



金程教育
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CFA一级培训项目

Ethics



Topic Weightings in CFA Level I

Session NO.	Content	Weightings
Study Session 1	Ethics & Professional Standards	15
Study Session 2-3	Quantitative Analysis	12
Study Session 4-6	Economics	10
Study Session 7-10	Financial Reporting and Analysis	20
Study Session 11	Corporate Finance	7
Study Session 12	Portfolio Management	7
Study Session 13-14	Equity Investment	10
Study Session 15-16	Fixed Income	10
Study Session 17	Derivatives	5
Study Session 18	Alternative Investments	4

Frame work of this course

- Code of Ethics
- Guidance for Standards I-VII
- Global Investment Performance Standards (GIPS)

Proceedings

➤ Primary Principles:

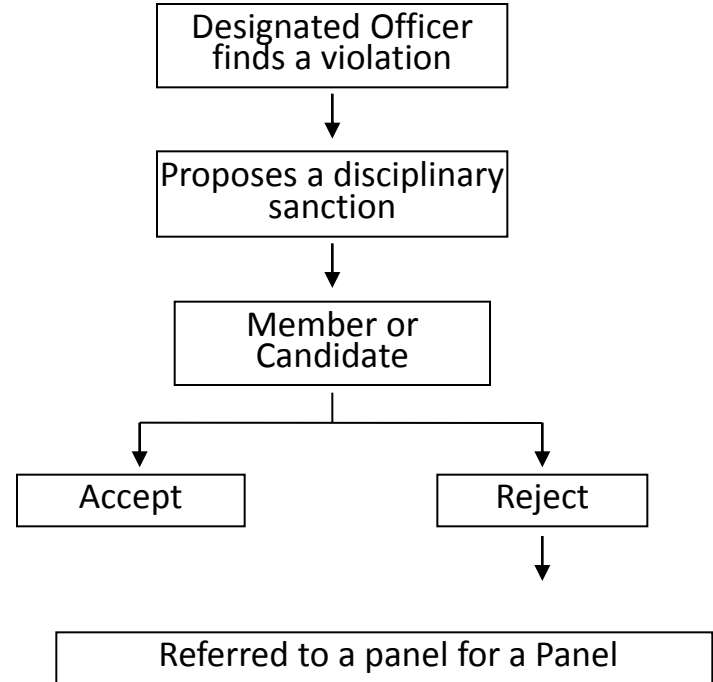
- fairness of the process to members and candidates
- confidentiality of the proceedings.

➤ CFA Institute **Disciplinary Review Committee (DRC)** of the Board has responsibility for the **Professional Conduct Program (PCP)** and enforcement of the Code and Standards.

- 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 (in writing) 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.

