# Ethical and Professional Standards (1)&(2)

CFA三级培训项目

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101% Contribution Breeds Professionalism

# Bob Hong

- **工作职称：**金程教育资深培训师、CFA持证人、RFP（注册财务策划师）
- **教育背景：**英国纽卡斯尔大学国际金融分析硕士（优等学位毕业）、上海对外贸易学院商务日语学士学位
- **工作背景：**九年专业金融培训经验，深悉各类金融资格证书考试重点及行业热点。先后讲授CFA 一级40班次，二级20班次，三级30班次，RFP课程10次，CFRM课程5次等。授课范围广泛，包括权益投资、固定收益投资、财务报表分析、经济学、衍生品投资、投资组合、资产配置、个人理财、私募投资、企业估值、债券投资组合管理等，同时也进行客户指定专题的培训。授课深入浅出，逻辑清晰，备受学员喜爱。拥有丰富金融从业经验，服务于摩根大通证券研究部和毕德投资咨询公司，从事行业与公司的分析和研究。在收购兼并等方面为跨国公司提供财务顾问咨询服务。并为国内中小企业寻找战略投资者和机构投资者提供咨询服务。精通日语，曾创立并领导日语小组支持东京的投资银行部门和债券市场部门
- **服务客户：** Areva，Lubrizal，Arkema，International Paper，Johnson Controls，Augusta、Philips、中国工商银行、中国银行、建设银行、农业银行、杭州银行、兴业证券、南京证券、湘财证券、兴业银行、杨浦区党校、太平洋保险、泰康人寿、中国人寿、人保资产管理、中国平安、华夏基金、中邮基金、富国基金、中国再保险、中国进出口银行、中信建投、北京外经贸大学、安徽省投资集团、阿里巴巴、携程等

# Topic in CFA Level III

| Session | Content |
|---|---|
| **Study Session 1-2** | **ETHICS & PROFESSIONAL STANDARDS (1)&(2)** |
| Study Session 3 | BEHAVIORAL FINANCE |
| Study Session 4 | CAPITAL MARKET EXPECTATIONS |
| Study Session 5 | ASSET ALLOCATION AND RELATED DECISIONS IN PORTFOLIO MANAGEMENT |
| Study Session 6 | DERIVATIVES AND CURRENCY MANAGEMENT |
| Study Session 7-8 | FIXED-INCOME PORTFOLIO MANAGEMENT (1)&(2) |
| Study Session 9-10 | EQUITY PORTFOLIO MANAGEMENT (1)&(2) |
| Study Session 11 | ALTERNATIVE INVESTMENTS FOR PORTFOLIO MANAGEMENT |
| Study Session 12-13 | PRIVATE WEALTH MANAGEMENT (1)&(2) |
| Study Session 14 | PORTFOLIO MANAGEMENT FOR INSTITUTIONAL INVESTORS |
| Study Session 15 | TRADING, PERFORMANCE EVALUATION, AND MANAGER SELECTION |
| Study Session 16 | CASES IN PORTFOLIO MANAGEMENT AND RISK MANAGEMENT |

# Framework

## Ethical and Professional Standards

- **SS1 Ethical and Professional Standards (1)**
  - R1 Code of Ethics and Standards of Professional Conduct
  - R2 Guidance for Standards I–VII
  - R3 Application of the Code and Standards: Level III
- **SS2 Ethical and Professional Standards (2)**
  - R4: Professionalism in the Investment Industry
  - R5: Asset Manager Code of Professional Conduct
  - R6: Overview of the Global Investment Performance Standards

# Reading 1

## Code of Ethics and Standards of Professional Conduct

# Framework

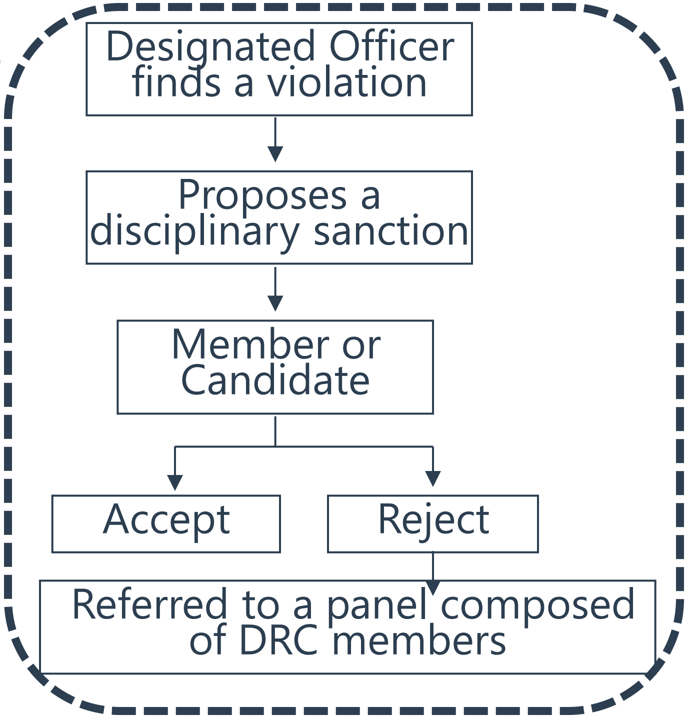
1. Proceedings
2. The Panel
3. Comparisons of AMC and Code and Standards
4. Ethics & Professional Standards

# 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, Professional Conduct staff 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
- **The Designated Officer 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.

# 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.

# Reading 2

## Guidance for Standards I–VII

# Framework

1. Professionalism
2. Integrity of Capital Markets
3. Duty To Clients
4. Duty To Employers
5. Investment
6. Conflicts of Interest
7. Responsibility as Members

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

# Guidance for Standards I-VII

Standards

| Standard | Guidance |
| --- | --- |
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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. Not expert on all laws that could **potentially** govern his activities, not expert on compliance, however, must comply with law directly governing.
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

# 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 → quit
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 - Investment Products and Applicable Laws**

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</u>**<u>. (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 understood** by those responsible for the supervision of 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 - <u>For Firms</u>**

23. Should encourage firms to consider the following: (con't)

✓ **<u>Provide information on applicable laws:</u>**

- Pertinent information that highlights applicable laws and regulations might be <u>distributed</u> to employees or made available in a <u>central location</u>.
- <u>Information sources</u> 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*).

✓ **<u>Establish procedures for reporting violations</u>:** Firms might provide <u>written protocols for reporting suspected violations</u>.

# Standard I(A): Case 1

- **Case 1. (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 can not determine 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 2

- **Case 2.(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.

# Guidance for Standards I-VII

| Standards | |
| --- | --- |
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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 <u>internal and external conflicts</u>.
4. Reject gift that <u>could be expected to compromise</u> their own or another's independence and objectivity. (**Best Practice**)
   - ✓ Ordinarily, <u>modest and normal gift</u> is OK <u>only if</u> its purpose is not to influence independence. Benefits may include gifts, invitations to lavish functions, tickets, favors, job referrals, and so on.
5. Gift <u>from corporate</u>: should evaluate both the <u>actual effect</u> on his independence and objectivity <u>and **in the eyes of clients**</u>.

# 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 -<u>Buy-Side clients</u>**

7. **Buy-Side Clients may try to pressure <u>sell-side analysts</u>.**
   - ✓ Institutional clients are the primary users of sell-side research, either <u>directly or with soft dollar brokerage</u>.
   - ✓ Rating downgrade: some portfolio managers may support sell-side ratings inflation → affect the <u>portfolio's performance and manager's compensation</u>.
   - ✓ Portfolio performance is subject to media and public scrutiny, affect the manager's <u>professional reputation</u>.

8. For portfolio managers:
   - ✓ It is <u>improper to threaten or engage in retaliatory practices</u>.
   - ✓ Although most portfolio managers do not engage in such practices, the perception by the research analyst that a reprisal is possible <u>may cause concern</u> 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 -Investment banking relationships**

**11. Firewall 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 not link analyst remuneration directly to** investment banking assignments in which analyst may participate as a team member.

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

13. Firms should also regularly review policies and procedures 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 -<u>Influence during the Manager Selection/Procurement Process</u>**

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 <u>should not solicit gifts, contributions, or other compensation that may affect</u> their independence and objectivity. Solicitations do not have to benefit members and candidates personally to conflict with Standard I(B).
    - <u>***Requesting contributions to a favorite charity or political organization***</u> 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 - <u>Issuer-Paid research</u>**

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 **<u>a flat fee that is not linked to their conclusions or recommendations</u> (directly or indirectly)**
29. Must **<u>fully disclose</u>** potential conflict of interest, <u>including the nature of compensation</u>. If not → misleading investors
30. Conduct a <u>thorough analysis</u> of the company's financial statements based on public information, benchmarking within a peer group, and industry analysis.
    - ✓ Distinguish between <u>fact and opinion</u>.

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

# Standard I(B): Recommended Procedures

➢ **Recommended Procedures (con't)**

- ***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

- **Case 1. (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***.

# Guidance for Standards I-VII

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

# Standard I(C): Content

- **Content:**

1. Must <u>not knowingly</u> 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**

2. 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).

     口头的、非公开的表述也不得有错误表述

   - ✓ "Knowingly" means that either know or should have known that the misrepresentation was being made or that **omitted** information could alter the investment decision-making process.
   - ✓ 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**

3. **The omission of a fact or outcome** has increased in importance because of the 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.
4. 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 - <u>Impact on Investment Practice</u>**

5. Guarantee the investment performance

   ✓ <u>**Prohibit:**</u> **Guaranteeing specific return** <u>which is inherently volatile,</u> because it is misleading to investors.

   美国国债

   ✓ <u>**Not prohibit:**</u> Providing clients with information on investments that have guarantees <u>built into the structure</u> of the product **or** for which an institution has <u>agreed to cover any losses</u>.

6. Members and candidates must not misrepresent any aspect of their practice, including (but not limited to) their <u>**qualifications or credentials**</u>, the <u>qualifications or services</u> 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

7. 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).
8. 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

- **<u>Guidance-Performance Reporting</u>**

9. Members and candidates may misrepresent the success of their performance record through presenting **<u>benchmarks that are not comparable to their strategy</u>.**
   - ✓ 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 <u>most appropriate</u> available benchmark from a universe of available options.
10. The transparent presentation of appropriate performance benchmarks is an important aspect in providing clients with information that is useful in making investment decisions.
11. Standard I(C) <u>does not require that a benchmark always be provided</u> 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

12. Some investment strategies may use reference indices <u>that do not reflect the opportunity set of the invested assets</u>.
    - ✓ 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 <u>disclose the reasons</u> behind the use of this reference index to avoid misrepresentations of their performance.
13. 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

14. 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**

15. 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.
16. The perceived anonymity granted through these platforms may entice individuals to misrepresent their qualifications or abilities or those of their employer.
    - ✓ Actions undertaken through social media that knowingly misrepresent investment recommendations or professional activities are considered a violation of Standard I(C).

# Standard I(C)

- **Guidance –Plagiarism**

**17. 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 ideas/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 –<u>Plagiarism</u>**

**18. <u>Forms of plagiarism:</u>**

- ✓ Take a study done by others, change name, and release.
- ✓ Using excerpts from others' reports (whether verbatim or slight changes in wording) <u>without acknowledgement</u>.
- ✓ Citing "<u>leading analysts" and "investment experts"</u> without naming specific reference.
- ✓ Using <u>charts and graphs</u> without stating sources.

# Standard I(C): Guidance - Plagiarism

- **Guidance - Plagiarism**

**19. Forms of plagiarism**：（con’t）

- ✓ 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 - <u>Plagiarism</u>**

21. <u>When citing from mainstream media outlet</u>:
    - ✓ Cannot only cite the information from the intermediary, in case of misunderstanding and potential deviation from the viewpoint of the original author.
    - ✓ **<u>Best practice</u>**: **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>.(知名机构的数据不必引用)
    - ✓ <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

- **Case 1. (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.

# Guidance for Standards I-VII

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

# Standard I(D): Content

- **Content**

  1. Must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

# 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 <u>negatively affects ability to perform professional activities</u>.
   - ✓ E.g. <u>abusing alcohol during business hours</u>. Because it could have a detrimental effect on the ability to fulfill professional responsibilities.
   - ✓ <u>**Personal bankruptcy**</u> may not reflect on the integrity or trustworthiness of the person declaring bankruptcy,
     - ◆ but <u>if the circumstances of the bankruptcy involve fraudulent or deceitful business conduct</u>, the bankruptcy may be a violation of this standard.

# Standard I(D): Recommended Procedures

- **Recommended Procedures**
  - Code of ethics: 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.
  - List of violations: Disseminate a list of potential violations and associated disciplinary sanctions to all employees.
  - Employee references: Check references to ensure good character and eligible for work in the investment industry.

# Standard I(D): Case 1-2

- **Case 1. (Fraud and Deceit)** Brink, an auto analyst and volunteer of local charities, while handling purchasing agreement of vans. Brink agrees 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 2. (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.

# Guidance for Standards I-VII

| Standards | | |
|---|---|---|
| | Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| | Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| | Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| | Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| | Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| | Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| | Responsibility as Members | Conduct as members and candidates;<br>Reference to CFA institute, designation |

# Standard II(A): Content

- **Content:**

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

# Standard II(A): Guidance

- **Guidance**

2. Trading or inducing others to trade on material nonpublic information will <u>cause investors to avoid capital markets</u> because the markets are perceived to be <u>"rigged"</u> in favor of the knowledgeable insider.
3. Must not use such information to：
   - ✓ directly <u>buy and sell of individual securities or bonds</u>
   - ✓ influence their <u>investment actions related</u> 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. <u>Substance and specificity determines the materiality</u>

- 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

- 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 (con't)

- 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. （是否selective，如果是披露方即上市公司进行挑选不构成公开。）

# Standard II(A): Guidance

➢ **Guidance – <u>When can use "nonpublic" Information？</u>**

8. A member or candidate may <u>use insider information</u> provided legitimately by the source company for the specific purpose of <u>conducting due diligence</u> 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 - <u>Investment Research Reports</u>**

**12. When a well-known or respected analyst <u>issues a report or makes changes</u> 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 <u>before it was distributed to clients</u>.**

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 <u>using his or her expertise to interpret the information</u>. The analyst's hard work, paid for by the client, generated the conclusions.

**14. <u>Simply because the public in general find the conclusions material does not require that the analyst make his/her work public</u>.** 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.
- Adopt compliance procedures[12].
- Adopt disclosure procedures.
- Issue press releases[13].
- Firewall elements[14].
- Appropriate interdepartmental communications.
- Physical separation of departments.
- Prevention of personnel overlap.
- A reporting system[15].
- Personal trading limitations[16].
- Record maintenance[17].
- Proprietary trading procedures (自营业务)[18].
- Communication to all employees[19].

# 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 prior to analyst meetings and conference calls 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, the company should promptly issue a press release or otherwise make the information publicly available.

# Standard II(A): Recommended Procedures

- **Recommended Procedures**

**17. <u>Firewall</u>**

- ✓ 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 (自营业务)***

✓ 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

- **Case 1. (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 2

- **Case 2. (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.

# Guidance for Standards I-VII

- Standards
  - Professionalism
    - Knowledge of the law;
    - Independence and objectivity;
    - Misrepresentation;
    - Misconduct
  - Integrity of Capital Markets
    - Material nonpublic information;
    - Market manipulation
  - Duty To Clients
    - Loyalty, prudence and care;
    - Fair dealing;
    - Suitability;
    - Performance presentation;
    - Preservation of confidentiality
  - Duty To Employers
    - Loyalty;
    - Additional compensation arrangements;
    - Responsibility of supervisors
  - Investment
    - Diligence and reasonable basis;
    - Communication with clients;
    - Record retention
  - Conflicts of Interest
    - Disclosure of conflicts;
    - Priority of transaction;
    - Referral fees
  - Responsibility as Members
    - Conduct as members and candidates;
    - 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. 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 intent 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. To increase liquidity, Futures Exchange made agreements with members to insure the minimum trading volume in exchange for reduction of commission.→ If for the interest of clients and disclosed, **not violate**. (see Case 5)

# Standard II(B): Case 1

- **Case 1. ("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 2

- **Case 2 (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.

# Guidance for Standards I-VII

**Standards**

| Standard | Guidance |
| --- | --- |
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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 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**
  - ✓ 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 - <u>Identifying the Actual Investment Client (con't)</u>**

9. Situations involving <u>potential conflicts of interest</u> 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 <u>responsibilities of</u> direct investment management, "clients" should also be considered.

    ✓ <u>Must look at roles and responsibilities</u> when making a determination of who their clients are.

    ✓ Easily identifiable client relationship: <u>company executive and the firm's public shareholders.</u>

# Standard III(A): Guidance

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

10. 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 - <u>Developing the Client's Portfolio (con't)</u>**

11. 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 <u>conflict with the best interests and objectives of the client</u>.
12. Must <u>follow any</u> guidelines set by their clients for asset management.
13. Investment decisions must be judged <u>in the context of the **total portfolio**</u> <u>rather than by individual investment</u> within the portfolio.

# Standard III(A): Guidance

- **Guidance - Soft Commission Policies**

14. 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."

15. 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 (con’t)**

**16. 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 insist on trading through that broker.

# Standard III(A): Guidance

- **Guidance – Proxy Voting Policies**

17. 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[18]
  - Client approval[19]
  - 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)[20]
    - ✓ Diversify[21]
    - ✓ 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 <u>(disclose to clients their proxy-voting policies)</u>[22]
    - ✓ Maintain confidentiality
    - ✓ Seek best execution
    - ✓ Place client interest first

# Standard III(A)

- **Recommended Procedures**

18. Regular account information.

    - ✓ Members and candidates with control of client assets should ***submit to each client, at least quarterly, an itemized statement showing***
        - the funds and securities in custody plus all debits, credits, and transactions that occurred during the period;
        - should disclose to the client where the assets 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.

19. Client approval.

    - ✓ If uncertain about the appropriate action to a client, should ask what he or she would expect or demand if he were the client.
    - ✓ If in doubt, should disclose questionable matter in writing to the client and obtain client approval.

# Standard III(A)

- **Recommended Procedures**

20. 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.***

**21. 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.

22. 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.

# Standard III(A): Case 2

- **Case 2 (<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.

# Guidance for Standards I-VII

- **Standards**
  - **Professionalism**
    - Knowledge of the law;
    - Independence and objectivity;
    - Misrepresentation;
    - Misconduct
  - **Integrity of Capital Markets**
    - Material nonpublic information;
    - Market manipulation
  - **Duty To Clients**
    - Loyalty, prudence and care;
    - Fair dealing;
    - Suitability;
    - Performance presentation;
    - Preservation of confidentiality
  - **Duty To Employers**
    - Loyalty;
    - Additional compensation arrangements;
    - Responsibility of supervisors
  - **Investment**
    - Diligence and reasonable basis;
    - Communication with clients;
    - Record retention
  - **Conflicts of Interest**
    - Disclosure of conflicts;
    - Priority of transaction;
    - Referral fees
  - **Responsibility as Members**
    - Conduct as members and candidates;
    - 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, or engaging in other professional activities.

# Standard III(B): Guidance

- **Guidance**

2. <u>Fairly ≠ equally</u>

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

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

3. <u>Report types</u>: initial detailed report, brief update report, by addition to or deletion from a recommended list, or simply by oral communication.

4. **<u>Premium level service</u> is okay**, if not disadvantage or negatively affect other clients. Should be disclosed to clients and available to everyone (should not be selective).

5. <u>Trade</u>: equitable system, <u>pro rata on order size, not on account size.</u>

# Standard III(B): Guidance

➢ **Guidance - *Investment Recommendations***

6. 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 <u>fair opportunity</u> to act <u>on every recommendation.</u>**
   - ✓ 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 **<u>communicated to all current clients;</u>** particular care should be taken that the <u>information reaches those clients who</u> 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 <u>advised of the changed</u> 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* (Con’t)**

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 sole proprietor and handles only discretionary accounts might not disseminate recommendations to the public, but should have formal written procedures to ensure that all clients receive fair investment action
- **Consider the following points when establishing compliance procedures**:
  - ✓ ***Limit the number of people who are privy*** to the fact that a recommendation is going to be disseminated
  - ✓ ***Shorten the time frame*** 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 systematic account review procedures to detect whether trading in one account is being used to benefit a favored client
- Disclose the level of services available

# 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. Why?
        - ◆ 一些公司会主推明星基金经理，把赚钱的交易指定给这位经理，从而使得其它经理的客户利益受损

# Standard III(B): Case 1

- **Case 1 (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 <u>intentionally allocates the profitable trades to Colby and spread the losing trades among other accounts</u>.
  - **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.

# Example: Standard III(B)

- Micheal, CFA, purchased a large block of stock at varying prices during the trading session. Micheal 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, so. According to the Standards of Practice Handbook, Micheal'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.

# Example: Standard III(B)

- **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.

# Guidance for Standards I-VII

Standards

| | |
|---|---|
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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 <u>investment experience, risk and return objectives, and financial constraints</u> prior to making any investment recommendation or taking investment action, must <u>reassess and update regularly</u>.
   - ✓ Determine that an investment is <u>suitable to the client's financial situation and consistent with written objectives</u>, mandates, and constraints before making an investment recommendation or taking investment action.
   - ✓ ***Judge the suitability in the context of the client's <u>total portfolio</u>***.
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 ***<u>consistent with the stated objectives and constraints of the portfolio</u>.***

# Standard III(C): Guidance

- **Guidance - *Developing an Investment Policy***

  3. <u>In an advisory relationship</u>, 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 **<u>incorporated into a written investment policy statement (IPS)</u>** 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 <u>client's tolerance for risk</u>.

- **Guidance - *Updating an Investment Policy***

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

# Standard III(C): Guidance

- **Guidance -*The Need for Diversification***
  6. An investment with high relative risk <u>may be suitable in the context of the entire portfolio</u> **or** <u>when the client's stated objectives contemplate speculative or risky investments</u>.
  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 <u>only on the basis of</u> 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 <u>stated mandate.</u>
  9. Those who manage pooled assets to a specific mandate are <u>not responsible for any individual investor</u>.
     - ✓ Only those who have <u>advisory relationship are responsible for individual clients.</u>

# 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.
  - ✓ an 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, <u>and review at least annually</u>;
- ✓ An appropriate suitability determination **<u>will not prevent</u>** some investments or investment actions from **<u>losing value</u>.**
- ✓ <u>Update investors' objectives and constraints periodically</u>

# 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

- **Case 1 (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 2

- **Case 2:(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 <u>because the risk profile of the fund may not be suitable for every client</u>. 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.

# Guidance for Standards I-VII

- Standards
  - Professionalism
    - Knowledge of the law;
    - Independence and objectivity;
    - Misrepresentation;
    - Misconduct
  - Integrity of Capital Markets
    - Material nonpublic information;
    - Market manipulation
  - Duty To Clients
    - Loyalty, prudence and care;
    - Fair dealing;
    - Suitability;
    - Performance presentation;
    - Preservation of confidentiality
  - Duty To Employers
    - Loyalty;
    - Additional compensation arrangements;
    - Responsibility of supervisors
  - Investment
    - Diligence and reasonable basis;
    - Communication with clients;
    - Record retention
  - Conflicts of Interest
    - Disclosure of conflicts;
    - Priority of transaction;
    - Referral fees
  - Responsibility as Members
    - Conduct as members and candidates;
    - 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 <u>fair, accurate, and complete</u>.

# 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 <u>weighted rate of return</u> rather than a single performance.

# Standard III(D): Guidance

- **Guidance: (con't)**

**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, <u>compliance with the GIPS standards is the best method to meet their obligations under Standard III(D).</u>
- ✓ 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 <u>knowledge and sophistication</u> of the audience to whom a performance presentation is addressed,
   - ✓ presenting the performance of the <u>weighted composite of similar</u> portfolios rather than using a single representative account,
   - ✓ including <u>terminated</u> 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 <u>the data and records</u> used to calculate the performance being presented.

# Standard III(D): Case 1

- **Case 1 (Performance Calculation and Selected Accounts Only).** In a presentation, Kilmer constructed the composite with balanced objective, and arbitrarily excluded accounts under certain asset level without disclosing the fact of exclusion and includes non-balanced accounts to boost return. 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.

# Guidance for Standards I-VII

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

# Standard III(E): Content

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

- **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.

# Standard III(E): Case 2

- **Case 2 (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.

