1. When comparing ethical standards with legal standards, which of the following statements is *most appropriate*?

✓ A. Behavior that complies with ethical standards may not always be legal.

B. A code of ethics provides specific rules that exceed legal requirements.

C. Regulations codify ethical standards, so a separate code of ethics is not needed.

Explanation

CFA Institute's curriculum repeatedly emphasizes that **legal standards** alone are **insufficient** to shape **appropriate behavior** among investment professionals. The reasons why include the following:

- Laws are often too narrow to adequately prohibit all improper behavior.
- Laws that curb improper behavior are often enacted long after the behavior is first observed; therefore, significant harm caused by the behavior can occur in the interim.

Ethics are created to govern **moral conduct**, which holds members and candidates to a higher standard than required by laws and regulations. The curriculum acknowledges that acting ethically may require members and candidates to perform illegal actions. For example, reporting dishonest conduct (ie, "whistleblowing") may be illegal, but it is ethically appropriate.

(Choice B) A code of ethics serves as a *general guide* for appropriate conduct. Specific rules are established by a standard of conduct, and the standard often clarifies a code of ethics.

(Choice C) Although laws may codify ethical standards, not all legal conduct is ethical. For example, it may be legal to use material nonpublic information as a basis for investing, but it is not ethical conduct.

Things to remember:
Legal standards alone are insufficient to shape appropriate behavior among investment professionals. A separate code of ethics can serve as a guide to appropriate moral conduct, which may exceed legal requirements. The CFA curriculum acknowledges that behaving ethically may sometimes violate applicable legal standards.

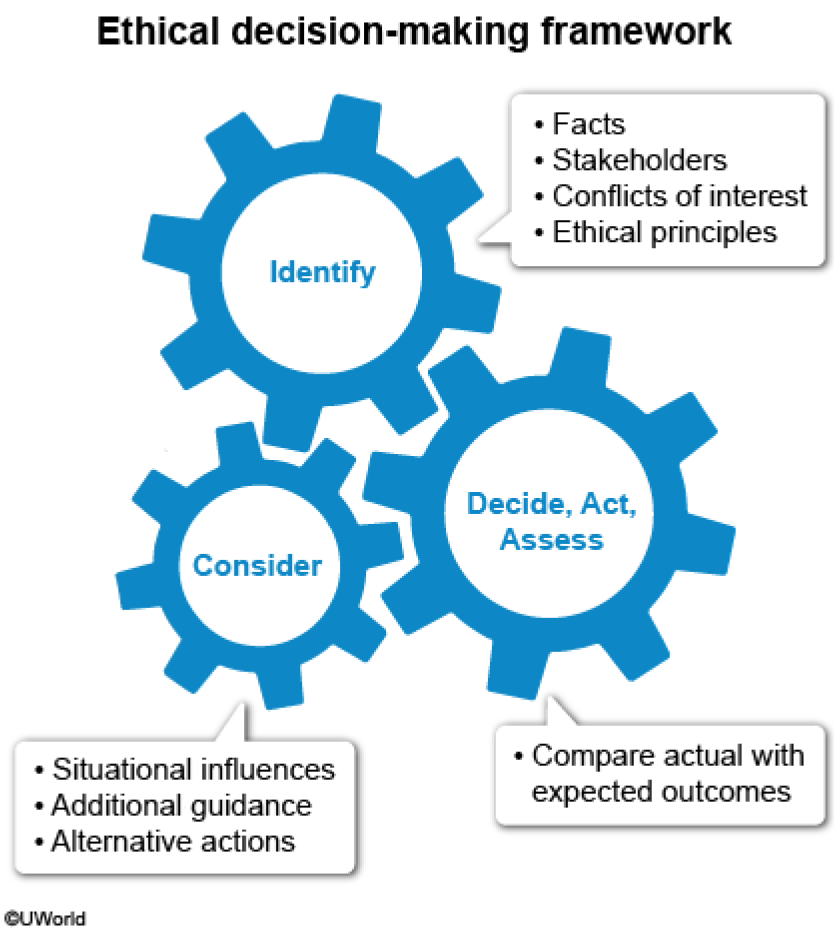
Compare and contrast ethical standards with legal standards

LOS

2. A framework for ethical decision-making will *most likely* be effective when:

- A. external stakeholders are considered.
- B. only verifiable information is included.
- C. the framework steps are followed in order.

Explanation



The **ethical decision-making framework** is designed to help identify important factors in the decision-making process. After identifying relevant information, the next step is to consider situational influences, additional guidance or advice, and alternative actions and consequences. After a decision is made and implemented, the decision-maker should assess the outcome.

One relevant factor is to identity **all stakeholders** (both internal and external) involved and the responsibilities that may be owed to each. It is also important to identify **all** potentially relevant **facts** of the situation, whether verifiable or not **(Choice B)**, and any **conflicts of interest**, existing or potential, that impact this decision. Finally, it is important to identify the **ethical principles** that bear on the decision.

The framework is presented as a guide to a decision-making process, and while it is presented in a logical order (identify, consider, decide, assess), the steps may be applied in any order in practice **(Choice C)**. Some steps may be repeated. For example, considering alternative actions may lead to identifying additional stakeholders or ethical principles.

Things to remember:
In the decision-making framework, it is important to identify all stakeholders, facts, existing or potential conflicts of interest, and ethical principles involved. The remaining steps include considering situational influences, additional guidance, and alternative actions, and assessing the decision after taking action. The process may not be linear; some steps may be repeated.