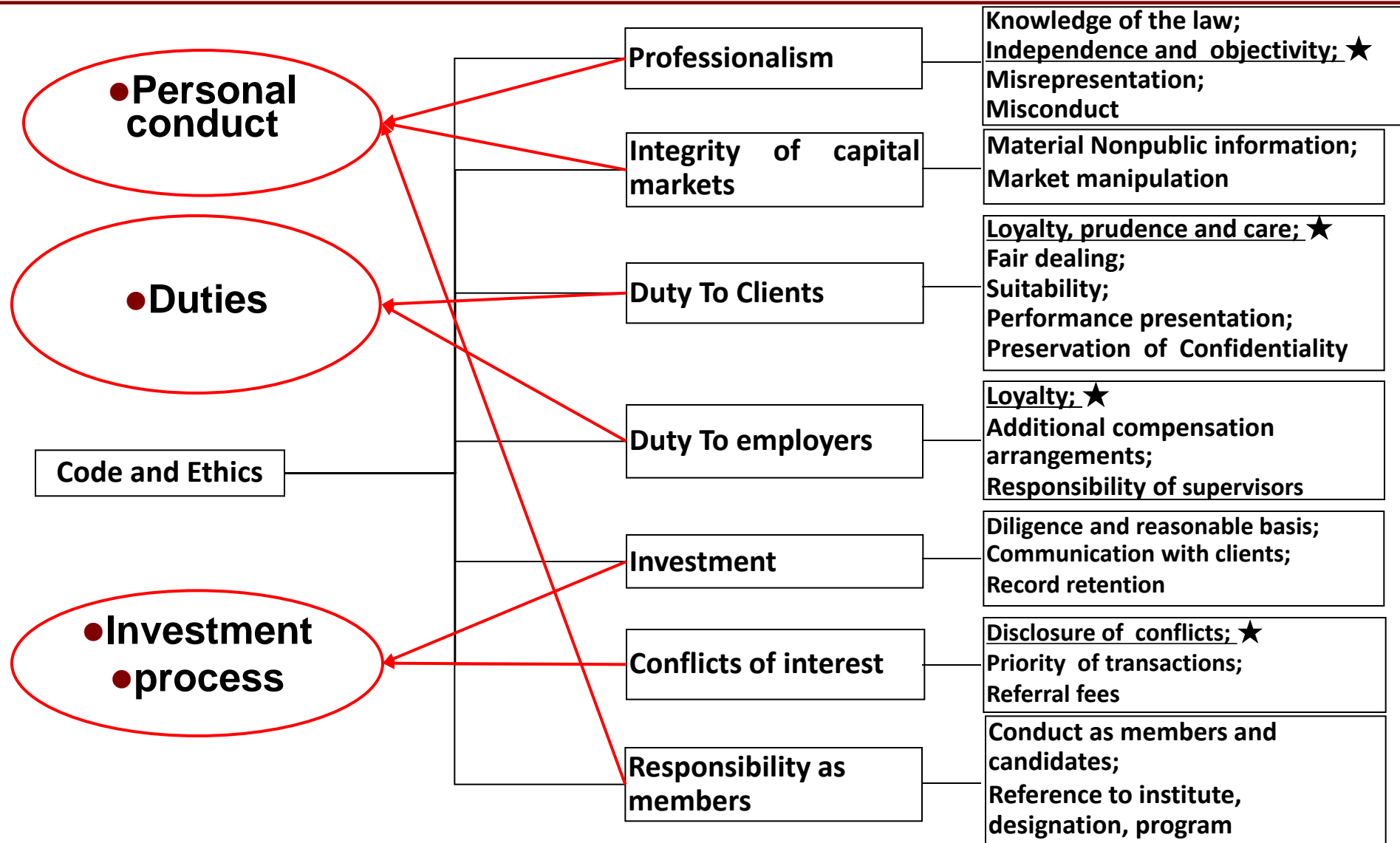
Proceedings

- Which of the following is not one of the two primary principles of the CFA Institute Rules of Procedure for Proceedings Related to Professional Conduct?
- A. Confidentiality of proceedings
 - B. Public disclosure of disciplinary sanctions
 - C. Fair process to the member and candidate
- Solution: B
 - B is correct because the two principles of the Rules of Procedure for Proceedings Related to Professional Conduct are confidentiality of proceedings and fair process to the member and candidate.

Frame work of this course

- Code of Ethics
- Guidance for Standards I-VII
- Global Investment Performance Standards (GIPS)

Seven Standards of Professional Conduct



Guidance for Standards I-VII



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, 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-Code and Standards vs. local law

➤ 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. Do not violate Code or Standards even if the activity is otherwise legal under local laws.
8. Comply with the last applicable law if transferable applicability

work (applicable)	live	compliance
Ms → Live	Ls	Ls < Code → Code
Ls → Live	Ms	Ms > Code → Ms

Standard I (A): Guidance - Participation or association with violations by others

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

9. Know → report through supervisor or compliance department → may consider confronting wrongdoers → (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 - Investment Products and Applicable Laws

➤ **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 where these products or packages will be sold as well as their places of origination. (the place of sales and origination)
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.
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- *For members and candidates*

➤ 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- *For members and candidates*

➤ 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 - *For Firms*

➤ Recommended procedures - *For Firms*

21. The formality and complexity of compliance procedures for firms depend on the nature and size of the organization and the nature of its investment operations.
22. Should encourage firms to consider the following policies and procedures:
 - ✓ ***Develop or adopt a code of ethics:*** The ethical culture starts at the top.
 - ◆ Should encourage supervisors or managers to adopt.
 - ◆ When in ethical dilemmas, adhering to the Code facilitates solutions and prevent the need of a “whistleblowing” solution publicly alleging concealed misconduct. Asset Manager Code of Professional Conduct, may be used as the basis for the codes