# Guidance for Standards I-VII

Standards

| | |
|---|---|
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>Reference to CFA institute, designation |

# Standard IV(A): Content

- **Content:**

  1. In matters related to their employment, must act for the benefit of employer and not deprive employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm 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 info does not come from the records of former employer or violate noncompete 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* (con't)**

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* (con't)**

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 (con't)**
  - ✓ 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

- **Case 1 (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, <u>every contribution to the website must be approved by the company's compliance department before posting</u>. Any opinions expressed on the website are disclosed as representing the perspective of the company. <u>Gupta also writes a personal blog to share his experiences with friends and family</u>. As with most blogs, Gupta's personal blog is widely available to interested readers through various internet search engines. Occasionally<u>, when he disagrees with </u>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 1

- **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.

# Example: Standard IV(A)

- 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.

# Example: Standard IV(A)

- **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.

# Guidance for Standards I-VII

**Standards**

| Standard | Guidance |
| --- | --- |
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>Reference to CFA institute, designation |

# Standard IV(B): Content

- **Content:**

1. 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.

# Standard IV(B): Guidance

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

- **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 Whitmans 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 2

- **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.

# Guidance for Standards I-VII

| | | |
|---|---|---|
| Standards | Professionalism | Knowledge of the law; Independence and objectivity; Misrepresentation; Misconduct |
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| | Duty To Clients | Loyalty, prudence and care; Fair dealing; Suitability; Performance presentation; Preservation of confidentiality |
| | Duty To Employers | Loyalty; Additional compensation arrangements; Responsibility of supervisors |
| | Investment | Diligence and reasonable basis; Communication with clients; Record retention |
| | Conflicts of Interest | Disclosure of conflicts; Priority of transaction; Referral fees |
| | Responsibility as Members | Conduct as members and candidates; Reference to CFA institute, designation |

# Standard IV(C): Content

- **Content:**

1. Members and Candidates must make reasonable efforts 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 prevent and detect violations by ensuring the establishment of effective compliance systems.

   - 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 and 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 <u>know what an adequate system is</u>， 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 <u>ensure that the procedures are monitored and enforced</u>.

10. **Once knowing a potential violation， supervisor must <u>promptly initiate an investigation to ascertain</u> 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 <u>limits on the employee's activities</u> or increasing the <u>monitoring</u> 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. → 原则
     - ◆ **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. → 实现步骤
     - ◆ 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 (con’t)
      - ✓ Once compliance program is in place, a supervisor should:
        - ◆Disseminate the contents to personnel;
        - ◆Periodically update procedures;
        - ◆Continually educate personnel regarding compliance procedures;
        - ◆Issue periodic reminders of procedures;
        - ◆Incorporate professional conduct evaluation 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;
        - ◆Increase supervision or place appropriate limitations 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).** 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.

# Standard IV(C): Case 2

- **Case 2 (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 2

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

# Example: Standard IV(C)

- 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.

# Example: Standard IV(C)

- **Solution: 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.

# Guidance for Standards I-VII

Standards

| Standards | | |
|---|---|---|
| Standards | Professionalism | Knowledge of the law; Independence and objectivity; Misrepresentation; Misconduct |
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| | Conflicts of Interest | Disclosure of conflicts; Priority of transaction; Referral fees |
| | Responsibility as Members | Conduct as members and candidates; 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**
  - 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.
  - Provide supporting information to clients → enhance transparency
- **Guidance - *Defining Diligence and Reasonable Basis***
  3. In providing investment service, often use a variety of resources (company reports, third-party research, and results from quantitative models).
  4. 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.
  5. 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***

6. 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.
- 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

- 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 <u>require a greater level of review</u> than information from more established research organizations.
- Should <u>verify</u> that the firm has a <u>policy about the timely and consistent review of approved research providers</u> to ensure the quality of the research.
- If such policy not in place, should encourage development and adoption.

# Standard V(A): Guidance

➢ ***Guidance – Using Quantitatively Oriented Research***

7. Need to have an understanding of the **parameters** used in the model or quantitative research.

8. 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***

9. 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.
10. Need to consider the time horizon of data input in financial models.
11. In development of a recommendation, may need to **test the models by using volatility and performance expectations** that represent **scenarios outside the observable databases.**
12. 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***

13. 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.
14. 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***

15. 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.
16. 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.
17. Always recommend "hot" issue indicates **NO** reasonable basis.

# Standard V(A): Recommended Procedures

- **Recommended Procedures**

18. 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 (con’t)**
  - ✓ 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 (<u>successful due diligence/failed investment</u>):** 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 <u>track record, the principals involved managing the fund, the fees charged and the fund's risky profile</u>, 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 2

- **Case 2 (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 2

- **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.

# Guidance for Standards I-VII

- **Standards**
  - **Professionalism**
    - Knowledge of the law;
    - Independence and objectivity;
    - Misrepresentation;
    - Misconduct
  - **Integrity of Capital Markets**
    - Material nonpublic information;
    - Market manipulation
  - **Duty To Clients**
    - Loyalty, prudence and care;
    - Fair dealing;
    - Suitability;
    - Performance presentation;
    - Preservation of confidentiality
  - **Duty To Employers**
    - Loyalty;
    - Additional compensation arrangements;
    - Responsibility of supervisors
  - **Investment**
    - Diligence and reasonable basis;
    - Communication with clients;
    - Record retention
  - **Conflicts of Interest**
    - Disclosure of conflicts;
    - Priority of transaction;
    - Referral fees
  - **Responsibility as Members**
    - Conduct as members and candidates;
    - 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***
   7. 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.
   8. 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***

**9.** **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 **Guidance -** ***Distinction between Facts and Opinions in Reports***

- 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

11. Investment securities and vehicles may have <u>limiting factors</u> 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.
12. Members and candidates have to disclose <u>significant risks known to them at the time of the disclosure</u>.
13. 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 **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**

14. 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.
15. 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.
16. 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

17. 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**

18. Changes in investment style, investment committee and ceilings for investment universe should be disclosed to clients and prospect clients.
19. Because the selection of relevant factors is an analytical skill, determination of whether analysts have used reasonable judgment on selection of factors depends on case-by-case review rather than a specific checklist.
    - ✓ To assist in the after-the-fact review of a report, must maintain records 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

- **Case 1(Notification of Changes to the Investment Process):** 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(B)-communication with clients  because Papis attempted to hide the nature of his decision to change external managers by making only a limited disclosure.

# Standard V(B): Case 2

- **Case 2 (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 2

- **Case 2 (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 been 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.

# Guidance for Standards I-VII

Standards

| | |
|---|---|
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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 <u>also may satisfy</u> the requirements of Standard V(C), but <u>should explicitly determine whether it does.</u>
8. **If no regulatory guidance in place, CFA Institute recommends maintaining records for <u>at least 7 years</u>.** 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 1-2

- **Case 1 (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 2 (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.

# Guidance for Standards I-VII

- **Standards**
  - **Professionalism**
    - Knowledge of the law;
    - Independence and objectivity;
    - Misrepresentation;
    - Misconduct
  - **Integrity of Capital Markets**
    - Material nonpublic information;
    - Market manipulation
  - **Duty To Clients**
    - Loyalty, prudence and care;
    - Fair dealing;
    - Suitability;
    - Performance presentation;
    - Preservation of confidentiality
  - **Duty To Employers**
    - Loyalty;
    - Additional compensation arrangements;
    - Responsibility of supervisors
  - **Investment**
    - Diligence and reasonable basis;
    - Communication with clients;
    - Record retention
  - **Conflicts of Interest**
    - Disclosure of conflicts;
    - Priority of transaction;
    - Referral fees
  - **Responsibility as Members**
    - Conduct as members and candidates;
    - 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.
4. Disclosures must be prominent and must be made **in plain language**
    - ✓ 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
    - Mere appearance of 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 inadvertently find conflicts, must report and resolve as quickly and effectively as possible.
7. Disclosure to Clients:
    - Disclose:
        - ✓ **corporate financing or market making relationship;**
        - ✓ Security holding
        - ✓ Directorship
        - ✓ **Individual relationship**
    - Should also disclose fee arrangements, subadvisory arrangements or situations involving nonstandard 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
   - 和内部的矛盾（研究部与投行部）
   - 和外部的矛盾（和上市公司之间）
   - 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 ownership in stock recommended, buy-side disclose procedures for reporting 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

- **Case 1 (<u>conflicts of interest and options and compensation arrangement</u>):** 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 Fitapatrick, an analyst at research department, that he is <u>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.</u>
  - **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 2

- **Case 2 (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. Carter accepts the offer but does not disclose this to his clients and employer. 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.

# Example: Standard VI(A)

- 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.

# Example: Standard VI(A)

- **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. Answer B is incorrect because an analyst is not prevented from writing a report simply because of the special relationship the analysts' employer has with the company as long as that relationship is disclosed. Answer A is incorrect because 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.

# Guidance for Standards I-VII

Standards

| Standards | Guidance |
| --- | --- |
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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. After 7 minutes, buy, it's a violation. Must have enough time to let clients have opportunities to respond to your recommendation.
- **Guidance - *Avoiding Potential Conflicts***
  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 making money from personal investments as long as
     - ✓ 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
- **Guidance - *Personal Trading Secondary to Trading for Clients***
  6. Clients and employers have priority over trades in which a member or candidate is the beneficiary owner.
  7. Some clients in certain investment situations require investment personnel to have **aligned interests**. But mustn't adversely affect client investment. （流动性）

# Standard VI(B): Guidance

- **Guidance - Standards for Nonpublic Information**

7. 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**

8. 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
9. 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
10. 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:**

11. Basic procedures:

✓ ***Limited participation in equity IPOs;***

✓ Restrictions on private placement;

✓ ***<u>Establish blackout/restricted periods;</u>***

✓ Should have ***<u>reporting procedures</u>*** for investment personnel, including:

◆ disclosure of personal holdings/beneficial ownerships at least annually

◆ <u>duplication of confirmations</u> of trades to firm and employee

◆ preclearance of participation in IPOs.

✓ Once trading restrictions are in place, must be enforced.

✓ Best method for monitoring and enforcing procedures is <u>through reporting requirements.</u>

✓ ***Disclosures of policies***

# Example: Standard VI(B)

- 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: Standard VI(B)

- **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.

# Guidance for Standards I-VII

| Standards | | |
|---|---|---|
| Standards | Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
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| | Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| | Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| | Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| | Responsibility as Members | Conduct as members and candidates;<br>Reference to CFA institute, designation |

# Standard VI(C): Content & Guidance

- **Content:**
  1. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from, or paid to, others for the recommendation of products or services.
- **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.

# 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 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 2

- **Case 2 (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.

# Guidance for Standards I-VII

**Standards**

| | |
|---|---|
| Professionalism | Knowledge of the law;<br>Independence and objectivity;<br>Misrepresentation;<br>Misconduct |
| Integrity of Capital Markets | Material nonpublic information;<br>Market manipulation |
| Duty To Clients | Loyalty, prudence and care;<br>Fair dealing;<br>Suitability;<br>Performance presentation;<br>Preservation of confidentiality |
| Duty To Employers | Loyalty;<br>Additional compensation arrangements;<br>Responsibility of supervisors |
| Investment | Diligence and reasonable basis;<br>Communication with clients;<br>Record retention |
| Conflicts of Interest | Disclosure of conflicts;<br>Priority of transaction;<br>Referral fees |
| Responsibility as Members | Conduct as members and candidates;<br>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. 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***

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

- **Guidance - *Additional CFA Program Restrictions***

  4. 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***

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

# Standard VII(A): Case 1

- **Case 1. (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 2

- **Case 2. (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. Ramirez schedules only companies that are his clients to make presentations to the society and excludes other companies.
  - **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.

# Example: Standard VII(A)

- 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

# Example: Standard VII(A)

- **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.

# Guidance for Standards I-VII

- Standards
  - Professionalism
    - Knowledge of the law;
    - Independence and objectivity;
    - Misrepresentation;
    - Misconduct
  - Integrity of Capital Markets
    - Material nonpublic information;
    - Market manipulation
  - Duty To Clients
    - Loyalty, prudence and care;
    - Fair dealing;
    - Suitability;
    - Performance presentation;
    - Preservation of confidentiality
  - Duty To Employers
    - Loyalty;
    - Additional compensation arrangements;
    - Responsibility of supervisors
  - Investment
    - Diligence and reasonable basis;
    - Communication with clients;
    - Record retention
  - Conflicts of Interest
    - Disclosure of conflicts;
    - Priority of transaction;
    - Referral fees
  - Responsibility as Members
    - Conduct as members and candidates;
    - 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 not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

# Standard VII(B): Guidance

- **Guidance**
  2. How to use CFA:
     - ✓ adj, not n.
     - ✓ Always capitalized.
     - ✓ CFA level Ⅰ ×
     - ✓ C.F.A ×
     - ✓ Don’t alter to create new words or phrases.
     - ✓ Mustn’t be used as part of the name of a firm.
     - ✓ Shouldn’t be given more prominence（e.g. larger, bold）than the charter holder’ name.
  3. Mustn’t cite the expected date of exam completion and award of charter.
  4. A candidate who has passed level Ⅲ but has not received charter can’t use CFA designation.
  5. 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 on the business card or letterhead of each individual 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:
   - ✓ Remit annually to CFA Institute a complete Professional Conduct Statement.
   - ✓ Pay membership dues annually.

- **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

- **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 <u>prominently links this fact to the notion that AZ's mutual funds have achieved superior performance</u>.
  - **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.

# Standard VII(B): Case 2

- **Case 2. (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.

# Example: Standard VII(B)

- 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).

# Example: Standard VII(B)

- **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.

# Reading 3

## Application of the Code and Standards: Level III

# Application of the Code and Standards: Level III

- **Marcia Lopez**
  - David Hockett and Team
  - The Kochanskis
- **Castle Biotechnology**
  - David Plume, PhD, CFA
  - Sandra Benning, CFA
  - Claris Deacon
- **Lionsgate Limited & Bank of Australia**
  - Tony Hill and Team
  - Rob Portman, CFA
  - Kirk Graeme, CFA
  - The Delaneys
  - David Milgram
- **Gabby Sim**

# Reading 4

## Professionalism in the Investment Industry

# Framework

1. How professions establish trust
2. Professionalism in Investment Management
3. Expectations of Investment Professionals
4. Framework for Ethical Decision-making

# Introduction

- **Introduction**
  - The ethical behavior is central to creating trust.
  - Professions help maintain trust in an industry by establishing codes and setting standards that put a framework around ethical behavior and technical competence.
  - The concept of professionalism is based on cultural norms, and interpretation of these norms varies by region and country.

# Professions

- **Definition:**
  - A **profession** is an occupational group that has specific education, expert knowledge, and a framework of practice and behavior that underpins community trust, respect, and recognition.
  - These standards **distinguish** professions from the craft guilds and trade bodies that were established in many countries.
    - ✓ Licensed status and technical standards
    - ✓ Uphold high ethical standards
    - ✓ Have a mission to serve society and enforce professional conduct rules

# Professions

- **How Professions Establish Trust**
  - For a profession to be credible, a primary goal is to establish trust among clients and among society in general.
    - ✓ Professions normalize practitioner behavior.
    - ✓ Professions provide a service to society.
    - ✓ Professions are client focused.
    - ✓ Professions have high entry standards.
    - ✓ Professions possess a body of expert knowledge.
    - ✓ Professions encourage and facilitate continuing education.
    - ✓ Professions monitor professional conduct.
    - ✓ Professions are collegial.
    - ✓ Professions are recognized overseeing bodies.
    - ✓ Professions encourage the engagement of members.

# Professions

- **Professions Are Evolving**
  - Greater transparency & public accountability
  - The investment management profession has become <u>**increasingly global**</u>, driven by the opening of capital markets, coordination of regulation across borders, and the emergence of technology.
  - Effective professions <u>continue to develop their role</u> to account for changing **best** practices.
  - Effective professions also actively **learn from other** professions, particularly in the area of ethics. New standards of conduct in the accounting profession might be an influence on standards considered in investment management, for example.

# Professionalism in Investment Management

- **Investment Industry**
  - The industry is **<u>still in the process of developing</u>** the framework and common understanding of what is means to be a profession.
  - **Trust** in the investment profession is earned with society through the expectation that professionals will have the **technical expertise**, the **knowledge of applicable law**, and an **understanding of ethics and professional standards** to serve their clients with care, transparency, and integrity.

# Professionalism in Investment Management

- **CFA Institute as an Investment Management Professional Body**
  - CFA Institution is an investment management professional body that embodies many of the tenets of a profession.
    - ✓ The mission of CFA Institute is "to lead the investment profession globally, by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society."
    - ✓ Where client interests and market interests conflict, the Code and Standards set an investment management professional's duty to market integrity as the overriding obligation.
    - ✓ CFA charterholders and candidates are required to certify every year that they adhere to the Code and Standards.

# Expectations of Investment Professionals

- Expectations for our profession are set in the Code of Ethics. 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.

# Framework for Ethical Decision-making

- **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.
- **Ethical Decision-Making Framework**
  - **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?

# Reading 5

## Asset Manager Code of Professional Conduct

# AMC Overview

- **Framework for AMC**
  1. Loyalty to Clients
  2. Investment Process and Actions
  3. Trading
  4. **Risk Management, Compliance, and Support**
  5. Performance and Valuation
  6. **Disclosures**

# Introduction

- **The purpose and the benefits of the asset manager code**
  - The asset manager code of professional conduct outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients. The code is meant to apply to firms that manage client assets as separate accounts or pooled funds.
  - The code should be adopted by the manager's senior management, board of directors, and similar oversight bodies.
  - The code sets forth minimum ethical standards for providing asset management services for clients.
  - The principles and standards embodied in the code must be supported by appropriate compliance procedures.
  - The provisions of this code may need to be supplemented with additional provisions to meet the requirements of applicable security regulation.
  - Providing clients with a code of ethics that sets a framework for how the manager conducts business is an important step toward developing the trust and confidence necessary for a successful investment management relationship.

# Introduction

- **Basic difference between the AMC and the handbook**
- The standards of practice handbook (handbook) provides guidance to the people who grapple with real ethical dilemmas in the investment profession on a daily basis; the handbook addresses the professional intersection where theory meets practice.
- The **Asset Manager Code of Professional Conduct** outlines the ethical and professional responsibilities of **firms** that manage assets on behalf of clients.
  - To firms that manage client assets as separate accounts or pooled funds (including **collective investment schemes, mutual funds, and fund of funds organizations**)
  - To asset managers, including hedge fund managers who may not already have such a code in place
  - To risk management as well as guidance for Managers seeking to claim compliance

# Introduction

- Cover **all employees** of the firm.
- Managers must adhere to **all applicable laws and regulations** governing their activities.
- Adoption of or compliance with the AMC requires firms to adhere to all the principles of conduct and provisions set forth in the Code. Statements referring **to partial or incomplete compliance are prohibited**. (e.g., "the firm complies with the Asset Manager Code except for . . ." or "the firm complies with parts A, B, and C of the Asset Manager Code")
- The firm must make the following statement whenever the firm claims compliance with the Code:
- "[Insert name of Firm] claims compliance with the CFA Institute Asset Manager Code of Professional Conduct. **This claim has not been verified by CFA Institute.**"

# General Principles of Conduct

- **Managers have the following responsibilities to their clients. Managers must:**
  - Act in a professional and ethical manner at all times.
  - Act for the benefit of clients.
  - Act with independence and objectivity.
  - Act with skill, competence, and diligence.
  - Communicate with clients in a timely and accurate manner.
  - Uphold the applicable rules governing capital markets.

# 1. Loyalty to Clients

- **Managers must:**
  - Place client interests before their own.
  - Preserve the confidentiality of information communicated by clients within the scope of the Manager–client relationship.
  - Refuse to participate in any business relationship or accept any gift that could reasonably be expected to affect their independence, objectivity, or loyalty to clients.

# Loyalty to Clients

- **Recommendations and Guidance:**
  - Place client interests before their own.
    - ✓ Client interests are paramount.
    - ✓ Managers should institute policies and procedures to ensure that client interests supersede Manager interests in all aspects of the Manager–client relationship, including (but not limited to) investment selection, transactions, monitoring, and custody.
    - ✓ Managers should take reasonable steps to avoid interests conflict.
    - ✓ Operational safeguards to protect client interests.
    - ✓ Compensation arrangements that align the financial interests of clients and Managers.

# Loyalty to Clients

- **Recommendations and Guidance:**
  - Preserve the confidentiality of information communicated by clients within the scope of the Manager–client relationship.
    - ✓ Hold information of the Manager–client relationship strictly confidential and must take all reasonable measures to preserve confidentiality. Information on the basis of their confidential relationship with the client.
    - ✓ （客户关系本身就是confidential，如无同意不能泄露）
    - ✓ Their special ability to conduct a portion of the client's business or personal affairs. Managers should create a privacy policy that addresses how confidential client information will be collected, stored, protected, and used.
    - ✓ Does not supersede a duty (and in some cases the legal requirement) to report suspected illegal activities involving client accounts to the appropriate authorities. Where appropriate, Managers should consider creating and implementing a written anti-money-laundering policy to prevent their organizations from being used for money laundering or the financing of any illegal activities.

# Loyalty to Clients

- **Recommendations and Guidance:**
  - Refuse to participate in any business relationship or accept any gift that could reasonably be expected to affect their independence, objectivity, or loyalty to clients.
    - ✓ Establish policies for accepting gifts or entertainment in a variety of contexts. To avoid the appearance of a conflict, Managers must refuse to accept gifts or entertainment from service providers, potential investment targets, or other business partners of more than a minimal value.
    - ✓ Establish a written policy limiting the acceptance of gifts and entertainment to items of **minimal value**. Managers should consider creating specific limits for accepting gifts (e.g., **amount per time period per vendor)** and **prohibit** the acceptance of **any cash gifts**.
    - ✓ Employees should be required to **document and disclose** to the Manager, through their supervisor, the firm's compliance office, or senior management, **the acceptance of any gift or entertainment**.
    - ✓ This provision is not meant to preclude Managers from maintaining multiple business relationships with a client as long as potential conflicts of interest are managed and disclosed.

# 2. Investment Process and Actions

- **Managers must:**
  - Use **reasonable care and prudent judgment** when managing client assets.
  - Not engage in practices designed to **distort** prices or artificially inflate trading volume with the intent to mislead market participants.
  - **Deal fairly and objectively** with all clients when providing investment information, making investment recommendations, or taking investment action.
  - Have a **reasonable and adequate** basis for investment decisions.
  - When managing a **portfolio or pooled fund** according to a specific mandate, strategy, or style:
    - ✓ Take only investment actions that are consistent with the stated objectives and constraints of that portfolio or fund.
    - ✓ Provide adequate disclosures and information so investors can consider whether **any proposed changes** in the investment style or strategy meet their investment needs.

# Investment Process and Actions

➢ **Managers must:**

- When managing separate accounts and before providing investment advice or taking investment action on behalf of the client:
  - ✓ Evaluate and understand the client's investment objectives, tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances (including tax considerations, legal or regulatory constraints, etc.) and any other relevant information that would affect investment policy.

    ⬇

    **IPS**
  - ✓ Determine that an investment is **suitable** to a client's financial situation.

# Investment Process and Actions

- **Recommendations and Guidance:**
  - Use reasonable care and prudent judgment when managing client assets.
    - ✓ Care and prudence necessary to meet their obligations to clients.
    - ✓ The exercise of prudence requires acting with the **care, skill, and diligence** that a person acting in a like capacity and familiar with such matters would use under the same circumstances.
    - ✓ In the context of managing a client's portfolio, prudence requires following the investment parameters set forth by the client and balancing risk and return. Acting with care requires Managers to act in a prudent and judicious manner in avoiding harm to clients.

# Investment Process and Actions

- **Recommendations and Guidance:**
  - Not engage in practices designed to distort prices or artificially inflate trading volume with the intent to mislead market participants.
    - ✓ Market manipulation is illegal in most jurisdictions and damages the interests of all investors by disrupting the efficient functioning of financial markets and causing deterioration in investor confidence.
    - ✓ **Transaction-based manipulation** includes, but is not limited to, transactions that artificially distort prices or volume to give the impression of activity or price movement in a financial instrument (e.g., trading in illiquid stocks at the end of a measurement period to drive up the price and improve Manager performance) and securing a large position with the intent to exploit and manipulate the price of an asset and/or a related derivative.
    - ✓ **Information-based manipulation** includes, but is not limited to, spreading knowingly false rumors to induce trading by others and pressuring sell-side analysts to rate or recommend a security in such a way that benefits the Manager or the Manager's clients.