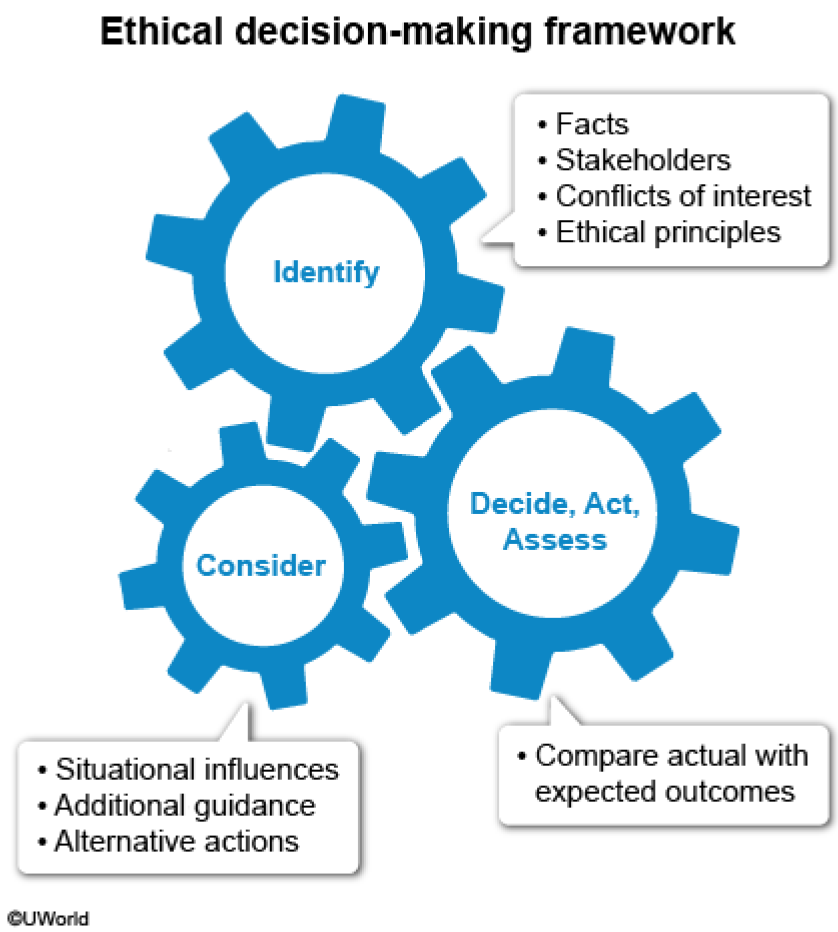
describe a framework for ethical decision making

LOS

3. Which of the following is *most likely* an appropriate goal of using an ethical decision-making framework?

- A. Allow for potential unintended consequences
- ✓ B. Justify the decision to a broad range of stakeholders
- C. Minimize the perspectives included in the decision-making process

Explanation



A **decision-making framework** broadens the decision maker's approach by helping **identify all relevant** facts, **stakeholders**, possible conflicts of interest, duties owed, and ethical principles involved in a decision. Once stakeholders have been identified, the framework encourages a decision maker to consider and **include** the stakeholders' **multiple perspectives** and concerns. Since a range of stakeholder concerns is included in the decision-making process, the decision maker can better justify the decision to stakeholders.

(Choice A) A decision maker should try to minimize the potential for unintended consequences in order to avoid the possibility that one decision, in turn, will create new problems.

(Choice C) Including multiple perspectives in the framework helps the decision maker consider factors that might otherwise be overlooked.

Things to remember:
A decision-making framework is most helpful when it broadens the decision maker's approach by helping identify all relevant facts, stakeholders, possible conflicts of interest, duties owed, and ethical principles involved in a decision. Since a range of stakeholder concerns is included in this process, the decision maker can better justify the decision to stakeholders.

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describe a framework for ethical decision making

LOS

4. Which of the following clauses in a corporate bond indenture is *most likely* a type of negative pledge clause?

A. Incurrence test

B. Pari passu clause

C. Cross-default clause

Explanation

Examples of affirmative and negative covenants

Affirmative	Negative
• Pay interest and principal on time • Keep collateral in good working order • Pay taxes and other expenses on time • Comply with legal and regulatory requirements	• Restriction on paying dividends • Cannot take on additional debt above a certain level • Assets cannot be sold until debt is repaid • Collateral cannot be pledged as security for additional debt

Bond indentures are legal contracts that define the relationship between bondholders and issuers. **Indentures** specify the features of the bond (eg, coupon rate, maturity date) as well as investor and issuer rights and obligations. For example, issuers are obligated to pay, and investors have the right to receive, interest and principal. There may be contingency provisions that give the issuer the right to retire (ie, call) the bond before maturity or give investors the right to convert the bond into stock.

Protective covenants are indenture provisions designed to protect the bondholders. These provisions are categorized as either:

- affirmative covenants, which require issuers to take specific actions that support the value of the bonds, or
- **negative covenants**, which prohibit issuers from taking actions that might adversely affect the value of the bonds.

An **incurrence test** is a negative covenant that prohibits actions such as dividend payments, share repurchases, or debt issuance unless issuers satisfy specified financial tests (eg, debt-to-EBITDA < 5).

(Choice B) A pari passu (ie, from a Latin phrase meaning "equal footing") clause is an affirmative covenant requiring an issuer to give a bonds' holders treatment equal to that given holders of similar seniority debt securities from the same issuer.

(Choice C) A cross-default clause is an affirmative covenant requiring an issuer to declare a bond in default, even in the absence of a failure to pay, if the issuer defaults on any other debt obligation.

