Standard V(B) Communication with Clients and Prospective Clients
Updated January 2024

Members and Candidates must:

Disclose to clients and prospective clients the nature of the services provided, along with information about the costs to the client associated with those services.

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

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

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

Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

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Guidance

Standard V(B) addresses member and candidate conduct with respect to communicating with clients. Both developing and maintaining clear, frequent, and thorough communication practices are critical to providing high-quality financial services to clients.

When clients understand the information communicated to them, they also can understand exactly how members and candidates are acting on their behalf, which gives clients the opportunity to make well-informed decisions about their investments. Such understanding can be accomplished only through clear communication.
For the purposes of Standard V(B), communication is not confined to a written report of the type traditionally generated by an analyst researching a security, company, or industry. A presentation of information can be made via any means of communication, including in-person recommendations or descriptions, electronic communications, social media posts, or media broadcasts.

The nature of client communications is highly diverse—from one word ("buy" or "sell") to in-depth reports of more than 100 pages. A communication may contain a general recommendation about the market, asset allocations, or classes of investments or may relate to a specific security. If recommendations are contained in abbreviated form (such as a recommended stock list), members and candidates should notify clients that additional information and analyses are available from the producer of the report.

When providing information to clients in electronic or digital format, members and candidates must take reasonable steps to ensure that such delivery treats all clients fairly. Members and candidates using any social media service to communicate business information must be diligent in their efforts to avoid unintended problems because these services may not be available to all clients.
Disclosing the Nature of Services and Information about Costs to Clients and Prospective Clients
A fundamental goal of the Code and Standards is to protect client interests and allow clients to make fully informed decisions about their investments and financial well-being. Providing clients with a description of the nature of the services they can expect from investment professionals and information about the costs of those services is critical to achieving this goal. The disclosures required by Standard V(B) permit clients to make informed decisions as to whether to engage in professional services with members, candidates, or their firms.

Full and fair disclosure builds trust with clients, and the disclosure of information about costs benefits clients and protects their interests. Standard V(B) makes clear that required disclosures cover all professional services provided by members and candidates. A clear understanding of the services that members and candidates provide is a foundational element to the client relationship. Clients must understand what services members and candidates will provide and, critically, what services they will not provide so that members and candidates can set appropriate expectations. Best practice is for members and candidates with client-facing responsibilities to clearly set out in written form at the outset of the engagement a description of the nature and parameters of the professional services as part of the engagement agreement, contract, or other documents stipulating the terms of the client relationship.

In addition to understanding the nature of the services, clients must understand the costs they will be expected to pay for those services so they can make informed decisions about the professional services being provided. Standard V(B) requires members and candidates to inform their clients and prospective clients about the services they will receive and the associated costs. Disclosures regarding the costs of the services to clients mandated by this standard are those expected to be charged to and paid for by the client. Members and candidates should provide a reasonable amount of detail regarding the costs to be incurred by clients. The standard, however, does not require members and candidates to provide specific dollar amounts. For example, a firm that charges clients a quarterly fee based on the market value of assets under management will be unable to specify a dollar amount in advance. Members and candidates are also not required to disclose a description of the costs to the firm of providing those services. Again, best practice is for members and candidates with client-facing responsibilities to disclose information about the nature of the services and the related costs at the outset of the relationship as part of the client agreement.

The disclosure responsibilities of members and candidates under this standard are ongoing. Initial disclosures at the outset of the relationship alone may not meet the requirements of the standard. If the services or costs change, members and candidates must update the disclosures and provide the updated information to all affected clients and prospective clients on a timely basis.

In addition, the scope of the disclosures is not limited to only those costs charged by the entity with which the client is in a direct relationship. Members and candidates with client-facing responsibilities must provide disclosures about all the costs associated with the investment services and products provided to the client. These disclosures include information on costs arising from services provided by affiliates, related entities, or third parties for products and services used by members, candidates, or their firms in providing services to clients. Members and candidates may not rely on the sophistication of clients and their supposed understanding of the nature and details of the investment process as a reason for not providing the information required by this standard. However, the information may be tailored to the knowledge and sophistication of each individual client.