# Investment Process and Actions

- **Recommendations and Guidance:**
  - Deal fairly and objectively with all clients when providing investment information, making investment recommendations, or taking investment action.
    - ✓ To maintain the trust that clients place in them, Managers must deal with all clients in a **fair and objective manner**.
    - ✓ Managers must not give preferential treatment to favored clients to the detriment of other clients.
    - ✓ In some cases, clients may pay for a higher level of service or certain services and certain products may only be made available to certain qualifying clients (e.g., certain funds may be open only to clients with assets above a certain level). These practices are **permitted** as long as they are disclosed and made available to all clients.
    - ✓ This provision is not intended to prevent Managers from engaging in secondary investment opportunities—referred to in some jurisdictions as "side-letter," "sidecar," or "tag-along" arrangements—with certain clients as long as such opportunities are fairly allocated among similarly situated clients for whom the opportunity is suitable.

# Investment Process and Actions

- **Recommendations and Guidance:**
  - Have a reasonable and adequate basis for investment decisions.
    - ✓ Managers must act with prudence and make sure their decisions have a **reasonable and adequate basis**.
    - ✓ Prior to taking action on behalf of their clients, Managers must analyze the investment opportunities in question and should act only after undertaking due diligence to ensure there is sufficient knowledge about specific investments or strategies.
    - ✓ Such analysis will depend on the style and strategy being used. For example, a Manager implementing a passive strategy will have a very different basis for investment actions from that of a Manager that uses an active strategy.
    - ✓ Managers can rely on **external third-party research** as long as Managers have made reasonable and diligent efforts to determine that such research has a reasonable basis. When evaluating investment research, Managers should consider the assumptions used, the thoroughness of the analysis performed, the timeliness of the information, and the objectivity and independence of the source.

# Investment Process and Actions

- **Recommendations and Guidance:**
  - ✓ Managers should have a thorough understanding of the securities in which they invest and the strategies they use on behalf of clients. Managers should understand the structure and function of the securities, how they are traded, their liquidity, and any other risks (including counterparty risk).
  - ✓ Managers who implement **complex and sophisticated investment strategies** should **understand** the **structure and potential vulnerabilities** of such strategies and communicate these in an understandable manner to their clients. For example, when implementing **complex derivative strategies**, Managers should understand the various risks and conduct statistical analysis (i.e., stress testing) to determine how the strategy will perform under different conditions. By undertaking adequate due diligence, Managers can better judge the suitability of investments for their clients.

# Investment Process and Actions

➢ **Recommendations and Guidance:**

- When managing a portfolio or pooled fund according to a specific mandate, strategy, or style:
  - ✓ Take only investment actions that are consistent with the stated objectives and constraints of that portfolio or fund.

    Managers must manage the funds or portfolios within the stated mandates or strategies. **Flexibility** is **not improper** but should be expressly **understood and agreed to by Managers and clients**. Best practice is for Managers to disclose such events to clients when they occur or, at the very least, in the course of normal client reporting.

# Investment Process and Actions

- **Recommendations and Guidance:**
  - ✓ Provide adequate disclosures and information so investors can consider whether **any proposed changes** in the investment style or strategy meet their investment needs.

    To give clients an opportunity to evaluate the suitability of investments, Managers need to provide adequate information to them about any proposed material changes to their investment strategies or styles. They must provide this information well **in advance of such changes**. Clients should be given enough time to consider the changes and take any actions that may be necessary. Clients should be permitted to redeem their investment, without incurring any undue penalties.

# Investment Process and Actions

➢ **Recommendations and Guidance:**

- When managing separate accounts and before providing investment advice or taking investment action on behalf of the client:
  - ✓ Evaluate and understand the client's investment objectives, tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances (including tax considerations, legal or regulatory constraints, etc.) and any other relevant information that would affect investment policy.
  - ✓ The information contained in an IPS allows Managers to assess whether a particular strategy or security is suitable for a client (in the context of the rest of the client's portfolio), and the IPS serves as the basis for establishing the client's strategic asset allocation. (Note: In some cases, the client will determine the strategic asset allocation; in other cases, that duty will be delegated to the Manager).
  - ✓ The IPS should also specify the Manager's role and responsibilities in managing the client's assets and establish schedules for review and evaluation.
  - ✓ The Manager should reach agreement with the client as to an **appropriate benchmark or benchmarks** by which the Manager's performance will be measured and any other details of the performance evaluation process (e.g., when performance measurement should begin).

# Investment Process and Actions

➢ **Recommendations and Guidance:**

✓ Determine that an investment is **suitable** to a client's financial situation.

Managers must evaluate investment actions and strategies **in light of each client's circumstances.**

✓ Not all investments are suitable for every client, and Managers have a responsibility to ensure that only **appropriate** investments and investment strategies are included in a client's portfolio. Ideally, individual investments should be evaluated in the context of clients' **total** assets and liabilities, which may include assets held outside of the Manager's account, to the extent that such information is made available to the Manager and is explicitly included in the context of the client's IPS.

# 3. Trading

- **Managers must:**

1. Not act or cause others to act on material nonpublic information that could affect the value of a publicly traded investment.
2. Give priority to investments made on behalf of the client over those that benefit the Managers' own interests.
3. Use commissions generated from client trades to pay for only investment related products or services that directly assist the Manager in its investment decision-making process, and not in the management of the firm.
4. Maximize client portfolio value by seeking best execution for all client transactions.

**Soft Dollar**

5. Establish policies to ensure fair and equitable trade allocation among client accounts.

# Trading

- **Recommendations and Guidance:**
  - Not act or cause others to act on material nonpublic information that could affect the value of a publicly traded investment.
    - ✓ Trading on material nonpublic information, which is illegal in most jurisdictions, erodes confidence in capital markets, institutions, and investment professionals and promotes the perception that those with inside and special access can take unfair advantage of the general investing public. Although trading on such information may lead to short-term profitability, over time, individuals and the profession as a whole suffer if investors avoid capital markets because they perceive them to be unfair by favoring the knowledgeable insider.
    - ✓ Different jurisdictions and regulatory regimes may define materiality differently, but in general, information is "**material**" if it is likely that a reasonable investor would consider it important and if it would be viewed as significantly altering the total mix of information available. Information is "**nonpublic**" until it has been widely disseminated to the marketplace (as opposed to a select group of investors).

# Trading

- **Recommendations and Guidance:**
  - Not act or cause others to act on **material nonpublic information** that could affect the value of a publicly traded investment.
    - ✓ Managers must adopt **compliance procedures**, such as establishing information barriers (e.g., fire walls), to prevent the disclosure and misuse of material nonpublic information. In many cases, pending trades or client or fund holdings may be considered material nonpublic information, and Managers must be sure to keep such information confidential. In addition, merger and acquisition information, prior to its public disclosure, is generally considered material nonpublic information. Managers should evaluate company-specific information that they may receive and determine whether it meets the definition of material nonpublic information.
    - ✓ This provision is not meant to prevent Managers from **using the mosaic theory** to draw conclusions—that is, combine pieces of material public information with pieces of nonmaterial nonpublic information to draw conclusions that are actionable.

# Trading

- **Recommendations and Guidance:**
  - Give priority to investments made on behalf of the client over those that benefit the Managers' own interests.
    - ✓ Managers must not execute their own trades in a security prior to client transactions in the same security. Investment activities that benefit the Manager must not adversely affect client interests. Managers must not engage in trading activities that work to the disadvantage of clients (e.g., front-running client trades).
    - ✓ In some investment arrangements, such as limited partnerships or pooled funds, Managers **put their own** capital at risk alongside that of their clients to align their interests with the interests of their clients. These arrangements are **permissible** only if clients are not disadvantaged.

# Trading

- **Recommendations and Guidance:**
  - Give priority to investments made on behalf of the client over those that benefit the Managers' own interests.
    - ✓ Managers should develop policies and procedures to monitor and, where appropriate**, limit the personal trading** of their employees.
    - ✓ In particular, Managers should require employees to **receive approval prior to any personal investments in initial public offerings or private placements.**
    - ✓ Managers should develop policies and processes designed to ensure that client transactions take precedence over employee or firm transactions.
    - ✓ One method is to create a restricted list and/or watch list of securities that are owned in client accounts or may be bought or sold on behalf of clients in the near future; prior to trading securities on such a list, employees would be required to **seek approval**.
    - ✓ In addition, Managers could require employees to provide the compliance officer with copies of trade confirmations each quarter and annual statements of personal holdings.

# Trading

- **Recommendations and Guidance:**
  - Use commissions generated from client trades to pay for only investment related products or services that directly assist the Manager in its investment decision-making process, and not in the management of the firm.
    - ✓ Managers must recognize that **commissions paid (and any benefits received in return for commissions paid) are the property of the client.** Consequently, any benefits offered in return for commissions must benefit the Manager's clients.
    - ✓ To determine whether a benefit generated from client commissions is appropriate, Managers must determine **whether it will directly assist** in the Manager's investment decision-making process. The investment decision-making process can be considered the qualitative and quantitative process and the related tools used by the Manager in rendering investment advice to clients. The process includes financial analysis, trading and risk analysis, securities selection, broker selection, asset allocation, and suitability analysis.
  - Some Managers have chosen to eliminate the use of soft commissions (also known as soft dollars) to avoid any conflicts of interest that may exist. Managers should disclose their policy on how benefits are evaluated and used for the client's benefit. Such an arrangement can be found in the CFA Institute Soft Dollar Standards.

# Trading

➢ **Recommendations and Guidance:**

- Maximize client portfolio value by seeking best execution for all client transactions.
  - ✓ When placing client trades, Managers have a duty to seek terms that secure best execution for and maximize the value of each client's portfolio (i.e., ensure the best possible result overall). Managers must seek the most favorable terms for client trades within each trades' particular circumstances (such as transaction size, market characteristics, liquidity of security, and security type). Managers also must decide which brokers or venues provide best execution while considering, among other things, commission rates, timeliness of trade executions, and the ability to maintain anonymity, minimize incomplete trades, and minimize market impact.
  - ✓ When a client directs the Manager to place trades through a specific broker or through a particular type of broker, Managers should alert the client that by limiting the Manager's ability to select the broker, the client may not be receiving best execution. **The Manager should seek written acknowledgment from the client of receiving this information.**

# Trading

- **Recommendations and Guidance:**
  - Establish policies to ensure fair and equitable trade allocation among client accounts.
    - ✓ When placing trades for client accounts, Managers must allocate trades fairly so that some client accounts are not routinely traded first or receive preferential treatment. Where possible, Managers should use block trades and allocate shares on a **pro-rata basis** by using an average price or some other method that ensures fair and equitable allocations.
    - ✓ When allocating shares of an initial or secondary offering, Managers should strive to ensure that all clients for whom the security is suitable are given opportunities to participate.
    - ✓ When Managers do not receive a large enough allocation to allow all eligible clients to participate fully in a particular offering, they must ensure that certain clients are not given preferential treatment and should establish a system to ensure that new issues are allocated fairly (e.g., pro rata). Manager’s trade allocation policies should specifically address how initial public offerings and private placements are to be handled.

# 4. Risk Management, Compliance, and Support

- **Managers must:**
  - Develop and maintain policies and procedures to ensure that their activities comply with the provisions of this Code and all applicable legal and regulatory requirements.
  - Appoint a **compliance officer** responsible for administering the **policies** and **procedures** and for **investigating complaints** regarding the conduct of the Manager or its personnel.
  - Ensure that portfolio information provided to clients by the Manager is accurate and complete and arrange **for independent third-party confirmation or review** of such information.
  - Maintain records for an appropriate period of time in an easily accessible format.

# Risk Management, Compliance, and Support

- **Managers must:**
  - Employ **qualified staff** and **sufficient human and technological resources** to thoroughly investigate, analyze, implement, and monitor investment decisions and actions.
  - Establish a **business-continuity plan** to address disaster recovery or periodic disruptions of the financial markets.
  - Establish a **firm-wide risk management process** that identifies, measures, and manages the risk position of the Manager and its investments, including the sources, nature, and degree of risk exposure.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **1.**Develop and maintain policies and procedures to ensure that their activities comply with the provisions of this Code and all applicable legal and regulatory requirements.
    - ✓ **Detailed and firm-wide compliance policies and procedures** are critical tools to ensure that Managers meet their legal requirements when managing client assets. In addition, the fundamental, principle-based, ethical concepts embodied in the Code should be put into operation by the implementation of specific policies and procedures.
    - ✓ **Documented compliance procedures** assist Managers in fulfilling the responsibilities enumerated in the Code and ensure that the standards expressed in the Code are adhered to in the day-to-day operation of the firms. The appropriate compliance programs, internal controls, and self-assessment tools for each Manager will depend on such factors as the **size** of the firm and the **nature** of its investment management business.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **2.** Appoint a ***compliance officer*** responsible for administering the policies and procedures and for investigating complaints regarding the conduct of the Manager or its personnel.
    - ✓ Effective compliance programs require Managers to appoint a **compliance officer** who is competent, knowledgeable, and credible and is empowered to carry out his or her duties.
    - ✓ Depending on **the size and complexity** of the Manager's operations, Managers may designate an existing employee to also serve as the compliance officer, may hire a separate individual for that role, or may establish an entire compliance department.
    - ✓ Where possible, the compliance officer should be **independent from the investment and operations personnel** and should **report directly to the CEO or board of directors.**

# Risk Management, Compliance, and Support

- ✓ The compliance officer and senior management should regularly make clear to all employees that adherence to compliance policies and procedures is crucial and that anyone who violates them will be held liable. Managers should consider requiring all employees to acknowledge that they have **received a copy of the Code** (as well as any subsequent material amendments), that they understand and agree to comply with it, and that they will report any suspected violations of the Code to the designated compliance officer. Compliance officers should take steps to implement appropriate **employee training** and conduct continuing **self-evaluation** of the Manager's compliance practices to assess the effectiveness of the practices.
- ✓ Among other things, the compliance officer should be charged with reviewing firm and employee transactions to ensure the priority of client interests. Because personnel, regulations, business practices, and products constantly change, the role of the compliance officer is particularly important.
- ✓ The compliance officer should document and act expeditiously to address any compliance breaches and work with management to take appropriate disciplinary action.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **3.** Ensure that portfolio information provided to clients by the Manager is accurate and complete and arrange for independent **third-party confirmation** or review of such information.
    - ✓ Managers have a responsibility to ensure that the information they provide to clients is accurate and complete. By receiving an independent third-party confirmation or review of that information, clients have an additional level of confidence that the information is correct, which may enhance the Manager's credibility.
    - ✓ Such verification is also good business practice because it may serve as a risk management tool to help the Manager identify potential problems. The confirmation of portfolio information may take the form of an **audit or review**, as is the case with most pooled vehicles, or may take the form of copies of account statements and trade confirmations from the custodian bank where the client assets are held.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **4.** Maintain records for an appropriate period of time in an easily accessible format.
    - ✓ Managers must retain records that substantiate their investment activities, the scope of their research, the basis for their conclusions, and the reasons for actions taken on behalf of their clients. Managers should also retain copies of other compliance related records that <u>support and substantiate</u> the implementation of the Code and related policies and procedures, as well as records of <u>any violations and resulting actions taken</u>. Records can be maintained either in <u>**hard copy or electronic form**</u>.
    - ✓ **Regulators often impose requirements** related to record retention. In the absence of such regulation, Managers must determine the appropriate minimum time frame for keeping the organization's records. <u>Unless otherwise required by local law or regulation</u> Managers should keep records for <u>**at least seven years**</u>.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **5.** Employ **qualified staff and sufficient human and technological resources** to thoroughly investigate, analyze, implement, and monitor investment decisions and actions.
    - ✓ To safeguard the Manager–client relationship, Managers need to allocate all the resources necessary to ensure that client interests are not compromised. Clients pay significant sums to Managers for professional asset management services, and client assets should be handled with the greatest possible care.
    - ✓ Managers of all sizes and investment styles struggle with issues of cost and efficiency and tend to be cautious about adding staff in important operational areas. Nevertheless, adequate protection of client assets requires appropriate administrative, back-office, and compliance support. Managers should ensure that **adequate internal controls** are in place to prevent fraudulent behavior.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - Employ qualified staff and sufficient human and technological resources to thoroughly investigate, analyze, implement, and monitor investment decisions and actions.
    - ✓ A critical consideration is **employing only qualified staff**. Managers must ensure that client assets are invested, administered, and protected by qualified and experienced staff. Employing qualified staff reflects a client-first attitude and helps ensure that Managers are applying the care and prudence necessary to meet their obligations to clients. This provision is not meant to prohibit the outsourcing of certain functions, but the Manager **retains the liability and responsibility for any outsourced work**.
    - ✓ Managers have a responsibility to clients to deliver the actual services they claim to offer. Managers must use adequate resources to carry out the necessary research and analysis to implement their investment strategies with due diligence and care. Also, Managers must have adequate resources to monitor the portfolio holdings and investment strategies. As investment strategies and instruments become increasingly sophisticated, the need for sufficient resources to analyze and monitor them becomes ever more important.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **6.** Establish a **business-continuity plan** to address disaster recovery or periodic disruptions of the financial markets.
    - ✓ Part of safeguarding client interests is establishing procedures for handling client accounts and inquiries in situations of national, regional, or local emergency or market disruption. Commonly referred to as **business-continuity** or **disaster-recovery planning**, such preparation is increasingly important in an industry and world highly susceptible to a wide variety of disasters and disruptions.
    - ✓ As with any important business planning, Managers should ensure that employees and staff are **knowledgeable** about the plan and are **specifically trained** in areas of responsibility. Plans should be tested on a firm-wide basis at intervals to promote employee understanding and identify any needed adjustments.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - Establish a **business-continuity plan** to address disaster recovery or periodic disruptions of the financial markets.
    - ✓ The level and complexity of business-continuity planning depends on the size, nature, and complexity of the organization. **At a minimum**, Managers should consider having the following:
      - ◆ adequate **backup**, preferably **off-site**, for **all account information**,
      - ◆ **alternative plans** for monitoring, analyzing, and trading investments if primary systems become unavailable,
      - ◆ plans for communicating with **critical vendors and suppliers**,
      - ◆ plans for **employee communication** and **coverage of critical business functions** in the event of a facility or communication disruption, and
      - ◆ plans for **contacting and communicating with clients** during a period of **extended disruption**.
    - ✓ Numerous other factors may need to be considered when creating the plan. According to the needs of the organization, these factors may include **establishing backup office and operational space** in the event of an extended disruption and dealing with **key employee deaths or departures**.

# Example: Business-Continuity Plan

- A compliance officer evaluates the firm's business-continuity plan. Under the current plan:
  - ✓ the technology division backs up all of the firm's computer systems and client records twice daily.
  - ✓ The back-ups are stored in a fireproof storage facility offsite.
  - ✓ Firm outsources certain emergency plans to a disaster recovery firm.
  - ✓ The disaster recovery firm is responsible for developing and implementing plans to communicate with employees and mission-critical vendors and suppliers in the event of a facility or communication disruption.
  - ✓ The same firm also provides plans for contacting and communicating with clients in event of an extended disruption.

# Risk Management, Compliance, and Support

- **Recommendations and Guidance:**
  - **7.** Establish a firm-wide risk management process that identifies, measures, and manages the risk position of the Manager and its investments, including the sources, nature, and degree of risk exposure.
    - ✓ Many investors, including those investing in hedge funds and alternative investments or leveraged strategies, invest specifically to increase their risk-adjusted returns. Assuming some risk is a necessary part of that process. The key to sound risk management by Managers is seeking to **ensure that the risk profile desired by clients matches the risk profile of their investments**. Risk management should complement rather than compete with the investment management process. Investment managers must implement risk management techniques that are consistent with their investment style and philosophy.
    - ✓ The types of risks faced by Managers include, but are not limited to, market risk, credit risk, liquidity risk, counterparty risk, concentration risk, and various types of operational risk. Such types of risks should be analyzed by Managers as part of a comprehensive risk management process for portfolios, investment strategies, and the firm. These examples are illustrative only and may not be applicable to all investment organizations.

# Risk Management, Compliance, and Support

- ✓ The firm's risk management process must be **objective, independent, and insulated from influence of portfolio managers**. Managers may wish to describe to clients how the risk management framework complements the portfolio management process while remaining separate from that process. Managers should **consider outsourcing** risk management activities if a separate risk management function is not appropriate or feasible because of the size of the organization.
- ✓ An effective risk management process will identify risk factors for individual portfolios as well as for the Manager's activities as whole. It will often be appropriate for managers to perform **stress tests, scenario tests, and back-tests** as part of developing risk models that comprehensively capture the full range of their actual and contingent risk exposures. The goal of such models is to determine how various changes in market and investment conditions could affect investments. The risk models should be continuously evaluated and challenged, and Managers should be prepared to describe the models to clients. Despite the importance of risk models, however, effective risk management ultimately depends on the experience, judgment, and ability of the Managers in analyzing their risk metrics.

# 5. Performance and Valuation

- **Managers must:**
  - Present performance information that is **fair, accurate, relevant, timely, and complete**. Managers must not misrepresent the performance of individual portfolios or of their firm.
  - Use fair-market prices to value client holdings and apply, in good faith, methods to determine the fair value of any securities for which no independent, third-party market quotation is readily available.

# Performance and Valuation

- **Recommendations and Guidance:**
  - Present performance information that is fair, accurate, relevant, timely, and complete. Managers must not misrepresent the performance of individual portfolios or of their firm.
    - ✓ Managers have a duty to present performance information that is a fair representation of their record and includes all relevant factors.
    - ✓ In particular, Managers should be certain not to misrepresent their track records by taking credit for performance that is not their own (i.e., when they were **not managing a particular portfolio or product**) or by selectively presenting certain time periods or investments (i.e., **cherry picking**).
    - ✓ **Any hypothetical or backtested performance must be clearly identified as such. Managers should provide as much additional portfolio transparency as feasibly possible. Any forward-looking information provided to clients must also be fair, accurate, and complete.**

# Performance and Valuation

➢ **Recommendations and Guidance:**

- Present performance information that is fair, accurate, relevant, timely, and complete. Managers must not misrepresent the performance of individual portfolios or of their firm.
  - ✓ A model for fair, accurate, and complete performance reporting is embodied in the Global Investment Performance Standards **(GIPS®)**, which are based on the principles of fair representation and full disclosure and are designed to meet the needs of a broad range of global markets.
  - ✓ By adhering to these standards for reporting investment performance, Managers help assure investors that the performance information being provided is both complete and fairly presented.
  - ✓ When Managers comply with the GIPS standards, both prospective and existing clients benefit because they can have a high degree of confidence in the reliability of the performance numbers the Managers are presenting. This confidence may, in turn, enhance clients' sense of trust in their Managers.

# Performance and Valuation

- **Recommendations and Guidance:**
  - Use fair-market prices to value client holdings and apply, in good faith, methods to determine the fair value of any securities for which no independent, third-party market quotation is readily available.
    - ✓ In general, fund Managers' fees are calculated as a percentage of assets under management. In some cases, an additional fee is calculated as a percentage of the annual returns earned on the assets. Consequently, a conflict of interest may arise where the portfolio Manager has the additional responsibility of determining end-of-period valuations and returns on the assets.
    - ✓ These conflicts may be overcome by transferring responsibility for the valuation of assets (including foreign currencies) to an **independent third party**. For pooled funds that have **boards of directors** comprising independent members, the independent members should have the responsibility of approving the asset valuation policies and procedures and reviewing the valuations. For pooled funds without independent directors, we recommend that this function be undertaken by independent third parties who are expert in providing such valuations.
    - ✓ Managers should use widely **accepted valuation methods** and techniques to appraise portfolio holdings of securities and other investments and should apply these methods on a **consistent** basis.

# 6. Disclosures

- **Managers must:**
  - Communicate with clients on an ongoing and timely basis.
  - Ensure that disclosures are **truthful, accurate, complete, and understandable and are presented** in a format that communicates the information effectively.
  - Include any material facts when making disclosures or providing information to clients regarding themselves, their personnel, investments, or the investment process.
  - Disclose the following:
    - ✓ **Conflicts of interests** generated by any relationships with brokers or other entities, other client accounts, fee structures, or other matters.
    - ✓ **Regulatory or disciplinary** action taken against the Manager or its personnel related to professional conduct.
    - ✓ The investment process, including information regarding lock-up periods, strategies, risk factors, and use of derivatives and leverage.
    - ✓ **Management fees** and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.

# Disclosures

- **Managers must:**
  - Disclose the following:
    - ✓ The amount of any **soft or bundled commissions**, the goods and/or services received in return, and how those goods and/or services benefit the client.
    - ✓ The performance of clients' investments on a regular and timely basis.
    - ✓ Valuation methods used to make investment decisions and value client holdings.
    - ✓ Shareholder **voting policies**.
    - ✓ Trade **allocation policies**.
    - ✓ Results of the review or audit of the fund or account.
    - ✓ Significant personnel or organizational changes that have occurred at the Manager.
    - ✓ **Risk management processes**.