Things to remember:
Bond indentures are legal contracts that define the relationship between bondholders and issuers. Many indenture provisions are protective covenants; affirmative (negative) covenants require (prohibit) specified actions by the issuer in order to protect bondholders. An incurrence test is a type of negative covenant.

Explain ethics
LOS

5. A Charterholder who lives and works in a country that adheres to a "suitability standard" recommends an investment that meets a client's long-term financial objectives. If there was an equally suitable investment that paid the Charterholder a lower fee, the adviser's conduct can be *best described* as:

A. legal and ethical.

✓ B. legal but unethical.

C. illegal and unethical.

Explanation

Instruments for compliance with professional ethics

Instrument	Owner	Describes
Code of ethics	Professional organization	Shared principles
Standards of conduct	Professional organization	Minimally acceptable behavior
Laws and regulations	Government	Legal limits of behavior

Legal standards alone are **insufficient** to shape **appropriate behavior** among **investment professionals**. Laws are often too narrow to adequately prohibit all improper behavior and are often enacted after injury or damage has been done.

Ethics are created to **govern moral conduct**, which holds Members and Candidates to a **higher standard** than required by **laws** and **regulations**. Ethical behaviors are those actions that conform to society's expectations for honesty, transparency, and fairness. They balance each person's self-interest with an awareness of how a person's actions affect others.

CFA Institute has adopted the Code and Standards as its statement of shared principles, on the belief that ethics for the global investment industry should be universal rather than based on local laws or customs. Global ethical standards are intended to create trust and integrity throughout the global financial system.

In this instance, a **suitability standard** is a legal obligation that requires just a **minimal** level of **investment** appropriateness **without consideration** for **other factors** (eg, fees paid to the adviser). In contrast, a fiduciary obligation requires the adviser to adhere to a higher standard that involves always serving the client's best interest, such as minimizing fees, all else being equal. Therefore, the Charterholder's actions were **legal but unethical (Choices A and C)**.

Things to remember:
Legal standards alone are insufficient to shape appropriate behavior among investment professionals. A separate code of ethics can serve as a guide to appropriate moral conduct, which may exceed legal requirements.

Compare and contrast ethical standards with legal standards

LOS

6. Which of the following *best describes* an illegal but ethical activity?

✓ A. Whistle-blowers alerting authorities of corporate corruption.

B. An analyst acting on a tip from a corporate insider in the United States.

C. Managers sharing the firm's complete fee structure with potential clients and the public.

Explanation

Legal vs. ethical behavior

	Legal	**Illegal**
Ethical	Adviser discloses fees to client	Whistle-blower exposes corruption but violates disclosure laws
Unethical	Adviser is not fiduciary where not required by law	Insider trading (US)

Laws are not the ideal means to prevent unethical behavior since they are geographically inconsistent, slow to be enacted, and subject to compliance. Financial regulations and securities laws define illegal activities. However, **abiding by laws** may or may not indicate **ethical** behavior, which **extends beyond laws** and includes adhering to societal expectations of **right and wrong**. Thus, conduct can be legal but unethical.

Conversely, conduct can be ethical but illegal. An example of this is an act of civil disobedience, which calls attention to an unethical law yet may violate local laws. Similarly, **whistle-blowers** who call attention to a company's illegal activity may be violating disclosure laws. Although alerting authorities to wrongdoing is **ethically correct**, it may **also** be **illegal**.

(Choice B) Using inside information to profit is morally wrong since perpetrators benefit to the detriment of others. This is true even where it is legal. In the United States, using material nonpublic information is both illegal and unethical since it violates local laws.

(Choice C) Managers publicly sharing fee information is legal and ethical. Firms have certain legal obligations regarding disclosures, including fees. It is also ethically correct to ensure that clients have enough information to make an informed decision.

Things to remember:
Laws are unsuited to prevent unethical behavior since they are geographically inconsistent, slow to be enacted, and subject to compliance. Ethical behavior extends beyond abiding by laws and includes adhering to societal expectations of right and wrong. Actions can be legal, ethical, neither, or both.

Compare and contrast ethical standards with legal standards

LOS

7. Which of the following *best describes* the purpose of the Code of Ethics for the global investment profession?

✓ A. To build trust with all market participants

B. To set the basis for laws and regulations

C. To determine minimally acceptable behaviors

Explanation

Instruments for compliance with professional ethics

Instrument	Owner	Describes
Code of ethics	Professional organization	Shared principles
Standards of conduct	Professional organization	Minimally acceptable behavior
Laws and regulations	Government	Legal limits of behavior

A **code of ethics** is a professional organization's **statement of shared principles**. It provides the moral compass for collective behavior. Ethical behaviors are those actions that conform to society's expectations for honesty, transparency, and fairness, balancing each person's self-interest with an awareness of how his or her actions affect others.

CFA Institute has adopted the stance that ethics for the global investment industry should be **universal** and not based on local laws or customs. This ubiquity creates **trust** and **integrity** in the whole global financial system. As stated in one of the principles in the CFA Institute Code of Ethics:

"*Members and Candidates must:*

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

A profession's code of ethics may or may not be accompanied by standards of conduct, whereas standards of conduct exist only to enhance their associated code of ethics. CFA Institute has adopted both in its Code of Ethics and Standards of Professional Conduct (the Code and Standards). CFA charterholders and Candidates are expected to know and comply with both.

(Choice B) It is a *government's* responsibility to establish legal limits of behavior through *laws and regulations*. The belief system used to create these policies in one country may differ from that of another country and from the shared ethical principles of a global organization.