Disclosures Regarding the Investment Process

Members and candidates must adequately describe to clients and prospective clients the basic parameters of their investment decision-making process. Such disclosure must address important factors that have positive and negative influences on the recommendations, including significant risks and limitations of the investment process used. Members and candidates must keep clients informed on an ongoing basis about changes to the investment process, especially newly identified significant risks and limitations. Only by thoroughly understanding the nature of the investment product or service can a client determine whether changes to that product or service could materially affect his or her investment objectives.

Understanding the basic characteristics of an investment is of great importance for judging the suitability of that investment on a standalone basis, but it is especially important for determining the impact each investment will have on the characteristics of a portfolio. Although the risk and return characteristics of a common stock might seem to be essentially the same for any investor when the stock is viewed in isolation, the effects of those characteristics greatly depend on the other investments held. For instance, if the particular stock will represent 90% of an individual's investments, the stock's importance in the portfolio is vastly different from what it would be to an investor with a highly diversified portfolio for whom the stock will represent only 2% of the holdings.

A firm's investment process may include the use of external advisers to manage various portions of clients' assets under management. Members and candidates must inform clients about the use of external advisers as part of their investment process. This disclosure allows clients to understand the full mix of products and strategies being applied that may affect their investment objectives. Disclosure of the use of external advisers also provides insight into the capabilities of the investment manager and the manager's reliance on other investment professionals to provide services.

Identifying Risks and Limitations

Members and candidates must disclose to clients and prospective clients significant limitations and risks associated with the investment process and notify them when significant changes in the risk characteristics of a security or asset strategy occur. The type and nature of significant risks depend on the investment process that members and candidates are following and the personal circumstances of the client.

Members and candidates must adequately disclose the general market-related risks and the 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. In general, the use of leverage constitutes a significant risk and must be disclosed.

Investment securities and vehicles may have limiting factors that influence a client's or prospective client's investment decision. Members and candidates must report to clients and prospective clients the existence of limitations significant to the decision-making process. 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.

Members and candidates must disclose significant risks known to them at the time of the disclosure. Members and candidates cannot be expected to disclose risks they are unaware of at the time recommendations or investment actions are made. In assessing compliance with Standard V(B), it is important to establish knowledge of a purported significant risk or limitation. Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the diligence and reasonable basis of the research of the member or candidate but may not constitute a breach of Standard V(B).

Disclosing Factors Important to Investment Analyses and Recommendations

When publishing a research report or recommendation, the member or candidate must present the basic characteristics of the investments being analyzed. Doing so will allow the reader to evaluate the report and incorporate information the reader deems relevant to his or her investment decision-making process. In preparing a recommendation about an asset allocation strategy, alternative investment vehicle, or structured investment product, for example, the member or candidate must include factors that are relevant and important to the asset classes or investment types that are the subject of the report. Follow-up communication of significant changes in the report or recommendation is required.

Once the analytical process has been completed, the member or candidate 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. A report writer who has done adequate investigation may emphasize certain areas, touch briefly on others, and omit certain aspects deemed unimportant. For instance, a report may dwell on a quarterly earnings release or new product introduction and omit other matters as long as the analyst clearly stipulates the limits to the scope of the report.

Members and candidates must support investment advice based on quantitative research and analysis with readily available reference material. Members and candidates must also disclose any changes in methodology.

Distinction between Facts and Opinions

Standard V(B) requires that opinions be separated from facts. Violations of this standard occur when members and candidates fail to separate the past from the future by not indicating that earnings estimates, changes in the outlook for dividends, or future market price information are opinions subject to future circumstances.

In the case of complex quantitative analyses, members and candidates must clearly separate fact from statistical conjecture and must identify the known limitations of an analysis. Members and candidates who fail to identify the limits of statistically developed projections leave investors unaware of the limits of the published projections. Members and candidates must use caution when promoting the perceived accuracy of any model or process because the ultimate output is merely an estimate of future results and not a certainty.

Manner of Disclosures

The manner in which members and candidates provide the disclosures required by Standard V(B) is at their individual discretion so long as the disclosures are appropriate, accurate, timely, and complete. Best practice dictates that such disclosures be made in written form. Often in large firms, disclosures about charges to and payments expected from clients are dictated by firm policy and practice. However, this situation does not relieve members and candidates of their responsibility to provide such information when doing so is part of their professional responsibilities. While members and candidates rely on and can be directed to use firm-generated disclosures, members and candidates should ensure that these disclosures meet the requirements of the Code and Standards. They have the responsibility to alert their firm when the communication is lacking, flawed, or insufficient to meet their responsibilities under the Code and Standards. In such cases, members and candidates should, when possible, supplement disclosures from the firm that they consider insufficient to meet the requirements of this standard. Ultimately, if members and candidates cannot rectify or supplement inadequate disclosures mandated by the firm, they should document their objections and take steps to dissociate from the activity.