# Disclosures

- **Recommendations and Guidance:**
  - Communicate with clients on an ongoing and timely basis.
    - ✓ Developing and maintaining clear, frequent, and thorough communication practices is critical to providing high-quality financial services to clients.
    - ✓ Understanding the information communicated to them allows clients to know how Managers are acting on their behalf and gives clients the opportunity to make well-informed decisions regarding their investments.
    - ✓ Managers must determine how best to establish lines of communication that fit their circumstances and that enable clients to evaluate their financial status.

# Disclosures

- **Recommendations and Guidance:**
  - Ensure that disclosures are truthful, accurate, complete, and understandable and are presented in a format that communicates the information effectively.
    - ✓ Managers must **not misrepresent** any aspect of their services or activities, including (but not limited to) their qualifications or credentials, the services they provide, their performance records, and characteristics of the investments or strategies they use. A misrepresentation is any untrue statement or omission of fact or any statement that is otherwise false or misleading.
    - ✓ Managers must ensure that misrepresentation does not occur in **oral representations**, **marketing** (whether through mass media or printed brochures), **electronic communications**, or **written materials** (whether publicly disseminated or not).
    - ✓ To be effective, disclosures must be made in **plain language** and in a manner designed to effectively communicate the information to clients and prospective clients. Managers must determine how often, in what manner, and under what particular circumstances disclosures must be made.

# Disclosures

- **Recommendations and Guidance:**
  - Include any material facts when making disclosures or providing information to clients regarding themselves, their personnel, investments, or the investment process.
    - ✓ Clients must have full and complete information to judge the abilities of Managers and their actions in investing client assets. "Material" information is information that reasonable investors would want to know relative to whether or not they would choose to use or continue to use the Manager.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ **Conflicts of interests** generated by any relationships with brokers or other entities, other client accounts, fee structures, or other matters.
      - ◆ Conflicts of interests often arise in the investment management profession and can take many forms. Best practice is to avoid such conflicts if possible.
      - ◆ When Managers cannot reasonably avoid conflicts, they must carefully manage them and disclose them to clients. Disclosure of conflicts of interests protects investors by providing them with the information they need to evaluate the objectivity of their Managers' investment advice and actions taken on behalf of clients and by giving them the information to judge the circumstances, motives, and possible Manager bias for themselves.
      - ◆ Examples of some of the types of activities that can constitute actual or potential conflicts of interest are the use of soft dollars or bundled commissions, referral and placement fees, trailing commissions, sales incentives, directed brokerage arrangements, allocation of investment opportunities among similar portfolios, Manager or employee holdings in the same securities as clients, whether the Manager co-invests alongside clients, and use of affiliated brokers.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ Regulatory or disciplinary action taken against the Manager or its personnel related to professional conduct.
      - ◆ Past professional conduct records are an important factor in an investor's selection of a Manager. Such records include actions taken against a Manager by any regulator or other organization.
      - ◆ Managers must <u>fully disclose any significant instances</u> in which the Manager or an employee was found to have violated standards of conduct or other standards in such a way that reflects badly on the integrity, ethics, or competence of the organization or the individual.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ The investment process, including information regarding lock-up periods, strategies, risk factors, and use of derivatives and leverage.
      - ◆ Managers must disclose to clients and prospects the manner in which investment decisions are made and implemented. Such disclosures should address the overall investment strategy and should include a discussion of the specific risk factors inherent in such a strategy.
      - ◆ Understanding the basic characteristics of an investment is an important factor in judging the suitability of each investment on a stand-alone basis, but it is especially important in determining the effect each investment will have on the characteristics of the client's portfolio.
      - ◆ 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.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ Management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.
      - ◆ Investors are entitled to **full and fair disclosures of costs** associated with the investment management services provided. Material that should be disclosed includes information relating to any fees to be paid to the Managers on an ongoing basis and periodic costs that are known to the Managers and that will affect investors' overall investment expenses.
      - ① At a minimum, Managers should provide clients with ***gross- and net-of-fees*** returns and disclose ***any unusual expenses***.
      - ② A general statement that certain fees and other costs will be assessed to investors may not adequately communicate the total amount of expenses that investors may incur as a result of investing. Therefore, Managers must not only use plain language in presenting this information but must clearly explain the methods for ***determining all fixed and contingent fees and costs*** that will be borne by investors and also must explain the transactions that will trigger the imposition of these expenses.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ Management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs.
      - ③ Managers should also retrospectively disclose to each ***client*** the ***actual*** fees and other costs charged to the clients, together with ***itemizations*** of such charges when requested by clients. This disclosure should include the specific ***management fee, any incentive fee, and the amount of commissions*** Managers paid on behalf of clients during the period.
      - ④ In addition, Managers must disclose to ***prospective clients*** the average or ***expected*** expenses or fees clients are likely to incur.
    - ✓ The amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.
      - ◆ Commissions belong to the client and should be used in their best interests. Any soft or bundled commissions should be used only to benefit the client. Clients deserve to know how their commissions are spent, what is received in return for them, and how those goods and/or services benefit them.

# Disclosures

➢ **Recommendations and Guidance:**

- Disclose the following:
  - ✓ **The performance** of clients' investments on a regular and timely basis.
    - ◆Clients may reasonably expect to receive regular performance reporting about their accounts. Without such performance information, even for investment vehicles with lock-up periods, clients cannot evaluate their overall asset allocations (i.e., including assets not held or managed by the Managers) and determine whether rebalancing is necessary. Accordingly, unless otherwise specified by the client, Managers must provide regular, ongoing performance reporting. Managers should report to clients **at least quarterly**, and when possible, such reporting should be provided **within 30 days after the end of the quarter**.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ **The performance** of clients' investments on a regular and timely basis.
    - ✓ **Valuation methods** used to make investment decisions and value client holdings.
      - ◆Clients deserve to know whether the assets in their portfolios are valued on the **basis of closing market values, third-party valuations, internal valuation models, or other methods**. This disclosure should be made by asset class and must be meaningful (i.e., not general or boilerplate) so that clients can understand how the securities are valued.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ Shareholder **voting policies**.
      - As part of their fiduciary duties, Managers that exercise voting authority over client shares must vote them in an informed and responsible manner. This obligation includes the paramount duty to vote shares in the best interests of clients.
      - To fulfill their duties, Managers must adopt policies and procedures for the voting of shares and disclose those policies and procedures to clients. These disclosures should specify, among other things, guidelines for instituting regular reviews for new or controversial issues, mechanisms for reviewing unusual proposals, guidance in deciding whether additional actions are warranted when votes are against corporate management, and systems to monitor any delegation of share-voting responsibilities to others. Managers also must disclose to clients how to obtain information on the manner in which their shares were voted.

# Disclosures

➢ **Recommendations and Guidance:**

- Disclose the following:
  - ✓ Trade **allocation policies**.
    - ◆By disclosing their trade allocation policies, Managers give clients a clear understanding of how trades are allocated and provide realistic expectations of what priority they will receive in the investment allocation process. Managers must disclose to clients any changes in the trade allocation policies. By establishing and disclosing trade allocation policies that treat clients fairly, Managers foster an atmosphere of openness and trust with their clients.
  - ✓ Results of the **review or audit** of the fund or account.
    - ◆If a Manager submits its funds or accounts (generally pooled or mutual funds) for an annual review or audit, it must disclose the results to clients. Such disclosure enables clients to hold Managers accountable and alerts them to any potential problems.

# Disclosures

- **Recommendations and Guidance:**
  - Disclose the following:
    - ✓ **<u>Significant personnel or organizational changes</u>** that have occurred at the Manager.
      - ◆ Clients should be made aware of significant changes at the Manager in a timely manner. "Significant" changes would include personnel turnover, merger and acquisition activities of the Manager, and similar actions.
    - ✓ **Risk management processes**.
      - ◆ Managers must disclose their risk management processes to clients. **<u>Material changes</u> to the risk management process** also must be disclosed. Managers should further consider regularly disclosing **<u>specific risk information and specific information regarding investment strategies</u>** related to each client. Managers must provide clients information detailing what relevant risk metrics they can expect to receive at the individual product/portfolio level.

# Reading 6

## Overview of the Global Investment Performance Standards

# GIPS Overview

- **Why is GIPS needed?**
  - Standardized Investment Performance: There is need to **standardize** the **calculation** and **presentation** of investment performance.
  - **Firms:** Global Passport. Firms in countries with minimal or no investment performance standards will be able to compete for business on an equal footing. Investors can readily compare investment performance among firms.
  - **Investor**: Investment managers that adhere to investment performance standards help **assure** investors that the firm's investment performance is **complete and fairly presented**. Both prospective and existing clients of investment firms benefit from a global investment performance standard by having a greater degree of confidence in the performance information presented to them.

# GIPS Overview

- **Objective of GIPS**
  - The GIPS are **voluntary** ,**minimum standards** for performance presentation
- **The goals of the GIPS are:**
  - To establish investment industry best practices for calculating and presenting investment performance that promote investor interests and instill investor confidence;
  - To obtain worldwide acceptance of a single standard for the calculation and presentation of investment performance based on the principles of **fair representation and full disclosure**;
  - To promote the use of accurate and consistent investment performance data;
  - To encourage fair, global competition among investment firms without creating barriers to entry;
  - To foster the notion of industry "self-regulation" on a global basis.

# GIPS Overview

- **2010 Edition of GIPS**
  - 2010 edition of the GIPS standards includes new provisions related to **risk**.
  - The **effective date** for the 2010 edition of the GIPS standards is 1 January **2011**.
  - Compliant presentations that include performance for periods that begin on or after 1 January 2011 must be prepared in accordance with the 2010 edition of the GIPS standards.
- **Implementation of GIPS**
  - The GIPS Executive Committee strongly encourages countries without an investment performance standard to promote the GIPS standards.
  - English version of the GIPS standards is the official governing version.
  - In cases in which **laws and/or regulations conflict** with the GIPS standards, firms are required to **comply with the laws and regulations** and **make full disclosure** of the conflict in the compliant presentation.

# Some Glossary

- **TIME-WEIGHTED RATE OF RETURN(TWRR)**
  - A method of calculating period-by-period returns that **negates** the effects of external cash flows.
- **MONEY-WEIGHTED RATE OF RETURN(MWRR)**
  - The internal rate of return that **accounts for** the timing and amount of all cash flows into and out of the portfolio

# Some Glossary

- **ACCRUAL ACCOUNTING**
  - The recording of financial transactions as they come into existence rather than when they are paid or settled.
    - ✓ Cash-basis accounting
- **CARVE-OUT**
  - A portion of a portfolio that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a **multiple-strategy portfolio managed to a broader mandate.** For periods beginning on or after 1 January 2010, a CARVE-OUT must be managed separately with its own cash balance.
    - ✓ E.g. the returns of a single asset class (e.g., equities) carved out of a multiple asset class portfolio (e.g., a balanced account invested in equity and fixed-income securities) are not permitted to be included in single asset class composite returns unless the carved-out segment is actually managed separately with its own cash balance.

# Some Glossary

- **COMPOSITE**
  - An aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy.
- **COMPOSITE DEFINITION**
  - Detailed criteria that determine the assignment of portfolios to composites. Criteria may include investment mandate, style or strategy, asset class, the use of derivatives, leverage and/or hedging, targeted risk metrics, investment constraints or restrictions, and/or portfolio type (e.g., segregated or pooled, taxable versus tax exempt).
- **COMPOSITE DESCRIPTION**
  - General information regarding the investment mandate, objective, or strategy of the composite. The composite description **must include all key features** of the composite and must include enough information to allow a prospective client to understand the key characteristics of the composite's investment mandate, objective, or strategy.

# Some Glossary

- **FIRM/DISTINCT BUSINESS ENTITY**
  - A unit, division, department, or office that is **organizationally and functionally segregated** from other units, divisions, departments, or offices and that retains discretion over the assets it manages and that should have autonomy over the **investment decision-making process**. Possible criteria that can be used to determine this include:
    - ✓ being a legal entity, having a distinct market or client type (e.g., institutional, retail, private client, etc.), and using a separate and distinct investment process.
- **INTERNAL DISPERSION**
  - A measure of the spread of the annual returns of individual portfolios **within a composite**. Measures may include, but are not limited to, high/low, range, or **standard deviation** (asset weighted or equal weighted) of portfolio returns.

## Some Glossary

- **LINK**
  - **Mathematical Linking**: The method by which sub-period returns are geometrically combined to calculate the period return using the following formula: Period return = $\mathbf{[(1+R_1)\ (1+R_2)\ldots(1+Rn)] - 1}$, where $R_1$, $R_2 \ldots R_n$ are the sub-period returns for sub-period 1 through n, respectively.
  - **Presentational Linking**: To be visually connected or otherwise associated within a complaint presentation (e.g., two pieces of information are linked by <u>placing them next to each other</u>).
- **PROSPECTIVE CLIENT**
  - Any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite. **Existing clients** may also qualify as prospective clients for any strategy that is different from their current investment strategy. **Investment consultants and other third parties** are included as prospective clients if they represent investors that qualify as prospective clients.

# Some Glossary

- **GROSS-OF-FEES**
  - The return on investments reduced by any **trading expenses** incurred during the period.
    - ✓ **GROSS-OF-FEES** (REAL ESTATE and PRIVATE EQUITY)
      - The return on investments reduced by any **transaction expenses** incurred during the period.
- **NET-OF-FEES**
  - The GROSS-OF-FEES return reduced by investment management fees (including performance-based fees and carried interest)
    - **Carried interest** - The profits that general partners are allocated from the profits on the investments.

# Some Glossary

- The GIPS standards recommend that gross-of-fees and net-of-fees returns not be reduced for administrative fees because these are typically **outside the control of the firm**.
    - Administrative fees, defined as all fees other than trading expenses and the investment management fee, could include custody, accounting, auditing, consulting, performance measurement, and legal fees, among others.
    - when trading expenses cannot be broken out of **bundled fees,** that is, combined fees, which may include any combination of management, trading, custody, and/or administrative fees. The GIPS Glossary cites all-in fees as an example of bundled fees.

# Some Glossary

- **TRADE DATE ACCOUNTING**
  - Recognizing the asset or liability on the date of the purchase or sale and not on the settlement date. Recognizing the asset or liability within three days of the date the transaction is entered into (trade date, T+ 1, T+2, or T+3) satisfies the TRADE DATE ACCOUNTING REQUIREMENT for purposes of the GIPS standards.

满足经济实质

- **SETTLEMENT DATE ACCOUNTING**
  - Recognizing the asset or liability on the date when the exchange of cash and investments is completed.

# Return Calculations

- External cash flows refer to contributions and withdrawals made to and from an account, as opposed to internal cash flows such as dividends and interest payments.
- If a contribution is received at the start of the period, it should be added to (or, in the case of a withdrawal, subtracted from) the account's beginning value.

$$r_{\mathrm{t}} = \frac{MV_1 - \left(MV_0 + CF\right)}{\left(MV_0 + CF\right)}$$

- If a contribution is received at the end of the evaluation period, it should be subtracted from (or, in the case of a withdrawal, added to) the account's ending value.

$$r_t = \frac{\left(MV_1 - CF\right) - MV_0}{MV_0}$$

# Calculate Return When No External Cash Flows

- Winter Asset Management manages institutional and individual accounts, including the account of the Mientkiewicz family. The Mientkiewicz account was initially valued at $1,000,000. One month later it was worth $1,080,000. Assuming no external cash flows and the reinvestment of all income, the return on the Mientkiewicz account for the month is:
- **Correct Answer:**

$$r_t = \frac{1{,}080{,}000 - 1{,}000{,}000}{1{,}000{,}000} = 8\%$$

# Calculate Return

- Assume that the account received a \$50,000 contribution at the beginning of the month. Further, the account's ending and beginning market values equal the same amounts previously stated, \$1,080,000 and \$1,000,000, respectively.
- **Correct Answer:**

$$r_t = \frac{1{,}080{,}000 - (1{,}000{,}000 + 50{,}000)}{1{,}000{,}000 + 50{,}000} = 2.86\%$$

- **If the contribution had occurred at month-end:**

$$r_t = \frac{(1{,}080{,}000 - 50{,}000) - 1{,}000{,}000}{1{,}000{,}000} = 3\%$$

# Time-Weighted Rate of Return (TWR)

- The **time-weighted rate of return (TWR)** requires that the account be valued every time an external cash flow occurs.
- **Time weighted rate of return (TWR)** calculates the compounded rate of growth of one unit of money invested in the portfolio at the beginning of the measurement period and is unaffected by the size and timing of cash flows.
  - The sub-period results are then compounded (linked) together:

$$TWRR=(1+r_1)(1+r_2)(1+r_3)...(1+r_n)-1$$

# Calculating Subperiod Rates of Return

- Let us assume that the account received two cash flows during month t: a contribution of $30,000 on day 5 and a contribution of $20,000 on day 16. Further, assume that we use a daily pricing system that provides us with values of the account (inclusive of the contributions) of $1,045,000 and $1,060,000 on days 5 and 16 of the month, respectively. **Correct Answer:**
  - Subperiod 1 = Days 1-5
  - Subperiod 2 = Days 6-16
  - Subperiod 3 = Days 17-30

$$r_{t,1} = \frac{(1{,}045{,}000 - 30{,}000) - 1{,}000{,}000}{1{,}000{,}000} = 1.50\%$$

$$r_{t,2} = \frac{(1{,}060{,}000 - 20{,}000) - 1{,}045{,}000}{1{,}045{,}000} = -0.48\%$$

$$r_{t,3} = \frac{(1{,}080{,}000 - 1{,}060{,}000)}{1{,}060{,}000} = 1.89\%$$

- **Continuing with the account, its TWR is**

$$r_{twr} = (1+1.5\%)(1+-0.48\%)(1+1.89\%) - 1 = 2.92\%$$

# Money-Weighted Rate of Return (MWR)

- The **money-weighted rate of return (MWR)** measures the compound growth rate in the value of all funds invested in the account over the evaluation period.)
- **Money weighted rate of return (MWR)** is the internal rate of return over the period and is affected by the size and timing of cash flows. Assumes the same return over each sub-period.

$$MV_1 = MV_0(1+R)^m + \sum_{i=1}^{n} CF_i (1+R)^{m-L(i)}$$

- Where: $MV_1$ = the ending value of the portfolio
- $MV_0$ = the beginning value of the portfolio
- m = number of time units in the evaluation period (e.g., the number of days in the month)
- $CF_i$ = cash flow i
- $L_{(i)}$ =number of time units (days, etc.) cash inflow i is in or cash outflow i is absent from the portfolio

# Calculating the MWR

- **Consider the account again. Its MWR is found by solving the following equation for R:**

$$1{,}080{,}000 = 1{,}000{,}000(1+R)^{30} + 30{,}000(1+R)^{30-5} + 20{,}000(1+R)^{30-16}$$

$$R = 0.09536\%$$

$$MWR = [(1+0.09536\%)^{30} - 1] = 2.90\%$$

# TWR vs. MWR

- **TWR:**
  - the growth of a single unit of money invested in the account.
  - only a linking of subperiod returns and is not affected by external cash flows.
  - TWRR reflects what would have happened to the beginning value if no external cash flows had occurred.
  - Can be data intensive and expensive.
- **MWR:**
  - the average growth rate of all money invested in an account.
  - It is sensitive to the size and timing of external cash flows to and from the account.
  - If the manager controls the timing of cash flows, MWRR is appropriate.
  - MWRR only requires a beginning and end of period market value.
- More funds in the high return subperiod produce a higher MWRR than TWRR.

# GIPS Overview

## ➢ II. PROVISIONS OF GIPS

**The GIPS are divided into 9 sections that reflect the basic elements involved in presenting performance information:**

- **0. Fundamentals of Compliance:** → 遵循GIPS规定最基本的要求
- **1. input data** → 计算收益的数据基础和要求
- **2. calculation methodology** → 有了数据之后采用什么计算方法
- **3. composite construction** → 有了计算方法之后如何构建Composite
- **4. disclosures**
- **5. presentation and reporting**
- **6. real estate**
- **7. private equity**
- **8. Wrap Fee/ SMA Portfolios**

准备工作：数据的准备、方法论的准备、组合的构建

完成了准备工作之后，具体应该如何披露和报告

针对一些特殊的investment而需采用补充准则

# GIPS Framework

- **Part 1 Compliance Standards**
- **Part 2. Compliance Width**
  - Firm
  - Composite
  - Portfolio
  - No partial comply
- **Part 3. Return Calculation**
  - Basic Principle
  - Calculation Frequency & Fee
- **Part 4. Presentation & Disclosure**
  - Compliance Presentation
  - Return Presentation

由于GIPS原文中涉及大量重复条文在不同段落中，为了方便学生理解记忆，将1~5条款中内容进行重排，以更好展现GIPS遵循过程。

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# 1. GIPS—Compliance Standards

➢ **Part 1. Compliance Standards**

- **0.A.1 Comply with all the requirements of the GIPS standards.**
- **0.A.2 Comply with all applicable laws and regulations regarding the calculation and presentation of performance.**
  - ✓ 4.A.22 Laws/regulations that conflict with GIPS: fact and how
- **0.A.3 Not present information that is false or misleading.**
- **0.A.5 Firms must document policies and procedures used in establishing and maintaining compliance with the GIPS standards.**

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
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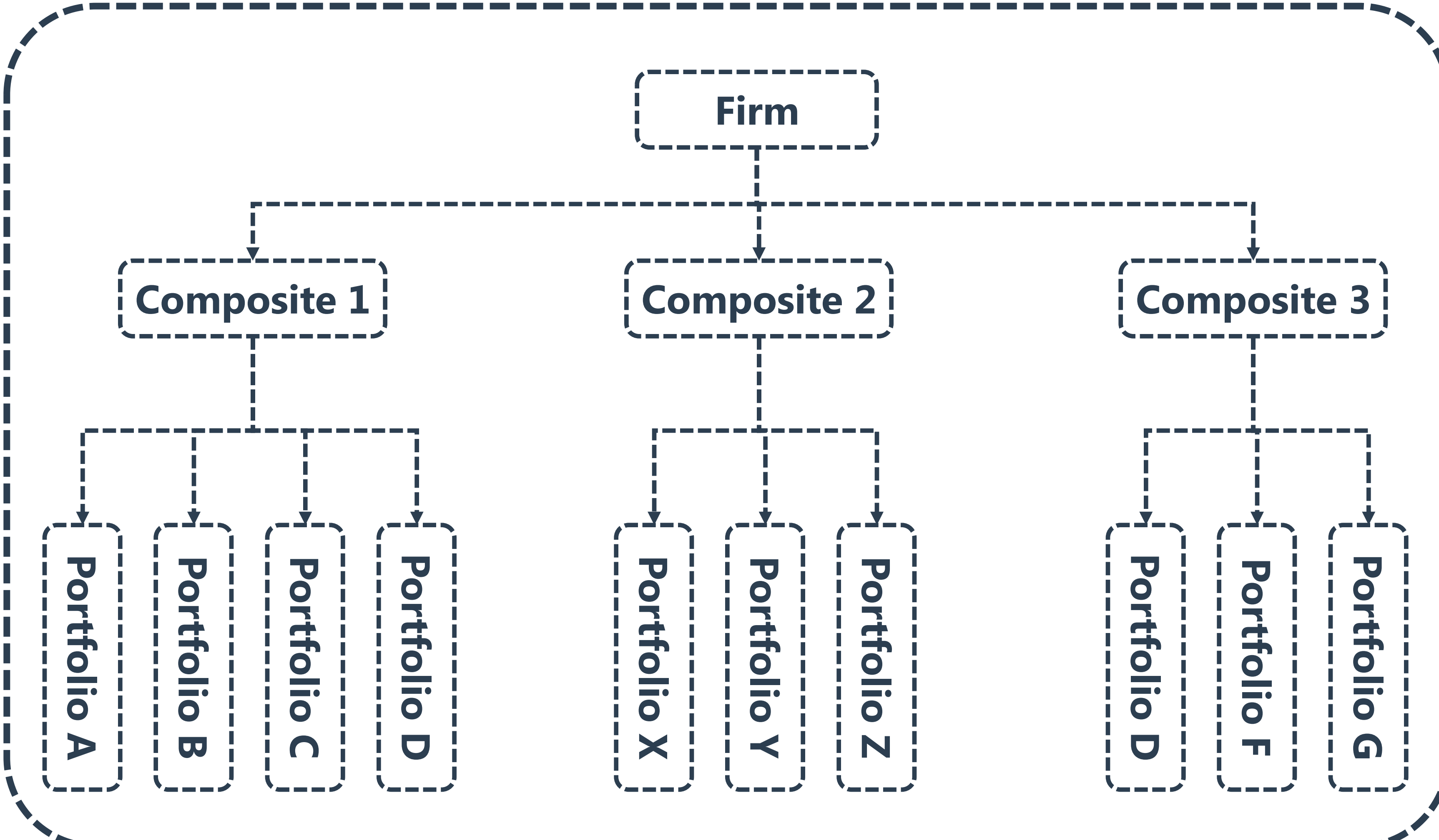
- **Further Topics**