(Choice C) *Standards of conduct* clarify the *minimally acceptable behaviors* required to conform to a profession's code of ethics and provide a guide to practicing its principles.

Things to remember:
A code of ethics is a professional organization's statement of shared principles. It provides the moral compass for collective behavior. A universal agreement on what is ethical for the global investment profession creates trust and integrity in the whole global financial system, which ultimately benefits society.

Describe the role of a code of ethics in defining a profession
LOS

8. If a professional organization has standards of conduct in addition to its code of ethics, the purpose of the standards is *most likely* to describe:

- A. shared principles.
- B. laws and regulations.
- ✓ C. acceptable behaviors.

Explanation

Instruments for compliance with professional ethics

Instrument	Owner	Describes
Code of ethics	Professional organization	Shared principles
Standards of conduct	Professional organization	Minimally acceptable behavior
Laws and regulations	Government	Legal limits of behavior

A **code of ethics** is a professional organization's **statement of shared principles**. **Standards of conduct** provide a **guide to practicing** the principles outlined in the code of ethics. Standards of conduct also **clarify** the **minimally acceptable behaviors** required to conform to the code of ethics. Although not addressed directly in standards of conduct, adherence to civil laws and regulations may be the minimally acceptable behavior in some cases.

Standards of conduct may be principle-based or rule-based. Principle-based standards are universally applicable to members of the profession and are based on the principles outlined in the code of ethics. Rule-based standards, while also relating to the principles in the code of ethics, are usually more narrowly applicable and specific to certain members or scenarios that may arise.

A code of ethics may or may not be accompanied by standards of conduct whereas standards of conduct exist only to enhance their associated code of ethics. CFA Institute has adopted both a code of ethics and standards of conduct (the "Code and Standards"); CFA charterholders and candidates are expected to know and comply with both.

(Choice A) Standards of conduct are used to describe minimally acceptable behaviors or practices, given the shared principles of the code of ethics. The code of ethics describes the shared principles.

(Choice B) Standards of conduct do not describe civil laws and regulations.

Things to remember:
Standards of conduct are used to clarify the minimally acceptable behaviors required to conform to the shared principles stated in a code of ethics; they do not address applicable civil laws and regulations.

Describe the role of a code of ethics in defining a profession
LOS

9. An investment professional *least likely* displays a high level of professionalism when:

✓ A. maximizing revenue for their employer.

B. working late to help a co-worker finish a project.

C. researching the efficacy of a new analytical model.

Explanation

A profession is an occupation that has an established body of knowledge and standards of practice and behavior. Relative to craft guilds and trade bodies, a profession holds itself to a higher ethical standard. A profession's primary goal is to establish trust between clients and society in general. Examples of professions include doctors, lawyers, and accountants.

Characteristics of a profession include
• Service to clients and society • Standardized practitioner behavior • High entry standards • Body of expert knowledge • Encouraging and facilitating continuing education • Professional conduct monitoring • Recognized governing body • Member engagement • Collegiality

By adhering to the tenets of a profession and by establishing shared principles that all members of the profession agree to and live by, investment professionals build credibility, respect, and trust with clients and society. A profession maintains trust by establishing minimum standards of care that ensure a culture of integrity and competency in practice.

In this instance, an **investment professional** has a duty to their employer, but not at the expense of their clients. The standard of care for an investment professional is a **fiduciary standard**. This requires **acting** in the **client's best interest**, which will not always allow for maximizing firm revenue.

(Choice B) Working late to help a co-worker finish a project is an example of *collegiality*.

(Choice C) Researching the efficacy of a new analytical model is a form of *continuing education*.

Things to remember:
A profession is an occupation that shares an established body of knowledge and standards of practice and behavior. By adhering to the tenets of a profession, investment professionals build credibility with the public, and, in turn, earn respect and build trust with clients and society.

explain professionalism in investment management

LOS

10. Which of the following *best explains* why recognition of investment management as a profession lags behind other professions? The investment management profession has *not yet*:

- A. created high entry standards.
- B. established a body of knowledge.
- ✓ C. required membership in a professional body.

Explanation

A profession is an occupation that has an established body of knowledge and standards of practice and behavior. Specialists (eg, physicians, lawyers, accountants) who share licensing, technical, or regulatory requirements may be recognized as belonging to a profession.

Investment management has most of the features of a recognized profession, such as an established body of knowledge **(Choice B)**. However, the investment management profession does not yet require membership in a professional organization, such as CFA Institute, to practice. In contrast, lawyers in the US and many other countries must not only pass the bar exam but also be admitted to the bar (ie, be a member in good standing of the bar association) to practice law.

(Choice A) The investment management profession does offer certifications and licensing [eg, CFA, Series 7, Financial Risk Manager (FRM)] that can act as high entry standards.

Things to remember:
A profession is an occupation that shares an established body of knowledge and standards of practice and behavior. Investment management has most of the features of a recognized profession; however, it does not require membership in a professional organization.

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explain professionalism in investment management
LOS

11. Which of the following is the *least effective* way for a professional association to build trust with clients? The association publicizes that it:

- A. administers a difficult qualifying exam.
- B. operates in a highly regulated industry.
- C. monitors compliance with a code of ethics.

Explanation

How a profession maintains trust
• Establishes norms of practice • Remains client focused • Maintains high entry standards • Monitors professional conduct • Nurtures a body of knowledge • Encourages lifelong learning • Functions as an oversight body or regulatory adviser

A respected **profession must** maintain credibility and **build trust** with clients (eg, the investment profession benefits from the trust of market participants). It does so most effectively through its **own initiatives**, **not merely** by operating in a **highly regulated** industry.