Generally, this standard affects only client-facing members. While CFA Institute encourages all investment professionals to help ensure that clients receive sufficient disclosures, this standard does not impose a duty on members and candidates who do not interact with clients to ensure that others comply with Standard V(B). As with other standards that may not be applicable to the professional responsibilities of all members and candidates (e.g., investment performance and suitability), those members and candidates who are part of a team of investment professionals providing services to clients but who do not have client-facing responsibilities need not expand their realm of responsibility to ensure appropriate disclosures to clients.

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Recommended Procedures for Compliance

Because the selection of relevant factors is an analytical skill, determination of whether a member or candidate has used reasonable judgment in excluding and including information in research reports depends heavily on case-by-case reviews rather than a specific checklist.

Members and candidates should encourage their firms to have a rigorous methodology for reviewing research that is created for publication and dissemination to clients.

To assist in the review of a report after its release, the member or candidate must maintain records indicating the nature of the research and should, if asked, be able to supply additional information to the client (or any user of the report) covering factors not included in the report.

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Application of the Standard

Example 1 (Costs of Services to Clients):

The nature of ABC Capital Private Equity Fund III’s investments requires ABC Capital to routinely provide structuring advice to the companies in which the fund invests, for which ABC Capital charges a fee to those companies. The policy of ABC Capital is to remit the fees it earns for structuring advice to the fund if the investment in the underlying company decreases in value but to retain the fees if the investment increases in value.

The private placement memorandum does not disclose this arrangement, because the firm's CEO, Alphonso, views it as a common industry practice and believes it provides a "win-win" for investors. ABC Capital's services contribute significantly to the returns enjoyed by the fund's investors, and ABC Capital earns a substantial fee.

Comment: Alphonso is in violation of Standard V(B) because the compensation received by ABC Capital has not been disclosed to clients who are investors in the fund. Alphonso may not rely on the sophistication of clients and their assumed understanding of the nature and details of the fee arrangements with underlying companies in which ABC Capital invests as a reason for not providing the information required by this standard. This is true even though investors in ABC Capital Private Equity Fund III benefit from the arrangement.

Example 2 (Costs of Services to Clients):

Jones is an investment adviser tasked with completing a manager search for a client's portfolio. The search mandate is to identify a short list of investment managers who offer core fixed-income strategies managed to the benchmark identified in the client's investment policy statement. Jones begins her search with a set of criteria defined by her firm's manager search process policy. She identifies three candidates that fulfill these criteria but notices that her top-ranked manager has significantly higher fees than the other candidates on her list. Her firm's search criteria list fees as less important relative to the other criteria to rank investment managers. To present investment performance for uniform comparison, Jones creates a fee comparison chart that lists each manager's performance on a gross-of-fees basis. She presents gross-of-fees performance over the same time periods and relative to the same benchmark. She also calculates the total amount of fees that would have been paid during each of the performance time periods presented. Finally, she lists each manager's fee schedule and any fees that may be charged in addition to the published fees. She explains to her client that prior to final selection, the investment managers will be required to present their final fee proposal.

Comment:: Jones's presentation of manager fees is appropriate because she provided a uniform comparison of manager services. Her presentation adheres to Standard V(B), which requires disclosure about the nature of services provided, along with information about the costs associated with those services.

Example 3 (Disclosure of Changed Fee Calculation Methodology):

Maalouf works in a branch office for a large wealth management firm. The firm's fees are based on a percentage of the value of the assets managed in each client account. The firm has a standard method for valuing assets and calculating fees for all its clients, which is disclosed to each client at the outset of the relationship. Maalouf becomes aware that, over time, the firm has transitioned to (1) using the market value of client assets at the end of the billing cycle instead of the average daily balance of the account and (2) including cash and cash equivalents in the fee calculation, which were previously excluded.