# Composite



Firm
Composite 1
Composite 2
Composite 3
Portfolio A
Portfolio B
Portfolio C
Portfolio D
Portfolio X
Portfolio Y
Portfolio Z
Portfolio D
Portfolio F
Portfolio G

# 2. Compliance Width

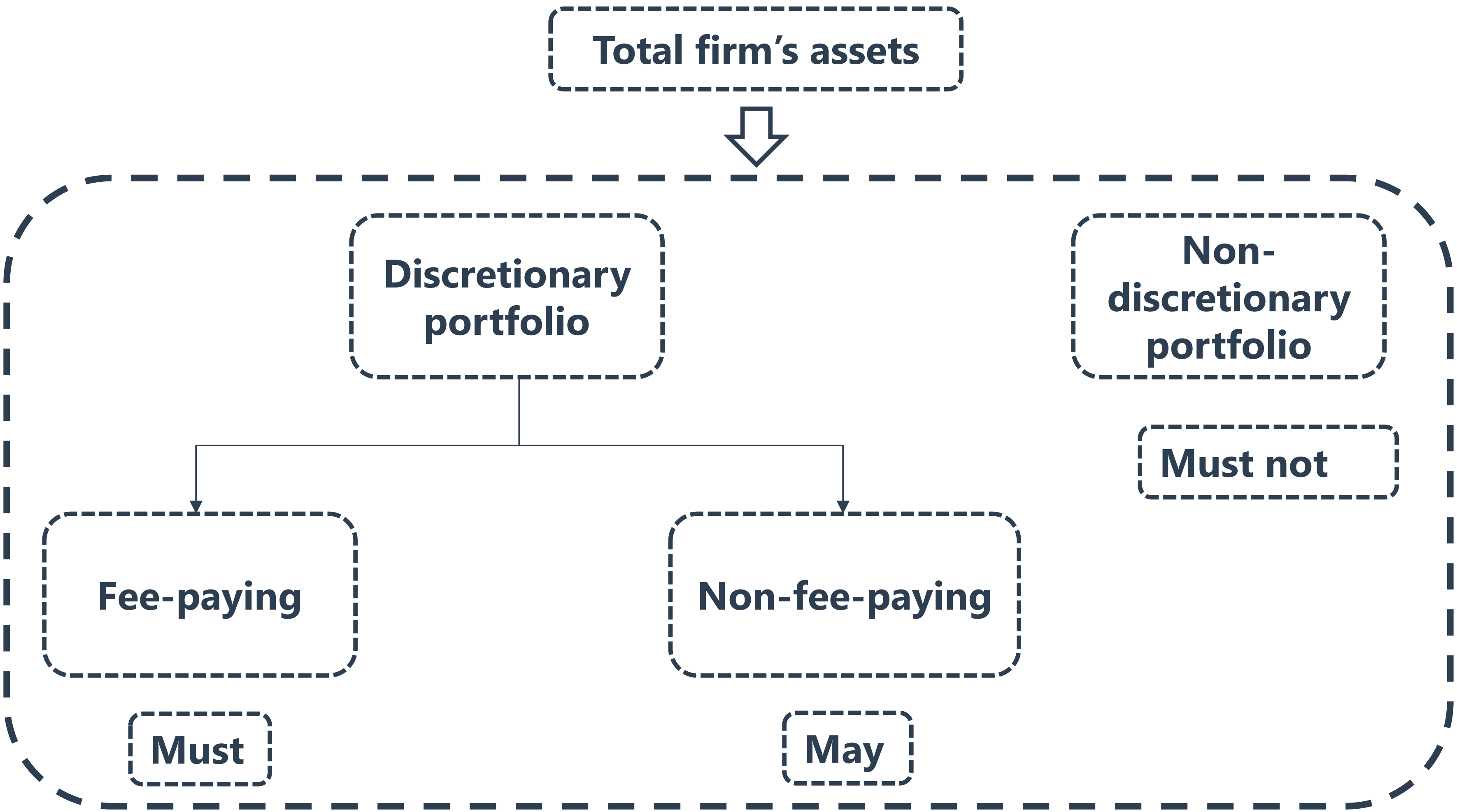
➢ **Part 2.1 Compliance Width - Firm**

- **0.A.4 The GIPS standards must be applied on a firm-wide basis.**
- **0.A.12 Firms must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity.**
  - ✓ A unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices and that retains discretion over the assets it manages and that should have autonomy over the investment decision-making process.
- **0.A.13 For periods beginning on or after 1 January 2011, total firm assets must be the aggregate fair value of all discretionary and non-discretionary assets managed by the firm.**
  - ✓ Discretionary: 限定大方向、投资批准
- **4.A.16 Firm redefined: disclose date, describe the definition, and explain the reason.**

# 2. Compliance Width

- **Part 2.2 Compliance Width - Composite**
  - **3.A.4 Composites must be defined according to investment mandate, objective, or strategy. Composites must include all portfolios that meet the composite definition. Any change to a composite definition must not be applied retroactively. The composite definition must be made available upon request.**
  - **3.A.1 All actual, fee-paying, discretionary portfolios must be included in at least one composite. Although non-fee-paying discretionary portfolios may be included in a composite (with appropriate disclosure), non-discretionary portfolios must not be included in a firm's composites.**
  - **0.A.10 Firms must provide a complete list of composite descriptions to any prospective client that makes such a request. Firms must include terminated composites on the firm's list of composite descriptions for at least five years after the composite termination date.**
    - ✓ **4.A.11 Firm's list of composite descriptions is available upon request.**

# Composite or not




- Non-discretionary: Client-imposed restrictions significantly hinder the firm from fully implementing its intended strategy( 3.A.1)

# 2. Compliance Width

- **Part 2.2 Compliance Width - Composite**
  - 3.A.2 Composites must include only actual assets managed by the firm.
  - 3.A.3 Firms must not link performance of simulated or model portfolios with actual performance.
  - 3.A.5 Composites must include new portfolios on a **timely and consistent basis** after each portfolio comes under management.
- **Disclosure:**
  - 4.A.10 Composite creation date
  - 4.A.17 Composite redefined: date, description, reason
  - 4.A.18 Change to the name of a composite.

# 2. Compliance Width

- **List of Composite Descriptions (example)**
  - **Large Cap Equity Growth Composite**
    - ✓ The Large Cap Equity Growth Composite includes all institutional portfolios that invest in large capitalization U.S. stocks that are considered to have growth in earnings prospects that is superior to that of the average company within the benchmark, the Russell 3000 Growth Index. The targeted tracking error between the composite and the benchmark is less than 3%.
  - **Balanced Growth Composite**
    - ✓ The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap U.S. equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50–70%, the typical allocation is between 55–65%. The account minimum for the composite is 5 million.

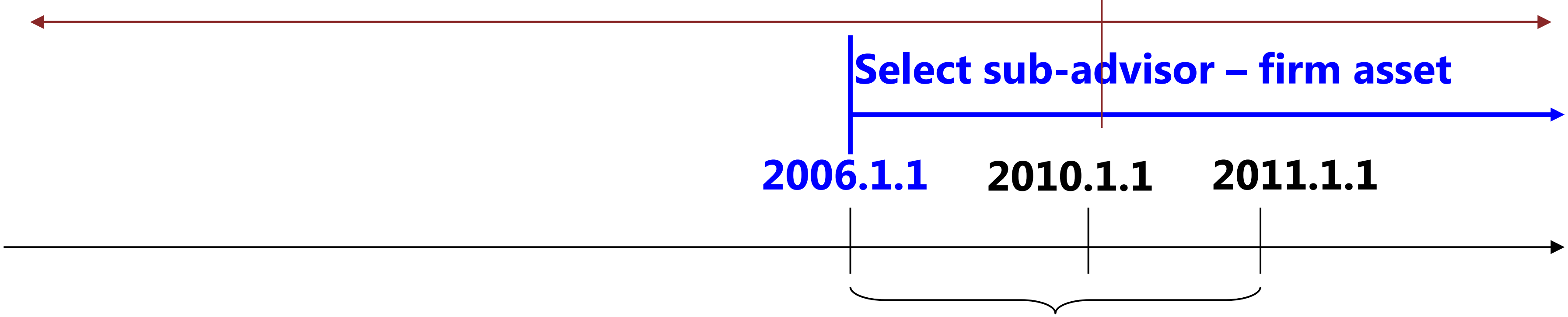
# 2. Compliance Width

- **Part 2.3 Compliance Width - Portfolio**
  - **0.A.14 Total firm assets must include assets assigned to a sub-advisor, if the firm has discretion over the selection of the sub-advisor.**
    - ✓ 4.A.25 When >= 2006, disclose **use** of a sub-advisor and the **periods** the sub were used
  - **3.A.8 For periods >= 2010, a carve-out must not be included in a composite unless the carve-out is managed separately with its own cash balance.**
    - ✓ 4.A.23 Before 2010, disclose policy used to allocate cash to carve-outs.
    - ✓ 5.A.5 For periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a composite includes carve-outs, the firm must present the **percentage** of composite assets represented by **carve-outs** as of each annual period end.
  - **3.A.9 If the firm sets a minimum asset level for portfolios to be included in a composite, the firm must not include portfolios below the minimum asset level in that composite. Any changes to a composite-specific minimum asset level must not be applied retroactively.**
  - **4.A.19 Disclose** minimum asset level and its changes

# Timeline

- ✓ Allocating cash to the carve-outs was permissible but should disclose policy used to allocate cash to carve-outs.
- ✓ If carve-outs were included in a composite, cash must have been allocated to the carve-out in a timely and consistent manner or the carve-out must have been accounted for separately with its own cash balance.

A **carve-out** must not be included in a composite unless the carve-out is managed separately with its own cash balance.




if a composite includes carve-outs, the firm must present the **percentage** of composite assets represented by **carve-outs** as of each annual period end.

# 2. Compliance Width

- **Part 2.3 Compliance Width - Portfolio**
  - **Portfolio transfer** and **terminate**

transfer

✓ 3.A.7 Portfolios must **not be switched from one composite** to another **unless** documented changes to a portfolio's investment mandate, objective, or strategy or the redefinition of the composite makes it appropriate. The historical performance of the portfolio must remain with the original composite. **Changes to composite definitions must not be applied retroactively.**

terminate

✓ 3.A.6 **Terminated portfolios** must be included in the historical performance of the composite up to the ***last full measurement period*** that each portfolio was under management.

✓ 3.A.10 Firms that wish to **remove portfolios** from composites in cases of **significant cash flows** must define "significant" on an ***ex-ante, composite-specific basis*** and must ***consistently*** follow the composite-specific policy.

◆ 4.A.32 Significant cash flow policy: disclose definition and period.to which the definition applies.

# Significant CF Example

- **Account #207 invests in illiquid, fixed income securities. The account receives a large cash infusion on April 12 that cannot be invested quickly at reasonable prices. It is expected to take 60 days for the funds to be reasonably invested.**
  - **Best** Solution:
    - ✓ Place the funds in **a new, temporary, subaccount** ( call it **207T**) until the funds are invested. **Continue to report** results for **207** in its appropriate composite. Results for 207T will not be reported in any composite. Once 207T is invested in accord with account objectives, 207Twill be merged into 207 and affect future results for 207.(Note that the client will need to receive reports showing the results of 207T and 207 to comply with general reporting requirements under the Standards of Professional Conduct. Subaccount 207T is only excluded from GIPS reporting.)
  - Alternative Solution
    - ✓ The funds could be placed directly into 207and **207** results would be **excluded** from the composite results until the funds are invested in accord with client objectives. GIPS composite results are based on monthly results so if the investments are completed by June 15, account 207 will be excluded from the composite for months April, May, and June.(Note that the client will need to receive reports showing the results of 207 to comply with general reporting requirements under the Standards of Professional Conduct. Account **207** is **temporarily excluded from GIPS reporting**.)

# 2. Compliance Width

- **Part 2.4 Compliance Width -No partial comply**
  - **0.A.6 If the Firm does <u>not meet all the requirements</u> of the GIPS standards, the must not represent or state that it is "in compliance with the Global Investment Performance Standards except for…" or make any other statements that may indicate <u>partial compliance</u> with the GIPS standards.**
  - **0.A.7 Statements referring to the calculation methodology as being "in accordance," "in compliance," or "consistent" with GIPS are prohibited.**
  - **0.A.8 Statements referring to the performance of a single, existing client portfolio as being "calculated in accordance with the GIPS are prohibited, <u>except when a GIPS-compliant firm reports the performance of an individual client's portfolio to that client.</u>**

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# 3. Return Calculation

➢ **Part 3.1 Return Calculation -Basic Principle**

- **1.A.2 For periods beginning on or after 1 January 2011, portfolio must be valued in accordance with the definition of FAIR VALUE.**
- **4.A.12 Firms must disclose that policies for *valuing portfolios*, *calculating performance*, and preparing *complaint presentations* are available upon request.**
- **2.A.1 Total returns must be used.**
  - ✓ 2.A.3 Returns from cash and cash equivalents held in portfolios must be included in all return calculations.
  - ✓ 1.A.6 Accrual accounting must be used for fixed-income securities and all other investments that earn interest income. The value of fixed-income securities must include accrued income.

# 3. Return Calculation

➢ **Part 3.1 Return Calculation -Basic Principle**

- **4.A.27 When >= 2011, disclose if use of *subjective* unobservable inputs for valuing portfolio**
- **4.A.28 When >= 2011, *disclose* if composite's valuation hierarchy *materially differs***

  Within same composite
- **1.A.1 All data and information necessary to support all items included in a compliant presentation must be captured and maintained.**

# 3. Return Calculation

- **GIPS valuation principles**
  - Market value (e.g., for an actively traded stock or bond use the last trade price)
  - Quoted prices for less actively traded identical or very similar investments (e.g. a stock trades infrequently, the last available price is a week old, and there is no material evidence indicating the price would have changed; another example is a dealer quote for a stock that has not recently traded)
  - Using market-based inputs to estimate price (e.g. using P/E or dividend yield for comparable and actively trade securities to infer a price estimate or using a YTM for similar actively trade bonds to price a bond that has not traded).
  - Price estimates based on not directly observable inputs (e.g., a discounted free cash flow price estimate based on projected cash flows and assumed discount rate)

# 3. Return Calculation

- **Part 3.2 Return Calculation - Portfolio Return – External Cash Flow**
  - **2.A.2 Firms must calculate time-weighted rates of return that adjust for external cash flows. Both periodic and sub-period returns must be geometrically linked. External cash flows must be treated according to the firm's composite-specific policy. At a minimum:**
    - ✓ a. For periods >= 2001, must calculate portfolio returns at least monthly.
    - ✓ b. For periods >= 2005, must calculate portfolio returns that adjust for daily-weighted external cash flows.
  - **1.A.3 Firms must value portfolios in accordance with the composite-specific valuation policy. Portfolios must be valued:**
    - ✓ For periods >= 2001, at least monthly.
    - ✓ For periods >= 2010, on the date of all large cash flows. Firms must ***define large cash flow for each composite*** to determine when portfolios in that composite must be valued.
    - ✓ No more frequently than required by the valuation policy.

# 3. Return Calculation—Portfolio

➢ **1. Original Dietz method (permitted until January 1, 2005).**

- The key assumption of the original Dietz method is that all cash flows occur at the midpoint of the period.

$$R_{Dietz} = \frac{EMV - (BMV + CF)}{BMV + 0.5CF}$$

分子上的Cash Flow是不需要经过time-weighted处理的，因为它反映的是一个现金流的增量，而分母上的Cash Flow则是需要加权处理的

✓ CF = the net cash flow for the period (contributions to the portfolio are entered as positive cash flows, and withdrawals are entered as negative cash flows)

# 3. Return Calculation—Portfolio

- **2. <u>Modified Dietz method that adjust for daily cash flows</u> (required for periods beginning on or after January 1, 2005, until January 1, 2010).**
  - **Modified Dietz method** improves upon the original Dietz method by assuming a constant rate of return on the portfolio during the period.

$$R_{MDietz} = \frac{EMV - (BMV + CF)}{BMV + \sum_{i=1}^{n} W_i \times CF_i}$$

$$\sum_{i=1}^{n} W_i \times CF_i = \text{ the sum of each cash flow}, CF_i, \text{multiplied by its weight}, W_i$$

$$W_i = \frac{CD - D_i}{CD}$$

where:

CD=the number of calendar days over the return period

$D_i$ = the day during the return period on which cash flow($CF_i$) occurred

# 3. Return Calculation—Portfolio

- **3. <u>TWRR using revaluation at the time of large external cash flows</u> (required for periods beginning on or after January 1, 2010).**
  - The **daily valuation method** calculates the true rather than an estimate.
  - It breaks the total performance period into subperiods that are defined by the occurrence of major cash flows.

$$R_i = \frac{EMV - BMV}{BMV}$$

  - ✓ EMV = end-of-subperiod market value of thee portfolio, before any cash flows in the period but including accrued income for the period;
  - ✓ BMV = beginning-of-subperiod market value including any cash flows at the end of the previous subperiod and including accrued income up to the end of the previous period.
  - The sub-period returns are then geometrically linked (chain-linked) to calculate a total return:

$$R_{TR} = [(1+R_1)(1+R_2)\ldots(1+R_n)] - 1$$

# 3. Return Calculation—Portfolio

- **Geometric Linking**

  - Monthly portfolio returns are geometrically linked to compute a quarterly return using the formula:

$$R_Q = [(1+R_{M1})(1+R_{M2})(1+R_{M3})] - 1$$

where:

$R_Q$ = the portfolio quarter return

$R_{M1\text{-}3}$ = portfolio returns for months 1,2,and 3, respectively

  - Applying this same concept, an annual return can be computed from quarterly portfolio returns with the formula:

$$R_{YR} = [(1+R_{Q1})(1+R_{Q2})(1+R_{Q3})(1+R_{Q4})] - 1$$

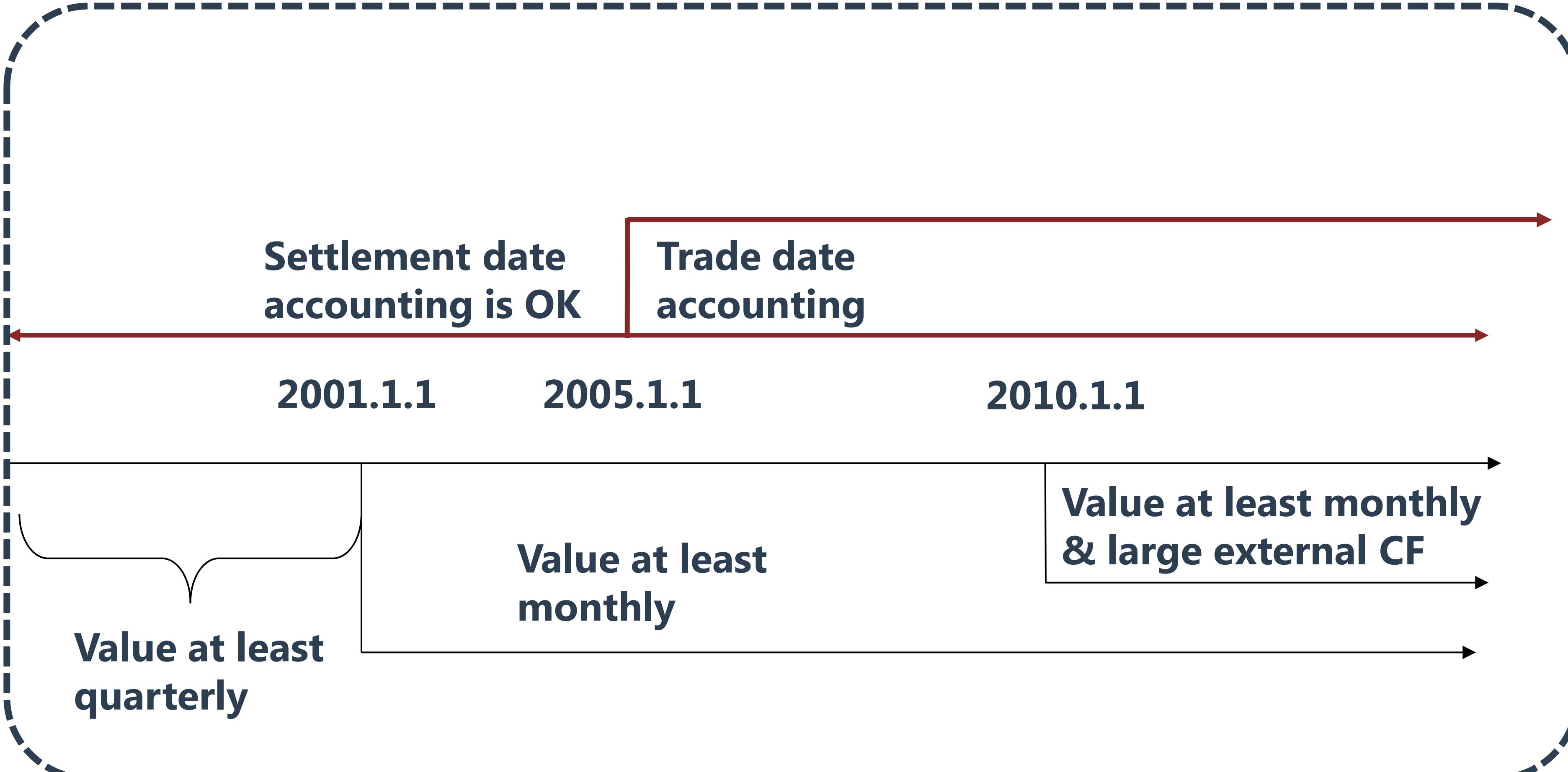
where:

$R_{Q1\text{-}4}$ =composite returns for Quarters 1,2,3 and 4

# 3. Return Calculation

- **Part 3.2 Return Calculation -Calculation Frequency -Portfolio Return**
  - **1.A.5 For periods >= 2005, firms must use *trade date accounting*.**
  - **1.A.4 For periods >= 2010, firms must value portfolios as of the *calendar month end or the last business day of the month.***
  - 4.A.26 Before 2010, disclose if portfolios not valued at calendar month end or on the last business day of the month.

# Timeline



Settlement date accounting is OK
Trade date accounting
2001.1.1
2005.1.1
2010.1.1
Value at least monthly & large external CF
Value at least monthly
Value at least quarterly

# Original Dietz method

- Consider a portfolio with a beginning value of $100,000 as of 31 May, a value of $109,000 on 5 June (including a cash contribution of $10,000 received that day), and an ending value of $110,550 on 30 June. Consider that the first subperiod ends and the second begins on the cash flow date, calculate the return using Dietz method and true time-weighed return.