The fact that an industry is highly regulated does not necessarily signal trustworthy professional practice; it indicates only a high degree of oversight. However, if the professional association shows initiative as an oversight body or a regulatory advisor, it suggests a degree of respect for the association due to its stature as an authoritative resource. This enhances the association's and, by extension, the profession's trustworthiness.

As shown in the image above, there are several ways that a profession can build trust. One way is creating a body of knowledge, maintaining high professional standards, and administering a qualifying exam to ensure that the standards are met **(Choice A)**. Another is monitoring compliance with an established code of ethics **(Choice C)**.

Things to remember:
A respected profession must build trust with clients. It does so most effectively through its own initiatives, not merely by operating in a highly regulated industry.

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describe professions and how they establish trust

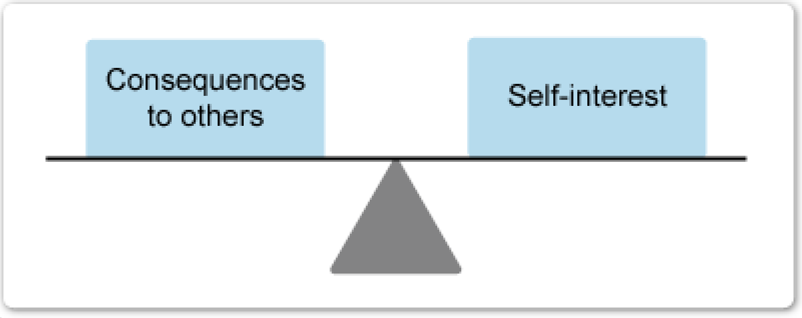
LOS

12. Which of the following *best* describes ethical conduct? Ethical conduct balances concerns for consequences to others with:

- ✓ A. self-interest.
- B. legal outcomes.
- C. minimally acceptable behavior.

Explanation

Ethical behavior: balance



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Ethics is defined as a set of principles that guide behavior. Those **ethical principles are commonly held beliefs** that designate good and bad, tolerable and intolerable, and required and optional behaviors.

Belief in ethical principles should lead to ethical conduct: behavior that **balances self-interest** with concern for **consequences** to **others**. Investment professionals often have to weigh the consequences of their actions for clients, employers, the profession, and/or the integrity of the financial markets against their own self-interest.

(Choice B) Laws are defined by governing bodies, not necessarily by commonly accepted moral principles. Ethical behavior does not attempt to balance concern for others with legal outcomes.

(Choice C) Ethical conduct may exceed minimally acceptable behavior, which is often described as standards of conduct. Such standards often accompany the code of ethics that describes ethical principles.

Things to remember:
Ethical principles are commonly held beliefs that define good and bad, tolerable and intolerable, and required and optional behaviors. Ethical principles are designed to lead to behavior that balances concern for consequences to others with self-interest.

Explain ethics
LOS

13. The *most appropriate* reason why trust is needed in the investment profession is so that investment managers can:

- A. deliver more value to society.
- B. increase the prestige of the investment profession.
- C. have greater control over client investment decisions.

Explanation

The economy and society are impacted by the degree to which the investment management profession remains ethical and trustworthy. Investment managers' actions direct and influence personal savings, retirement planning, investor behavioral patterns, business project decision-making, and risk management. These **benefits** can be **delivered to society** only if clients and employers **trust** the advice and direction of investment managers.

Skillful and accurate analysis and valuation of assets leads to better investment management and, ultimately, better corporate practices. Knowing that investment analysts and managers are analyzing results gives companies an incentive to strive for better corporate governance and performance, which lead to more efficient allocation of capital to products and projects that deliver more value to society.

(Choices B and C) Greater trust in the investment profession *does* lead to greater control of client decision-making since clients tend to follow the advice of those they trust. However, the narrow goal of controlling client decision-making is not the most appropriate reason to build trust. Similarly, the goal of increasing the prestige of the investment profession benefits the profession itself, not its clients or society; therefore, it is not the most appropriate reason to build trust.

Things to remember:
Investment managers deliver value to society by performing skillful valuations and providing sound advice to clients. This value can be delivered only if clients and employers trust the advice and direction of investment managers.

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describe the need for high ethical standards in investment management
LOS

14. According to CFA Institute, which of the following *best describes* the motivation for codifying an investment firm's belief system?

- A. Ethical behavior improves customer satisfaction.
- ✓ B. A firm's conformity to societal expectations benefits all stakeholders.
- C. An ethical environment based on altruistic motives attracts more clients.

Explanation

According to CFA Institute, ethics extends past legal norms and incorporates moral principles and specific rules of conduct. Moral principles are socially defined norms of appropriate and inappropriate conduct. They set expectations that ethical individuals must meet.

Investment firms often **conform their** codified set of moral **beliefs** to ethical expectations set by **society**. Conduct is considered **ethical** if it **benefits society** and **improves** conditions for the **stakeholders** involved. Since the industry and society are both hurt if trust erodes, clients must be able to trust investment professionals and hold them to the highest ethical standards

Unethical behavior hurts clients directly and tarnishes the industry, and society pays for it with lower use of capital and higher regulatory (ie, taxpayer-funded) oversight costs. The motivating force behind promoting and adopting an ethical program is to avoid this damage. Incidental benefits, such as improving customer satisfaction or attracting more clients, are not the motivation **(Choices A and C)**.

