second warnings to clients and make them aware of the publicity of the platform and the confidentiality of personal information.

Example

Preservation of confidentiality

- Tim was recently appointed to the board of directors of a national not-for-profit organization. The program is beginning a new fund-raising campaign to expand the number of annual scholarships it provides. Tim believed that many of his clients made annual donations to charity. The next week in his regular newsletter to all clients, he included a small section discussing the fund-raising campaign and his position on the organization's board. Which of the following is correct regarding to Tim?

A. Tim violated the Code and Standards by soliciting donations from her clients through the newsletter.

B. Tim did not violate the Code and Standards.

C. Tim violated the Code and Standards by not getting approval of the organization before soliciting her clients.

Example

Preservation of confidentiality

- Correct Answer: B.
  - Tim did not provide any information about her clients to the leaders or managers of the national not-for-profit organization; thus, she has not violated Standard III (E) Preservation of Confidentiality. Providing contact information about her clients for a direct-mail solicitation would have been a violation.
  - Answer A is incorrect because the notice in the newsletter did not violate Standard III (E). Answer C is incorrect because the fund-raising campaign had already begun, so discussing the opportunity to donate was appropriate.

Preservation of confidentiality

- The CFA Institute Professional Conduct Program (PCP) has begun an investigation into Chris Jones, a Level II CFA candidate, and a number of his CFA charterholder colleagues. Jones has access to confidential client records that could be useful in clearing his name and wishes to share this information with the PCP. Which of the following most accurately describes Jones's duties with regard to preservation of confidentiality?

A. Sharing the confidential information with the PCP would violate the Standards.

B. The Standards encourage, but do not require, that Jones support the PCP investigation into his colleagues.

C. Jones may share confidential information about former clients with the PCP but may not share confidential information about current clients.

Preservation of confidentiality

- Correct Answer: B.
  - Members and candidates are required to cooperate with PCP investigations into their own conduct and encouraged to cooperate with PCP investigations into the conduct of others.
  - Sharing confidential information with the PCP is not a violation of Standard III(E) Preservation of Confidentiality. Any client information shared with the PCP will be kept in strict confidence.
  - Standard III(E) states that members and candidates are required to maintain confidentiality of client records even after the end of the client relationship.

Summary

Guidance for Standards I–VII

III(E).Preservation of confidentiality

To all former, current, prospective clients

IV(A). Loyalty

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard IV(A): Content

- **Content:**

  1. In matters related to their employment, must <u>act for the benefit</u> of employer and <u>not deprive employer of the advantage of their skills and abilities</u>, <u>divulge confidential information</u>, or <u>otherwise cause harm</u> to their employer.

Standard IV(A): Guidance

- **Guidance**

2. **Core rule:** Protect the interests of their firms by refraining from any conduct that would injure the firm, deprive it of profit, or deprive it of the member's or candidate's skills and ability.

- **Guidance - Employer Responsibilities**

3. **Encouraged** to provide employer with a copy of the Code and Standards. These materials will inform the employer of the responsibilities of a CFA Institute member or candidate in the CFA Program. The Code and Standards also serve as a basis for questioning employer policies and practices that conflict with these responsibilities.

4. Employers are not obligated to adhere to the Code and Standards. Senior management has the additional responsibility to devise compensation structures and incentive arrangements that do not encourage unethical behavior.

Standard IV(A): Guidance

- **Guidance - Independent Practice**

5. "Undertaking independent practice" means engaging in competitive business, as opposed to making preparations to begin such practice.
6. Should abstain from independent competitive activity that could conflict with the interests of their employer.
   - ✓ Although IV(A) does not preclude from entering into an independent business while still employed, those who planning to engage in such practice for compensation must notify their employer and describe:
     - Types of services they will render to prospective independent clients,
     - The expected duration of the services,
     - The compensation for the services.
7. Should not render services until they receive consent from their employer to all of the terms of the arrangement.

Standard IV(A): Guidance

- **Guidance - Leaving an Employer**

8. Before leaving, the following will cause a violation:
   - ✓ Misappropriation of trade secrets.
   - ✓ Misappropriation of client lists. Memorizing client lists (name and address) is not permitted unless the information does not come from the records of former employer or violate non-compete agreement.
   - ✓ Misuse of confidential information.
   - ✓ Soliciting employer's clients prior to cessation of employment.
   - ✓ Self-dealing. (appropriating for one's own property a business opportunity or information belonging to one's employer)
9. After leaving, the following will cause a violation:
   - ✓ Violation of terms in existing non-compete contract.
   - ✓ Taking records or files (even rejected idea list) to a new employer without the written permission of the previous employer.

Standard IV(A): Guidance

- **Guidance - Leaving an Employer (cont.)**

10. Once notice is provided to the employer of the intent to resign, must follow the policies and procedures to notify clients of planned departure.
11. Once an employee has left the firm, the skills and experience that an employee obtained while employed are not "confidential" or "privileged" information.
    - ✓ IV(A) does not prohibit experience or knowledge gained at one employer from being used at another employer.
12. Simple knowledge of names and existence of clients is not confidential information unless deemed such by an agreement or by law.
13. Firm records or work performed on behalf of the firm that is stored in paper copy or electronically while employed should be erased or returned to the employer unless the firm gives permission to keep those records after employment ends.

Standard IV(A): Guidance

- **Guidance - Leaving an Employer (cont.)**

14. In some markets, there are agreements between employers within an industry that outline information that departing employees are permitted to take upon resignation, such as the "Protocol for Broker Recruiting" in the United States.

    ✓ Individuals are allowed to take some general client contact information when departing.

    - To be protected, a copy of the information the individual is taking must be provided to the local management team for review.
    - Additionally, the specific client information may only be used by the departing employee and not others employed by the new firm.

Standard IV(A): Guidance

- **Guidance – Use of Social Media**

15. Communications through social media platforms that potentially reach current clients should adhere to the employer's policies and procedures regarding notification of departing employees.
16. Specific accounts and user profiles of members and candidates may be created for solely professional reasons, including firm approved accounts for client engagements. Such business related accounts would be considered part of the firm's assets, thus requiring members and candidates to transfer or delete the accounts as directed by their firm's policies and procedures.
    - ✓ **Best practice** for members and candidates is to maintain separate accounts for their personal and professional social media activities.
    - ✓ Members and candidates should discuss with their employers how profiles should be treated when a single account includes personal connections and also is used to conduct aspects of their professional activities.

Standard IV(A): Guidance

- **Guidance - Whistleblowing**

17. Personal interests, and interests of employer, are secondary to protecting the integrity of capital markets and the interests of clients.
18. When an employer is engaged in illegal or unethical activities, actions taken by the employee that would normally violate loyalty to employer (e.g. *violating certain policies, contradicting employer instructions, or preserving a record by copying employer records*) may be justified. Such action would be permitted only if the intent is clearly aimed at protecting clients or the integrity of the market, not for personal gain.

- **Guidance - Nature of Employment**

19. The applicability is based on the nature of the employment-employee versus **independent contractor**. Duties within an independent contractor relationship are governed by the oral or written agreement between the member and the client.

Standard IV(A): Recommended Procedures

- **Recommended Procedures**

20. If the policies are not currently in their procedures, should encourage firms to adopt the following:

    ✓ Competition policy

    - Must understand any restrictions placed by the employer on offering similar services outside the firm while still employed.
    - If an employer elects to have its employees sign a noncompete agreement, should ensure that the details are clear and fully explained prior to signing the agreement.

    ✓ **Termination policy.**

    - Should establish clear procedures regarding the resignation process, including addressing how the termination will be disclosed to clients and staff.
    - May also outline the procedures for transferring responsibilities of ongoing research responsibilities and account management.

Standard IV(A): Recommended Procedures

- **Recommended Procedures**

20. If the policies are not currently in their procedures, should encourage firms to adopt the following: (cont.)

    ✓ Incident-reporting procedures.

    - Should be aware of firm's policies related to whistleblowing and encourage firms to adopt industry best practices. Many firms are required by regulatory mandates to establish confidential and anonymous reporting procedures that allow employees to report potentially unethical and illegal activities in the firm.

    ✓ Employee classification.

    - Should understand status within employer firm. Firms are encouraged to adopt a standardized classification structure for employees and indicate how each of the policies applies to each employee class.

Standard IV(A): Case 1-2

- **Case 1 (Soliciting Former Clients).** Tim, a pension manager, is leaving for a new company. Before resigning from the old employer, Tim asks 4 big accounts at the old firm to leave with her and solicit existing prospective clients for her new employer.
  - **Comment:** Tim violated Standard IV(A)-loyalty **by soliciting** the current and prospective clients of the old employer **before her resignation.**
- **Case 2 (Former Employer's Documents and Files).** Terry has decided to leave his employer and start his own business. He has been careful not to solicit the employer's clients and planning to copy and take with him the followings: the clients list, clients account statements, sample marketing presentations, recommendation list, computer models, etc.
  - **Comment:** Except with the consent of their employer, departing employees may **not take employer property** which includes what Terry plans to take. So it is a violation standard IV(A)-loyalty.

Standard IV(A): Case 3

- **Case 3 (Ownership of Completed Prior Work).** Clay enters an oral part time working agreement (a study of wireless industry using BA's resources) with BA while seeking a full time job. As Clay nears completion of the study, she gets a job at W&C and is pondering submitting the draft of the wireless study for publication by W&C.
  - **Comment:** Clay must not give her draft to W&C unless gets permission from BA because she has an employer-employee relationship with BA therefore has the obligation to act for the benefit of the employer. Clay must not take from BA any research file material that she may have used.

Standard IV(A): Case 4-5

- **Case 4 (Ownership of Completed Prior Work).** Madeline spends her summer as an unpaid intern at M&L helping GIPS compliance work. Two months later, she gets a job at MMC, also a GIPS compliant. Before leaving M&L, she copies the firm's software that she helped develop.
  - **Comment:** Internship is an employment and Madeline violated Standard IV(A)-loyalty because she misappropriated M&L's property without permission.
- **Case 5 (Starting a New Firm).** Allen, an equity analyst, without notice to her employer, registers to start an investment company that will compete with her employer. However, she has not actively sought clients.
  - **Comment:** It is not a violation **as long as Allen only prepares** her new business on her own time outside the office and if Allen will not be soliciting clients for the business or otherwise operating the new company until she has left her current employer.

Standard IV(A): Case 6

- **Case 6 (Soliciting Former Clients).** Chisolm left his former firm for a competing firm and wants to contact his former clients. Is this a violation of Standard IV(A)-loyalty for Chisolm?
  - **Comment:** It mainly depends on the nature and extent of the contact with former clients and the information Chisolm uses. If Chisolm uses confidential or privileged information obtained from former employer, it is violation. If Chisolm maintains his duty of loyalty before joining new firm and adheres to **non-compete agreement** and just use **public information** about former firm after departing to contact former clients, it is not violation.

Standard IV(A): Case 7

- **Case 7 (Competing with Current Employer).** Some employees are planning to depart in a few weeks and have been careful not to conflict with their duty to current employer. An RFP (request for proposal) for hiring new investment consultant from current clients has been sent to the employer and other competitors. The employees believe the new entity would be qualified to respond to the RFP and eligible for the business. The RFP submission period is likely to end before resignations are effective. Is it permissible for the departing employees to respond to the RFP?
  - **Comment:** When the employees respond to RFP, their employer is also responding to RFP. There will be direct competition between the employees and the employer. Such conduct would violate Standard IV(A)-loyalty unless the group of employees received permission from their employer as well as the entity sending out the RFP.

Standard IV(A): Case 8-9

- **Case 8 (Externally Compensated Assignments).** Mota is an analyst at Tyson Investments. He works part time as a mayor for his hometown.
    - **Comment:** If Mota's mayoral duties are so extensive and time-consuming that they might detract from his ability to fulfill his responsibilities at Tyson, he should discuss his outside activities with his employer and come to a mutual agreement regarding how to manage his personal commitments with his responsibilities to his employer.
- **Case 9 (Soliciting Former Clients).** McQuillen leaves her employer without a non-compete agreement and she does not take any of her client lists or other employer property. Now she obtains the phone number of former clients through public records and contacts them.
    - **Comment:** McQuillen is not in violation of Standard IV(A)-loyalty because she has not used information or records from her former employer and is not prevented by an agreement with her former employer from soliciting her former clients.

Standard IV(A): Case 10

- **Case 10 (Soliciting Former Clients)** Angel Crome is a private banker for YBSafe Bank. Recently, She is extremely frustrated by the recent loss of reputation by her current employer and subsequent client insecurity. A local headhunter contacted Crome a few days ago and offered her an interesting job with a competing private bank. Crome figures that she can solicit at least 70 percent of her clients to follow her and gladly enters into the new employment contract.
  - **Comment:** Crome can resign from YBSafe Bank, but she can't use client records built and kept with her in her capacity as an employee of YBSafe Bank. Client lists are proprietary information of her former employer and must not be used for her or her new employer's benefit. The use of written, electronic, or any other form of records, other than publicly available information, to contact her former clients at YBSafe Bank will be a violation of Standard IV(A)-loyalty.

Standard IV(A): Case 11

- **Case 11 (Leaving an Employer)** Laura Webb just left her position as portfolio analyst at Research Systems, Inc. (RSI). Her employment contract included a non-solicitation agreement that requires her to wait two years before soliciting RSI clients for any investment related services. Upon leaving, Webb was informed that RSI would contact clients immediately about her departure and introduce her replacement. While working at RSI, Webb connected with clients, other industry associates, and friends through her LinkedIn network. Her business and personal relationships were intermingled because she considered many of her clients to be personal friends. Realizing that her LinkedIn network would be a valuable resource for new employment opportunities, she updated her profile several days following her departure from RSI. LinkedIn automatically sent a notification to Webb's entire network that her employment status had been changed in her profile.
  - **Comment:** Prior to her departure, Webb should have discussed any client information contained in her social media networks.
  - By updating her LinkedIn profile after RSI notified clients, she has appropriately placed her employer's interests ahead of her own personal interests. In addition, she has not violated the non-solicitation agreement with RSI, unless it prohibited any contact with clients during the two-year period.

Standard IV(A): Case 12

- **Case 12 (Confidential Firm Information)** Sanjay Gupta is a research analyst at Naram Investment Management (NIM). NIM uses a team-based research process that results in a company view on the investment opportunities covered by the team members. Gupta provides commentary for NIM's clients through the company blog which is posted weekly on the NIM password protected website. According to NIM's policy, every contribution to the website must be approved by the company's compliance department before posting. Any opinions expressed on the website are disclosed as representing the perspective of the company. Gupta also writes a personal blog to share his experiences with friends and family. As with most blogs, Gupta's personal blog is widely available to interested readers through various internet search engines. Occasionally, when he disagrees with the team-based research opinions of NIM, Gupta uses his personal blog to express his own opinions as a counterpoint to the commentary posted on the NIM website. Gupta believes this provides his readers with a more complete perspective on these investment opportunities.