Comment: Advisory fees are critical information that clients need to know. When investment advisers develop and maintain clear, frequent, and thorough communication with clients about the costs of their services, clients can make well-informed decisions about their investments, including about whether to engage or retain an investment adviser. Maalouf and his firm may change the advisory fee calculation methodology and policies over time for existing accounts, but Maalouf must make clients aware of any such changes. Maalouf violated Standard V(B); it is improper to change the fee calculation methodology without disclosure even if it results in lower fees.

Example 4 (Sufficient Disclosure of Investment System):

Williamson, director of marketing for Country Technicians, Inc., is convinced that she has found the perfect formula for increasing Country Technicians' income and diversifying its product base. Williamson plans to build on Country Technicians' reputation as a leading money manager by marketing an exclusive and expensive investment advice letter to high-net-worth individuals. One hitch in the plan is the complexity of Country Technicians' investment system—a combination of technical trading rules (based on historical price and volume fluctuations) and portfolio construction rules designed to minimize risk. To simplify the newsletter, she decides to include only each week's top five "buy" and "sell" recommendations and to leave out details of the valuation models and the portfolio structuring scheme.

Comment: Williamson's plans for the newsletter violate Standard V(B). Williamson need not describe the investment system in detail in order to implement the advice effectively, but she must inform clients of Country Technicians' basic process. Without understanding the basis for a recommendation, clients cannot evaluate its limitations or its inherent risks.

Example 5 (Providing Opinions as Facts):

Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Dox completed this calculation on the basis of the core samples from the company's latest drilling. According to Dox's calculations, the company has more than 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong buy."

Comment: Dox violated Standard V(B). His calculation of the total gold reserves for the property based on the company's recent sample drilling is a quantitative opinion, not a fact. Opinion must be distinguished from fact in research reports.

Example 6 (Proper Description of a Security):

Thomas, an analyst at Government Brokers, Inc., a brokerage firm specializing in government bond trading, has produced a report that describes an investment strategy designed to benefit from an expected decline in US interest rates. The firm's derivative products group has designed a structured product that will allow the firm's clients to benefit from this strategy. Thomas's report describing the strategy indicates that high returns are possible if various scenarios for declining interest rates are assumed. Citing the proprietary nature of the structured product underlying the strategy, the report does not describe in detail how the firm may be able to offer such returns or the related risks in the scenarios, nor does the report address the likely returns of the strategy if, contrary to expectations, interest rates rise.

Comment: : Thomas violated Standard V(B) because her report fails to describe properly the basic characteristics of the actual and implied risks of the investment strategy, including how the structure was created and the degree to which leverage was embedded in the structure. The report must include a balanced discussion of how the strategy would perform in the case of both rising and falling interest rates, preferably illustrating how the strategies might be expected to perform in the event of a reasonable variety of interest rate and credit risk–spread scenarios. If liquidity issues are relevant to the valuation of either the derivatives or the underlying securities, Thomas must address those risks as well.

Example 7 (Notification of Fund Mandate Change):

May & Associates is an aggressive growth manager that represents itself as a specialist at investing in small-cap US stocks. One of May's selection criteria is a maximum capitalization of US$2 billion for any given company. After a string of successful years of superior performance relative to its peers, May has expanded its client base significantly, to the point at which assets under management now exceed US$20 billion. For liquidity purposes, May's chief investment officer, Clio, decides to lift the maximum permissible market-cap ceiling to US$8 billion and change the firm's sales and marketing literature accordingly to inform prospective clients and third-party consultants.

Comment: : Although Clio appropriately informs potentially interested parties about the change in investment process, he must also notify May's existing clients. Among the latter group might be a number of clients who not only retained May as a small-cap manager but also retained mid-cap specialists in a multiple-manager approach. Such clients may regard May's change of criteria as a style change that distorts their overall asset allocations.

Example 8 (Notification of Fund Mandate Change):

In addition to lifting the ceiling for May & Associates' universe from US$2 billion to US$8 billion, Clio extends the firm's small-cap universe to include a number of non-US companies.

Comment: Standard V(B) requires Clio to advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in US small-cap stocks. Clio must disclose changes in the investment process to all interested parties

Example 9 (Notification of Changes to the Investment Process):

RJZ Capital Management is an active value-style equity manager that selects stocks by using a combination of four multifactor models. The firm has found favorable results when backtesting the most recent 10 years of available market data in a new dividend discount model designed by the firm. This model is based on projected inflation rates, earnings growth rates, and interest rates. Rodriguez, the president of RJZ, decides to replace its simple model that uses price to trailing 12-month earnings with the new model.