Things to remember:
Ethics is a belief system identifying good and bad behavior. For investment firms, conduct is considered ethical if it benefits society and improves conditions for the stakeholders involved. Unethical behavior hurts clients, the industry, and society. The motivation behind promoting and adopting an ethical program is to avoid damage for society and stakeholders.

Explain ethics

LOS

15. Which of the following *best describes* the need for high ethical standards in investment management?

- A. To preserve the trust that supports the industry
- B. To increase the prestige of working in the industry
- C. To establish consistency across global laws and regulations

Explanation

How a profession maintains trust
• Establishes norms of practice • Remains client focused • Maintains high entry standards • Monitors professional conduct • Nurtures a body of knowledge • Encourages lifelong learning • Functions as an oversight body or regulatory adviser

Protecting and serving clients is the foundation of the **investment management profession**, and the relationship between the profession and its clients is **predicated on trust**. Clients trust that investment professionals will carry out their duties with the utmost care, placing clients' interests above their own.

The industry:

- **earns trust** by establishing shared principles by which all members of the profession agree to live and
- **maintains trust** by establishing minimum standards of care that ensure a culture of integrity and competency in practice.

The investment profession benefits society by creating trust with all market participants.

(Choice B) By adhering to high ethical standards, the profession builds trust with clients and society. Increasing the prestige of an individual is not a reason high ethical standards are needed.

(Choice C) Ethical codes are created to define and govern moral conduct. The investment profession follows the CFA Institute Code of Ethics and Standards of Professional Conduct, which holds Members and Candidates to a higher standard than what is required by laws and regulations. Laws are unsuited to prevent unethical behavior since they are inconsistent across sovereignties, slow to be enacted, and subject to compliance. Ethical behavior extends beyond abiding by laws; it includes adhering to societal expectations of right and wrong.

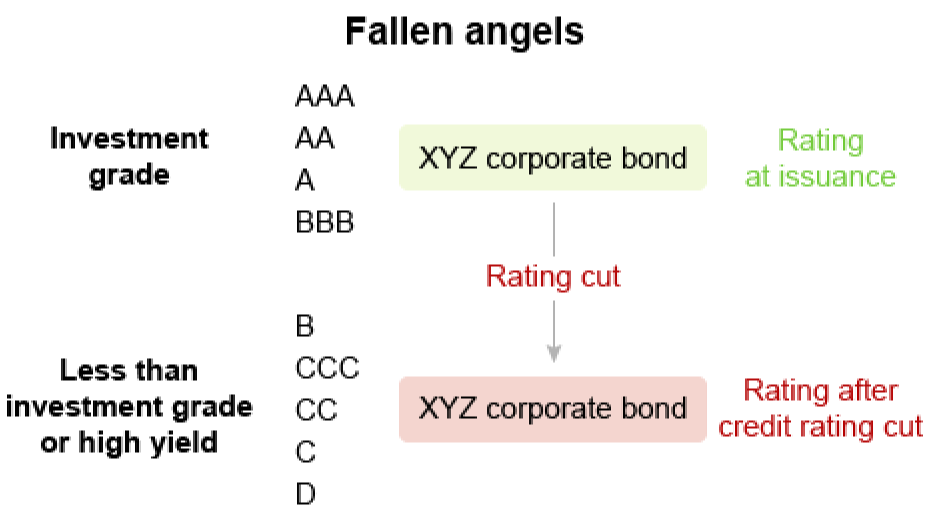
Things to remember:
The effectiveness of the investment management profession is based on trust. The profession must build trust by requiring its members to agree to live and work by shared principles of integrity. Professional trust is maintained by establishing ethical standards of care that ensure integrity and competency.

describe the need for high ethical standards in investment management
LOS

16. Of the following choices, "fallen angels" *most appropriately* describes bonds currently rated below investment grade that:

- A. are considered distressed debt.
- B. investors believe are likely to default.
- ✓ C. were issued with an investment-grade rating.

Explanation



Credit ratings are based on the probability of an issuer defaulting and the estimated loss to bondholders should default occur. Bonds with credit ratings below investment grade expose investors to greater credit risk. Since investors must be compensated for the greater likelihood of credit-related losses, such bonds trade at wider credit spreads over sovereign debt, compared with investment-grade debt. Due to the relatively high YTMs the market requires on **less-than-investment-grade securities**, they are also known as **high-yield bonds**.

Many high-yield issuers are newer or smaller corporations that are riskier due to less predictable earnings and less stable cash flow. Other bonds currently rated less than investment grade may have had an **investment-grade rating when issued**.

However, due to adverse factors (eg, tough competitive environment, poor management decisions) there was a deterioration in profitability or asset values that negatively affected the company's capacity to meet its obligations. This reduction in credit quality results in a **credit rating cut** that places the issue in the **high-yield category**. This fall from "investment grade" results in such issues being referred to as **fallen angels**.

(Choices A and B) Distressed debt represents bonds currently in default, or whose issuer is in bankruptcy or in such poor financial condition that there is a strong possibility of default and/or bankruptcy. A fallen angel's credit quality could deteriorate to this extent, but most fallen angels are not in the distressed debt category.

Things to remember:
Bonds with below-investment-grade ratings are also referred to as high-yield bonds. Bonds issued with an investment-grade rating but currently rated as high-yield bonds are known as fallen angels.