Standard IV(A): Case 12

- **Comment:** Gupta is in violation of Standard IV(A)-loyalty for disclosing confidential firm information through his personal blog. The recommendations on the firm's blog to clients are not freely available across the internet, but his blog provides the firm's recommendation.
- **Additionally**, by posting research commentary on his personal blog, Gupta is using firm resources for his personal advantage. To comply with Standard IV(A)-loyalty members and candidates must receive consent from their employer prior to using company resources.

Loyalty

- Jane, CFA, quit her job as a portfolio manager at an investment firm. She had signed a non-solicitation agreement with the firm several years ago. Jane received permission to take his investment performance history with her. And also took a copy of the firm's software-trading platform. Subsequently, on social media sites, Jane sent out messages announcing she was looking for clients for her new investment management firm. Access to Jane' social media sites is restricted to friends, family, and former clients. Jane least likely violated the CFA Institute Standards of Professional Conduct concerning her:

  A. Trading software.

  B. Investment performance history.

  C. Non-solicitation agreement.

Loyalty

- Correct Answer: B.
  - B is correct because the portfolio manager received permission to use his investment performance history from his prior employer.
  - The member violated his non-solicitation agreement by indicating his availability to new clients on several social media sites accessible by clients of his former employer, a violation of Standard IV(A) Loyalty, because he did not act for the benefit of his former employer.
  - In this case, the member may cause harm to his former employer if his weekend messages result in clients moving to his new business from his former employer. The member also violated this standard by taking his employer's property, trading software.

Summary

Guidance for Standards I–VII

IV(A).Loyalty

Independent practice when on job, leaving and social media

whistleblowing

Independent contract

IV(B).
Additional compensation arrangements

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard IV(B): Content

- **Content:**

1. 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.

Standard IV(B): Guidance

- **Guidance**

2. No gifts, benefits, compensation or consideration are to be accepted which may create a conflict of interest with the employer's interest unless written consent is received from all parties.
3. "Written Consent" includes any form of communication that can be documented (for example, communication via computer e-mail that can be retrieved and documented).
4. Must obtain permission for additional compensation/benefits because such arrangements may affect loyalty and objectivity and create potential conflicts of interest.
5. **There may be instances in which a member or candidate is hired by an employer on a "part-time" basis.**
   - ✓ Members and candidates should discuss possible limitations to their abilities to provide services that may be competitive with their employer during the negotiation and hiring process.

Standard IV(B): Recommended Procedures

- **Recommended Procedures**

6. Should make an immediate written report to employer specifying any compensation they propose to receive for services in addition to the compensation or benefits received from their employer.
7. The details of the report should be confirmed by the party offering the additional compensation, including performance incentives by clients.
8. The written report should state the terms of any agreement under which a member or candidate will receive additional compensation;
   - ✓ Include **the nature** of the compensation, the approximate **amount** of compensation, and the **duration** of the agreement.

Standard IV(B): Case 1-2

- **Case 1 (Notification of Client Bonus Compensation).** Whitman, an employee at ATC, manages the account of Cochran, a client. Cochran proposes to Whitman that if the performance above 15% before tax, the Whitman could enjoy a trip to Monaco. Whitman is paid a salary by his employer and does not inform this arrangement to his employer.
  - **Comment:** Whitman violated Standard IV(B)-additional compensation arrangements by failing to disclose the vacation arrangement to his employer. This arrangement could compromise objectivity.
- **Case 2 (Notification of Outside Compensation).** Jones sits on the board of directors of EUI and receives no monetary compensation, but receives membership privileges for his family at all EUI facilities. Jones buys the EUI stock for the clients for which it is appropriate and does not disclose this arrangement to his employer.
  - **Comment:** Jones violated Standard IV(B)-additional compensation arrangements by failing to disclose to his employer the non-monetary benefits for his directorship.

Standard IV(B): Case 3

- **Case 3 (Prior Approval for Outside Compensation).** Hollis, an analyst is currently recommending the purchase of ABC Oil shares. ABC offers to send a company plane to pick Hollis up and arrange for his accommodations while visiting. Hollis, after gaining the approvals, accepts the meeting with the CEO but declines the offered travel arrangements. Following the meeting, Hollis joins Andrews and the investment relations officer for dinner at an upscale restaurant near ABC headquarters. Upon returning to Specialty Investment Management, Hollis provides a full review of the meeting to the director of research, including a disclosure of the dinner attended.
  - **Comment:** Hollis's actions did not violate Standard IV(B)-additional compensation arrangements.
    - ✓ Through gaining approval before accepting the meeting and declining the offered travel arrangements, Hollis sought to avoid any potential conflicts of interest between his company and ABC Oil.
    - ✓ Because the location of the dinner was not available prior to arrival and Hollis notified his company of the dinner upon his return, accepting the dinner should not impair his objectivity.
    - ✓ By disclosing the dinner, Hollis has enabled Specialty Investment Management to assess whether it has any impact on future reports and recommendations by Hollis related to ABC Oil.

Example

Additional compensation arrangements

- A fund manager who is an independent third party is responsible for the equity portfolio of a high-tech company. He sits as the board member of the company and is invited to take the plane of board's directors for free. Because there is no cash transaction, he did not disclose this arrangement to his employer, and he did not explain to his clients and prospective clients. Which of the following did he most likely violate?

  A. Only violate for disclosure of conflict of interests

  B. Only violate additional compensation arrangement

  C. Violate both

- Correct Answer: C.
  - The fund manager violates disclosure of conflict of interests and additional compensation arrangement. The fund manager should disclose the board relationship because there exists compensation though there is no cash transaction. The relationship should also be disclosed to his clients and prospective clients.

Summary

Guidance for Standards I–VII

IV(B).Additional compensation arrangement

Written consent from employer

IV(C).
Responsibility of supervisors

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard IV(C): Content

- **Content:**

1. Members and Candidates must make <u>reasonable efforts</u> to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations and the Code and Standards.

Standard IV(C): Guidance

- **Guidance**

2. Can delegate, but not relieve of supervisory responsibility.

   ✓ Should instruct about methods to prevent and detect violations of laws, rules, regulations, firm policies, and the Code and Standards.

- **Guidance - Detection Procedures**

3. Exercise reasonable supervision by establishing and implementing written compliance system and ensuring periodic review on the system.

Standard IV(C): Guidance

- **Guidance**

4. At a minimum, Standard IV(C) requires that members and candidates with supervisory responsibility make reasonable efforts to <u>prevent and detect violations</u> by ensuring the establishment of <u>effective compliance systems.</u>

- ✓ A code of ethics,
- ✓ Compliance policies and procedures,
- ✓ Reviewing employee actions to determine whether they are following the rules
- ✓ Education and training programs,
- ✓ An incentive structure that rewards ethical conduct, and
- ✓ Adoption of firm-wide best practice standards (e.g. the GIPS Standards, CFA Institute Asset Manager Code of Professional Conduct).

Standard IV(C): Guidance

- **Guidance – Supervision includes detection**

5. Exercise reasonable supervision by establishing and implementing written compliance procedures and ensuring that those procedures are followed through periodic review.
6. If a member or candidate has adopted reasonable procedures and taken steps to institute an effective compliance program, then the member or candidate may not be in violation of Standard IV(C) if he or she does not detect violations that occur despite these efforts.

- **Guidance - Inadequate Procedures**

7. **Those who have supervisory responsibility should bring an inadequate compliance system to the attention of the firm's senior managers and recommend corrective action.**
8. If the member or candidate clearly cannot discharge supervisory responsibilities because of the absence of a compliance system or because of an inadequate compliance system, the member or candidate should decline in writing to accept supervisory responsibility until the firm adopts reasonable procedures to allow adequate exercise of supervisory responsibility.

Standard IV(C): Guidance

- **Guidance – System for supervision**

9. Should know what an adequate system is, and make reasonable efforts to see that appropriate procedures are established, documented, communicated to covered personnel, and followed.
   - ✓ Once such procedures are in place, supervisor must make reasonable efforts to ensure that the procedures are monitored and enforced.
10. **Once knowing a potential violation, supervisor must promptly initiate an investigation to ascertain the extent of the wrongdoing.**
    - ✓ Relying on employee's statements or assurances that the wrongdoing will not recur is **not enough**.
    - ✓ Reporting the misconduct up the chain of command and warning the employee to cease the activity are also **not enough**.
    - ✓ Should take steps to ensure that the violation will not be repeated, by **placing limits on the employee's activities or increasing the monitoring of the employee's activities**.

Standard IV(C): Recommended Procedures

- **Recommended Procedures**

11. Codes of ethics or compliance procedures

    ✓ To ensure that a culture of ethics and integrity is created rather than merely a focus on following the rules, the principles in the code of ethics must be stated in a way that is accessible and understandable to everyone in the firm.

    ✓ Codes vs. Procedures

    - **Codes:** Consist of fundamental, principle-based ethical and fiduciary concepts applicable to all of the firm's employees. And these concepts should be implemented by detailed, firmwide compliance procedures.
    - **Procedures:** Assist firm's personnel in fulfilling the responsibilities in codes of ethics, and make probable that the ideals in the codes will be adhered to in the day-to-day operation.
    - Codes should be in plain language and address general fiduciary concepts. Codes presented in this way are effective in stressing to employees that they are in positions of trust and act with integrity all the time. Mingling compliance procedures in the codes goes against the goal of reinforcing the ethical obligation of employees.

Standard IV(C): Recommended Procedures

- **Recommended Procedures**

12. May be in violation of IV(C) if he knows or should know that the procedures to detect and prevent violations are not being followed.

Adequate compliance procedures should

- ✓ Be clearly written;
- ✓ In plain language, easy to understand;
- ✓ Designate a compliance officer;
- ✓ Describe the hierarchy of supervision and assign duties among supervisors;
- ✓ Create a system of checks and balances;
- ✓ Outline the scope of the procedures and procedures to document the monitoring and testing of compliance procedures;
- ✓ Outline permissible conduct;
- ✓ Procedure for reporting violations and sanctions.

Standard IV(C): Recommended Procedures

- **Recommended Procedures**

12. Adequate procedure (cont.)
    - ✓ Once compliance program is in place, a supervisor should:
        - ☐ Disseminate the contents to personnel;
        - ☐ Periodically update procedures;
        - ☐ Continually educate personnel <u>regarding **compliance procedures**</u>;
        - ☐ Issue periodic reminders of procedures;
        - ☐ Incorporate <u>professional conduct evaluation</u> in employee's performance review;
        - ☐ Review the actions of employees;
        - ☐ Take steps to enforce procedures once violation occurred.
    - ✓ Once violation is discovered, a supervisor should:
        - ☐ Promptly respond;
        - ☐ Thoroughly investigate to determine the scope of the wrongdoing;
        - ☐ <u>Increase supervision or place appropriate limitations</u> on the wrongdoer pending the outcome of the investigation.

Standard IV(C): Recommended Procedures

- **Implementation of compliance education and training**

13. Regular ethics and compliance training, in conjunction with adoption of a code of ethics, is critical to investment firms seeking to establish a strong culture of integrity and to provide an environment in which employees routinely engage in ethical conduct in compliance with the law.
14. Supervisors and firms must look closely at their incentive structure to determine whether it encourages profits and returns at the expense of ethically appropriate conduct.
    - ✓ Only when compensation and incentives are firmly tied to client interests and how outcomes are achieved rather than how much income is generated for the firm, will employees work to achieve a culture of integrity.
    - ✓ Training and education assist individuals in both recognizing areas that are prone to ethical and legal pitfalls and identifying those circumstances and influences that can impair ethical judgment.
    - ✓ Education helps employees make the link between legal and ethical conduct and the long-term success of the business.

Standard IV(C): Case 1

- **Case 1 (Supervising Research Activities).** Mattock, head of research dept. of H&V, a brokerage firm, has decided to change recommendation for Timber from buy to sell. In line with H&V's procedures, she orally advises other executives of her proposed actions before the report is prepared for publication. After that, one of the executives of H&V, Frampton immediately sells Timber stock from his own account and some discretionary client accounts. And other personnel also inform certain institutional customers of the changed recommendation before the report is disseminated to all H&V customers.
  - **Comment:** Mattock violated Standard IV(C)-responsibility of supervisors by failing to supervise reasonably and adequately the actions of those accountable to her. She also must ensure that her firm has adequate procedures for unethical practice.

Standard IV(C): Case 2

- **Case 2 (Supervising Research Activities).** Miller, the research director, is under pressure to find potential acquisition target. Miller gets a proposal from one of his staff who recommend such a candidate and without extensive analysis and due diligence, he asks the staff to make a memo and send it to the portfolio manager before his vacation. After Miller returns, he only finds the staff's advice is untrustworthy.
  - **Comment:** Miller violated Standard IV(C)-responsibility of supervisors by not exercising reasonable supervision when he agrees to send out the memo without reasonable and adequate basis.
  - Also violating V(A)-Diligence and Reasonable Basis, I(D)-Misconduct.

Standard IV(C): Case 3

- **Case 3 (Supervising Trading Activities and Record Keeping).** Henry, the president of Crozet company, extremely impressed by Tabbing's performance in the past two years, directs Tabbing to act as portfolio manager for the funds. Henry assigns Tabbing to manage 20% of the assets of Crozet Employee Profit-Sharing Plan, a defined contribution retirement plan. <u>Unbeknownst</u> to Henry, Tabbing frequently places futures for both funds without providing the FCMs designation of the account for which the trade has been placed. <u>Crozet has no written operating procedures or compliance manual concerning its futures trading, and its compliance dept. does not review such trading</u>. After observing the market's movement, Tabbing assigns to the pension fund the positions with favorable execution prices and assigns positions with less-favorable execution prices to the mutual funds.
  - **Comment:** Henry violated Standard IV(C)-responsibility of supervisors by failing to adequately supervise Tabbing with respect to her futures trading and establish necessary control system to detect or prevent Tabbing's violations.

Standard IV(C): Case 4

- **Case 4 (Inadequate Supervision):** Michael Papis is the chief investment officer of his state's retirement fund which uses outside advisers for the real estate. He decides to change the outside adviser to his business school classmate Nagle who runs an asset management company and is searching for retirement fund's allocation. And the notice of change will be known in the next annual report.
  - **Comment:** Papis's actions highlight the need for supervision and review at all levels in an organization. His responsibilities may include the selection of external advisers, but the decision to change advisers appears arbitrary.
  - Violating **III(B)-Fair dealing, IV(C)-Supervisory Responsibility, V(A)-Diligence and Reasonable Basis, VI(A)-Disclosure of Conflicts, VI(B)-Communication with Clients and Prospective Clients.**

Standard IV(C): Case 5

- **Case 5 (Supervising Research Activities)** Mary Burdette was a junior auto industry analyst. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a <u>proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page</u>.
  - **Comment:**
    - ✓ Graf has violated Standard IV(C)-responsibility of supervisors by failing to reasonably supervise Burdette with respect to the contents of her tweet.
    - ✓ He did not establish reasonable procedures to prevent the unauthorized dissemination of company research through social media networks.
    - ✓ Graf must make sure all employees receive regular training about FIM's policies and procedures, including the appropriate business use of personal social media networks.