# Original Dietz method

➤ **Correct Answer:**

- Using Original Dietz method:

$$R_{Dietz} = \frac{\text{EMV} - (\text{BMV+CF})}{\text{BMV+0.5CF}}$$

$$= \frac{110,550 - 100,000 - 10,000}{100,000 + (10,000 \times 0.5)} = 0.0052 = 0.52\%$$

- Using true time-weighted return

$$r_{t,1} = \frac{V_1 - V_0}{V_0} = \frac{(109,000 - 10,000) - 100,000}{100,000} = -0.01$$

$$r_{t,2} = \frac{V_1 - V_0}{V_0} = \frac{110,550 - 109,000}{109,000} = 0.0142$$

$$r_{twr} = (1 + r_{t,1}) \times (1 + r_{t,2}) - 1 = (1 - 0.01)(1 + 0.0142) - 1 = 0.41\%$$

# Modified Dietz method计算return再link

- Given the portfolio information in the figure below, use the modified Dietz method to calculate the rate of return for this portfolio for April, May, June, and the second quarter of 2005.
- Figure 1: Second Quarter 2005 Portfolio Data

| Date | Market Value ($) | Cash Flow ($) | Market Value After Cash Flow($) |
|---|---|---|---|
| 03/31/05 | 220,000 | | |
| 04/30/05 | 228,800 | | |
| 05/12/05 | 238,700 | +44,000 | 282,700 |
| 05/31/05 | 289,300 | | |
| 06/20/05 | 297,000 | -33,000 | 264,000 |
| 06/30/05 | 269,500 | | |

# Modified Dietz method计算return再link

➢ **Correct Answer:**

$$\text{April:}\quad R_{Apr}=\frac{228{,}800-220{,}000}{220{,}000}=4.0\%$$

$$\text{May:}\quad R_{May}=\frac{289{,}300-228{,}800-44{,}000}{228{,}800+(44{,}000)(0.61)}=6.45\%$$

$$\text{June:}\quad R_{June}=\frac{269{,}500-289{,}300-(-33{,}000)}{289{,}300+(-33{,}000)(0.33)}=4.74\%$$

Second quarter return:

$$R_{QT2}=(1+R_{Aptil})\ (1+R_{May})(1+R_{June})-1=\ (1.04)(1.0645)(1.0474)-1=15.96\%$$

# Daily valuation method计算return再link

- Given the information in the figure below, use the daily valuation method to calculate the rate of return for this portfolio for April, May, June, and the second quarter of 2005.
- Figure 2: Second Quarter 2005 Portfolio Data

| Date | Market Value ($) | Cash Flow ($) | Market Value After Cash Flow ($) |
| --- | --- | --- | --- |
| 03/31/05 | 550,000 | | |
| 04/30/05 | 560,000 | | |
| 05/12/05 | 565,000 | 55,000 | 620,000 |
| 05/31/05 | 633,000 | | |
| 06/20/05 | 645,000 | -22,000 | 623,000 |
| 06/30/0 5 | 627,000 | | |

# Daily valuation method计算return再link

➢ **Correct Answer:**

April: $R_{Apt}=\dfrac{560{,}000-550{,}000}{550{,}000}=1.82\%$

May: $May_1$ =04/30/05 through 05/12/05 $R_{May\,1}=\dfrac{565{,}000-560{,}000}{560{,}000}=0.89\%$

$May_2$ =04/30/05 through 05/12/05 $R_{May\,2}=\dfrac{633{,}000-620{,}000}{620{,}000}=2.10\%$

Geometrically linked return for May (04/30/05 through 05/31/05):

$$R_{May}=(1+R_{May\,1})\ (1+R_{May\,2})-1=\ (1.0089)(1.0210)-1=3.01\%$$

June: $June_1$ =05/31/05 through 06/20/05 $R_{June_1}=\dfrac{645{,}000-633{,}000}{633{,}000}=1.90\%$

$June_2$ =06/20/05through 06/30/05 $R_{June\,2}=\dfrac{627{,}000-623{,}000}{623{,}000}=0.64\%$

Geometrically linked return for June (05/31/05 through 06/30/05):

$$R_{June}=(1+R_{June_1})(1+R_{June\,2})-1=(1.019)(1.0064)-1=2.55\%$$

Second quarter return:

$$R_{QT2}=(1+R_{April})(1+R_{May})(1+R_{June})-1=(1.0182)(1.0301)(1.0255)-1=7.56\%$$

# 3. Return Calculation - Composite

➢ **Part 3.3 Return Calculation -Calculation Frequency -Composite Return**

- 2.A.6 Composite returns must be calculated by asset-weighting the individual portfolio returns using:
  - ✓ Beginning-of-period values or
  - ✓ A method that reflects both beginning-of-period values and external cash flows.
- 2.A.7 Composite returns must be calculated:
  - ✓ a. For periods>= 2006, by asset weighting at least **quarterly**.
  - ✓ b. For periods>= 2010, by asset-weighting at least **monthly**.

# 3. Return Calculation - Composite

- Composite Construction:

A composite is defined as a group of portfolios that are managed with the same strategy or objective . Portfolio managers might manage hundreds of individual portfolios. It is inefficient to report returns on every individual portfolios. Therefore GIPS requires managers to report a composite return for various groups or portfolios they manage.

- Example:

| Portfolio | Size | Return |
|---|---|---|
| A | $15million | 8% |
| B | $10million | 10% |
| C | $5million | 12% |

- The firm can simply disclose the composite return of the portfolios as a group.
- The composite return is 9.33%

## 3. Return Calculation - Composite

- **1. The beginning market value-weighted composite** return, $R_{BMV}$, can be calculated using the formula:

$$R_{BMV} = \frac{\sum_{i=1}^{n}(BMV_i)(R_i)}{BMV_{total}}$$

where:

$BMV_i$ = the beginning-of-period marker value for portfolio i

$R_i$ = the rate of return for portfolio i

$BMV_{total}$ = the total market value at the beginning of period for all the portfolios in the composite

# 3. Return Calculation - Composite

- **2. The beginning market value plus cash-flow-weighted composite return** (i.e., R BMV+ CF) can be calculated as follows:

$$R_{BMV+CF} = \frac{\sum_{i=1}^{n}\left\{\left[BMV_i + \left(\sum_{j=1}^{n}(CF_{i,j})(W_{i,j})\right)\right]R_i\right\}}{\sum_{i=1}^{n}\left[BMV_i + \left(\sum_{j=1}^{n}(CF_{i,j})(W_{i,j})\right)\right]}$$

where

$CF_{i,j}$ = cash flow j within the period for portfolio i (contirbutions to the portfolio are positive flows,and withdrawals or distributions are negative flows)

$R_i$ = the return for portfolio

$$W_{i,j} = \frac{CD - D_{i,j}}{CD}$$

where:

CD = total number of calendar days in the period

$D_{i,j}$ = the day during the period on which cash flow j occurred in portfolio i

# Example

**Exhibit 10 A Composite Including Four Portfolios: Weighted External Cash Flows**

| | Cash Flow Weighting Factor | Portfolio ($ Thousands) | | | | |
|---|---|---|---|---|---|---|
| | | A | B | C | D | Total |
| Beginning assets (31 May) | | 100.00 | 97.40 | 112.94 | 124.47 | 434.81 |
| External cash flows: | | | | | | |
| 5 June | 0.83 | 10.00 | 15.00 | | | 25.00 |
| 8 June | 0.73 | | | | −15.00 | −15.00 |
| 17 June | 0.43 | | −5.00 | | | −5.00 |
| 24 June | 0.20 | | | | −6.50 | −6.50 |
| 29 June | 0.03 | | −2.50 | | −4.00 | −6.50 |
| Ending assets (30 June) | | 110.55 | 105.20 | 113.30 | 100.50 | 429.55 |
| Beginning assets + Weighted cash flows | | 108.30 | 107.63 | 112.94 | 112.10 | 440.97 |
| Percent of total beginning assets | | 23.00% | 22.40% | 25.97% | 28.63% | 100.00% |
| Percent of total beginning assets + Weighted cash flows | | 24.56% | 24.41% | 25.61% | 25.42% | 100.00% |

*Note*: Weighted cash flows reflect two-decimal-place precision in the weighting factors.

# Example

| | Percent of Beginning Assets | Percent of Beginning Assets+Weighted Cash Flows | Return for the Month |
|---|---|---|---|
| Portfolio A | 23.00% | 24.56% | 0.51% |
| Portfolio B | 22.40% | 24.41% | 0.28% |
| Portfolio C | 25.97% | 25.61% | 0.32% |
| Portfolio D | 28.63% | 25.42% | 1.36% |
| | 100.00% | 100.00% | |
| **Composite Return:** | | | |
| based on beginning assets: | | | 0.65% |
| based on beginning assets plus weighted CF: | | | 0.62% |

# Example

- Under the "beginning assets" weighting method, the composite return is:

  $Rc=(0.0051\times0.23)+(0.0028\times0.224)+(0.0032\times0.2597)+(0.0136\times0.2863)$

  $=0.0065=0.65\%$

- Under the "beginning assets plus weighted cash flows" method, the composite return is:

  $Rc=(0.0051\times0.2456)+(0.0028\times0.2441)+(0.0032\times0.2561)+(0.0136\times0.2542)$

  $=0.0062=0.62\%$

# 3. Return Calculation—Fee Issues

- **Part 3.4 Fee Issues**
  - **2.A.4 All returns must be calculated after the deduction of the actual trading expenses incurred during the period. Firms must not use estimated trading expenses.**
    - ✓ **Bundled fee:** A fee that combines multiple fees into one total or "bundled" fee. Bundled fees can include any combination of investment management fees, trading expenses, custody fees, and/or administrative fees. E.g. wrap fees; all-in fees.
  - **2.A.5 If the actual trading expenses cannot be identified and segregated from a bundled fee:**
    - ✓ For **gross-of-fees returns**, returns must be reduced by the entire bundled fee or the portion of the bundled fee that includes the trading expenses. Firms must not use estimated trading expenses.
    - ✓ For **net-of-fees returns**, returns must be reduced by the entire bundled fee or the portion of the bundled fee that includes the trading expenses and the investment management fee. Firms must not use estimated trading expenses.

# 3. Return Calculation—Fee Issues

- **Part 3.4 Fee Issues**
  - 4.A.24 Disclose types of fees in bundled fee.
  - **5.A.7 If a composite includes portfolios with bundled fees, the firm must present the percentage of composite assets represented by portfolios with bundled fees as of each annual period end.** 收益低估
  - **5.A.6 If a composite includes non-fee-paying portfolios, the firm must present the percentage of composite assets represented by non-fee-paying portfolios as of each annual period end.**

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# 4. Presentation & Disclosure—Basic Information

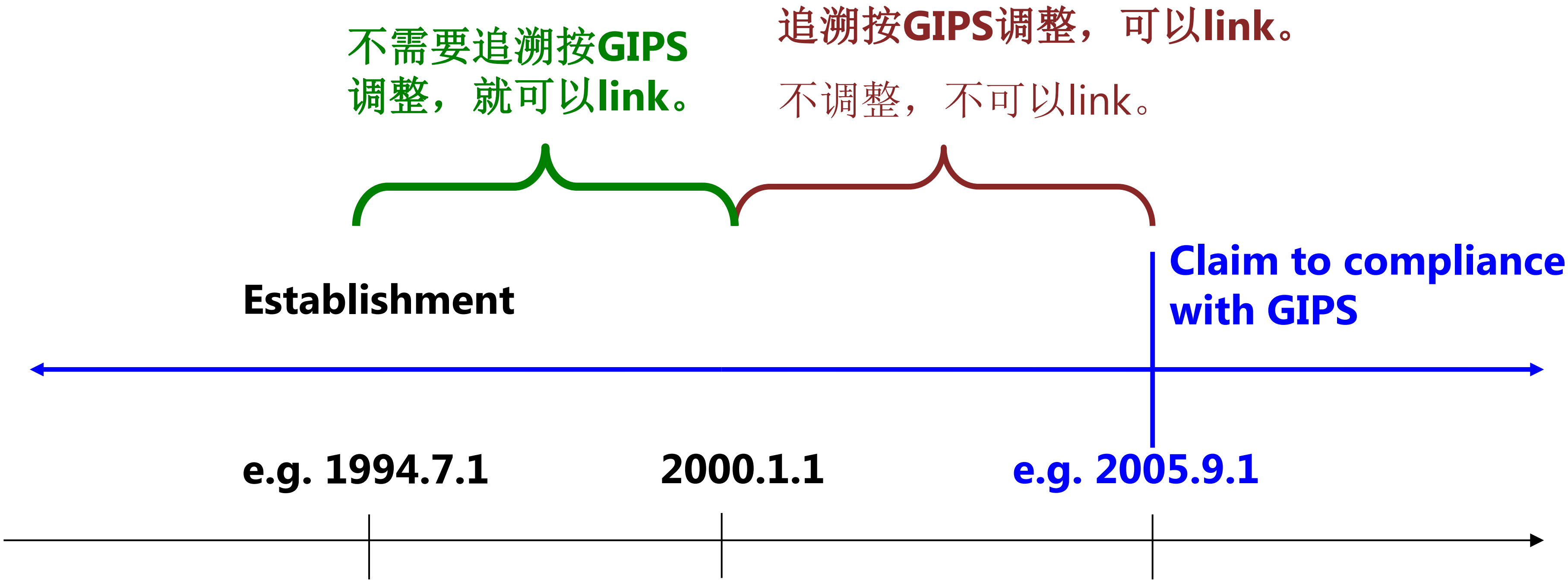
- **Part 4.1 Presentation & Disclosure- Basic Information**
  - **Definitions**
    - ✓ 4.A.2 Definition of **F**irm
    - ✓ 4.A.3 **C**omposite description
    - ✓ 4.A.4 **B**enchmark description
  - **Fee**
    - ✓ 4.A.5 Gross-of-fees return: return on the investments reduced by any trading expenses.
    - ✓ 4.A.6 Net-of-fees return: gross-of-fees return reduced by the investment management fees.
    - ✓ 4.A.9 **F**ee Schedule
  - **4.A.7 Currency**
  - 4.A.13 Presence, use, and extent of leverage, derivatives, and short positions if use is material
  - 4.A.14 All Significant events
  - 4.A.20 Treatment of withholding taxes & information on benchmark returns net of withholding taxes
  - 4.A.21 When >=2011, material differences in exchange rates or valuation sources among portfolios in composite and benchmark

# 4. Presentation & Disclosure

➢ **Part 4.2 Presentation & Disclosure - Return Presentation**

- 0.A.15 Changes in a firm's organization must not lead to alteration of historical composite performance.
- 0.A.16 When the firm jointly markets with other firms, the firm claiming compliance with the GIPS standards must be sure that it is clearly defined and separate relative to other firms being marketed, and that it is clear which firm is claiming compliance.
- 5.A.4 Returns for periods of less than one year must not be annualized.
- 5.A.3 Firms must not link non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance. Firms may link non-GIPS-compliant performance to GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2000.
    - ✓ 4.A.15 For period <=2000 that does not comply with GIPS, FIRMs must disclosure periods of non-compliance

# Timeline



不需要追溯按GIPS
调整，就可以link。
追溯按GIPS调整，可以link。
不调整，不可以link。
Claim to compliance
with GIPS
Establishment
e.g. 1994.7.1
2000.1.1
e.g. 2005.9.1

# 4. Presentation & Disclosure

- **Part 4.2 Presentation & Disclosure - Return Presentation**
  - **5.A.8**
    - ✓ a. **Performance of a past firm or affiliation** must be linked to or used to represent the historical performance of a new or acquiring firm **if the three conditions are met**, on a composite-specific basis:
      - substantially all of the investment **decision makers** are employed by the new or acquiring firm (e.g., research department staff, portfolio managers, and other relevant staff);
      - the decision-making **process** remains substantially intact and independent within the new or acquiring firm; and
      - the new or acquiring firm has **records** that document and support the performance.
    - ✓ b. If a firm **acquires another firm** or affiliation, the firm has **one year** to bring any non-compliant assets into compliance.
  - **4.A.35 Disclose if the performance from a past firm or affiliation is linked**

# 4. Presentation & Disclosure

Composite 自身风险和benchmark

- **Part 4.2 Presentation & Disclosure - Risk Presentation**
  - **5.A.2 For periods beginning on or after 1 January 2011, firms must present, as of each annual period end:**
    - ✓ a. The three-year annualized ex-post standard deviation (using monthly returns) of both the composite and the benchmark; and
    - ✓ b. An additional three-year ex-post risk measure for the benchmark (if available and appropriate) and the composite, if the firm determines that the three-year annualized ex-post standard deviation is not relevant or appropriate. The periodicity of the composite and the benchmark must be identical when calculating the ex-post risk measure.
      - ◆ 4.A.33 Disclose if the three-year annualized ex-post standard deviation of the composite and/or benchmark is not presented because 36 monthly returns are not available
      - ◆ 4.A.34 Disclose if not three-year annualized ex-post standard: why not relevant/ appropriate, additional risk measure and why it is selected

# 4. Presentation & Disclosure

- **Part 4.2 Presentation & Disclosure - Risk Presentation**
- **4.A.8 Disclose internal dispersion.**
- **Internal dispersion:** a measure of the spread of the annual returns of individual portfolios within a composite. It allows clients to see how consistently the firm implemented its strategy across individual portfolios
  - **Highest and lowest returns** earned by portfolios that were in the composite for the full year.
  - Or alternatively, **High/low range**
  - The **equal-weighted standard deviation** of returns to portfolios in the composite

$$\sigma_C = \sqrt{\frac{\sum_{i=1}^{n}[R_i - MEAN(R)]^2}{n-1}}$$

  - The **asset-weighted standard** deviation $dispersion = \sqrt{\sum_{i=1}^{n} w_i (R_i - C_{ASSET})^2}$
  - The **interquartile range** — the difference between the returns in the first and third quartiles of the distribution. It measures the part of the population between the bottom of the first quartile and the bottom of the third quartile.

# 4. Presentation & Disclosure

- **Part 4.3 Presentation & Disclosure-Benchmark**
  - **4.A.29 Disclose if no benchmark: why**
  - **4.A.30 Disclose if changes the benchmark: date, description, reason**
    - ✓ In most cases, the benchmark is changed from one benchmark to another on a prospective basis only.
    - ✓ There may be times when a firm determines that it is appropriate to change the benchmark for **a given composite retroactively.**
  - 4.A.31 Disclose if use **custom benchmark** or **combination of multiple benchmarks** : components, weights, and rebalancing process.

# 4. Presentation & Disclosure

- **Part 4.4 Presentation & Disclosure-Compliance Presentation**
  - **4.A.1 Disclose compliance with GIPS**
    - ✓ 0.A.9 Firms must make every reasonable effort to provide a **compliant presentation** to **all** prospective clients. Must not choose to whom they present a compliant presentation . As long as a prospective clients has received a compliant presentation within the previous 12 months, the firm has met this requirement.
    - ✓ 0.A.11 Firms must provide a compliant presentation for any composite listed on the firm's list of composite descriptions to any prospective client that makes such a request.

# 4. Presentation & Disclosure

业绩披露和
报告原则

- **5.A.1 The following items must be presented in each compliant presentation:**
  - **a.** At least **5 years** of performance (or since inception if less than five years) that meets the requirements of the GIPS standards. After a firm presents a minimum of five years of GIPS compliant performance, the firm must present an additional year of performance each year, building up to a minimum of **10 years** of GIPS compliant performance.
  - **b. (1) Composite returns** for each annual period. Composite returns must be clearly identified as gross-of-fees **or** net-of-fees.
    - ✓ For composites with a composite inception date of 1 January 2011 or later, when the initial period is less than a full year, returns from the composite inception date through the initial annual period end.
    - ✓ For composites with a composite termination date of 1 January 2011 or later, returns from the last annual period end through the composite termination date.

# 4. Presentation & Disclosure

业绩披露和
报告原则

- **5.A.1 The following items must be presented in each compliant presentation:**
  - **c.** The total return for the **(2)** **<u>benchmark</u>** for each <u>annual period</u>. The benchmark must reflect the investment mandate, objective, or strategy of the composite.
  - **d.** The **(3)** **<u>number of portfolios</u>** in the composite as of each annual period end. If the composite contains <=5 portfolios at period end, the number of portfolios is not required.
  - **e. (4)** **<u>Composite assets</u>** as of each annual period end.
  - **f. (5)** Either **<u>total firm assets</u> or <u>composite assets as a percentage of total firm assets</u>**, as of each annual period end.

# 4. Presentation & Disclosure

业绩披露和报告原则

➢ **5.A.1 The following items must be presented in each compliant presentation:**

- **g.** A measure of **(6)** **internal dispersion** of individual portfolio returns for each annual period. If the composite contains <=5 portfolios for the full year, a measure of internal dispersion is not required.
- **h.** The three-year annualized ex-post standard deviation (using monthly returns) of both the **(7) composite** and the **(8) benchmark**.

# Global Investment Performance Standards

- **Section 0~5. Recommendations**

# Section 0~5. Recommendations

- **0.B Fundamentals of Compliance — Recommendations**
  - 0.B.1 Firms should comply with the recommendations of the GIPS.
  - 0.B.2 Firms should be verified.
  - 0.B.3 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.
  - 0.B.4 Firms should provide to each existing client, <u>on an **annual** basis</u>, a <u>compliant presentation</u> of the composite in which the client's portfolio is included.

# Section 0~5. Recommendations

- **1.B Input Data — Recommendations**
  - 1.B.1 Firms should value portfolios on the date of all external cash flows.
  - 1.B.2 Valuations should be obtained from a qualified independent third party.
  - 1.B.3 Accrual accounting should be used for dividends (as of the ex-dividend date).
  - 1.B.4 Firms should accrue investment management fees.

# Section 0~5. Recommendations

➢ **2.B Calculation Methodology — Recommendations**

- 2.B.1 Returns should be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes should be accrued.
- 2.B.2 For periods prior to 1 January 2010, firms should calculate composite returns by asset-weighting the individual portfolio returns at least monthly.

# Section 0~5. Recommendations

➢ **3.B Composite Construction — Recommendations**

- 3.B.1 If the firm sets a minimum asset level for portfolios to be included in a composite, the firm should not present a compliant presentation of the composite to a prospective client known not to meet the composite's minimum asset level.
- 3.B.2 To remove the effect of a significant cash flow, the firm should use a **temporary new account**.

# Section 0~5. Recommendations

- **5. Presentation and Reporting — Recommendations**
  - 5.B.1 Firms should present gross-of-fees returns.
  - 5.B.2 Firms should present the following items:
    - ✓ a. Cumulative returns of the composite and the benchmark for all periods;
    - ✓ b. Equal-weighted mean and median composite returns;
    - ✓ c. Quarterly and/or monthly returns; and
    - ✓ d. annualized composite and benchmark returns for periods longer than 12 months.
  - 5.B.3 For periods prior to 1 January 2011, firms should present the three-year annualized ex-post standard deviation (using monthly returns) of the composite and the benchmark as of each annual period end.
  - 5.B.4 For each period for which an annualized ex-post standard deviation of the composite and the benchmark are presented, the corresponding annualized return of the composite and the benchmark should also be presented.

# Section 0~5. Recommendations

- **5. Presentation and Reporting — Recommendations**
  - 5.B.5 For each period for which an annualized return of the composite and the benchmark are presented, the corresponding annualized ex-post standard deviation (using monthly returns) of the composite and the benchmark should also be presented.
  - 5.B.6 Firms should present additional relevant composite-level ex-post risk measures.
  - 5.B.7 Firms should present more than 10 years of annual performance in the compliant presentation.
  - 5.B.8 Firms should comply with the GIPS standards for all historical periods.
  - 5.B.9 Firms should update compliant presentations quarterly.

# Appendix: Sample 1 (0-5)

**SAMPLE 1 INVESTMENT FIRM BALANCED GROWTH COMPOSITE**

**1 January 2002 through 31 December 2011**

| Year | Composite Gross Return (%) | Composite Net Return (%) | Custom Benchmark Return (%) | Composite 3-Yr St Dev (%) | Benchmark 3-Yr St Dev (%) | Number of Portfolios | Internal Dispersion (%) | Composite Assets ($ M) | Firm Assets ($ M) |
|---|---|---|---|---|---|---|---|---|---|
| 2002 | –10.5 | –11.4 | –11.8 | | | 31 | 4.5 | 165 | 236 |
| 2003 | 16.3 | 15.1 | 13.2 | | | 34 | 2.0 | 235 | 346 |
| 2004 | 7.5 | 6.4 | 8.9 | | | 38 | 5.7 | 344 | 529 |
| 2005 | 1.8 | 0.8 | 0.3 | | | 45 | 2.8 | 445 | 695 |
| 2006 | 11.2 | 10.1 | 12.2 | | | 48 | 3.1 | 520 | 839 |
| 2007 | 6.1 | 5.0 | 7.1 | | | 49 | 2.8 | 505 | 1,014 |
| 2008 | –21.3 | –22.1 | –24.9 | | | 44 | 2.9 | 475 | 964 |
| 2009 | 16.5 | 15.3 | 14.7 | | | 47 | 3.1 | 493 | 983 |
| 2010 | 10.6 | 9.5 | 13.0 | | | 51 | 3.5 | 549 | 1,114 |
| 2011 | 2.7 | 1.7 | 0.4 | 7.1 | 7.4 | 54 | 2.5 | 575 | 1,236 |

# Appendix: Sample 1 (0-5)

- Sample 1 Investment Firm claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 1 Investment Firm has been independently verified for the periods 1 January 2000 through 31 December 2010. The verification report is available upon request. Verification assesses whether
  - (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and
  - (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.
- Verification does not ensure the accuracy of any specific composite presentation.

# Appendix: Sample 1 (0-5)

➢ **Notes:**

1. Sample 1 Investment Firm is a balanced portfolio investment manager that invests solely in US-based securities. Sample 1 Investment Firm is defined as an independent investment management firm that is not affiliated with any parent organization. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

2. The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap US equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50–70%, the typical allocation is between 55–65%. The account minimum for the composite is $5 million.