Standard I (A): Procedures - *For Firms*

➤ Recommended procedures - *For Firms*

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

✓ ***Provide information on applicable laws:***

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

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

Standard I(A): Case 1-2

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

Standard I(A): Case 3-5

- **Case 3. (Dissociating from a Violation)** Washington finds his employer omits some performance in calculating composite to inflate performance, and is asked to use promotional material that includes erroneous number to solicit business.
 - **Comment:** The employer commits misrepresentation; Washington must dissociate from that and bring the fact to supervisor or compliance dept. If it's not remedied, he should consider whether resignation is appropriate, even consider other employment, because using the erroneous number would be construed as assisting in violation.
- **Case 4. (Following the Highest Requirements)** Collins, a Wall Street analyst works in a developing country with little laws concerning insider trading.
 - **Comment:** Collins should be aware of the risk and adhere to the Code and Standards which is more strict and address material nonpublic information officially.
- **Case 5. (Following the Highest Requirements)** Jameson is a CFA charterholder based in the US and also works as a registered investment advisor in an island nation that prohibits participation in IPOs, he believes the Code and Standards apply and ignores the strict prohibition on IPOs in the island.
 - **Comment:** Jameson must follow the stricter requirements of the local law. By ignoring it, he is in violation of Standard I (A).

Standard I(A): Case 6

- **Case 6. (Laws and Regulations Based on Religious Tenets)** Janney's firm receives expressions of interest from potential clients from the Middle East who are seeking investments that comply with Islamic law. The marketing and promotional materials do not specify whether or not the fund is a suitable investment for an investor seeking compliance with Islamic law. Because the fund is being distributed globally, Janney is concerned about the reputation of the fund and the firm and 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. Janney and the firm could be proactive in their efforts to acknowledge areas where the new fund may not be suitable for clients.

Standard I(A): Case 7

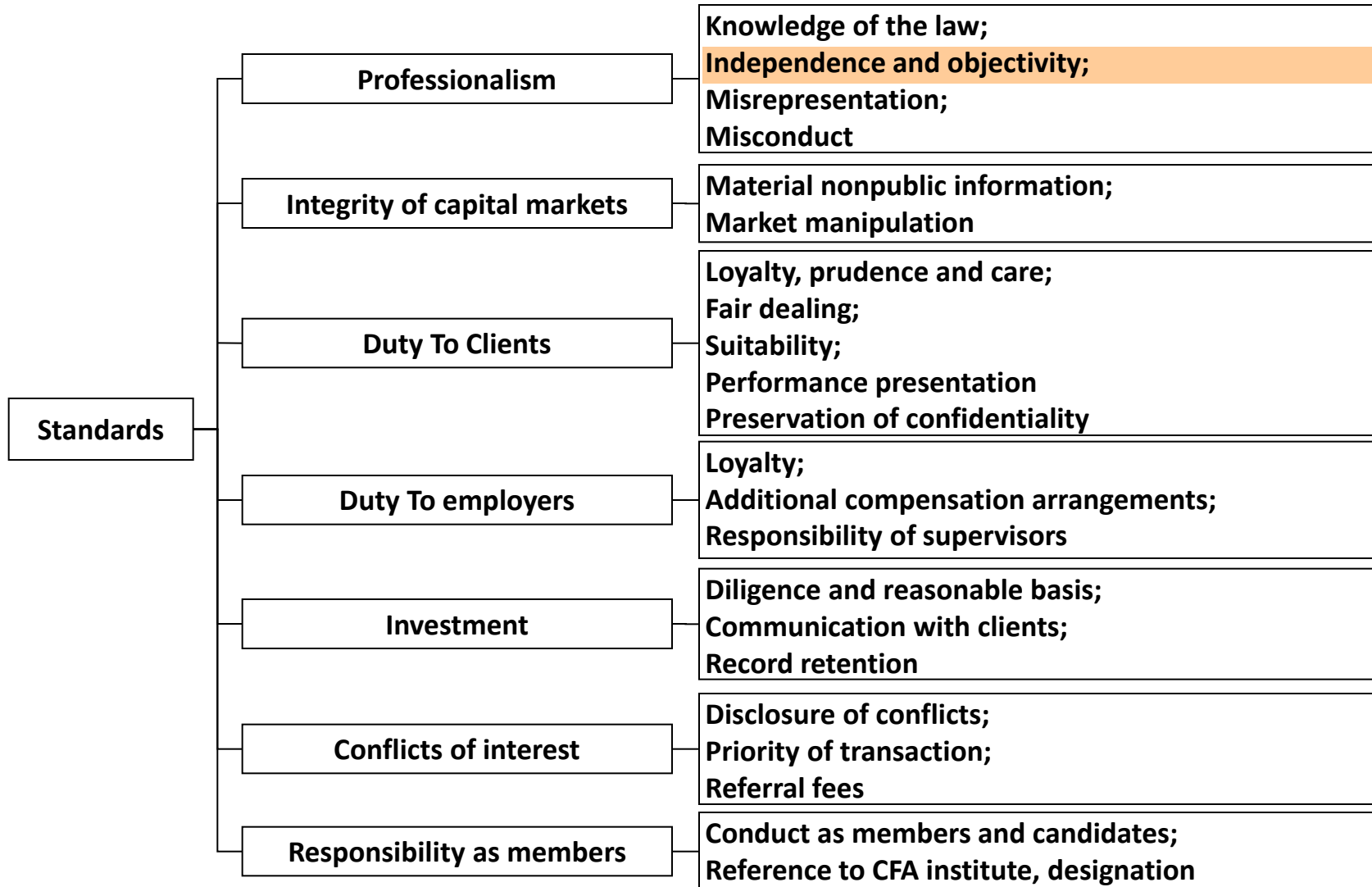
- **Case 7. (Reporting Potential Unethical Actions)** Blume, a portfolio manager, notes that a broker is responsible for the new business and is allocated payments for research. However, she knows the portfolios do not invest in securities in the broker's country. And she has not seen any research come from this broker. Blume asks her supervisor about the name being on the list and is told that someone in marketing is receiving the research and that the name being on the list is OK. She believes that what is going on may be that the broker is being paid for new business through the inappropriate research payments and wishes to dissociate from the misconduct.
- **Comment:** Blume should follow the firm's policies and procedures for reporting potential unethical activity, which may include discussions with her supervisor or someone in a designated compliance department. She should communicate her concerns appropriately while advocating for disclosure between the new broker relationship and the research payments.