Standard IV(C): Case 6

- **Case 6 (Supervising Research Activities)** Chen supervises a team of 10 analysts in a fast-paced and understaffed organization. One of Chen's direct reports, Huang Mei covers the banking industry. Chen must submit the latest updates to the portfolio management team tomorrow morning. Huang has yet to submit her research report on ZYX Bank because <u>she is uncomfortable providing a "buy" or "sell" opinion </u>of ZYX on the basis of the completed analysis. Pressed for time and concerned that Chen will reject a "hold" recommendation, she researches various websites and blogs on the banking sector for whatever she can find on ZYX. <u>She is impressed by the originality and resourcefulness of this blogger's report</u>. Huang submits her report and "sell" recommendation to Chen <u>without any reference to the independent blogger's report</u>. Given the late time of the submission and the competence of Huang's prior work , Chen compiles this report with the recommendations from each of the other analysts and meets with the portfolio managers to discuss implementation.

Standard IV(C): Case 6

- **Comment:**
  - ✓ Chen has violated Standard IV(C)-responsibility of supervisors <u>by neglecting to reasonably and adequately follow the firm's approved review process for Huang's research report</u>.
  - ✓ <u>The delayed submission and the quality of prior work do not remove</u> Chen's requirement to uphold the designated review process.
  - ✓ A member or candidate with supervisory responsibility must make reasonable efforts to <u>see that appropriate procedures</u> are established, documented, communicated to covered personnel, and followed.

Responsibility of supervisors

- Madeline Smith, CFA, was recently promoted to senior portfolio manager. In her new position, Smith is required to supervise three portfolio managers. Smith asks for a copy of her firm's written supervisory policies and procedures but is advised that no such policies are required by regulatory standards in the country where Smith works. According to the Standards of Practice Handbook, Smith's most appropriate course of action would be to:

A. Require her firm to adopt the CFA Institute Code of Ethics and Standards of Professional Conduct.

B. Decline to accept supervisory responsibility until her firm adopts procedures to allow her to adequately exercise such responsibility.

C. Require the employees she supervises to adopt the CFA Institute Code of Ethics and Standards of Professional Conduct.

Responsibility of supervisors

- Correct Answer: B.
  - According to guidance for Standard (IV(C), if a member cannot fulfill supervisory responsibilities because of the absence of a compliance system or because of an inadequate compliance system, the member should decline in writing to accept supervisory responsibility until the firm adopts reasonable procedures to allow the member to adequately exercise such responsibility.

Summary

Guidance for Standards I–VII

IV(C).Responsibility of supervisors

System of supervision

Respond to violation promptly

V(A).
Diligence and reasonable basis

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards	
I. Professionalism	(A) Knowledge of the law; (B) Independence and objectivity; (C) Misrepresentation; (D) Misconduct.
II. Integrity of Capital Markets	(A) Material nonpublic information; (B) Market manipulation.
III. Duty To Clients	(A) Loyalty, prudence and care; (B) Fair dealing; (C) Suitability; (D) Performance presentation; (E) Preservation of confidentiality.
IV. Duty To Employers	(A) Loyalty; (B) Additional compensation arrangements; (C) Responsibility of supervisors.
V. Investment	(A) Diligence and reasonable basis; (B) Communication with clients; (C) Record retention.
VI. Conflicts of Interest	(A) Disclosure of conflicts; (B) Priority of transaction; (C) Referral fees.
VII. Responsibility as Members	(A) Conduct as members and candidates; (B) Reference to CFA institute, designation.

Standard V(A): Content

- **Content:**
  - 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.

Standard V(A): Guidance

- **Guidance**

3. The requirements for research conclusions vary in relation to the role in investment decision-making process, but must make reasonable efforts to cover all pertinent issues when arriving at a recommendation.
4. Provide supporting information to clients → enhance transparency.

Standard V(A): Guidance

- **Guidance - Defining Diligence and Reasonable Basis**

5. In providing investment service, often use a variety of resources (company reports, third-party research, and results from quantitative models).
6. Some attributes to consider:
   - ✓ Global, regional, and country macroeconomic conditions
   - ✓ Current stage of the industry's business cycle,
   - ✓ Company's operating and financial history,
   - ✓ Mutual fund's fee structure and management history,
   - ✓ Output and potential limitations of quantitative models,
   - ✓ Quality of the assets included in a securitization,
   - ✓ Appropriateness of selected peer-group comparisons.
7. Can base decisions only on the information available at the time the decision is made. The steps taken in developing a diligent and reasonable recommendation should minimize unexpected downside events.

Standard V(A): Guidance

- **Guidance - Using Secondary or Third-Party Research**

8. **Criteria** in forming an opinion on whether research is sound include:
   - ✓ Assumptions used,
   - ✓ Rigor of the analysis performed,
   - ✓ Date/timeliness of the research, and
   - ✓ Evaluation of objectivity and independence of recommendations

- If rely on secondary or third-party research, must make reasonable and diligent efforts to determine whether it is sound. If suspect the soundness, must not rely on that information.
  - ✓ **Secondary** research is defined as research conducted by someone else in the member's or candidate's firm.
  - ✓ **Third-party** research is research conducted by entities outside the member's or candidate's firm, such as a brokerage firm, bank, or research firm.
- May rely on others in the firm to determine soundness and use the information in good faith assuming the due diligence process was deemed adequate.

Standard V(A): Guidance

- **Guidance - Using Secondary or Third-Party Research (cont.)**
  - The sources of the information and data will influence the level of the review a member or candidate must undertake.
    - ✓ Information and data taken from internet sources, such as personal blogs, independent research aggregation websites, or social media websites, likely require a **greater** level of review than information from more established research organizations.
  - Should verify that the firm has a policy about the **timely and consistent review** of approved research providers to ensure the quality of the research.
  - If such a policy is not in place at the firm, the member or candidate should encourage the development and adoption of a formal review practice.

Standard V(A): Guidance

- **Guidance – Using Quantitatively Oriented Research**

9. Need to have an understanding of the **parameters** used in the model or quantitative research.
10. Although not required to be experts in technical aspects of the models，must understand the **assumptions and limitations** inherent in any model and **how the results were used** in the decision-making process.

Standard V(A): Guidance

- **Guidance – Developing Quantitatively Oriented Research**

11. Individuals who create new quantitative models and services must exhibit a higher level of diligence in reviewing new products than the individuals who ultimately use the analytical output.
    - ✓ Members and candidates involved in the development and oversight of quantitatively oriented models, methods, and algorithms must **understand the technical aspects of** the products they provide to clients.
    - ✓ A thorough testing of the model and resulting analysis should be completed prior to product distribution.
12. Need to consider the **time horizon** of data input in financial models.
13. In development of a recommendation, may need to **test the models** by using volatility and performance expectations that represent scenarios **outside the observable databases.**
14. In reviewing computer models or the resulting output, pay attention to the assumptions and rigor of the analysis to ensure that the model incorporates **negative market events.**

Standard V(A): Guidance

- **Guidance - Selecting External Advisers and Subadvisers**

15. Why adopt external advisers and subadvisers?
    - ✓ The progression of financial instruments and allocation techniques leads to the use of specialized managers to invest in specific asset classes that complement the firm's in-house expertise.
16. Need to ensure that the firm has standardized criteria for reviewing external advisers. Such **criteria** would include, but would not be limited to, the following:
    - ✓ Reviewing the adviser's **established code of ethics**
    - ✓ Understanding the adviser's **compliance and internal control procedures**
    - ✓ Assessing the **quality** of the published return information
    - ✓ Reviewing the adviser's **adherence to its stated strategy**

Standard V(A): Guidance

- **Guidance - Group Research and Decision Making**

17. The conclusions or recommendations of the group report represent the consensus of the group, but may not necessarily be the views of the member or candidate, even though his name is included on the report.
18. If not reflect his or her conclusion, must dissociate from the **group research?**
    - ✓ If the consensus opinion has a reasonable and adequate basis and is independent and objective, need not decline to be identified with the report, even if it does not reflect his opinion.
19. Always recommend "hot" issue indicates **NO** reasonable basis.

Standard V(A): Recommended Procedures

- **Recommended Procedures**

20. Should encourage firms to consider the following:

    ✓ Establish a policy requiring that research reports, credit ratings, and investment recommendations have a basis that can be substantiated as reasonable and adequate.

    ✓ Develop detailed, written guidance for analysts and review committees for judging reasonable and adequate basis of a particular recommendation.

    ✓ Develop measurable criteria for assessing the quality of research, the reasonableness and adequacy of the basis for any recommendation or rating, and the accuracy of recommendations over time.

    ✓ Develop detailed, written guidance that establishes minimum levels of scenario testing of all computer-based models used in developing, rating, and evaluating financial instruments.

Standard V(A): Recommended Procedures

- **Recommended Procedures (cont.)**

21. Should encourage firms to consider the following:
    - ✓ Develop measurable criteria for assessing outside providers, including
        - The quality of information being provided,
        - The reasonableness and adequacy of the provider's collection practices,
        - And the accuracy of the information over time. The established policy should outline how often the provider's products are reviewed.
    - ✓ Adopt a standardized set of criteria for evaluating the adequacy of external advisers. The policy should include how often and on what basis the allocation of funds to the adviser will be reviewed.

Standard V(A): Case 1

- **Case 1 (sufficient due diligence):** Hawke, a corporate finance officer, believes the tax benefit for oil and gas companies will soon be removed and convinces some companies that to capitalize on this, an equity financing must be arranged very quickly. Lacking sufficient resources to conduct adequate research on all the prospective issuers, Hawke decides to estimate the issuing prices based on the relative size of each company and to justify the pricing later.
  - **Comment:** Hawke has violated Standard V(A)-Diligence and Reasonable Basis by pricing the issues simply based on size without reasonable and adequate analysis. He should have taken on only the work he could adequately handle.

Standard V(A): Case 2

- **Case 2 (sufficient scenario testing):** Dhaliwal, a corporate finance manager, is persuading FRL, whose multiples are higher than equivalent stocks, to do a secondary equity financing. During the sales marketing, Dhaliwal use the optimal projections made by the FRL management as the base-case number to justify the high price for the secondary issue.
    - **Comment:** Dhaliwal has violated Standard V(A)-Diligence and Reasonable Basis by misrepresenting the optimal level as the base level and misleading the investors.

Standard V(A): Case 3-4

- **Case 3 (developing a reasonable basis):** Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the "hot" security of the day.
  - **Comment:**
    - ✓ Witt has violated Standard V(A)-Diligence and Reasonable Basis because his recommendation for stocks has not been based on reasonable and adequate basis.
    - ✓ Also **violating IV(C)-Supervisory Responsibility if no procedure or not detecting.**
- **Case 4 (timely client updates):** Dunlop is searching a specialist US equity manager for her pension client. She conducts thorough due diligence and extensive analysis and selects 5 qualified managers and puts them in briefing report that is delivered to the client 10 days later. In the time of Dunlop's search and delivery of the report to the client, she gets an update for one of the manager in her briefing report (top executive leaves), and she does not provide the client with this updated information.
  - **Comment:** Dunlop violated Standard V(A)-Diligence and Reasonable Basis by not checking the database in a timely manner and updating her report to the client.

Standard V(A): Case 5-6

- **Case 5 (group research opinions):** Mastakis, a junior analyst, is writing a residential mortgage report for the firm. After he submitted the report for review, the majority of the committee disagrees with his conclusion. And the report is significantly changed. Should he ask his name be taken off the report?
  - **Comment:** Mastakis has not violated Standard V(A)-Diligence and Reasonable Basis as long as he has a reasonable and adequate basis. When the report is a group effort, <u>not all members of the team may agree with all aspects of the report.</u> He can ask to have his name removed from the report, but if he has a reasonable and adequate basis or is confident in the research process, he does not have to dissociate from the report even he disagrees.
- **Case 6 (reliance on third-party research):** McDermott runs a small firm that relies on a larger investment research firm to provide reports and makes recommendations <u>based on these reports.</u>
  - **Comment:** McDermott <u>can rely on third-party research but must make reasonable and diligent efforts to determine</u> that such research is sound.

Standard V(A): Case 7

- **Case 7 (<u>due diligence in submanager selection</u>):** Ostrowski uses the CFA Institute model "request for proposal" to design a questionnaire for his search. By deadline, he receives seven questionnaires from domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges <u>the lowest fees</u> because doing so will have the least impact on his firm's bottom line.
  - **Comment:** If Ostrowski choose the firm solely because it charges the lowest fees, he may violated Standard V(A)-diligence and reasonable basis which requires members and candidates choose adviser or subadviser based on a full and complete services, performance history, and cost structure.
  - Violating **III(C) Suitability** → **violating III(A) Loyalty, Prudence and Care**.
  - Violating III(C) Suitability → **violating I(D) Misconduct**.
  - Violating **V(A) Diligence and Reasonable Basis**.

Standard V(A): Case 8

- **Case 8 (Sufficient Due Diligence):** Michael Papis is the chief investment officer of his state's retirement fund which uses outside advisers for the real estate. He decides to change the outside adviser to his business school classmate Nagle who runs an asset management company and is searching for retirement fund's allocation. And the notice of change will be known in the next annual report.
  - **Comment:** Papis has violated Standard V(A)-diligence and reasonable basis. His responsibilities may include the selection of the external advisors, but the decision to change advisers appears to have been arbitrary.
  - Violating **IV(C)-Supervisory Responsibility, V(A)-Diligence and Reasonable Basis, VI(A)-Disclosure of Conflicts, VI(B)-Communication with Clients and Prospective Clients.**

Standard V(A): Case 9

- **Case 9 (use of quantitatively oriented models):** Liakos' client, Carapalis, is convinced that commodity prices will become more volatile. Carapalis asks Liakos to quickly engineer a strategy to benefit from this expectation. Because of tight deadline, the modeling group outsources parts of the work to trusted 3rd parties. Liakos implements the disparate components of the strategy as the firms complete them.

  Within a month, Carapalis is proven correct. But her derivatives position returns huge losses, and the losses increase daily. Liakos investigates and realizes that, although each of the various components of the strategy had been validated, they had never been evaluated as an integrated whole. In extreme conditions, portions of the model worked at cross-purposes with other portions, causing the overall strategy to fail dramatically.