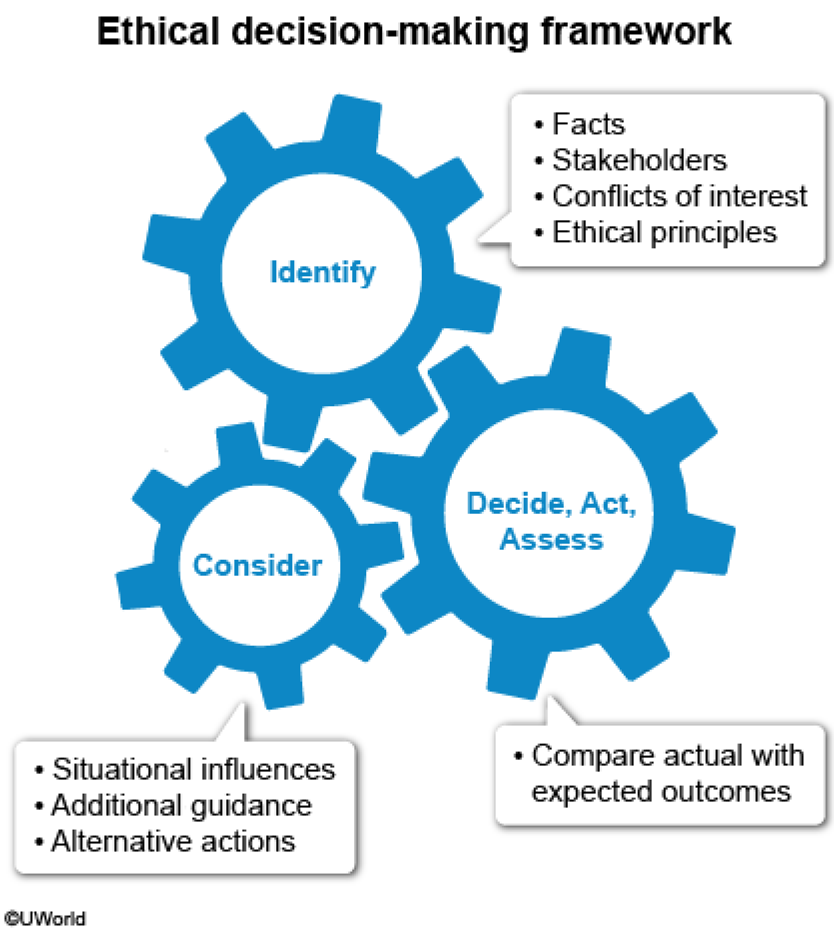
Explain ethics

LOS

17. To avoid making a decision that has unforeseen ethical consequences, which of the following tools would *most likely* be helpful?

- A. Code of ethics
- B. Standards of conduct
- ✓ C. Ethical decision-making framework

Explanation



The **ethical decision-making framework** is a **tool** designed to help **identify** all important **factors** and **stakeholders** in the decision-making process, allowing for sound **ethical decisions**. After relevant information is identified, the next step is to consider situational influences, additional guidance or advice, and alternative actions and consequences. After a decision is made and implemented, the decision-maker should assess the outcome.

The framework is presented as a guide to a decision-making process, and while it is presented in a logical order (identify, consider, decide, assess), the steps may be applied in any order in practice. The framework should be thought of as an iterative feedback loop, and steps may be repeated. In this instance, **using** the **framework** could have **limited** the possibility and impact of unforeseen consequences.

(Choice A) A code of ethics is a written set of principles and beliefs that specific groups of individuals agree to live by, but it is not a decision-making tool itself.

(Choice B) Standards of conduct are an extension of a code of ethics, representing the agreed upon rules and standards that govern behavior.

Things to remember:
The ethical decision-making framework is a tool designed to help identify all important factors and stakeholders in the decision-making process, allowing for sound ethical decisions. The framework is presented as a guide to a decision-making process.

describe a framework for ethical decision making
LOS

18. The investment profession *most likely* builds and maintains trust by:

- A. advocating for increased legal penalties.
- B. establishing standards that match those of regulators.
- ✓ C. having its members accurately convey investment traits to clients.

Explanation

How a profession maintains trust
• Establishes norms of practice • Remains client focused • Maintains high entry standards • Monitors professional conduct • Nurtures a body of knowledge • Encourages lifelong learning • Functions as an oversight body or regulatory adviser

A profession differs from an occupation in that it requires specialized skills, a commitment to help others, and a common code of ethics. An occupation can evolve into a profession if its members have a distinctive conviction toward ethical behavior, which may be embodied in a code of ethics and standards of practice.

A profession becomes respected by having its members create and maintain trust with stakeholders. **Professions create trust** when members' conduct reflects the profession's ethical principles. For example, within the investment management profession, Members and Candidates who truthfully explain to clients an investment's characteristics (eg, risks, returns, fees) **demonstrate ethical behavior**. This way, clients can make informed decisions, and investment professionals can earn clients' trust.

(Choice A) Advocating for stiffer penalties against wrongdoers does not necessarily indicate that a profession is trustworthy, just that the industry is open to a high degree of regulatory oversight. A respected profession must build trust with clients through its own initiatives, not merely by operating in a highly regulated industry.

(Choice B) A professional organization can set standards that differ from those of regulators and still maintain trust by providing a framework to resolve those differences, such as a code of ethics.

Things to remember:
A respected profession must build trust with clients. Professions create trust by having members' conduct reflect the ethical principles of the profession. For example, Members and Candidates who truthfully explain to clients an investment's characteristics demonstrate ethical behavior.

describe professions and how they establish trust

LOS

19. Regarding unethical behavior, overconfidence bias *least likely* leads to overestimating:

A. the morality of one's own behavior.

B. one's underlying intrinsic motivations.

✓ C. external situational influences on one's behavior.