Standard I(A): Case 8

➤ **Case 8.**(Failure to Maintain Knowledge of the Law, New)** 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) 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



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

Standard I(B): Guidance

➤ Guidance

6. Gift from clients: Receiving a gift, benefit, or consideration from a client can be distinguished from gifts given by entities seeking to influence independence to the detriment of other clients. Client's gift should be disclosed, if not → violate I(B).
 - ✓ **When possible**, prior to accepting “bonuses” or gifts from clients, members and candidates should disclose to their employers such benefits offered by clients.
 - ◆ If notification is not possible prior to acceptance, members and candidate must disclose to their employers benefits previously accepted from clients.
 - ✓ Disclosure allows the employer of a member or candidate to make an independent determination about the extent to which the gift may affect the member's or candidate's independence and objectivity.

Standard I(B): Guidance -*Buy-Side clients and portfolio managers*

➤ Guidance -*Buy-Side clients*

7. Buy-Side Clients may try to pressure sell-side analysts.
 - ✓ Institutional clients are the primary users of sell-side research, either directly or with soft dollar brokerage.
 - ✓ Rating downgrade: some portfolio managers may support sell-side ratings inflation → affect the portfolio's performance and manager's compensation.
 - ✓ Portfolio performance is subject to media and public scrutiny, affect the manager's professional reputation.
8. For portfolio managers:
 - ✓ It is improper to threaten or engage in retaliatory practices.
 - ✓ Although most portfolio managers do not engage in such practices, the perception by the research analyst that a reprisal is possible may cause concern and make it difficult to maintain independence.

Standard I(B): Guidance -*Fund manager relationships*

➤ Guidance -*Fund manager relationships and Custodial Relationships(new)*

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 -*Investment banking relationships*

➤ 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-Performance Measurement and Attribution

➤ Guidance -Performance Measurement and Attribution(new)

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 - *Public companies*

➤ 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 - *Credit rating agency opinions*

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

➤ **Guidance -Influence during the Manager Selection/Procurement Process(new)**

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

Standard I(B): Guidance - *Influence during the Manager Selection/Procurement Process*

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- *Issuer-Paid research*

➤ Guidance - *Issuer-Paid research*

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

Standard I(B): Guidance

➤ Guidance - *Travel Funding*

- 31. May be influenced by discussions exclusively with the company executives when flying on a corporate jet.
- 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 for Compliance