Standard V(A): Case 9

- **Case 9 (use of quantitatively oriented models):**
  - **Comment:** Liakos violated Standard V(A)-diligence and reasonable basis. He must understand the statistical significance of the model results and be able to explain them to clients.
  - Liakos <u>did not take adequate care to ensure a thorough review of the whole model</u>; its components were evaluated only individually. Because Carapalis intended to implement the strategy as a whole rather than as separate parts, Liakos should have tested how the components interacted as well as how they performed individually.

Standard V(A): Case 10

- **Case 10 (successful due diligence/failed investment):** Newbury is an investment adviser to high-net-worth clients. One of his clients asked him about a risky hedge fund which has a high expected return. Through diligence research, Newbury tell his client that this fund is using long-short strategy in the energy sector and extensive leverage. After reviewing of the fund's track record, the principals involved managing the fund, the fees charged and the fund's risky profile, Newbury recommends the fund to this client because this client have a risky profile as well. However, several weeks later, the fund suffered a severe loss and the client is questioning Newbury about his work.
  - **Comment**： Newbury's recommendation is appropriate. The investment is not guaranteed by Newbury's report. However, Newbury should discuss the his analysis process and the investment downside risk with client and make sure the client is fully understand the underlying risk combined to the expected return.

Standard V(A): Case 11

- **Case 11 (Quantitative Model Diligence)** Barry Cannon is the lead quantitative analyst at a Hedge Fund. He found some intriguing research that can be used in his model through a internet blog, run by Expert CFA. Under the pressure of his company, Barry include these online research factors to his new model and recommends it to several fund managers.
  - **Comment:** Cannon has violated Standard V(A)-Diligence and Reasonable Basis <u>by failing to have a reasonable basis</u> for the new recommendations made to the portfolio managers. The factors Barry put into his model should be fully test and determine the effect on the model before he make recommendation for it.
  - Also violating VII(B)-Reference to CFA Institute, the CFA Designation, and the CFA Program

Standard V(A): Case 12

- **Case 12 (Selecting a Service Provider)** Ellen Smith is a performance analyst at Artic Global Advisors, a firm that manages global equity mandates for institutional clients. Her supervisor ask her to review 5 models and recommend one of them to represent their company's investment style to clients. Smith found one of the model contains very complex algorithm and something about a "black box". Smith recommended this model without researching the others because she think the complexity of this model will definitely impress the clients.
  - **Comment:** The complexity is not necessarily combined with a firm's investment style, and suitability of the model to clients. It is Smith's responsibility to view all the models and perform a sufficient level of diligence in reviewing this model before make recommendation.
  - Additionally, she should also check weather the "black box" aligns with the investment practices of the firm.
  - To avoid the violation, Smith is required to review all five models and understand their processes before recommending it.
  - Also violating I(D)-Misconduct, III(B)-Fair Dealing, III(A)-Loyalty, Prudence and Care.

Standard V(A): Case 13

- **Case 13 (Subadviser Selection)** Craig Jackson is working for Adams Partners, Inc.. His recent assignment is to select a hedge fund sub-adviser to diversify the portfolios of the firm's large fund-of-funds accounts. The allocation must be in place before the start of the next quarter. Through a database, Jackson found a list of advisory firm that claim compliance with GIPS standards. Jackson then picks 20 of the firms from this list and evaluate their last quarter and annual performance to determine which firm is the best selection.
  - **Comment:** A good performance and compliance with GIPS standard is not meaning that the underlying firm is the best choice for Jackson's firm. Jackson should conduct sufficient review of potential firms to satisfy the requirement of Standard V(A)-Diligence and Reasonable Basis.
  - Also violating I(D)-Misconduct, III(B)-Fair Dealing, III(A)-Loyalty, Prudence and Care.

Standard V(A): Case 14

- **Case 14 (Manager Selection)** Timothy Green works for Peach Asset Management, where he creates proprietary models that analyze data from the firm request for proposal questionnaires to identify managers for possible inclusion in the firm's fund-of-funds investment platform. There are several criteria when accepting a new manager to the platform. However, Green uses only the data submitted to make a recommendation for adding new manager due to the massive respondents to questionnaires.
  - **Comment:** Green is in violation of Standard V(A)-diligence and reasonable basis. When he recommend a new manager, the criteria which Peach Asset Management made should be met through faithful effort.
  - Before recommending a firm for inclusion he must <u>go beyond considering only the information provided by the manager</u> on the request for proposal questionnaire.

Standard V(A): Case 15

- **Case 15 (Technical Model Requirements)** Dupont is in charge of developing and updating credit risk models. His models need to be regularly updated with the latest market data in order to perform accurately. Dupont does not interact with or manage money for any of the firm's clients. John Smith has only very superficial knowledge of the model and asks Dupont about very basic questions regarding the output recommendations. Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. Dupont thus neglects to update the US model. After several months without regular updates, Dupont's diagnostic statistics starts to show alarming signs with respect to the quality of the US credit model. Instead of conducting the long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick "fix" and he continues working on the new emerging market model. Several months later, another set of diagnostic statistics reveals nonsensical results and Dupont realizes the earlier change contained an error.

Standard V(A): Case 15

- **Comment:**
  - Smith violated standard V(A)-diligence and reasonable basis, because exercising "diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions" means that members and candidates must understand the technical aspects of the products they provide to clients.
    - ✓ Smith does not understand the model he is relying on to manage money.
    - ✓ Members and candidates should also make reasonable enquiries into the source and accuracy of all data used in completing their investment analysis and recommendations.
  - Dupont violated V(A)-Diligence and Reasonable Basis even if he does not trade securities or make investment decisions.
    - ✓ Dupont's models give investment recommendations and Dupont is accountable for the quality of those recommendations.
    - ✓ Members and candidates should make reasonable efforts to test the output of pre-programed analytical tools they use. Such validation should occur before incorporating the tolls into their decision-making process.

Example

Diligence and reasonable basis

- Katherine, CFA, is a research analyst at an independent research firm. Katherine is part of a team of analysts who focus on the automobile industry. Recently, even though Katherine felt confident that the research process was properly conducted, she disagreed with two research "sell" recommendations written by her team. In discussions with several clients, Katherine states "even though my name is on the sell reports, these stocks are a buy because sales and share prices for both auto companies would rise significantly due to strong demand for their vehicles." Concerning the "sell" recommendations, which of Katherine 's following actions would most likely violate the CFA Institute Standards of Professional Conduct?

  A. Dissociating from the report

  B. Distinguishing between fact and opinion

  C. Sharing her personal opinion of the stocks

- Correct Answer: C.
  - The analyst can express her disagreement with the team by documenting her difference of opinion, but it is inappropriate for the analyst to make selective disclosure. Members and candidates must make every effort to treat all individual and institutional clients in a fair and impartial manner.

Example

Diligence and reasonable basis

- Fred Johnson, CFA, a financial analyst and avid windsurfer, has begun an investment survey of the water sports leisure industry. His brother sells windsurfing gear in Tampa and tells him that Swordfish9 is the "hottest windsurfing rig on the market and will be highly profitable for Swordfish Enterprises." Johnson had never heard of Swordfish9 previously, but after testing the board himself became very excited about the Swordfish9 and issued an investment recommendation of "buy" on Swordfish Enterprises. As a result of issuing the recommendation, Johnson has:

  A. Not violated the Code and Standards.

  B. Violated the Code and Standards by failing to establish a reasonable and adequate basis.

  C. Violated the Code and Standards by failing to consider the suitability of the investment for his clients.

Example

Diligence and reasonable basis

- Correct Answer: B.
  - Johnson has apparently let his recreational passion cloud his judgment. This is not to say that Swordfish Enterprises is not or will not be an excellent investment. However, if he had never heard of the firm previously, issuing an investment recommendation without conducting a thorough financial investigation indicates a failure to exercise diligence and. also indicates that he lacks a reasonable and adequate basis for his recommendation.
  - He is in violation of Standard V(A) Diligence and Reasonable Basis.

Summary

Guidance for Standards I–VII

V(A).Diligence and reasonable basis

Define, Others' report, quants oriented research and techniques

select subadvisers, group research

V(B).
Communication with clients

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard V(B): Content

Content

Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes used to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might **materially affect** those processes.
2. Disclose to clients and prospective clients significant **limitations and risks** associated with the investment process.
3. 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.
4. **Distinguish** between **fact and opinion** in the presentation of investment analysis and recommendations.
   - ✓ "…will be…"→ fact
   - ✓ "…may be …"→ opinion

Standard V(B): Guidance

- **Guidance - Informing Clients of the Investment Process**

5. Keep clients informed on an ongoing basis about changes to the investment process.
6. Understanding the basic characteristics of an investment is important in judging suitability on a stand-alone basis, it's especially important in determining the impact each investment will have on the characteristics of a portfolio.
7. Should inform clients about the specialization or diversification expertise of external advisers.

- **Guidance - Different Forms of Communication**

8. All means of communications are included here, not just research reports, so in person, over the call, or by the computer are okay.
   - ✓ When providing information to clients through **new technologies**, members and candidates should take reasonable steps to ensure that such delivery would **treat all clients fairly.**
9. If recommendations are **in capsule form** (such as a recommended stock list), should notify clients that additional information and analyses are available upon request.

Standard V(B): Guidance

- **Guidance - Identifying Risk and Limitations of Analysis**

10. **Members and candidates must outline to clients and prospective clients significant risks and limitations of the analysis contained in their investment products or recommendations.**
    - ✓ The type and nature of significant risks will depend on the investment process that members and candidates are following and on the personal circumstances of the client
11. **Guidance - Risks**
    - ✓ In general, the use of leverage constitutes a significant risk and should be disclosed.
    - ✓ Adequately disclose the general market-related risks.
    - ✓ Risks associated with the use of complex financial instruments that are deemed significant.
    - ✓ Other types of risks that members and candidates may consider disclosing include, but are not limited to, counterparty risk, country risk, sector or industry risk, security-specific risk, and credit risk.

Standard V(B): Guidance

12. Investment securities and vehicles may have **limiting factors** that influence a client's or potential client's investment decision.
    - ✓ Examples of such factors and attributes include but are not limited to investment liquidity and capacity.
        - **Liquidity** is the ability to liquidate an investment on a timely basis at a reasonable cost.
        - **Capacity** is the investment amount beyond which returns will be negatively affected by new investments.
13. Members and candidates have to disclose significant risks known to them at the time of the disclosure.
14. Members and candidates cannot be expected to disclose risks they are unaware of at the time recommendations or investment actions are made.
    - ✓ A **one-time investment loss** that occurs after the disclosure does not constitute a pertinent factor in assessing whether significant risks and limitations were properly disclosed.
    - ✓ Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the V(A)-Diligence and Reasonable Basis of the research of the member or candidate, but may not reveal a breach of Standard V(B).

Standard V(B): Guidance

- **Guidance - Report Presentation**

15. The member or candidate who prepares the report must include those elements that are important to the analysis and conclusions of the report so that the reader can follow and challenge the report's reasoning.
16. A report writer who has done adequate investigation may emphasize certain areas, touch briefly on others, and omit certain aspects deemed unimportant. As long as the analyst clearly stipulates the limits to the scope of the report.
17. Investment advice based on quantitative research and analysis must be supported by readily available reference material and should be applied in a manner consistent with previously applied methodology.
    - ✓ If changes in methodology are made, they should be highlighted.

Standard V(B): Guidance

18. Separate opinions from facts:
    - ✓ If not indicate that earnings estimates, changes in the dividend outlook, and future market price information are **opinions** subject to future circumstances, thus fail to separate past from future and violate V(B).
    - ✓ In the case of complex quantitative analyses, analysts must clearly separate fact from statistical conjecture and should identify the known limitations of an analysis.
    - ✓ Should explicitly discuss with clients and prospective clients the assumptions used in the investment models and processes to generate the analysis.
    - ✓ Caution should be used in promoting the accuracy of any model or process to clients because the ultimate output is merely an estimate of future results and not a certainty.

Standard V(B): Recommended Procedures

- **Recommended Procedures**

19. Changing in investment style, investment committee and ceilings for investment universe should be disclosed to clients and prospect clients.
20. Because the selection of relevant factors is an analytical skill, determination of whether analysts have used reasonable judgment on selection of factors depends on <u>case-by-case review</u> rather than a specific checklist.
    - ✓ To assist in the after-the-fact review of a report, must <u>maintain records</u> indicating the nature of the research and should be able to supply additional information to the client (or any user of the report) covering factors not included in the report.

Standard V(B): Case 1-2

- **Case 1 (sufficient disclosure of investment system)** Williamson is marketing a sophisticated new model to high-net-worth investors. To simplify the newsletter, she includes only each week's top-five recommendations and to leave out details of the valuation models and the portfolio-structuring scheme.
  - **Comment:** Williamson violated Standard V(B)-communication with clients by **not including all** the relevant factors behind the investment advice.

- **Case 2 (providing opinions as facts)** Dox, a mining analyst, included in his report his own assessment of the geological extent of mineral reserves likely to be found on the subject company. He wrote, "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong buy."
  - **Comment:** Dox's assessment of the gold reserve is a opinion not a fact, he just did not distinguish fact from opinion. It's a violation.
  - Violating V(B) Communication with Clients and Prospective Clients → **Possibly Violating I(C) Misrepresentation by not distinguishing between facts and opinions.**

Standard V(B): Case 3

- **Case 3 (notification of fund mandate change)** MAA is a successful small cap manager with increasing new clients. For liquidity purpose, the CIO decides to lift the maximum market-cap ceiling from 250 million to 500 million and informs prospective clients and third-party consultants.
  - **Comment:** The CIO must also inform the existing clients about this material change otherwise he violated Standard V(B)-communication with clients.

Standard V(B): Case 4-5

- **Case 4 (notification of fund mandate change):** Continued with Case 3, MAA extends its small-cap universe to include non-US stock rather than lifting the ceiling for its universe.
  - **Comment:** Standard V(B)-communication with clients requires that May's CIO advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in domestic small-cap stocks.
- **Case 5 (notification of changes to the investment process)** RJZ is a value equity manager using multifactor models. After some successful back-testing analysis, the company decides to replace its multifactor models with a new DDM.
  - **Comment:** Because the introduction of a new model and different valuation model represents a material change in the investment process, RJZ must communicate to the firm's clients. RJZ is moving toward DDM that is at least partly dependent on the firm's forecasting skills. Clients would likely view that as a significant change rather than a mere refinement.

Standard V(B): Case 6-7

- **Case 6 (notification of changes to the investment process)** RJZ loses its chief architect of its multifactor valuation system and without informing its clients, the president decides to <u>redirect the firm to indexing style.</u>
  - **Comment:** The president violated Standard V(B)-communication with clients by failing to disclose to clients a substantial change to its investment process.
- **Case 7 (notification of changes to the investment process)** FAM has just changed its internal investment policy whereby the responsibility for selecting stock from outside the firm's approved <u>list is shifted from individual analyst to a committee</u>. Morales, a manager in FAM, fails to notify her clients of the change.
  - **Comment:** It's a violation for Morales that did not disclose the process change to all her clients.