# Appendix: Sample 1 (0-5)

- **Notes:**

3. The custom benchmark is 60% YYY US Equity Index and 40% ZZZ US Aggregate Bond Index. The benchmark is rebalanced monthly.

4. Valuations are computed and performance is reported in US dollars.

5. Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Composite and benchmark returns are presented net of non-reclaimable withholding taxes. Net-of-fees returns are calculated by deducting the highest fee of 0.83% from the monthly gross composite return. The management fee schedule is as follows: 1.00% on the first $25 million; 0.60% thereafter.

# Appendix: Sample 1 (0-5)

- **Notes:**

6. This composite was created in February 2000. A complete list of composite descriptions is available upon request.

7. Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year.

8. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The standard deviation is not presented for 2002 through 2010 because monthly composite and benchmark returns were not available and is not required for periods prior to 2011.

# Appendix: Sample 2 (0-5)

**SAMPLE 2 ASSET MANAGEMENT COMPANY ACTIVE WORLD EQUITY COMPOSITE**

**Creation Date: 1 July 2005**
**Reporting Currency: EUR**

| Year | Gross Return (%) | XYZ World Index Return (%) | Dispersion (Range) (%) | # of Portfolios | Composite Assets (€ M) | % of Firm Assets (%) |
|---|---|---|---|---|---|---|
| 2011 | –1.9 | –0.5 | 0.2 | 6 | 224.9 | 2.1 |
| 2010 | 16.3 | 13.5 | 0.7 | 8 | 256.7 | 2.0 |
| 2009 | 29.0 | 25.8 | 1.5 | 8 | 205.6 | 1.9 |
| 2008 | –39.8 | –36.4 | 1.3 | 7 | 164.1 | 1.5 |
| 2007 | –2.8 | –2.7 | n/a | ≤ 5 | 143.7 | 1.2 |
| 2006 | 9.3 | 7.5 | n/a | ≤ 5 | 62.8 | 0.4 |
| 2005* | 14.2 | 12.6 | n/a | ≤ 5 | 16.1 | < 0.1 |

*Returns are for the period from 1 July 2005 (inception date) through 31 December 2005.

# Appendix: Sample 2 (0-5)

- ***Compliance Statement***
  - Sample 2 Asset Management Company claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 2 Asset Management Company has not been independently verified.
- ***Definition of the Firm***
  - Sample 2 Asset Management Company is an independent investment management firm that was established in 1997. Sample 2 Asset Management Company manages a variety of equity, fixed-income, and balanced assets for primarily European clients.

# Appendix: Sample 2 (0-5)

- ***Policies***
  - Sample 2 Asset Management Company's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- ***Composite Description***
  - The Active World Equity Composite includes accounts whose objective is to exceed the XYZ World Index by 2% over a rolling three-year period. Securities are selected using the firm's proprietary analytics tool, which selects securities expected to be the top performers from within the XYZ World Index universe. Portfolios are more concentrated, typically holding approximately 100–120 securities, versus the benchmark, which reflects the performance of more than 500 holdings. Composite returns may, therefore, have a lower correlation with the benchmark than a more diversified global equity strategy.

# Appendix: Sample 2 (0-5)

- ***Benchmark***
  - The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ country-specific developed market indices. Sources of foreign exchange rates may be different between the composite and the benchmark; however, there have not been material differences to date. Benchmark returns are net of withholding taxes.
- ***Fees***
  - Returns are presented gross of management fees, custodial fees, and withholding taxes but net of all trading expenses.
- ***List of Composites***
  - A list of all composite descriptions is available upon request.

# Appendix: Sample 2 (0-5)

- ***Fee Schedule***
  - The standard fixed management fee for accounts with assets under management of up to €50 million is 0.35% per annum; 0.25% thereafter.
- ***Minimum Account Size***
  - The minimum portfolio size for inclusion in the composite is €1 million.
- ***Internal Dispersion***
  - Internal dispersion is calculated using the asset-weighted standard deviation of annual gross-of-fees returns of those portfolios that were included in the composite for the entire year. For those years when less than six portfolios were included in the composite for the full year, no dispersion measure is presented.

# Appendix: Sample 2 (0-5)

➢ ***Ex-Post Standard Deviation***

- The three-year annualized ex-post standard deviation of the composite and benchmark as of each year end is as follows:

➢

| Year | Composite 3-Yr St Dev (%) | Benchmark 3-Yr St Dev (%) |
|---|---|---|
| 2011 | 12.9 | 14.6 |
| 2010 | 13.2 | 14.1 |
| 2009 | 17.0 | 16.3 |
| 2008 | 15.6 | 14.2 |

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# Global Investment Performance Standards

- **Verification**
  - The primary purpose of verification is to establish that a firm claiming compliance with the GIPS standards has adhered to the Standards. Verification will also increase the understanding and professionalism of performance measurement teams and consistency of presentation of performance results.
  - The verification procedures attempt to strike a balance between ensuring the quality, accuracy, and relevance of performance presentations and minimizing the cost to firms of independent review of performance results. Firms should assess the benefits of improved internal processes and procedures, which are as significant as the marketing advantages of verification.

  Besides, verification is **recommended** but **not required** up to this point.

# Global Investment Performance Standards

- **Verification**
  - **1. Verification must be performed by a qualified independent third party.**
  - **2. Verification assesses whether:**
    - ✓ a. the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and
    - ✓ b. The firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.
  - **3. A single verification report is issued with respect to the whole firm. Verification cannot be carried out on a composite.**
  - **4. The initial minimum period for which verification can be performed is one year (or from firm inception date through period end if less than one year).**
  - **5. The firm must not state that it has been verified unless a verification report has been issued.**

# Global Investment Performance Standards

- **Verification**
  - **6. A principal verifier may accept the work of another verifier. Reliance considerations and conclusions must be documented by the principal verifier.**
  - 7. Verifiers may use a **sampling methodology**. Verifiers MUST consider the certain criteria when selecting samples.
  - 8. After performing the verification, the verifier may conclude that the firm is not in compliance with the GIPS standards or that the records of the firm cannot support a verification. in such situations, the verifier must issue a statement to the firm clarifying why a verification report could not be issued.
  - 9. The verification report must state that the verification has been conducted in accordance with these verification procedures.

# Global Investment Performance Standards

- **Performance Examinations**
  - In addition to a verification, a firm may choose to have a specifically focused performance examination of **a particular composite compliant presentation**. However, a performance examination report **must not be issued** unless a verification report has also been issued.
  - The performance examination may be performed concurrently with the verification. A performance examination **is not required** for a firm to be verified.
  - The firm must not state that a composite has been examined unless the performance examination report has been issued for the specific composite.

# 4. Presentation & Disclosure - Claim of compliance

- **For FIRMS that are verified:**
  - "[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.
  - Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation."

# 4. Presentation & Disclosure——Claim of compliance

- **For COMPOSITES of a verified FIRM that have also had a performance EXAMINATION:**
  - "[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates].
  - Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The [insert name of COMPOSITE] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request."

# 4. Presentation & Disclosure——Claim of compliance

- **For FIRMS that have not been verified:**
  - "[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has not been independently verified."

# Global Investment Performance Standards

- **GIPS valuation principles**
  - For periods beginning on or after January 1, 2011, the GIPS require firms to use fair values.
    - ✓ For a regularly traded security, the recent reported **trading price** is used as fair value
    - ✓ If this is not available (due perhaps to the asset being infrequently traded, transaction prices not being reported, or a private investment with no transactions occurring), then fair value establishes a hierarchy for what to use instead.
    - ✓ The hierarchy is in descending order of usage. A method lower in the hierarchy is used only when all methods higher in the hierarchy are unavailable.

# Global Investment Performance Standards

- **GIPS Advertising Guidelines**
  - The guidelines **only** apply to firms that already satisfy all the requirements of the standards on a firm-wide basis and claim compliance with the standards. Firms that claim compliance can **choose** to advertise that claim using the GIPS advertising guidelines.
  - In cases where applicable law or regulation conflicts with the GIPS Advertising Guidelines, the guidelines require firms to comply with the law or regulation. Firms must disclose any conflicts between laws/regulations and the GIPS Advertising Guidelines.
  - **Definition of Advertisement**
    - ✓ An advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, FIRM brochures, letters, media, or any other written or electronic material addressed to more than one prospective client. Any written material (**other than one-on-one presentations and individual client reporting**) distributed to maintain existing clients or solicit new clients for an advisor is considered an advertisement.

# Global Investment Performance Standards

- **All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines MUST disclose the following:**

披露业绩 vs.没有披露业绩

  - 1. The definition of the firm.
  - 2. How a prospective client can obtain a compliant presentation and/or the firm's list of composite descriptions.
  - 3. The GIPS compliance statement for advertisements:

**"[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS® )."**

  - Compared to the claim of performance presentation compliance:

" (Insert name of firm) claims compliance with the Global Investment Performance Standards (GIPS ®) and has prepared and presented this report in compliance with the GIPS standards. (Insert name of firm) has not been independently verified. "

# Global Investment Performance Standards

- **All advertisements that include a claim of compliance with the GIPS Advertising Guidelines and that present performance results MUST also include the following information:**
  - 4. The **composite description.**
  - 5. **Composite total returns** according to one of the following: (Note: Returns for periods of less than one year MUST NOT be annualized)
    - ✓ 1-,3-,5- annualized composite returns (or since the composite inception date),
    - ✓ Period-to-date composite returns + 1-,3-,5- annualized composite returns (or since ..)
    - ✓ Period-to-date composite returns + 5 years of annual composite returns (or since...)
  - 6. Performance is **gross and/or net** of fees.
  - 7. Total return for **Benchmark.** 8. **Benchmark description.** 9. If **no benchmark, why**
  - 10. The **currency** for performance.
  - 11. The presence, use and extent of **leverage, derivatives and short positions if use is material**
  - 12. Period of **noncompliant performance** before 2000.
  - 13. **Laws and/or regulations** conflict with GIPS

# Sample Advertisement Without Performance

- **Generic Asset Management**
  - Generic Asset Management is the institutional asset management division of Generic Inc. and is a registered investment advisory firm specializing in qualitative growth-oriented investment management.
  - Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write to Generic Asset Management, 123 Main Street, Returnsville 12345, or jpaul@genericassetmanagment.com.

# Sample Advertisement With Performance

## SAMPLE ADVERTISEMENT INCLUDING ONE-, THREE-, AND FIVE-YEAR ANNUALIZED RETURNS

**Generic Asset Management: Global Equity Growth Composite**

| | Ending 31 Mar 2012 | | |
|---|---|---|---|
| | 1-Year | 3-Year Annualized | 5-Year Annualized |
| Global Equity Growth Composite | –0.3% | 13.7% | 0.1% |
| XYZ World Index | –0.5% | 13.8% | –0.6% |

*Note:* Returns are shown in US dollars net of fees.

# Sample Advertisement With Performance

**SAMPLE ADVERTISEMENT INCLUDING PERIOD-TO-DATE AND ONE-, THREE-, AND FIVE-YEAR ANNUALIZED RETURNS**

**Generic Asset Management: Global Equity Growth Composite**

| | Ending 31 Mar 2012 | Ending 31 Dec 2011 | | |
|---|---|---|---|---|
| | Period to Date (3 months) | 1-Year | 3-Year Annualized | 5-Year Annualized |
| Global Equity Growth Composite | –3.84% | 1.3% | 15.0% | –1.2% |
| XYZ World Index | –4.94% | 1.5% | 14.1% | –0.7% |

*Note:* Returns are shown in US dollars net of fees.

# Sample Advertisement With Performance

**SAMPLE ADVERTISEMENT INCLUDING FIVE YEARS OF ANNUAL RETURNS**

**Generic Asset Management: Global Equity Growth Composite**

| | Period to Date (3 months to 31 Mar 2012) | Annual Returns Periods Ended 31 December | | | | |
|---|---|---|---|---|---|---|
| | | 2011 | 2010 | 2009 | 2008 | 2007 |
| Global Equity Growth Composite | −3.84% | 1.3% | 13.0% | 33.0% | −40.6% | 9.6% |
| XYZ World Index | −4.94% | 1.5% | 11.8% | 30.8% | −40.3% | 9.6% |

*Note:* Returns are shown in US dollars net of fees.

# Sample Advertisement With Performance

- Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative, growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indices.
- Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®).
- To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write to Generic Asset Management, 123 Main Street, Returnsville 12345, or jpaul@genericassetmanagment.com.

# Global Investment Performance Standards

➢ **Challenges Related to Calculation of After-tax Returns**

- GIPS standards do **not require** compliant firms to present after-tax returns for composites. But the GIPS Executive Committee places the responsibility for country-specific guidance on after-tax returns on GIPS country sponsors.
- Effective from 1 January 2011, all after-tax performance reporting presented as part of a compliant presentation will be supplemental information.
- **Challenges:** 1) **Two methods**: pre-liquidation & mark-to-liquidation. Not consider future gains or losses, thus not measure portfolio's true economic value. 2) no appropriate **benchmark** 3) **client-directed trades** that out of manager's control

# Global Investment Performance Standards

- **After-tax return calculation challenges**
  - Pre-liquidation method: unrealized capital gains are untaxed, understate the tax effect
  - Market-liquidation method: all gains are taxed, overstate the tax effect.
  - How to modify?
    - ✓ Mutual fund: imperfect because subject to fees, deviate from index they emulate; tax liabilities are affected by the manager's security transactions and by the collective deposit and redemption activities of shareholders.
    - ✓ ETF: do not incur taxes-> better suited as benchmark for after-tax return evaluation
    - ✓ Custom security-based benchmarks: well positioned to simulate the tax impact of external cash flows on benchmark results.
    - ✓ Shadow portfolio: which simulated purchases and sales are triggered by client-initiated cash flows.

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# 6. Real Estate

- **The real estate provisions <u>supplement</u> all the required and recommended elements of the GIPS standards , except the real estate provisions that override the existing GIPS provisions**
- 以下情况不适用**real estate provision**
  - Publicly traded real estate securities, such as public REITs **(房地产公司股票)**
  - Commercial mortgage-backed securities **(CMBS)**
  - Private debt investments, including commercial and residential loans **(房地产贷款)** where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying real estate.

# 6. Real Estate

## ➢ Input Data — Requirements

- 6.A.1 For periods>= 2011, valued in accordance with the definition of **fair value**
- 6.A.2 For periods>= 2008, be valued at least **quarterly**.
- 6.A.3 For periods >= 2010, value as of **each quarter end** or **the last business day of each quarter**
- 6.A.4 Must have an external valuation:
  - ✓ a. Before 2012, at least once every 36 months.
  - ✓ b. After 2012, at least once **every 12 months.**
- 6.A.5 External valuations must be performed by an **independent external** professionally designated, certified, or licensed commercial property valuer/appraiser. if not available, only well-qualified independent property valuers or appraisers.

# 6. Real Estate

- **Calculation Methodology — Requirements**
  - 6.A.6 Firms must calculate portfolio returns at least quarterly.
    - ✓ 6.A.7 All returns must be calculated after the deduction of **actual transaction expenses** incurred during the period.
    - ✓ 6.A.8 After 2011, **income returns** and **capital returns** (component returns) must be calculated **separately** using geometrically linked time-weighted rates of return.
  - 6.A.9 Composite time-weighted rates of return, including component returns, must be calculated by asset-weighting the individual portfolio returns at least quarterly.

# 6. Real Estate

➢ **Disclosure — Requirements**

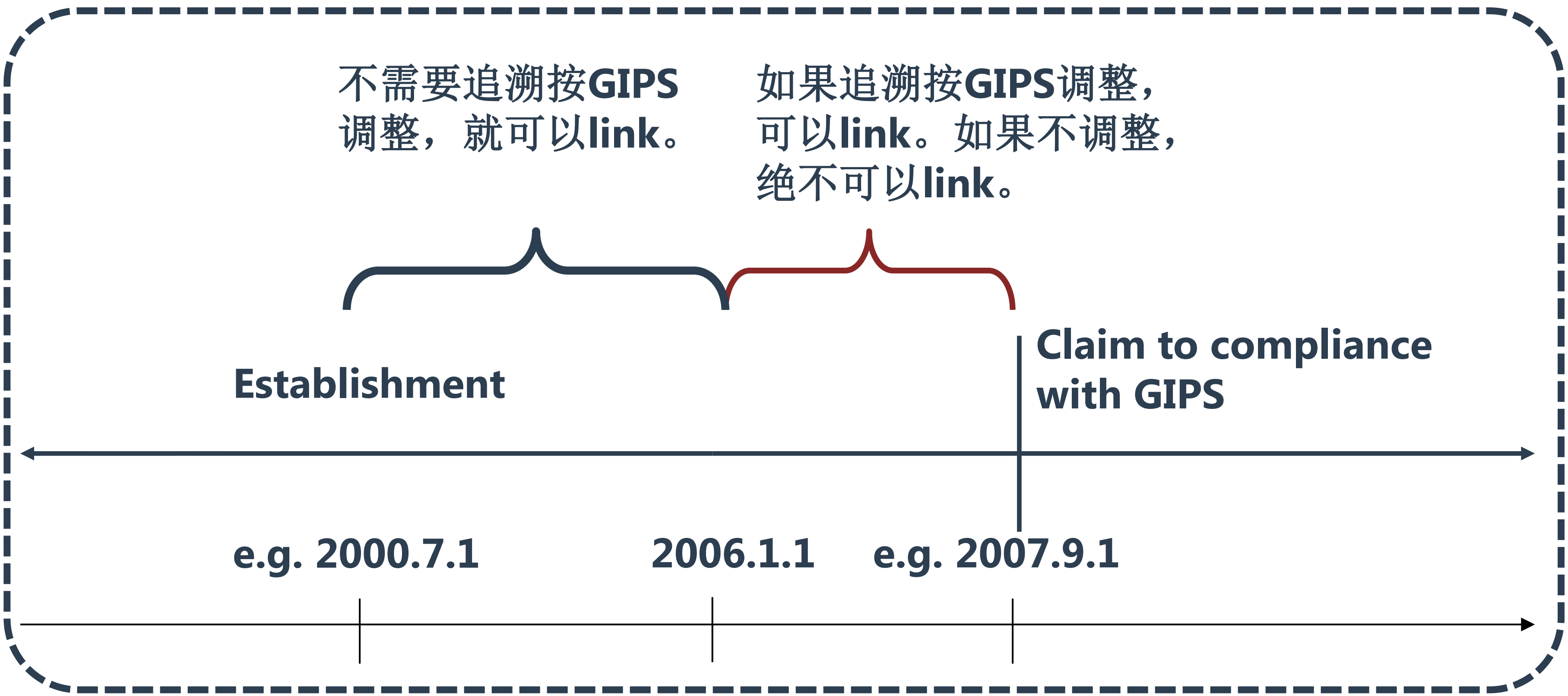
- 6.A.10
  - ✓ a) discretion,
  - ✓ b) internal valuation methodologies ,
  - ✓ c) changes to valuation policies and/or methodologies,
  - ✓ d) differences between an external valuation and the valuation used in performance reporting and the reason ,
  - ✓ e) frequency of valuation,
  - ✓ f) when component returns are calculated separately using geometrically linked time-weighted rates of return,
  - ✓ g) **adjustments** to make the sum of the income return and the capital return equals the total return.
- 6.A.11 >=**2006** GIPS and non-compliant performance may not be linked: Prior to this date, any such link must be disclosed.
- 6.A.12 Gross-of-fees returns: transaction expenses.
- 6.A.13 Net-of-fees returns: investment management fees and transaction expenses.

# 6. Real Estate

- **Presentation and Reporting — Requirements**
  - 6.A.14 Firms must present component returns in addition to total returns. Composite component returns must be clearly identified as gross-of-fees or net-of-fees.
  - 6.A.15 Firms must not link non-GIPS-compliant performance for periods >= 2006 to their GIPS-compliant performance. Firms may link non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods >= 2006.
  - 6.A.16 The following items must be presented in each compliant presentation:
    - ✓ a. As a measure of internal dispersion, high and low annual time-weighted rates of return for the individual portfolios in the composite. If the composite contains <=5, a measure of internal dispersion is not required.
    - ✓ b. As of each annual period end, the percentage of composite assets valued using an external valuation during the annual period.

# Timeline

- REAL ESTATE

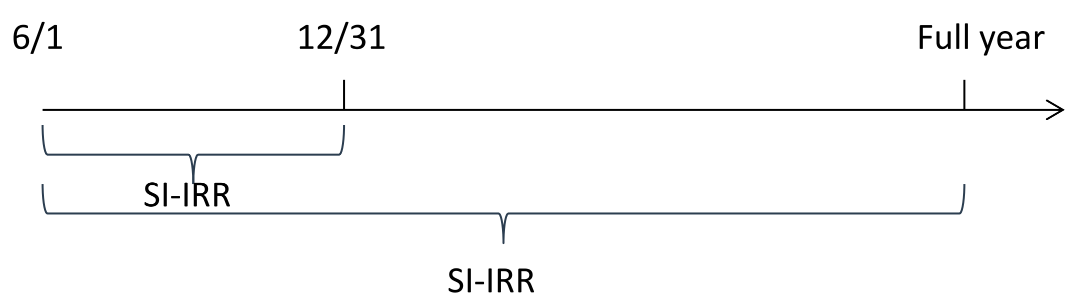


# 6. Real Estate

➢ **Additional Requirements for RE closed-end fund**

- 6.A.17 Firms must calculate annualized since inception internal rates of return **(SI-IRR).**
- 6.A.18 The SI-IRR must be calculated using **quarterly cash flows** at a minimum.
- For standard 0-5:


- For R/E Close-end and P/E funds:



# 6. Real Estate

➢ **Additional Requirements for RE closed-end fund**

- 6.A.19 Composites must be defined by vintage year and investment mandate, objective, or strategy. The composite definition must remain consistent throughout the life of the composite.
  - ✓ 6.A.22 Firms must disclose the vintage year of the composite and how the vintage year is defined.
- 6.A.20 Firms must disclose the final liquidation date for liquidated composites.
- 6.A.21 Firms must disclose the frequency of cash flows used in the SI-IRR calculation.

# 6. Real Estate

- **Additional Requirements for RE closed-end fund**
  - 6.A.23 The following items must be presented in each compliant presentation:
    - ✓ Net-of-fees SI-IRR of the composite, 5 years of performance, Each subsequent year, an additional year of performance.
      - When >=2011, non-annualized net-of-fees SI-IRR through the initial annual period end.
      - For periods ending on or after 1 January 2011, present the net of- fees SI-IRR through the composite final liquidation date.
  - 6.A.24 If present gross-of-fees SI-IRR, same periods as the net-of-fees SI-IRR.
  - 6.A.25 Firms must present, as of each annual period end:
    - ✓ a. composite since inception paid-in capital;
    - ✓ b. composite since inception distributions;
    - ✓ c. composite cumulative committed capital;
    - ✓ d. TVPI; e- DPI; f- PIC; g-RVPI
  - 6.A.26 SI-IRR of the benchmark through each annual period end. The benchmark must: a.) reflect the investment mandate, objective, or strategy of the composite; b) same time period c) same vintage year

# 6. Real Estate

- **Real Estate Provisions Summary**
  - After 2010.1.1, valued **quarterly** of each quarter end or the last business day of each quarter;
  - After 2012.1.1, external valuation **at least once every 12 months** unless client agreements stipulate otherwise, but at least not more than 36 months
  - Must present component return (capital and income return) in addition to total return, component returns must be clearly identified as **gross-of-fees** or **net-of-fees.**
  - As a measure of internal dispersion, **high and low** annual time-weighted rates of return for the individual portfolios in the composite must be presented in each compliant presentation

# 6. Real Estate

- **Additionally, Real Estate Provisions especially for closed-end fund**
  - Calculate annualized **SI-IRR**
  - composites must be defined by **vintage year** and **investment mandate, objective, or strategy**
  - Present since inception paid-in capital/distribution/committed capital and **TVPI / DPI / RVPI / PIC multiple.**

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
  - Part 3 Return Calculation
  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# 7. Private Equity

- The provisions apply to the calculation and presentation of private equity investments made by fixed life, fixed commitment private equity investment vehicles **including primary funds and fund of funds**. These provisions also apply to fixed life, fixed commitment secondary funds
- Private equity open-end and evergreen funds must follow Sections 0–5.
- Real estate closed-end funds must follow Section 6.