Explanation

Factors that challenge ethical behavior

Internal (beliefs or biases)	External (situational influence)
• Belief that "I'm above average" • Overconfidence • Ability to rationalize	• Financial reward • Prestige • Loyalty to employer

Ethical judgment can be challenged by internal or external factors. Internal factors are beliefs or biases that impede cognitive reasoning and judgment. A common example is **overconfidence bias**, which leads individuals to **ignore relevant factors** and, instead, **rely** on a belief in their own **superior ethical judgment** and **intrinsic motivations (Choices A and B)**.

An external factor is a situational influence, such as a cultural or environmental factor, that may encourage or discourage ethical judgment and behavior. In the investment industry, common situational influences that challenge ethical behavior involve money and prestige. Individuals are more likely to **underestimate situational influences** on their behavior due to **overconfidence bias**.

Things to remember:
Overconfidence bias can lead individuals to ignore relevant factors and, instead, rely on a belief in their own superior ethical judgment. Individuals are more likely to underestimate situational influences on their behavior due to overconfidence bias.

Identify challenges to ethical behavior

LOS

20. A profession *most likely* establishes trust with members of the public by:

- A. overseeing firms' robust compliance procedures.
- ✓ B. developing a pervasive culture of integrity among all professionals.
- C. working with regulators to create a highly regulated, protective environment.

Explanation

How a profession maintains trust
• Establishes norms of practice • Remains client focused • Maintains high entry standards • Monitors professional conduct • Nurtures a body of knowledge • Encourages lifelong learning • Functions as an oversight body or regulatory adviser

To establish and maintain trust and become respected and successful, a profession must build credibility with the public. The profession:

- **earns trust** by establishing **shared principles** that all members of the profession agree to and live by.
- maintains trust by establishing **minimum standards** of care that ensure a culture of **integrity** and **competency** in practice.

The investment profession benefits by creating trust with all market participants and end users.

(Choice A) Firm-level compliance oversight alone is insufficient for building trust with the public. Employers' standards and practices are not necessarily consistent with those of the professional organization. For the investment profession, trust is built by putting clients' interests first and nurtured through the collective ethical behavior of the industry's professionals, not by any individual firm's compliance.

(Choice C) The global investment industry is highly regulated by various governments' rules and laws. However, the fact that an industry is highly regulated does not guarantee trustworthy professional practice; it indicates only a high degree of compliance and/or government oversight.

Things to remember:
To become respected, a profession must build trust with the public by agreeing to live and work by shared principles of integrity. Professional trust is maintained by establishing standards of care that ensure integrity and competency. A profession does this most effectively through its own initiatives, not merely by operating in a highly regulated environment or relying only on firm compliance.

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describe professions and how they establish trust

LOS

21. Which of the following *best explains* a need for trust in the investment management profession? Investment management professionals are expected to:

- A. maximize client wealth.
- B. work in a highly regulated environment.
- ✓ C. be more aware of risks than their clients.

Explanation

Compared to clients, investment management **professionals** are **expected** to have a **superior knowledge** of investing. Therefore, **clients** expect that professionals are more aware of investment costs and risks and must be able to **trust** that those **costs and risks** will be carefully considered and **fully** and clearly **disclosed to the clients**.

Without this trust, clients would be less able to access the benefits of investing and apply them to achieving lifetime goals, such as education and retirement. In addition, institutional investors would be unable to efficiently allocate funds based on accurate asset valuations and analyses of market conditions.

(Choice A) Investment management professionals focus on meeting client goals, which may or may not include maximizing wealth.

(Choice B) Investment management professionals do work in a highly regulated environment, but this does not explain the need for trust in the profession.

Things to remember:
Investment management professionals are expected to be more aware of investment costs and risks, which should be carefully considered and fully and clearly disclosed to clients. Clients must be able to trust that an investment management professional's superior knowledge will be used in the clients' best interest.

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describe the need for high ethical standards in investment management
LOS

22. Which of the following situational influences is *most likely* to challenge ethical behavior?

- A. Loyalty to clients
- ✓ B. Loyalty to employer
- C. Belief in financial market integrity

Explanation

Factors that challenge ethical behavior

Internal (beliefs or biases)	External (situational influence)
• Belief that "I'm above average" • Overconfidence • Ability to rationalize	• Financial reward • Prestige • Loyalty to employer

Ethical judgment can be challenged by internal or external factors. An external factor is a **situational influence**—such as a cultural or environmental factor—that may **encourage or discourage ethical judgment** and behavior. In the investment industry, common situational influences that challenge ethical behavior involve money and prestige.

Loyalty to employers or colleagues can be a situational influence that challenges ethical behavior. For example, an adviser may put his or her employer's revenue goals ahead of a client's best interests.

Internal factors are beliefs or biases that impede cognitive reasoning and judgment. A common example is overconfidence, which leads an individual to ignore relevant factors and instead rely on a belief in the individual's superior ethical judgment.

(Choice A) Loyalty to clients is a situational influence that supports ethical behavior, and it is specified as a requirement of members and candidates of the CFA Institute in its Code of Ethics and Standards of Professional Conduct.

(Choice C) Believing in the integrity of the financial markets is a situational influence that is likely to encourage and support ethical behavior.

Things to remember:
A situational influence is an external factor that may influence ethical judgment and behavior. Loyalty to the employer can, under certain circumstances, lead to poor ethical decisions. Internal factors are beliefs or biases that impede cognitive reasoning and judgment.

Identify challenges to ethical behavior
LOS