Standard V(B): Case 8

- **Case 8 (Sufficient Disclosure of Investment System)** Chinn is the investment director for DAM, which manages the endowment of a charitable organization. Because of <u>recent staff departures</u>, DAM has decided to limit its direct investment to large-cap securities. The small-cap and midcap management are left to outside <u>managers.</u> Chinn informed charity with a letter states "the investment team managing the endowment's large-capitalization allocation is under my supervision directly. I will also coordinate the selection and ongoing review of external managers responsible for allocation to other classes."
  - **Comment:** Chinn fully obeyed the Standard V(B)-communication with clients by <u>appropriately and accurately discuss this condition of the fund to his clients.</u>
  - Standard V(B)-communication with clients states that members and candidates should disclose the investment process used to construct the portfolio of the fund. In this case, hiring outside managers is one situation that should be disclosed to clients.

Standard V(B): Case 9

- **Case 9 (Notification of Changes to the Investment Process):** Michael Papis is the chief investment officer of his state's retirement fund which uses <u>outside advisers </u>for the real estate. He decides to change the outside adviser to his business school classmate Nagle who runs an asset management company and is searching for retirement fund's allocation. And the notice of change will be known in the next annual report.
  - **Comment:** Papis has violated Standard V(B)-communication with clients because Papis attempted to hide the nature of his decision to change external managers by making only a limited disclosure.
  - Violating **IV(C)-Supervisory Responsibility, V(A)-Diligence and Reasonable Basis, VI(A)-Disclosure of Conflicts, VI(B)-Communication with Clients and Prospective Clients.**

Standard V(B): Case 10

- **Case 10 (Notification of Error)** Dupont is in charge of developing and updating credit risk models. His models need to be regularly updated with the latest market data in order to perform accurately. Dupont does not interact with or manage money for any of the firm's clients. John Smith has only very superficial knowledge of the model and asks Dupont about very basic questions regarding the output recommendations. Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. Dupont thus neglects to update the US model.

  After several months without regular updates, Dupont's diagnostic statistics starts to show alarming signs with respect to the quality of the US credit model. Instead of conducting the long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick "fix" and he continues working on the new emerging market model. Several month after the quick "fix" Dupont discovered this fix contains an error and immediately correct it. Smith then find out that some of the trades were based on this error and then remove the securities purchased on the basis of the trouble result. He did not report this to any people.

Standard V(B): Case 10

- ## Case 10 (Notification of Error)
  - **Comment**: The most appropriate action for Smith is disclose the full information of these error and the results of the error to his clients and inform his clients the correction has been made. Clients themselves can judge if this fund is still suitable for them. Otherwise, Smith is in violation of Standard V(B)-communication with clients.
  - **Also violating V(A)-Diligence and Reasonable Basis.**

Standard V(B): Case 11

- **Case 11 (Notification of Risks and Limitations)** Yuri Yakovleve is a quantitative analyst. He recently developed a new investment strategy by constructing portfolios only include small-cap stocks. These stocks are typically illiquid and are able to generate significant risk adjusted returns.

  After full examination, Yuri's company QSC approved a $10 million fund to create a tracking record for this new model. After 2 years, the fund generates a 20% return which is definitely higher than the benchmark.

  Alan Wellard, the manager of marketing team, would like to introduce this model to large institutional clients. Yuri then informed him that this strategy contains a limitation, which is the capacity. According to the current market data, Yuri calculated the fund is able to handle $100 million fund. Once reached this limit, the fund will be negatively affected.

  Alan Wellard think the offering material should focus solely on the great adjusted return of this strategy. Yuri does not object due to the fund has remain approximately $88 million capacity, which he think is far enough for the market.

Standard V(B): Case 11

- **Case 11 (Notification of Risks and Limitations)**
  - **Comment:**
    - ✓ Yuri and Wellard should inform their clients and prospective client about this limitation even though the limit is far from being reached.
    - ✓ If clients are unable to understand the terminologies this fund used, Yuri and Wellard is responsible for full explanations and appropriate education. Determine the suitability of this fund for clients is Wellard’s and Yuri’s job as well.

Standard V(B): Case 12

- **Case 12 (Notification of Risks and Limitations)** During an industry conference, Lily Smith noticed that John Baker, an investment manager from BA company, attracted a lot of attention from the meeting participants. After the meeting, base on her knowledge of Baker's reputation and the interest he received at that conference, Lily Smith recommends adding BA company to the approval committee. She states "John Baker is well respected in the industry and his sight is needed by clients. Our clients will certainly be benefited from BA company."
  - **Comment:** In this case, Smith failed to distinguish between opinion and the fact. Her statement of Baker's reputation solely depend on Baker's attraction on the conference. This fact makes her recommendation an opinion rather than fact, and she is in violation of Standard V(B).
  - Also violating III(C)-Suitability, III(A)-Loyalty, Prudence and Care.

Example

Communication with clients

- Cathy Jone, CFA, is the chief investment officer of Northwest Mutual Fund, whose investment objective is to invest in fixed income emerging market securities. Originally, Cathy Jone allocates the fund's assets primarily to bonds of commodity producers in emerging markets and invests in a combination of several different investments to ensure an acceptable level of risk. The allocation is clearly disclosed in all fund communications. However, high volatility in the commodities markets at the start of the year makes Cathy Jone pessimistic about returns, so he shifts the fund into emerging market and U.S. government securities, positions he maintains at the end of the year. This change is noted in the next annual report to fund shareholders. Cathy Jone's investment change least likely violated the CFA Institute Code of Ethics and Standards of Professional Conduct concerning:

  A. Communication with clients.

  B. Diversification.

  C. Investments outside his mandate.

Communication with clients

- Correct Answer: B.
  - B is correct because the investment officer has invested in a combination of several different investments to ensure an acceptable level of risk rather than having all assets in a single investment, and he has sought a reasonable amount of diversification.
  - However, the shift into emerging market and U.S. government securities was communicated to clients in the annual report and not on an ongoing basis, in violation of Standard V (B) Communication with Clients and Prospective Clients.
  - Additionally, the investment officer has not followed the investment style previously communicated to fund investors (i.e., to invest in fixed income emerging market securities), specifically, when he invested in U.S. government securities, a violation of Standard III (C) Suitability.

Summary

Guidance for Standards I–VII

V(B).Communication with clients

Different forms of communications, report presentation

Investment process, risk and limitations

Facts and opinions

V(C).
Record retention

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard V(C): Content

- **Content:**

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

Standard V(C): Guidance

- **Guidance**

2. Records may be maintained either in hard copy or electronic form.

- **Guidance - Records Are Property of the Firm**

3. Records created in professional activities are the property of the firm. When leaving the firm, cannot take those records, including originals or copies of supporting records of his work, to the new employer without the express consent of the previous employer.
4. Cannot use historical recommendations or research reports created at the previous firm because the supporting documentation is unavailable.
5. For future use, must re-create the supporting records at the new firm through **public** sources, or directly from **covered company**, and not from memory or sources through previous employer unless with permission.

Standard V(C): Guidance

- **Guidance - New Media Records**

6. Members and candidates should understand that employers and local regulators are developing digital media retention policies, but these policies may lag behind the advent of new communication channels.
   - ✓ Such lag places greater responsibility on the individual for ensuring that all relevant information is retained.

- **Guidance - Local Requirements**

7. Fulfilling local regulatory requirements also may satisfy the requirements of Standard V(C), but should explicitly determine whether it does.
8. **If no regulatory guidance in place, CFA Institute recommends maintaining records for at least 7 years.** If there is a legal requirement for retention period, follow the legal requirement.
   - ✓ If legal requirement regarding record maintenance is 5 years, how long should we keep records?

Standard V(C): Recommended Procedures

- **Recommended Procedures**

9. The responsibility to maintain records that support investment action generally falls with the firm rather than individuals.
   - ✓ Must archive research notes and other documents, either electronically or in hard copy, that support their current investment-related communications.
   - ✓ Doing so will assist their firms in complying with requirements for preservation of internal or external records.

Standard V(C): Case 1

- **Case 1 (record retention and IPS objectives and recommendations):** One of Lindstrom's clients is complaining that his benchmark-oriented portfolio incurred severe losses in technology sector. The IPS of the clients mandates to follow benchmark and the portfolio technology weight is consistent with the benchmark and acknowledged by the client.
    - **Comment:** Lindstrom has not violated Standard V(C)-record retention as long as he has records indicating the investment management is consistent with the IPS and the records have been acknowledged by the clients.

Standard V(C): Case 2-3

- **Case 2 (record retention and research process):** Young, a luxury retail analyst, bases his report on various sources, including onsite company visits, interviews with management, customer surveys and secondary research from analysts covering related industries.
  - **Comment:** Young must carefully document and keep records of all the information that goes into his report, including secondary or third-party research.
- **Case 3 (records as firm, not employee, property):** Blank has successfully developed an analytical model while working at GPIM, now he is hired by one of the GPIM's competitors. Blank takes copies of the records supporting the model to his new firm.
  - **Comment**: The records created by Blank supporting the research model he developed at GPIM are the records of GPIM. He can't take the record without the permission of GPIM. Blank must re-create the records supporting his model at the new firm.

Example

Record retention

- Guillermo Sandoval, CFA, owns an asset management firm with offices downtown, To minimize rent expenses, each year Sandoval ships the previous year's research records to a nearby warehouse. There, the reports are digitized and stored in both electronic and hard-copy forms. After five years, all paper copies are destroyed and only electronic copies are retained. Are Sandoval's record-retention procedures in compliance with the CFA Institute Standards of Practice?

  A. Yes

  B. No, because he did not retain the copies in his offices

  C. No, because he failed to retain the original documents

- Correct Answer: A.
  - The Standards do not require on-site storage.

Summary

Guidance for Standards I–VII

V(C).Record retention

Property of firm

local requirement and at least 7 years

VI(A). Disclosure of conflicts

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard VI(A): Content

- **Content:**

1. 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 their employer.
2. Must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

Standard VI(A): Guidance

- **Guidance**

3. Try our best to avoid any potential and actual conflict of interest **when possible**.
4. Disclosures must be prominent and must be made <u>in plain language.</u>
   - ✓ Best practice: update disclosures when the nature of a conflict of interest changes materially.
5. If an analyst was asked to cover the company, when **inherit** the shares of the company in subject.
   - ✓ Must disclose if continue to follow.
   - ✓ Best practice: assign another analyst to follow up the company.

Standard VI(A): Guidance

- **Guidance**

6. Disclosure to **Employers**
   - ✓ Conflict of interest may create problems.
     - Restrict personal trading, outside board membership, and related activities to prevent situations that could give the appearance of a conflict of interest.
     - If find conflicts, must report and resolve as quickly and effectively as possible.
   - ✓ The same circumstances that generate conflicts to be reported to clients and prospective clients also would dictate reporting to employers, such as ownership of stocks analyzed or recommended.
7. Disclosure to **Clients:**
   - ✓ Disclose:
     - Corporate financing or market making relationship;
     - Security holding
     - Directorship
     - Individual relationship
   - ✓ Should also disclose fee arrangements, sub-advisory arrangements or situations involving non-standard fee structures. Equally important is to disclose arrangements in which the firm benefits directly from recommendations.

Standard VI(A): Guidance

- **Guidance**

8. Cross-Departmental Conflicts
   - ✓ Broker-sponsored limited partnerships to invest venture capital.
     - ☐ Conflicts exist because not only to follow issues after IPO, but also to promote in the secondary market.
9. Conflicts with Stock Ownership
   - ✓ **May** prohibit from owning any such securities → overly burdensome.
   - ✓ Sell-side disclose <u>ownership</u> in stock recommended, buy-side disclose <u>procedures for reporting</u> requirements for personal transactions.
10. Conflicts as a Director
    - ✓ Duties owed to clients and to shareholders of the company
    - ✓ Investment personnel as a director receive the securities or options
    - ✓ Board service receiving MNI

Standard VI(A): Recommended Procedures

- **Recommended Procedures**

11. Disclosure of performance arrangement
    - ✓ Firms are encouraged to include information on compensation package in firms' promotional literature.
    - ✓ If fee based on capital gains or capital appreciation (performance fee), ***should disclose;***
    - ✓ If outstanding options exist for incentives, should disclose the **amount and expiration date** of these options as a footnote to any research report published.
12. Incentive fees should not be in conflict with the interests of clients'.
    - ✓ If Yes, should disclose to clients;
    - ✓ If employer not permit disclosure, should dissociate, or ***quit*** the job.

Standard VI(A): Case 1-3

- **Case 1 (conflicts of interest and business relationships):** Weiss is writing a research report on Vimco, a client of his firm's M&A department Weiss's colleagues sit on the board of directors of Vimco subsidiaries.
  - **Comment:** Weiss must disclose in his research report the special relationship between his firm and Vimco.
- **Case 2 (conflicts of interest and business stock ownership):** DR, an investment management firm, sells a 25% interest in its partnership to FNY. Immediately after the sales, the president of DR changes her recommendation of FNY from sell to buy and adds FNY commercial paper on the firms approved list for purchase.
  - **Comment:** The president must disclose the new relationship with FNY.
- **Case 3 (conflicts of interest and personal stock ownership):** Fargmon, a research analyst, has been recommending Kincaid because of its innovative new copier. As he is asked to write a follow-up report on Kincaid, his wife inherits $3 million of Kincaid stock.
  - **Comment:** Fargmon must disclose his wife's ownership of the Kincaid stock to his employer and in his follow-up report.
  - **Best practice**: Ask the firm to assign another analyst to follow-up.

Standard VI(A): Case 4-5

- **Case 4 (conflicts of interest and personal stock ownership):** Robert buys 100,000 shares of D. Mining. She intends to sell these shares at the sign of any substantial upward price movement. Then she is asked to write a report on the stocks in the mining industry. Even without owning the stocks, Robert would recommend D. Mining as a "buy" in the report. And the stock market price would go up once issued.
  - **Comment:** Robert must disclose the ownership of the D. Mining stocks in the report and to her employer before writing the report because she would probably gain once she sells them.
- **Case 5 (conflicts of interest and compensation arrangement):** Dyson is managing pension funds with long term objectives. After his employer introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance, Dyson changes his strategy and buys high beta stocks which are seemingly contrary to the client's IPS to boost short term performance without changing the IPS.
  - **Comment:**
    - ✓ Dyson violated Standard VI(A)-disclosure of conflicts by failing to inform her clients of the changes in her compensation arrangement that created a conflict of interest.