➤ Recommended procedures for Compliance

- 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 – “pay it yourself”; not reimbursed by corporate issuer; limit use of corporate aircraft to situations in which commercial transportation is not available; issuer shouldn't always host the analyst.
- 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 for Compliance

➤ Recommended procedures for Compliance (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 1-3

- **Case 1. (Travel Expenses)** A mining company invited a group of analysts to mining facilities and arranged for chartered group flights from site to site and 3 night accommodation in the **only motel nearby**. Taylor accepts this offer but Adams follows his company's policy and pays for his hotel room himself.
 - **Comment:** Adams strictly avoiding the conflict of interest but Taylor is not necessarily violating Standard I(B) because what the mining company offers is just **too modest and normal** to compromise the analyst's independence and objectivity even in the clients' eyes.
- **Case 2. (Research Independence)** Dillon promises to provide full research coverage of the potential client in a presentation.
 - **Comment:** Dillon may agree to provide research coverage, but must not commit to providing favorable recommendation.
- **Case 3. (Research Independence and Intrafirm Pressure)** Fritz concluded M&M is overpriced but hesitated to issue a report like that because he is afraid to hurt the future business relationship with M&M.
 - **Comment:** Fritz must maintain independence and objectivity and based the report solely on the consideration of company fundamentals. Place on the restricted list for corporate client if unwilling to hurt the relationship

Standard I(B): Case 4-5

- **Case 4. (Research Independence and Issuer Relationship Pressure, NEW)** As in Case 3, Fritz has concluded that M&M stock is overvalued at its current level, but he is concerned that a negative research report might jeopardize a close rapport that he has nurtured over the years. A negative report might result also in management retaliation-for instance, cutting him off from participating in conference calls.
- **Comment:** As in Case 3, Fritz's analysis must be objective and based solely on consideration of company fundamentals. Any pressure from M&M is inappropriate. Fritz should reinforce the integrity of his conclusions by stressing that his investment recommendation is based on relative valuation, which may include qualitative issues with respect to M&M's management.
- **Case 5. (Research Independence and Sales Pressure)** Warner is credit analyst whose salary is closely linked to the performance of the corporate bond department. Near the quarter's end, salespeople ask her to push problematic bond in large inventory which were unable to be sold due to announcement of an operating problem.
- **Comment:** Warner's opinion on the bonds must not be affected by internal pressure or compensation. In this case, **she must refuse to push the problematic bond to clients unless able to justify that the market price has adjusted for the operating problem.**

Standard I(B): Case 6-7

- **Case 6*. (Research Independence and Prior Coverage)** The boss asked Jorund must keep the prevailing “buy” recommendation for a specific stock under any circumstances.
 - **Comment:** Jorund must be independent and objective in her investment analysis and not be affected by her boss.
 - ✓ Tell her boss that she cannot cover the company under these constraints
 - ✓ or take over coverage of the company, reach her own independent conclusions, and if they conflict with her boss’s opinion, share the conclusions with her boss or other supervisors in the firm so that they can make appropriate recommendations.
- **Case 7. (Gifts and Entertainment from Related Party)** Grant directed a large portion of his commission business to NY brokerage house and accepted 2 tickets to World Cup, hotel and meals etc. He fails to disclose that to his supervisor.
 - **Comment:** Grant has violated Standard I (B) by accepting substantial gifts. This may impede his independence and objectivity

Standard I(B): Case 8-9

- **Case 8. (Gift and Entertainment from Client)** Green achieved an annual return for the client that consistently beat the benchmark. As reward, the client offers 2 tickets to London and use of the flat for a week; Green disclosed the gift to his supervisor.
- **Comment:** Green does not violate Standard I(B) because she disclosed the gift from one of her clients. Members and candidates should disclose to their employers, if they may accept bonuses or gifts from clients.
- **Case 9*. (Travel Expense from External Manager)** Wayne recommends Penguin as the foreign equity manager for the pension fund because of its proved experience and performance record. After the pension selected Penguin, a reporter challenged Wayne's recommendation to be based on Penguin's sponsorship for Asian trip which benefit Wayne. In fact, Penguin partly supported the trip cost.
- **Comment:** Wayne must avoid the Asian trip experience to impede his independence and objectivity in selection of managers.
 - **The best practice:** Basic expenses of the trip be paid by his employer and limit the contact with sponsors to informational and educational manner and disclose to public.