Comment: Because the introduction of a new and different valuation model represents a material change in the investment process, Rodriquez must communicate the change to the firm's clients. RJZ is replacing a model based on hard data with a new model that is at least partly dependent on the firm's forecasting skills. This is a significant change rather than a mere refinement of RJZ's process.

Example 10 (Notification of Changes to the Investment Process):

At Fundamental Asset Management, Inc., the responsibility for selecting stocks for the firm's "approved" list recently shifted from individual security analysts to a committee consisting of the research director and three senior portfolio managers. Morales, a portfolio manager with Fundamental Asset Management, believes this change is not important enough to communicate to her clients.

Comment: Standard V(B) requires Morales to disclose the process change to all her clients because this is a fundamental change to stock selection for the fund.

Example 11 (Sufficient Disclosure of Investment System):

Chinn is the investment director for Diversified Asset Management, which manages the endowment of a charitable organization. Because of recent staff departures, Diversified has decided to limit its direct investment focus to large-cap securities and supplement the needs for small-cap and mid-cap management by hiring outside fund managers. In describing the planned strategy change to the charity, Chinn's update letter states, "As investment director, I will directly oversee the investment team managing the endowment's large-capitalization allocation. I will coordinate the selection and ongoing review of external managers responsible for allocations to other classes." The letter also describes the reasons for the change and the characteristics external managers must have to be considered.

Comment: Standard V(B) requires the disclosure of the investment process used to construct the portfolio of the endowment fund. Changing the investment process from managing all classes of investments within the firm to the use of external managers is an example of information about the investment process that must be communicated to clients. The charity can now make a reasonable decision about whether Diversified Asset Management remains the appropriate manager for its endowment.

See also Standard V(A)–Diligence and Reasonable Basis.

Example 12 (Notification of Risks and Limitations):

Quantitative analyst Yakovlev has developed an investment strategy that selects small-cap stocks on the basis of quantitative signals. Yakovlev's strategy typically identifies only a small number of stocks (10–20) that tend to be illiquid, but according to his backtests, the strategy generates significant risk-adjusted returns. The partners at Yakovlev's firm, QSC Capital, are impressed by these results. After a thorough examination of the strategy's risks, stress testing, historical backtesting, and scenario analysis, QSC decides to seed the strategy with US$10 million of internal capital in order for Yakovlev to create a track record for the strategy.

After two years, the strategy has generated performance returns greater than those of the appropriate benchmark and the Sharpe ratio of the fund is close to 1.0. On the basis of these results, QSC decides to actively market the fund to large institutional investors. While creating the offering materials, Yakovlev informs the marketing team that the capacity of the strategy is limited. The extent of the limitation is difficult to ascertain with precision; it depends on market liquidity and other factors in his model that can evolve over time. Yakovlev indicates that given the current market conditions, investments in the fund beyond US$3 billion of capital could become more difficult and negatively affect expected fund returns.

Wellard, the manager of the marketing team and a partner with 30 years of marketing experience, explains to Yakovlev that these are complex technical issues that will muddy the marketing message. According to Wellard, the offering material should focus solely on the great track record of the fund. Yakovlev does not object because the fund has only US$100 million of capital, very far from the US$3 billion threshold.

Comment: Yakovlev and Wellard have not appropriately disclosed a significant limitation associated with the investment product. Yakovlev believes this limitation, once reached, will materially affect the returns of the fund. Although the fund is currently far from the US$3 billion mark, current and prospective investors must be made aware of this capacity issue.

Example 13 (Notification of Risks and Limitations):

Brickell Advisers offers investment advisory services mainly to South American clients. Ramon, a risk analyst at Brickell, describes to clients how the firm uses value at risk (VaR) analysis to track the risk of its strategies. Ramon assures clients that the firm’s process of calculating a VaR at a 99% confidence level, using a 20-day holding period, and applying a methodology based on an ex ante Monte Carlo simulation is extremely effective. The firm has never had losses greater than those predicted by this VaR analysis.

Comment: Ramon has not sufficiently communicated the risks associated with the investment process to satisfy the requirements of Standard V(B). The losses predicted by a VaR analysis depend greatly on the inputs used in the model. The size and probability of losses can differ significantly from what an individual model predicts. Ramon must disclose how the inputs were selected and the potential limitations and risks associated with the investment strategy.