Standard VI(A): Case 6

- **Case 6 (conflicts of interest and options and compensation arrangement):** Wayland Securities often takes agent options for undertaking small issues to compensate relatively small fees. Hunter, the head of Wayland, worries about the agent option for FRL, a small IPO client, will expire with no profit. She indicates Fitzpatrick, an analyst at research department, that he is eligible for 30% of the option and now would be a good time to give some additional coverage to FRL. Fitzpatrick agrees and immediately issues a favorable report.
  - **Comment:** Fitzpatrick must disclose in the report the volume and the expiration date of the option as well as the additional compensation he receives personally.

Standard VI(A): Case 7

- **Case 7 (conflicts of interest and compensation arrangement):** Carter is approached by a stock promoter for BC company, who offers to pay Carter additional compensation for sales of BC's stock. <u>Carter accepts the offer but does not disclose this to his clients and employer.</u> Carter sells BC stocks to his clients.
    - **Comment:** Carter violated Standard VI(A)-disclosure of conflicts by failing to disclose the additional compensation to his clients and employer, this conflict of interest would interfere his independence and objectivity.

Standard VI(A): Case 8

- **Case 8 (Conflict of Interest and Requested Favors)：**Michael Papis is the chief investment officer of his state's retirement fund which uses outside advisers for the real estate. He decides to change the outside adviser to his business school classmate Nagle who runs an asset management company and is searching for retirement fund's allocation. And the notice of change will be known in the next annual report.
  - **Comment:** Papis has violated Standard VI(A)-disclosure of conflicts by not disclosing to his employer his **personal relationship** with Nagle. This information would help his firm identify his independence and diligence in deciding to change managers.
  - Violating **IV(C)-Supervisory Responsibility, V(A)-Diligence and Reasonable Basis, VI(A)-Disclosure of Conflicts, VI(B)-Communication with Clients and Prospective Clients.**

Standard VI(A): Case 9

- **Case 9 (Conflict of Interest and Business Relationships)** Wade, a trust manager for a bank, is offered by W Fund a service fee to promote their funds. He asked another manager to do due diligence of W and concluded the funds were fairly valued. So Wade accepted W's offer and exclusively promoted its funds to clients. He did not disclose the fee and allowed the income flow directly to the bank.
  - **Comment:** Wade is violating VI(A)-disclosure of conflicts <u>by not disclosing the portion of the service fee</u>. The manger and clients would not know his decision to highly recommend W's funds without information of the fee offer. Besides, the bank would probably rely on W's fund service fee and may be hesitate to offer other products.
  - **Also Violating I(B)-Independence and Objectivity.**

Example

Disclosure of conflicts

- Jasmine is a junior research analyst in H&H, a brokerage and investment banking firm. H&H's mergers and acquisitions department has represented the Company ABC in all of its acquisitions for the past 10 years. Two of Howard & Howard's senior officers are directors of various ABC subsidiaries. Jasmine has been asked to write a research report on ABC. What is the best course of action for her to follow?

  A. Jasmine may write the report but must refrain from expressing any opinions because of the special relationships between the two companies.

  B. Jasmine should not write the report because the two H & H officers serve as directors for subsidiaries of ABC.

  C. Jasmine may write the report if she discloses the special relationships with the company in the report.

Disclosure of conflicts

- Correct Answer: C.
  - The correct answer is C. This question involves Standard VI(A)-Disclosure of Conflicts. The question establishes a conflict of interest in which an analyst, Jasmine, is asked to write a research report on a company that is a client of the analysts' employer. In addition, two directors of the company are senior officers of Jasmine's employer. Both facts establish that there are conflicts of interest that must be disclosed by Jasmine in her research report.
  - An analyst is permitted to write a report simply because of the special relationship the analysts' employer has with the company as long as that relationship is disclosed.
  - Whether or not Jasmine expresses any opinions in the report is irrelevant to her duty to disclose a conflict of interest. Not expressing opinions does not relieve the analyst of the responsibility to disclose the special relationships between the two companies.

Summary

Guidance for Standards I–VII

VI(A).Disclosure of conflicts

To employers, to clients

Conflict of Cross-department, ownership of stock, as director

VI(B).
Priority of transactions

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

I. Professionalism	(A) Knowledge of the law; (B) Independence and objectivity; (C) Misrepresentation; (D) Misconduct.
II. Integrity of Capital Markets	(A) Material nonpublic information; (B) Market manipulation.
III. Duty To Clients	(A) Loyalty, prudence and care; (B) Fair dealing; (C) Suitability; (D) Performance presentation; (E) Preservation of confidentiality.
IV. Duty To Employers	(A) Loyalty; (B) Additional compensation arrangements; (C) Responsibility of supervisors.
V. Investment	(A) Diligence and reasonable basis; (B) Communication with clients; (C) Record retention.
VI. Conflicts of Interest	(A) Disclosure of conflicts; (B) Priority of transaction; (C) Referral fees.
VII. Responsibility as Members	(A) Conduct as members and candidates; (B) Reference to CFA institute, designation.

Standard VI(B): Content

- **Content:**

1. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is <u>the beneficial owner,</u> which means transactions that ultimately benefit Member or Candidate.

Standard VI(B): Guidance

- **Guidance**
  2. Client > employer > individual
     - ✓ Individual - beneficial owner.
  3. <u>After 7 minutes, buy, it's a violation</u>. Must have enough time to let clients have opportunities to respond to your recommendation.
- **Guidance - <u>Avoiding Potential Conflicts</u>**
  4. Conflicts between the client's interest and an investment professional's personal interest may occur.
  5. Although conflicts of interest exist, it's OK for individual managers, advisers, or fund employees <u>making money from personal investments as long as</u>
     - ✓ The client is not disadvantaged by the trade,
     - ✓ The investment professional does not benefit personally from trades undertaken for clients,
     - ✓ Comply with applicable regulatory requirements

     For example, trading contrary to recommendation due to payment of college tuition, down payment of house, or margin call, etc.
- **Guidance - <u>Personal Trading Secondary to Trading for Clients</u>**
  6. Clients and employers have priority over trades in which a member or candidate is the <u>beneficiary owner</u>.
  7. Some clients in certain investment situations require investment personnel to have <u>aligned interests</u>. But <u>mustn't adversely affect</u> client investment.

Standard VI(B): Guidance

- **Guidance - Standards for Nonpublic Information**

8. Prohibit from conveying nonpublic information to any person **whose relationship to the member or candidate makes him a beneficial owner of the person's securities**. Must not convey this information to any other person if the nonpublic information can be deemed material.

- **Guidance - Impact on All Accounts with Beneficial Ownership**

9. Personal transactions include those for own account, for family (including immediate family members) accounts, and for accounts of direct or indirect pecuniary interest, such as a trust or retirement account.
10. Family accounts that are client accounts should be treated like any other firm account, should not be disadvantaged because of that relationship.
    - ✓ Disadvantage parents who are normal fee-paying clients: violate III (B) fair dealing
11. If have beneficial ownership in the account, may be subject to preclearance or reporting requirements of the employer or applicable law.

Standard VI(B): Recommended Procedures

- **Recommended Procedures:**

12. Basic procedures:

- ✓ ***Limited participation in equity IPOs;***
- ✓ Restrictions on private placement;
- ✓ ***Establish blackout/restricted periods;***
- ✓ Should have reporting procedures for investment personnel, including:
  - Disclosure of personal holdings/beneficial ownerships at least annually
  - Duplicate copies or confirmations of trades from brokers
  - Preclearance procedures.
- ✓ ***Disclosures of policies regarding personal investing***

Standard VI(B): Case 1-2

- **Case 1 (personal trading):** Long, a research analyst, postponed his recommendation of buying a stock for the firm as he could buy first for his personal account.
  - **Comment:** Long violated Standard VI(B)-priority of transactions by taking advantage of his knowledge of the stock's value before his employer.
- **Case 2 (trading for family member account):** Baker maintains an account in her husband's name with her individual clients and when allocating shares in hot issues, she acquires for her husband's account first and then her clients if possible.
  - **Comment:** It's a violation; Baker must acquire shares for the clients first and for her husband's account only after dong so and should disclose her personal trading to all interested parties.

Standard VI(B): Case 3-4

- **Case 3 (personal trading and disclosure):** Michaels is leading a luxury life with a low paying job as an investment staff serving both the research depart. and the investment management depart. The director of the company investigates and discovers that Michaels has made **front running** trading based on firms recommendations. Michaels declined to complete his quarterly personal transaction form.
  - **Comment:**
    - ✓ Michaels violated Standard VI(B)-priority of transactions by placing personal trading ahead of client transactions.
    - ✓ And his supervisor violated Standard IV(C)-responsibilities of supervisors for having not prevented this.
    - ✓ Michaels would violate Standard II(A)-material nonpublic information if he communicated material information before being public about the firm's recommendation to others.

- **Case 4 (trading prior to report dissemination):** Seven minutes after informed the sell recommendation for a stock in an in-house meeting, Riley closes out a deal.
  - **Comment:** Riley exploited the sell recommendation and did not give customers the opportunity to act before the firm itself did. It's a violation.

Standard VI(B): Case 5

- **Case 5 (Family accounts as equal):** Toffler, a portfolio manager at Esposito, manages retirement account established with the firm by her parents. Whenever IPOs is available, she first allocates shares to all her other clients for whom the investment is appropriate; <u>only then</u> does she place remaining portion in her parents' account if the issue is appropriate for them. She did so that no body could blame her of favoring her parents.
  - **Comment:** As fee-paying clients, Toffler's parents are entitled to the same treatment as other clients. So, Toffler has violated Standard VI(B)-priority of transactions.

Example

Priority of transaction

- Teresa Avila, CFA, is a micro cap investment analyst at a hedge fund. The fund requires Avila to hold any securities she recommends for the fund in her own account as well. Because Avila has such a small account, whenever she trades for her own portfolio she combines the transactions with those of the hedge fund so she is sure to have her account aligned with the fund. Has Avila most likely violated any CFA Institute Standards of Professional Conduct?

  A. No.

  B. Yes, related to Misconduct.

  C. Yes, related to Priority of Transactions.

Example

Priority of transaction

- Correct Answer: C.
  - C is correct as Standard VI(B) requires that investment transactions for clients and employers have priority over transactions in which members have beneficial ownership. By executing her own accounts transactions with those of the hedge fund the analyst has violated this Standard as micro cap securities can be thinly traded and easily influenced by changes in the volume of activity. So the analyst may benefit when she combines her transactions with the hedge funds and she should let the fund execute its orders before she makes changes to her account.
  - A is incorrect because the Priority of Transactions Standard has been violated.
  - B is incorrect because this Standard has not been violated.

Example

Priority of transaction

- Kate Wilson, CFA, is an equity analyst. Wilson enters two transactions for her personal account. Wilson sells 500 shares of Tibon, Inc., a stock on which her firm currently has a "Buy'' recommendation. Wilson buys 200 shares of Hayfield Co. and the following day issues a research report on Hayfield with a "Buy" recommendation. Has Wilson violated the Code and Standards?

  A. No.

  B. Yes, both of her actions violate the Code and Standards.

  C. Yes, but only one of her actions violates the Code and Standards.

- Correct Answer: C.
  - Only one of these transactions is a violation. Standard VI(B) Priority of Transactions requires members and candidates to give clients an adequate opportunity to act on a recommendation before trading for accounts in which the member or candidate has a beneficial ownership interest.
  - Members and candidates may trade for their own accounts as long as they do not disadvantage clients, benefit personally from client trades, or violate any regulations that apply. The Standard does not prohibit members and candidates from entering personal transactions that are contrary to what their firms are recommending for clients, as long as the transaction does not violate any of these criteria.

Summary

Guidance for Standards I–VII

VI(B).Priority of transactions

Not self-benefit firstly

Clients>employer>personal

Family client is client.

VI(C).
Referral fees

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

Standard VI(C): Content & Guidance

- **Content:**

1. Members and Candidates must disclose to **all** 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 **in advance**.

- **Guidance**

2. Such disclosure will allow the client or employer to evaluate
   - ✓ **<u>Any partiality</u> shown in any recommendation of services**
   - ✓ **The <u>full cost</u> of the service.**
3. Disclose nature of consideration.
   - ✓ For example, flat fee or percentage basis, one-time or continuing benefit, based on performance, benefit in form of research or other noncash benefit, together with the estimated dollar value.
   - ✓ **Consideration** includes all fees, whether in cash , in soft dollar, or in kind.

Standard VI(C): Recommended Procedures

- **Recommended Procedures**
  - Encourage employers to develop procedures for referral fees.
  - Firm ***may completely restrict*** such fees; if not restrict, should indicate the appropriate steps for requesting approval.
  - Employers should have investment professionals provide to the clients notification of approved referral fee programs and provide the employer regular ***(at least quarterly)*** updates on the amount and nature of compensation received.

Standard VI(C): Case 1

- **Case 1 (disclosure of referral arrangements and outside parties):** BSI, a broker, enters a referral arrangement with LBL, a consulting firm. BSI directs certain prospective accounts to LBL in exchange for research service and commission business. Maxwell Inc., contacts White, a partner at LBL, and says they want him to serve as an investment manager for their employee profit-share plan by the recommendation of Harold at BSI. White accepted but did not disclose the referral arrangement.
  - **Comment:** White violated Standard VI(C)-referral fees by failing to inform the client the **referral fee** payable in services and commissions to BSI. Such disclosure could have caused Maxwell to reassess this plan and make a critical evaluation of LBL services.
  - **Violating VI(C) –Referral fees → VI(A) Disclosure of Conflicts →I(C)-Independence and Objectivity.**

Standard VI(C): Case 2

- **Case 2 (disclosure of interdepartmental referral arrangements):** Handley works for the trust dept. at CTB and receives compensation for each referral he makes to brokerage dept. and the personal management dept. at CTB. He refers several clients to personal management dept. and does not disclose the referral arrangement.
  - **Comment:** Handley has violated Standard VI(C)-referral fees by failing to disclose the referral arrangement even within the firm. Standard VI(C)-referral fees does not distinguish between fees received from a third party or within the firm.

Standard VI(C): Case 3

- **Case 3 (disclosure of referral arrangements and informing firm):** Katherine Roberts, a portfolio manager at KI managing assets for high-net-worth individuals, directs a large portion of its commissions to her alumni's firm, NI, which provides not-so-useful research reports. In return, NI recommends the investment services of Roberts to its wealthiest clients. This arrangement is <u>not disclosed to either KI or the clients referred by NI</u>.
    - **Comment:** Roberts violated Standard VI(C)-referral fees by failing to inform her employer of the referral arrangement.

Standard VI(C): Case 4

- **Case 4 (Disclosure of Referral Arrangements and Outside Organizations)** Burl works as a portfolio manager at HI as well as a membership of advisory board of his child's school, which is seeking to raise money for new facilities. Burl discusses a plan with his HI supervisor and school's board to donate a portion of his service fee from clients referred by parents and gets approval by both parties. Burl establishes the IPS in which his plan is clearly discussed including the referral fees and receives referrals after distribution of IPS.
    - **Comment**: Burl has not violated Standard VI(C)-referral fees because he secured the permission of his employer, HI, and the school prior to beginning the program and because he discussed the arrangement with the client at the time the IPS was designed.