# 7. Private Equity

- **Input Data — Requirements**
  - 7.A.1 After 2011, PE must be valued in accordance with the definition of **fair value**.
  - 7.A.2 PE must be valued at least **annually**.
- **Calculation Methodology — Requirements**
  - 7.A.3 Calculate **annualized SI-IRR**.
  - 7.A.4 After 2011, SI-IRR must be calculated using daily cash flows. Stock distributions must be included as cash flows and must be valued at the time of distribution.
  - 7.A.5 All returns must be calculated after the deduction of actual transaction expenses incurred during the period.
  - 7.A.6 Net-of-fees returns must be net of actual investment management fees (including carried interest).
  - 7.A.7 For fund of funds, all returns must be net of all underlying partnership and/ or fund fees and expenses, including carried interest.

# 7. Private Equity

- **Composite Construction — Requirements**
  - 7.A.8 Composite definitions must remain consistent.
  - 7.A.9 Primary funds must be included in at least one composite defined by vintage year and investment mandate, objective, or strategy.
  - 7.A.10 Fund of funds must be included in at least one composite defined by vintage year of the fund of funds and/or investment mandate, objective, or strategy.
- **Disclosure — Requirements**
  - 7.A.11 Firms must disclose the vintage year of the composite and how the vintage year is defined.
  - 7.A.12 Firms must disclose the final liquidation date for liquidated composites.
  - 7.A.13 Firms must disclose the valuation methodologies.
  - 7.A.14 After 2011, must disclose material changes to valuation policies and/or methodologies.

# 7. Private Equity

## Disclosure — Requirements

- 7.A.15 If adhere to industry valuation guidelines in addition to the GIPS, disclose which guidelines have been applied.
- 7.A.16 Calculation methodology for benchmark. If firms present the public market equivalent of a composite as a benchmark, firms must disclose the index used to calculate the public market equivalent.
- 7.A.17 Frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.
- 7.A.18 For gross-of-fees returns, any other fees are deducted in addition to the transaction expenses.
- 7.A.19 For net-of-fees returns, any other fees are deducted in addition to the investment management fees and transaction expenses.
- 7.A.20 For any performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

# 7. Private Equity

## ➢ Disclosure — Requirements

- **7.A.21**
  - ✓ a. Both net-of-fees and gross-of-fees SI-IRR. 5 years of performance. Each subsequent year, firms must present an additional year of performance. composite returns must be clearly identified as gross-of-fees or net-of-fees.
  - ✓ b. After 2011, when the initial period is less than a full year, firms must present the non-annualized net-of-fees and gross-of-fees SI-IRR through the initial annual period end.
  - ✓ c. After 2011, firms must present the net-of-fees and gross-of-fees SI-IRR through the composite final liquidation date.
- 7.A.22 After 2011, for fund of funds composites, if the composite is defined only by investment mandate, objective, or strategy, firms must also present the SI-IRR of the underlying investments aggregated by vintage year as well as other measures as required in 7.A.23. These measures must be presented gross of the fund of funds investment management fees and must be presented as of the most recent annual period end.

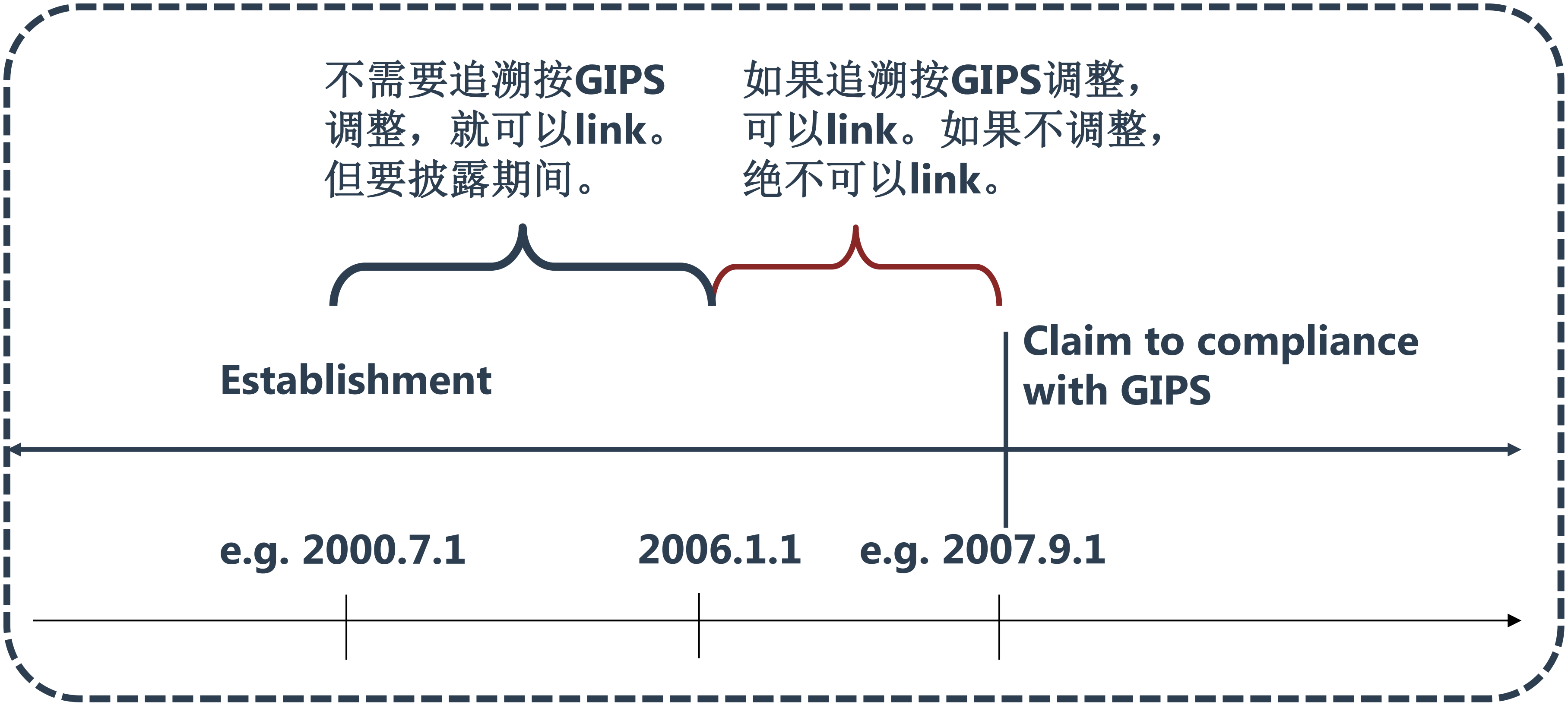
# 7. Private Equity

## Disclosure — Requirements

- 7.A.23 Just as 6.A.25
- 7.A.24 Just as 6.A.26
- 7.A.25 For fund of funds composites, benchmark must be the same vintage year and investment mandate, objective, or strategy.
- 7.A.26 After 2011, for fund of funds composites, firms must present the percentage of composite assets that is invested in direct investments.
- 7.A.27 After 2011, for primary fund composites, firms must present the percentage of composite assets that is invested in fund investment vehicles .
- 7.A.28 Firms must not present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, firms may present non-GIPS-compliant performance.

# Timeline

➢ **Private Equity**



# 7. Private Equity

## ➢ Private Equity — Summary

- Must be valued at least **annually.**
- Calculate annualized **SI-IRR,** using daily cash flows (after 2011.1.1)
- Firms must present **both the net-of-fees and gross-of-fees SI-IRR** of the composite
- For primary funds defined by vintage year and investment mandate, objective, or strategy. (一种形式)
- For FOF, defined by vintage year of the fund of funds and/or investment mandate, objective, or strategy. (三种形式)  After 2011.1.1, defined only by investment mandate, objective, or strategy, firms must also present the SI-IRR of the underlying investments aggregated by vintage year
- Present since inception paid-in capital/distribution/committed capital and **TVPI / DPI / RVPI / PIC multiple.**

# GIPS Framework

- **General Standard (0-5)**
  - Part1 Compliance Standards
  - Part2 Compliance Width
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  - Presentation & Disclosure
- **Real Estate**
- **Private Equity**
- **Wrap Fee/SMA Portfolio**
- **Further Topics**

# Global Investment Performance Standards

- **If a composite contains portfolios with bundled fees, firms must disclose the types of fees that are included in the bundled fee.**
- **A bundled fee is a fee that combines multiple fees into one total or "bundled" fee. Bundled fees can**
  - include any combination of investment management fees, trading expenses, custody fees, and/or administrative fees. Two examples of bundle fees are all-in fees and wrap fees.
    - ✓ All-in Fee
      - ◆a type of bundled fee that can include any combination of investment management fees, trading expenses, custody fees, and administrative fees.
      - ◆All-in fees are client specific and typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.

# Global Investment Performance Standards

➢ **8. Wrap fee/separately managed account (SMA) portfolios**

- **Wrap fee:** A type of bundled fee and are specific to a particular investment product.
- The wrap fee is charged to the client by the sponsor for investment management services and typically includes associated trading expenses that cannot be separately identified.
- Wrap fees can be **all-inclusive**, asset-based fees and may include a combination of investment management fees, trading expenses, custody fees, and/or administrative fees.
- **A wrap fee portfolio** is sometimes referred to as a "Separately managed account" (SMA) or "managed account."

# Wrap fee/separately managed account (SMA)

**Account owner. E.g.: pension fund participants**

**Sponsor. E.g.: pension fund sponsor**

Investment management firm's client. acts as a conduit

**Investment management firm**

sub-adviser, provides investment management, custodial, and administrative functions, as well as trading for the client.

# Global Investment Performance Standards

- **8. WRAP FEE/SEPARATELY MANAGED ACCOUNT (SMA) PORTFOLIOS**
  - These provisions apply **to all wrap fee/SMA portfolios** where there are bundled fees and the wrap fee/SMA sponsor serves as an intermediary between the firm and the end user of the investment services.
  - These provisions are not applicable to portfolios defined as other types of bundled fee portfolios.
  - These provisions are also not applicable if the firm does not have discretionary portfolio management responsibility for the individual wrap fee/SMA portfolios.
  - All wrap fee/SMA compliant presentations that include performance results after 2006 must meet all these provisions.
  - Wrap fee portfolios also known as separately managed account
  - Wrap fee portfolios, also known as separately managed accounts (SMAs), are typically managed by investment management firms serving as sub-advisors to a sponsor who acts as the client's investment advisor. The sponsor charges the client a single bundled fee which combines fees for various services such as Investment management, trading, custody, and administrative functions.

# Global Investment Performance Standards

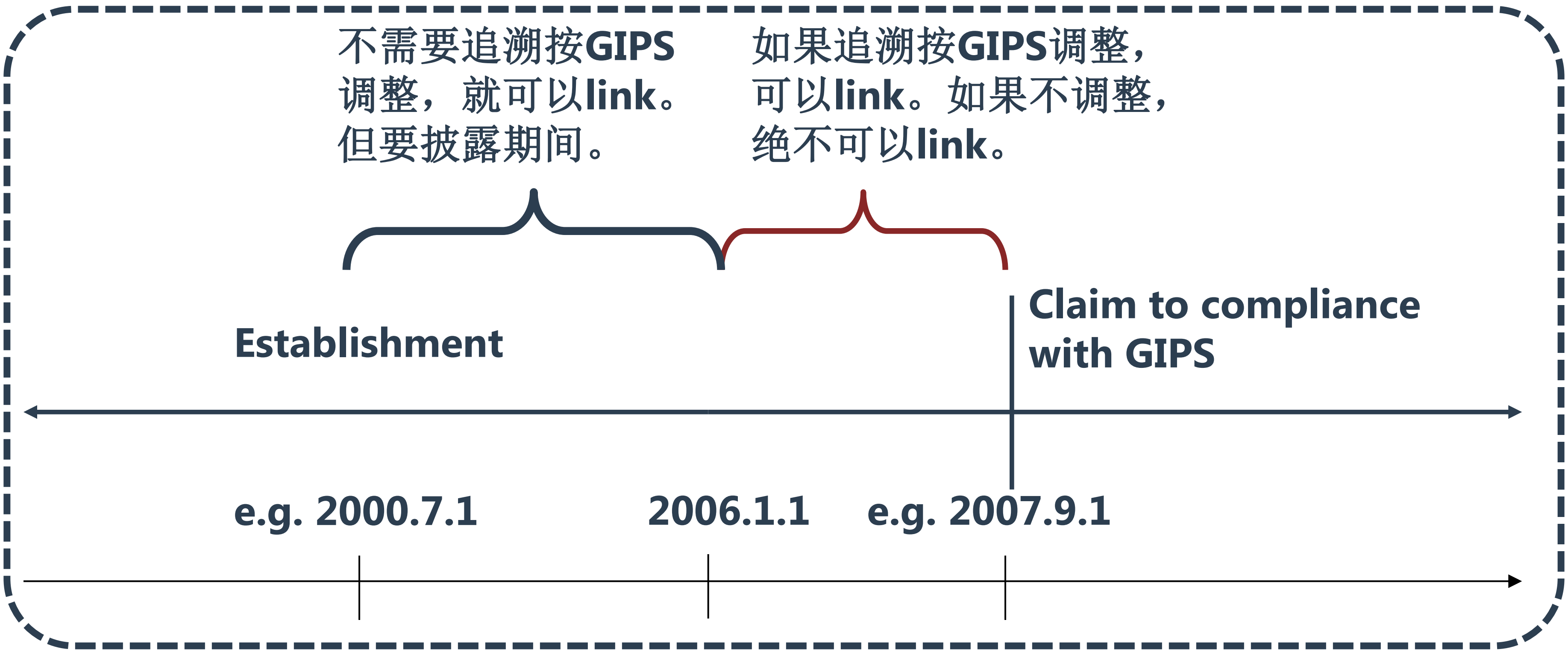
- **Composite Construction — Requirements**
  - 8.A.1 Firms must include the performance record of actual wrap fee/SMA portfolios in appropriate composites in accordance with firm's established portfolio inclusion policies These composites must be used in the firm's compliant presentations presented to wrap fee/SMA prospective clients.
- **Disclosure — Requirements**
  - 8.A.2 For all wrap fee/SMA compliant presentations that include periods prior to the inclusion of an actual wrap fee/SMA portfolio in the composite, the firm must disclose, for each period presented, that the composite does not contain actual wrap fee/SMA portfolios.
  - 8.A.3 Disclose the periods of **non-compliance for period before 2006**.
  - 8.A.4 When firms present composite performance that includes only that sponsor's wrap fee/SMA portfolios (sponsor-specific composite) :
    - ✓ a. Name of the wrap fee/SMA sponsor
    - ✓ b. If the sponsor-specific composite compliant presentation is intended for the purpose of **generating wrap fee/SMA business** and does not include performance net of the entire wrap fee, the compliant presentation must disclose that the **named sponsor-specific compliant presentation is only for the use of the named wrap fee/SMA sponsor**.

# Global Investment Performance Standards

- **Presentation and Reporting — Requirements**
  - 8.A.5 Composite presented must include the performance of all actual wrap fee/SMA portfolios, if any, managed according to the composite investment mandate, objective, or strategy, regardless of the wrap fee/SMA sponsor.
  - 8.A.6 Performance must be presented **net of the entire wrap fee**.
  - 8.A.7 Firms must not link non-GIPS-compliant performance after 2006 to their GIPS-compliant performance. firms may link non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods after 2006.

# Timeline

- **Wrap fee/SMA portfolios**



# Summary

- **Valuation frequency of three types of Asset**
  - Provisions of standard **0-5**： For general investment, portfolio must be valued at least **monthly** and on the date of all large external cash flows
  - **R/E:** real estate investment must be valued at least **quarterly**
  - **P/E:** private equity investment must be valued at least **annually**
- **Fee Schedule**
  - **Traditional asset**: composite returns must be clearly identified as gross-of-fees **or** net-of-fees
  - **Real estate**: returns must be clearly identified as gross-of-fees **or** net-of-fees; after 2011.1.1, firms must present the **net-of-fees SI-IRR** for closed-end fund.
  - **Private Equity**: Net-of-fees returns must be calculated with consideration given to management fees and carried interest; firms must present both the net-of-fees **and** gross-of-fees annualized SI-IRR of the composite

# Summary

➢ **Available Upon Request Conclusion**

- 3.A.4 The composite definition must be made available upon request. 4.A.11 Firm's list of composite descriptions is available upon request.
- 4.A.12 Firms must disclose that policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- The verification and performance examination reports are available upon request (或有)

# Summary

➢ **Whether can change retroactively**

- 3.A.4 Any change to a composite definition MUST NOT be applied retroactively.
- 3.A.9 Any changes to a composite-specific minimum asset level MUST NOT be applied retroactively
- 3.A.30 There may be times when a firm determines that it is appropriate to change the benchmark for a given composite retroactively

# Frequently-tested questions of GIPS

- **1.** If the GIPS-compliant Firm recognizes the asset or liability within three days of the date the transaction , does this policy comply with the trade-date accounting requirement?
- **Answer:** Yes.

- **2.** If the returns in the first and second year are 10% and 8%, what's the cumulative return for the two years?
- **Answer:** $(1+10\%)*(1+8\%)-1=18.8\%$, but annualized return$=(1+18.8\%)^{1/2}-1=9\%$

- **3.** How must the GIPS-compliant firm deal with external cash flow?
- Answer:
  - Define large cash flow ex ante, then value when occurring;
  - Define significant cash flow, then remove the portfolio from the composite or establish a temporary account

- **4.** If the client of portfolio dictates the types of investment, can this portfolio be classified as discretionary?
- **Answer:** It depends. If the investment manager maintains the autonomy in the pursuit of the intended strategy, OK

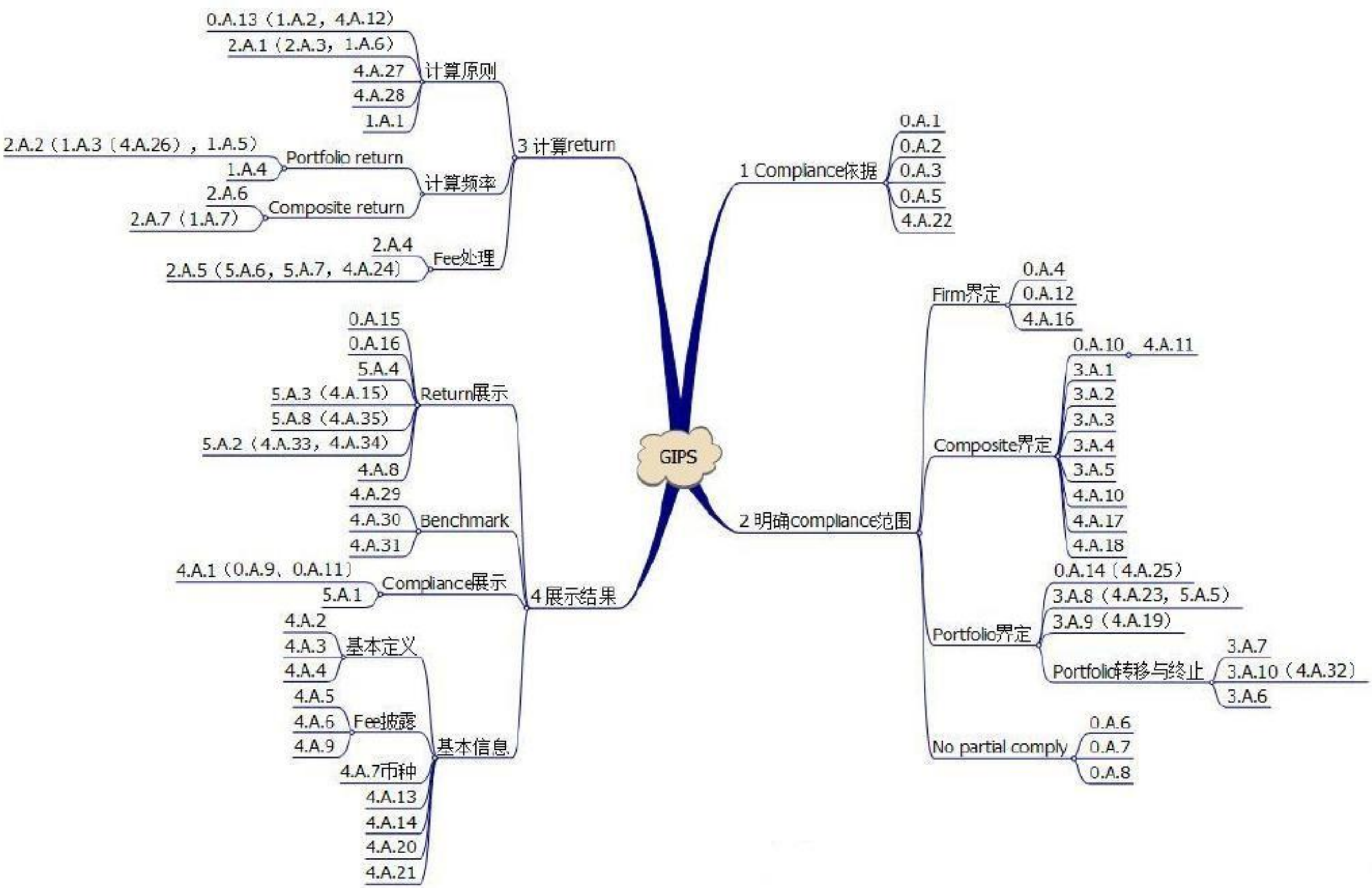
# Frequently-tested questions of GIPS

- **5.** Based on the requirement of GIPS, can the firm use the back-tested return as supplement?
- **Answer:** Yes, but can’t link.

- **6.**Based on the requirement of GIPS, can the firm change the benchmark retrospectively?
- **Answer:** Yes, but encouraged to show the former benchmark.

- **7.** Based on the requirement of GIPS, can the firm change the amount of minimum asset level?
- **Answer:** Yes, but can’t apply retrospectively.

- **8.** Based on the requirement of GIPS, whether can the firm design the composite based on the type of clients?
- **Answer:** Yes.


GIPS
1 Compliance依据
0.A.1
0.A.2
0.A.3
0.A.5
4.A.22
2 明确compliance范围
Firm界定
0.A.4
0.A.12
4.A.16
Composite界定
0.A.10
4.A.11
3.A.1
3.A.2
3.A.3
3.A.4
3.A.5
4.A.10
4.A.17
4.A.18
Portfolio界定
0.A.14（4.A.25）
3.A.8（4.A.23，5.A.5）
3.A.9（4.A.19）
Portfolio转移与终止
3.A.7
3.A.10（4.A.32）
3.A.6
No partial comply
0.A.6
0.A.7
0.A.8
3 计算return
计算原则
0.A.13（1.A.2，4.A.12）
2.A.1（2.A.3，1.A.6）
4.A.27
4.A.28
1.A.1
计算频率
Portfolio return
2.A.2（1.A.3（4.A.26），1.A.5）
1.A.4
Composite return
2.A.6
2.A.7（1.A.7）
Fee处理
2.A.4
2.A.5（5.A.6，5.A.7，4.A.24）
4 展示结果
Return展示
0.A.15
0.A.16
5.A.4
5.A.3（4.A.15）
5.A.8（4.A.35）
5.A.2（4.A.33，4.A.34）
4.A.8
Benchmark
4.A.29
4.A.30
4.A.31
Compliance展示
4.A.1（0.A.9、0.A.11）
5.A.1
基本信息
基本定义
4.A.2
4.A.3
4.A.4
Fee披露
4.A.5
4.A.6
4.A.9
4.A.7币种
4.A.13
4.A.14
4.A.20
4.A.21

## It’s not the end but just beginning.

- Always believe that good things are possible, and remember that mistakes can be lessons that lead to discoveries. Take your fear and transform it into trust; learn to rise above anxiety and doubt. Turn your "worry hours" into "productive hours". Take the energy that you have wasted and direct it toward every worthwhile effort that you can be involved in. You will see beautiful things happen when you allow yourself to experience the joys of life. You will find happiness when you adopt positive thinking into your daily routine and make it an important part of your world.
- 请坚信，美好的降临并非不可能，失误也许是成功的前奏。将惶恐化作信任，学会超越担忧和疑虑。让“诚惶诚恐”的时光变得“富有成效”。不要挥霍浪费精力，将它投到有意义的事情中去。当你下意识品尝生命的欢愉时，美好就会出现。当你积极地看待生活，并以此作为你的日常准则时，你就会找到快乐的真谛。

# 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电子邮件告知我们，具体的内容包含：
    - ✓ 您的姓名或网校账号
    - ✓ 所在班级（eg.202111CFA三级长线无忧班）
    - ✓ 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
  - 请发送电子邮件至：academic.support@gfedu.net
- **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**。后续我们也将开通其他问题反馈渠道（如微信等）。