Standard VI(C): Case 5

- **Case 5 (Disclosure of Referral Arrangements and Outside Parties)** Arrow is contracted by the sponsor of a pension to select the most appropriate new manager for the pension. Overseas Investments is selected and produces excellent performance. Arrow is found accepting kickbacks from Overseas Investments and other managers. The sponsor conducts an independent review and confirms the recommendation of Overseas Investments is objective and appropriate despite the fees paid to Arrow.
  - **Comment:** <u>Arrow has violated Standard VI(C)</u>-referral fees for not disclosing the fee being paid by Overseas Investments. Thus raises the question of a potential lack of objectivity in the recommendations.

Example

Referral fees

- Fred Brubacher, CFA, is an analyst at Van City Bank (VCB). Brubacher receives compensation for referrals to the banks brokerage and personal financial-planning divisions. His recent referrals are long-time clients from his previous employer, and Brubacher does not mention VCB's referral arrangement. Does Brubacher violate any CFA Institute Standards?

  A. No

  B. Yes, with respect to misrepresentation

  C. Yes, with respect to conflicts of interest

- Correct Answer: C.
  - Compensation or other benefits received for the recommendation of products or services represents a conflict of interest. According to the Standards, Brubacher must disclose the referral fee arrangement.

Summary

Guidance for Standards I–VII

VI(C).Referral fees

all their employer, clients, and prospective clients in advance

VII(A).
Conduct as members and candidate

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard VII(A): Content

- **Content:**

1. 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 the CFA Institute programs.

Standard VII(A): Guidance

- **Guidance:**

2. Standard VII(A) covers the conduct of CFA Institute members and candidates involved with the CFA Program and **prohibits** any conduct that undermines the public's confidence that the CFA charter represents a level of achievement based on merit and ethical conduct.
3. Conduct covered includes but is not limited to
   - ✓ Giving or receiving assistance (cheating) on any other CFA Institute examination;
   - ✓ Violating the rules and policies of the CFA Program related to exam administration;
   - ✓ Providing confidential program or exam information to candidates or the public;
   - ✓ Disregarding or attempting to circumvent security measures established by CFA Institute for the CFA exam;
   - ✓ Improperly using an association with CFA Institute to further personal or professional goals;
   - ✓ Misrepresenting information on the Professional Conduct Statement or in the CFA Institute Continuing Education Program.

Standard VII(A): Guidance

- **Guidance - Confidential Program Information**

4. CFA Institute is vigilant about protecting the integrity of the CFA Program content and examination process and prohibits candidates from disclosing confidential material gained during the exam process.

- **Guidance - Additional CFA Program Restrictions**

5. Violating any of the testing policies, such as the calculator policy, personal belongings policy, or the Candidate Pledge, constitutes a **violation of Standard VII(A).**

- **Guidance - Expressing an Opinion**

6. Expressing opinions regarding the CFA Program or CFA Institute is OK.

Standard VII(A): Case 1

- **Case 1. (Sharing Exam Questions)** Nero serves as a proctor in the CFA exam, she reviews a copy of the Level II exam on the evening prior to the exam's administration and provides information concerning the exam questions to two candidates who use it to prepare for the exam.
  - **Comment**: Standard VII(A)-conduct as members and candidates prohibits members from disclosing and/or soliciting confidential material gained prior to or during the exam. All of the three compromised the integrity and validity of the Level II exam and undermined the ethical framework.

Standard VII(A): Case 2

- **Case 2. (Bring Written Material into Exam Room)** Prior to entering the Level II CFA exam room, Sullivan <u>writes the formula on the palm of his hand</u>. During the afternoon section of the exam, a proctor notices Sullivan looking at the palm of his hand. She asks to see his hand and finds the formula to be readable.
    - **Comment**: Sullivan's conduct compromised the validity of his exam performance and violated Standard VII(A)-conduct as members and candidates. Sullivan's conduct was also in direct contradiction of the rules and regulations of the CFA Program, the Candidate Pledge, and the CFA Institute Code and Standards.

Standard VII(A): Case 3

- **Case 3. (Writing after Exam Period End)** At the conclusion of the morning section of the Level I CFA examination, The proctors announce that all candidates are to stop writing immediately. John Davis continues to randomly fill in ovals on his answer sheet. He keeps writing under the first warning and finally puts down after proctor's second request.
  - **Comment**: By continuing to complete his exam after time was called, Davis has violated Standard VII(A)-conduct as members and candidates. His conduct is an unfair advantage over other candidate and compromised the integrity and validity of the exam.

Standard VII(A): Case 4

- **Case 4. (Sharing Exam Content)** After completing the Level II CFA exam, Rossi writes the following in her blog "It was really difficult, but fair. I think I did especially well on the derivatives questions. And there were tons of them! I think I counted 18! The ethics questions were really hard. I'm glad I spent so much time on the Code and Standards. I was surprised to see there were no questions at all about IPO allocations. I expected there to be a couple."
  - **Comment**: Rossi did not violate Standard VII(A)-conduct as members and candidates when she wrote about how difficult she found the exam or how well she thinks she may have done. By revealing portions of the CBOK covered on the exam and areas not covered, however, she did violate Standard VII(A)-conduct as members and candidates and the Candidate Pledge.

Standard VII(A): Case 5

- **Case 5. (Sharing Exam Content)** The week after completing the Level I examination, Gagne and several others begin a discussion thread on the forum about the most challenging questions and attempt to determine the correct answers.
  - **Comment:** Gagne has violated Standard VII(A)-conduct as members and candidates by providing and soliciting confidential exam information. The group's discussion included question-specific details considered to be confidential to the CFA Program.

Standard VII(A): Case 6

- **Case 6. (<u>Sharing Exam Content</u>)** The day after the CFA examination, CFA4Sure sends an e-mail to all its customers asking them to share with the company the hardest questions from the exam. Marisol Pena e-mails a <u>summary of the questions she found most difficult on the exam</u>.
  - **Comment**: Pena has violated Standard VII(A)-conduct as members and candidates by disclosing a portion of the exam questions. If the CFA4Sure employees who participated in the solicitation of confidential CFA Program information are CFA Institute members or candidates, they also have violated Standard VII(A)-conduct as members and candidates.

Standard VII(A): Case 7

- **Case 7. (Discussion of Exam Grading Guidelines and Results)** Prior to grading CFA examinations, Wesley Whitcomb signs a CFA Institute Grader Agreement not to reveal or discuss the exam materials with anyone outside. After finishing grading, he tells his friends who are candidates in the program which question he graded, discusses the answer and adds that few candidates scored well on the question.
  - **Comment:** Whitcomb violated Standard VII(A)-conduct as members and candidates by breaking the Grader Agreement and disclosing information related to a specific question on the exam, which compromised the integrity of the exam process.

Standard VII(A): Case 8

- **Case 8. (Compromising CFA Institute Integrity as a Volunteer)** Jose Ramirez is a investor-relations consultant for small companies that are seeking greater exposure to investors. He is also the program chair for the CFA Institute society in the city where he works. <u>Ramirez schedules only companies that are his clients to make presentations to the society and excludes other companies</u>.
  - **Comment:** Ramirez, by using his volunteer position at CFA Institute to benefit himself and his clients, compromises the reputation and integrity of CFA Institute and thus violates Standard VII(A)-conduct as members and candidates.

Standard VII(A): Case 9

- **Case 9. (Compromising CFA Institute Integrity as a Volunteer)** As a member of the CFA Institute GIPS Executive Committee, Marguerite Warrenski has advance knowledge of confidential information regarding the GIPS standards including any new or revised standards the committee is considering. <u>She tells her clients that her Executive Committee membership will allow her to better assist her clients in keeping up with changes to the Standards and facilitating their compliance with the changes</u>.
  - **Comment:** Warrenski is using her association with the GIPS Executive Committee to promote her firm’s services to clients and potential clients. She implies that she can take advantage of confidential information to further clients’ interest which compromise the reputation and integrity of the CFA institute.

Conduct as members and candidates

- A and B finished the CFA exam and meet at the gate. A said “Most candidates spent a much longer time than recommended by CFA Institute”. B said “I’m surprised to see that the Black-Scholes-Merton model is not covered this time.” Who most likely violate the CFA code and standards?

  A. Only A violate

  B. Only B violate

  C. Both

- Correct Answer: B.
  - A does not violate the standards by just disclosing that the time spent is only much longer that recommended by CFA institute. However, she violates the standards by disclosing the formula appeared on the exam.

Summary

Guidance for Standards I–VII

VII(A).Conduct as members and candidates

No specific exam content, opinion is ok.

VII(B).
Reference to institute, designation, program

- Content
- Guidance
- Recommend practices and procedures
- Case study

Guidance for Standards I-VII

Standards

- **I. Professionalism**
  - (A) Knowledge of the law;
  - (B) Independence and objectivity;
  - (C) Misrepresentation;
  - (D) Misconduct.
- **II. Integrity of Capital Markets**
  - (A) Material nonpublic information;
  - (B) Market manipulation.
- **III. Duty To Clients**
  - (A) Loyalty, prudence and care;
  - (B) Fair dealing;
  - (C) Suitability;
  - (D) Performance presentation;
  - (E) Preservation of confidentiality.
- **IV. Duty To Employers**
  - (A) Loyalty;
  - (B) Additional compensation arrangements;
  - (C) Responsibility of supervisors.
- **V. Investment**
  - (A) Diligence and reasonable basis;
  - (B) Communication with clients;
  - (C) Record retention.
- **VI. Conflicts of Interest**
  - (A) Disclosure of conflicts;
  - (B) Priority of transaction;
  - (C) Referral fees.
- **VII. Responsibility as Members**
  - (A) Conduct as members and candidates;
  - (B) Reference to CFA institute, designation.

Standard VII(B): Content

- **Content:**

1. When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must <u>not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program</u>.

Standard VII(B): Guidance

- **Guidance**

2. How to use CFA:
   - ✓ adj, not n.
   - ✓ Always capitalized.
   - ✓ CFA level Ⅰ ×
   - ✓ C.F.A ×
   - ✓ Pseudonyms or online profile names created to hide identity should not be tagged with CFA designations.
   - ✓ Mustn’t cite the expected date of exam completion and award of charter.
3. A candidate who has passed level III but has not received charter can’t use CFA designation.
4. In citing the designation in a resume, a charterholder should use the date that he or she received the designation and should cite CFA institute as the conferring body.
   - ✓ **Example：**CFA, 2001, CFA Institute（optional Charlottesville, Virginia, USA）

Standard VII(B): Guidance

- **Guidance**

6. It's only appropriate to use CFA logo <u>on the business card or letterhead of each individual</u> CFA charterholder. Candidates can mention in their C.V.
7. The order of CFA and CPA doesn't matter.

- **Guidance – CFA Institute membership**

8. Once accepted as a member, must satisfy the followings to maintain status:
   - ✓ <u>Remit annually to CFA Institute a complete Professional Conduct Statement.</u>
   - ✓ <u>Pay membership dues annually.</u>

- **Guidance – Using CFA Designation**

9. If a charterholder fails to meet membership requirements, he forfeits the right to use CFA designation. Until membership is reactivated, can only state that they were charterholders in the past.

Standard VII(B): Guidance

- **Guidance – Referring to candidacy**

10. When can you state yourself as a candidate?
    - ✓ After receiving registration acceptance letter by CFA Institute
    - ✓ Before exam results have been received
11. If a candidate passes each level of the exam on the first try and wants to state that he or she did so, that is not a violation because it is <u>a statement of fact</u>,
    - ✓ But <u>must not o</u>ver-promise the competency and future investment results

Standard VII(B): Recommended Procedures

- **Recommended Procedures**
  - Should disseminate written information and the accompanying guidance to legal, compliance, public relations, and marketing departments.
  - Should encourage firms to create templates that are approved by a central authority (such as the compliance department) as being consistent with VII(B).

Standard VII(B): Case 1-2

- **Case 1. (Passing Exams in Consecutive Years)** An advertisement for AZ Investment Advisors states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.
  - **Comment:** AZ may state that all principals passed the three examinations on the first try as long as this statement is true, but it must not be linked to performance or imply superior ability.

- **Case 2. (Right to Use CFA Designation)** Five years after receiving CFA charter, Louis Vasseur resigns his investment position. He does not file a completed Professional Conduct Statement and does not pay his CFA Institute membership dues. He starts a new business and prints business cards that display "CFA" after his name.
  - **Comment:** Vasseur has violated Standard VII(B)-reference to CFA institute, designation because his right to use the CFA designation was suspended when he failed to file his Professional Conduct Statement and stopped paying dues.

Standard VII(B): Case 3-4

- **Case 3. ("Retired" CFA Institute Membership Status)** James Simpson retires from his firm. He does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. Simpson designs a plain business card (without a corporate logo) and he continues to put "CFA" after his name.
  - **Comment:** Simpson has violated Standard VII(B)-reference to CFA institute, designation because he failed to file his Professional Conduct Statement and ceased paying dues, his membership has been suspended and he must give up the right to use the CFA designation.
- **Case 4. (CFA Logo-Individual Use Only)** Asia Futures Ltd is a small quantitative investment advisory firm. The firm takes great pride in the fact that all its employees are CFA charterholders. To underscore this fact, the firm's senior partner is proposing to change the firm's letterhead to include the following:

Asia Futures Ltd. CHARTERED CFA FINANCIAL ANALYST®

  - **Comment:** The CFA Logo is a certification mark intended to identify *individual* charterholders and must not be incorporated in a company name.

Standard VII(B): Case 5-6

- **Case 5. (Stating Facts about CFA Designation and Program)** Rhonda Reese has been a CFA charterholder since 2000. She tells a friend who is considering enrolling in the CFA Program that she has learned a great deal from the CFA Program and that many firms require their employees to be CFA charterholders. She would recommend the CFA Program to anyone pursuing a career in investment management.
  - **Comment:** Reese's comments comply with Standard VII(B)-reference to CFA institute, designation. Her statements refer to facts: The CFA Program enhanced her knowledge, and many firms require the CFA designation for their investment professionals.
- **Case 6. (Order of Professional and Academic Designations)** Tatiana Prittima has earned both her CFA designation and a PhD in finance. She would like to cite both her accomplishments on her business card but is unsure of the proper method for doing so.
  - **Comment:** The order of designations cited on such items as resumes and business cards is a matter of personal preference. Prittima is free to cite the CFA designation either before or after citing her PhD.

Standard VII(B): Case 7

- **Case 7 (Use of Fictitious Name)** Barry Glass is a lead quantitative analyst and is responsible for the development of proprietary fund models. He reads one blog run by Expert CFA and is intrigued by the research. So he incorporates some factors from the blog into the fund models to recommend several new investments.
  - **Comment:** “Expert CFA” has violated Standard VII(B)-reference to CFA institute, designation by using the CFA designation inappropriately. Charterholder should not attach the CFA designation to anonymous or fictitious names meant to conceal their identity.
  - As with any research report, authorship of online comments must include the charterholder’s full name along with any reference to the CFA designation.

Example

Reference to CFA institute, designation

- Jenny passed the Level I CFA examination in 2008 and the Level II examination in 2013. For the level III examination, he is not currently enrolled. Which of the following is the most appropriate way for Jenny to refer to his participation in the CFA Program based on the CFA Institute Standards of Professional Conduct,?

  A. Candidate in the CFA Institute CFA Program.

  B. Passed Level II of the CFA examination in 2013.

  C. Jeffrey Jones, CFA (expected 2014).

- Correct Answer: B.

  - No designation exists for someone who has passed Level I, Level II, or Level III of the CFA exam, see Standard VII(B). Persons who have passed a certain level of the exam may state that they have completed that level. A person can state he is a candidate only if he is currently enrolled in the CFA Program. It is also an improper reference to use "expected" a part of the designation.

Contrast between Some Similar Standards

- **1 : I(C) Misrepresentation, III(D) performance Presentation, V(B) Communication with clients**
  - I(C) focuses on performance presentation, so guarantee the investment performance with volatile return, misrepresentation of service and qualification, and plagiarism violate this standard.
  - III(D) focuses on the statement of performance to clients, so the misleading statement concerning performance, including give clients the hint that they can earn the historical yield, violate this standard
  - V(B) focuses on disclosing the member's own changes for clients, letting clients know their information, and differenciating between fact and opinion
- **TIPS**
  - **VI(A) → IV(B) , VI(A) →I(B)**
  - III(D) →I(C)

Contrast between Some Similar Standards

Contrast between some similar standards

I(C) Misrepresentation	没有及时改正的打字错误；不实陈述；抄袭
III(D) Performance presentation	过去业绩不可以暗示未来；业绩简报可以但必须有详细信息支持；GIPS的一些原则
V(B) Communication with Clients and Prospective Clients	区分事实与意见； 向客户披露投资流程中重大因素的变化；明确分析中的局限性和风险

Contrast between Some Similar Standards

- **2 : III(B) Fair dealing, VI(B) Priority of Transactions**
  - III(B) focuses on constraining the fairness of the order of transaction between <u>clients</u>
  - VI(B) focuses on the order of transaction among <u>clients, individuals and employers</u>

- **3 : IV(B) Additional compensation arrangement, VI(A) Disclosure of Conflicts**
  - IV(B) focuses on disclosing the additional compensation <u>from clients and the third-party to the employer</u>
  - VI(A) focuses on disclosing the possible interest conflict to <u>clients and public</u>, so that clients can have right judgments

Contrast between Some Similar Standards

- **Contrast between some similar standards**

III(B) Fair Dealing	客户之间要一视同仁
VI(B) Priority of Transactions	客户>雇主>个人

IV(B) Additional Compensation Arrangements	为雇主的利益
VI(A) Disclosure of conflicts	主要是为客户及公众的利益

Summary

Guidance for Standards I–VII

VII(B).Reference to institute, designation, program

Factual statement, right to use the designation

Summary

Module: Guidance for Standards I–VII

I. Professionalism; II. Integrity of Capital Markets;

III. Duty To Clients; IV. Duty To Employers; V. Investment;

VI. Conflicts of Interest; VII. Responsibility as Members

Module

Introduction to the Global Investment Performance Standards (GIPS)

1. Introduction to the Global Investment Performance Standards (GIPS)

Introduction to GIPS

- The reason of the creation of the GIPS standards, the entities of compliance, and the parties benefited from compliance
- The composites in performance reporting
- The fundamentals of compliance
- The concept of independent verification

Introduction to GIPS

I.I Why were the GIPS Standard created?

- **GIPS are a set of ethical principles based on a standardized, industry-wide approach**
- **Misleading practices that hinder performance comparability:**
  - Representative accounts: showing a top-performing portfolio as representative of a firm's result.
  - Survivorship Bias: excluding "weak performance" accounts that have been terminated.
  - Varying Time Periods: showing performance for selected time periods with outstanding returns.

Introduction to GIPS

I.II. Who can claim compliance

- **Complying with the GIPS standards is voluntary**
- **Any firms that actually manage assets can claim compliance with the Standards.**
  - Consultants → can't claim compliance unless actually manage assets.
  - Software (and vendor of software) cannot be compliant → can assist firms in compliance with GIPS
- **Asset owners** may comply with the GIPS standards in the same way as firms if they **compete for business**. If they don't compete for business but report their performance to an oversight body, asset owners may choose to comply with the GIPS standards for asset owners.
- **Firm-wide and full compliance**
  - Can't be achieved on a single product or composite.
  - Two options: (1) Fully comply with all requirements; (2) Not comply with all requirements and not claim compliance

Introduction to GIPS

I.III. Who benefits from compliance?

- **Benefit 3 groups: asset managers, prospective clients and asset owners and their oversight bodies.**
- **For firms:**
  - Can assure prospective clients that their track record is complete and fairly presented;
  - Able to participate in competitive bids against other compliant firms throughout the world;
  - Strengthen firm’s internal control over performance-related processes.
- **For investors:**
  - Have greater confidence in the integrity of performance presentation of a compliant firm, and can easily compare performance presentation from different firms.
  - Compliance enhances the credibility of firms.
- **For asset owners and their oversight bodies:**
  - Report to the oversight body using the same principles facilitates the understanding of the sources of risk and excess return in the funds under supervision.

Introduction to GIPS

II. Composites

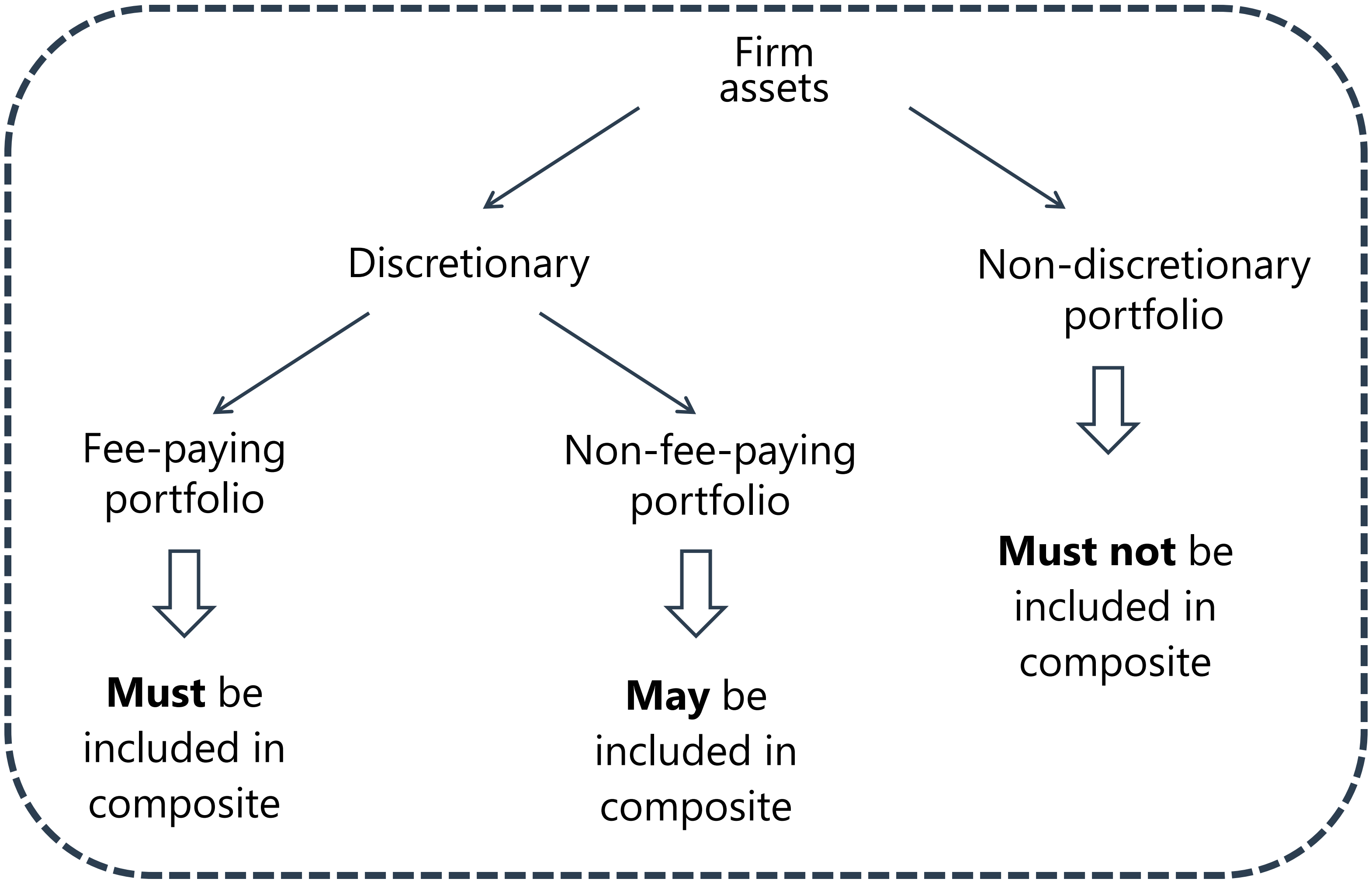
- A composite is a grouping of individual discretionary portfolios representing a similar investment strategy, objective, or mandate.
- A composite, such as Global Equities, must include all fee-paying portfolios (current and past) that the firm has managed in accordance with this particular strategy.
- **The firm should identify which composite each managed portfolio is to be included in before the portfolio's performance is known.**
  - This prevents firms from choosing portfolios to include in a composite in order to create composites with superior returns.

Introduction to GIPS

III. Fundamentals of compliance

- **Firm-wide basis**
  - Compliance **cannot** be achieved on a single product or composite.
- **Two important issues** that a firm must consider when becoming compliant with the GIPS standards are:
  - **Definition of the firm** is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined.
  - **Firm's definition of discretion** establishes criteria to judge which portfolios must be included in a composite and is based on the firm's ability to implement its investment strategies.
- Firms should adopt **the broadest, most meaningful** definition of the firm. The scope of this definition should **include all geographical offices operating under the same brand name**, regardless of the actual name of the individual investment management company.

Introduction to GIPS – Composite or not?



Non-discretionary portfolio excluded in composite but included in firm assets.

Introduction to GIPS

IV. Verification

- **Verification** is the review of an investment management firm's performance measurement processes and procedures **by an independent third-party "verifier".**
  - Third-party verification brings credibility to the claim of compliance and supports the overall guiding principles of full disclosure and fair representation of investment performance.
- **Verification tests:**
  - Whether the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis.
  - Whether the firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards.
- A single verification report is issued in respect of the whole firm; verification cannot be carried out for a single composite.

Summary

Introduction to the Global Investment Performance Standards (GIPS)

Introduction to GIPS

Module

Ethics Application

1. Ethics Application

Ethics Application

- **Case Mandracken:**
  - SBS Bank (SBS) serves as a custody bank for a wide range of clients. SBS charges its clients an asset-based fee for these services. Pursuant to the bank's client agreement, custody clients agree to reimburse the bank for out-of-pocket expenses for items paid by the custodian on their behalf. Although SBS charges custody clients an established rate for SWIFT messages, the rate is greater than the actual cost of providing this service.
  - Mandracken, CFA, a vice president at SBS who oversees client service responsibilities, recognizes this discrepancy and brings it to the attention of his supervisor. In an email, Mandracken states that "although disclosure of charging for SWIFT fees is noted in the clients' fee schedules, the fees have always included an increase over actual cost, so the charge to clients is not a true pass-through because we add a margin." Mandracke's supervisor instructs him to reduce the SWIFT fee rate <u>for new clients</u> and to revisit the <u>rate for existing clients when their contracts are renewed</u>.

Ethics Application

- To meet his obligations under the CFA Institute Code and Standards, Mandracken should

A. implement the corrective procedures as directed by his supervisor.

B. implement the corrective procedures as directed by his supervisor but report his objections to the bank's board of directors.

C. refuse to participate in any client interactions using the fee schedule until the bank revises the SWIFT rate to reflect the actual cost of the service.

Ethics Application

- **Correct Answer: C**
  - If a violation is found, the member should report. And then, the situation is not remedied, the member should dissociate from such violation, even quit the job. Inaction by a member and continuing association with those involved in illegal or unethical conduct might be viewed as participation or assistance in the illegal or unethical conduct.
  - SBS is misrepresenting its reimbursable expenses to its custody clients and overcharging them. Although Mandracken brings the issue to the attention of his supervisor, his supervisor's corrective measures are inadequate because they (1) address the issue only for new clients, (2) do not immediately address the issue for existing clients, and (3) do not address the misrepresentation and overcharges to past clients.
  - Mandracken must thus refuse to participate in any client interactions that use the fee schedule until the bank revises the SWIFT fees charged to custody clients to reflect actual out-of-pocket costs.

Module

Ethics Application

- **Standards**
  - **I. Professionalism**
    - (A) Knowledge of the law;
    - (B) Independence and objectivity;
    - (C) Misrepresentation;
    - (D) Misconduct.
  - **II. Integrity of Capital Markets**
    - (A) Material nonpublic information;
    - (B) Market manipulation.
  - **III. Duty To Clients**
    - (A) Loyalty, prudence and care;
    - (B) Fair dealing;
    - (C) Suitability;
    - (D) Performance presentation;
    - (E) Preservation of confidentiality.
  - **IV. Duty To Employers**
    - (A) Loyalty;
    - (B) Additional compensation arrangements;
    - (C) Responsibility of supervisors.
  - **V. Investment**
    - (A) Diligence and reasonable basis;
    - (B) Communication with clients;
    - (C) Record retention.
  - **VI. Conflicts of Interest**
    - (A) Disclosure of conflicts;
    - (B) Priority of transaction;
    - (C) Referral fees.
  - **VII. Responsibility as Members**
    - (A) Conduct as members and candidates;
    - (B) Reference to CFA institute, designation.

问题反馈

- 如果您认为金程**课程讲义/题库/视频**或其他资料中**存在错误，欢迎您告诉我们**，所有提交的内容我们会在最快时间内核查并给与答复。
- **如何告诉我们？**
  - 将您发现的问题通过扫描右侧二维码告知我们，具体的内容包含:
    - ✓ 您的姓名或网校账号
    - ✓ 所在班级
    - ✓ 问题所在科目(若未知科目，请提供章节、知识点和页码）
    - ✓ 您对问题的详细描述和您的见解
- **非常感谢您对金程教育的支持，您的每一次反馈都是我们成长的动力。**