Standard I(B): Case 10-11

- **Case 10. (Research Independence and Compensation Arrangements)** Herrero is hired to write a research report and the compensation will be a flat fee plus a bonus based on new investors attracted.
- **Comment:** The bonus for attracting investors can reasonably be expected to compromise his independence and objectivity. The bonus will provide incentive to draft a positive report regardless of the facts. **Herrero must not accept the payment arrangement with bonus. He should accept only a flat fee not tied to conclusions.**
- **Case 11. (Recommendation Objectivity and Service Fees, NEW)** Wade, trust manager for Central Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class of funds. To entice Central to promote the class of funds, Western offered to pay the bank a service fee of 0.25 percent. Without disclosing the fee to the bank, Wade asked one of the investment managers to review Western's funds. Two years later, the funds managed by Western begin to underperform their peers. Wade is counting on the fees to reach his profitability targets and continues to push these funds as acceptable investments for Central's clients.
- **Comment:**
 - ✓ Wade is violating Standard I(B) because the fee arrangement has affected the objectivity of his recommendations.
 - ✓ Wade is relying on the fee as a component of the department's profitability and is unwilling to offer other products that may affect the fees received. See also Standard VI(A)—Disclosure of Conflicts.

Standard I(B): Case 12

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

Standard I(B): Case 13

➤ **Case 13** (Influencing Manager Selection Decisions, NEW)** Adrian, CFA is a senior portfolio manager for ZZZY Capital Management who oversees a team of investment professionals that manage labor union pension funds. ZZZY succeeded in being hired a few years ago by the United Doughnut and Pretzel Bakers Union (UDPBU) to manage their globally diversified pension fund. UDPBU's investment board is chaired by a recognized key decision maker and long-time leader of the union, Ernesto Gomez. To improve ZZZY's chances of winning the competition, Mandel had become accustomed to making significant monetary contributions to Gomez's union reelection campaigns. In order to secure the position, Mandel continued to contribute to Gomez's reelection campaign chest as well as to entertain lavishly the union leader and his family at top restaurants on a regular basis. All of Mandel's outlays were routinely handled as marketing expenses reimbursed by ZZZY's expense accounts, and so they were disclosed to his senior management as supposedly being instrumental in maintaining a strong close relationship with an important client.

- **Comment:** Mandel not only offered, but actually gave monetary gifts, benefits, and other considerations that reasonably could be expected to compromise Gomez's objectivity. Therefore, Mandel was in violation of Standard I(B).

Standard I(B): Case 14

- **Case14 *** (Influencing Hiring Decisions, NEW)** Adrian Mandel CFA had heard about the upcoming manager search competition for the UDPBU Pension Fund through a broker-dealer contact. The contact told him that a well-known retired professional golfer, Bobby “The Bear” Finlay, who had become a licensed broker-dealer serving as a pension consultant, was orchestrating the UDPBU manager search. Finlay had gained celebrity status with several labor union pension fund boards. Mandel decided to improve ZZZY’s chances of being invited to participate in the search competition by befriending Finlay to curry his favor. Knowing Finlay’s love of entertainment, Mandel wined and dined Finlay at high-profile bistros where Finlay could glow in the fan recognition lavished on him by all the other patrons. Mandel’s endeavors paid off handsomely when Finlay recommended to the UDPBU board that ZZZY be entered as one of three finalist asset management firms in their search.
- Comment: Similar to Example 13, Mandel lavished gifts, benefits, and other considerations in the form of expensive entertainment that could reasonably be expected to influence the consultant to recommend the hiring of his firm. Therefore, Mandel was in violation of Standard I(B).

Standard I(B): Case 15

- **Case 15*** (Fund Manager Relationships, NEW)** Amie Scott is a performance analyst within her firm with responsibilities for analyzing the performance of external managers. While completing her quarterly analysis, she notices there was a change in one of the managers reported composite construction that aided in concealing the bad performance of a particularly large account by placing that account into a new residual composite. This change allowed the manager to remain at the top of the list of manager performance. Scott knows her firm has a large allocation to this manager and the fund's manager is a close personal friend of the CEO. She needs to deliver her final report, but is concerned with pointing out the composite change.
- Comment: Scott would be in violation of Standard I(B) if she did not disclose the change in her final report. The analysis of managers' performance should not be influenced by personal relationships or the size of the allocation to the outside managers. By not including the change, Scott would not be providing an independent analysis of the performance metrics for her firm.

Standard I(B): Case 16

- **Case 16*** (Intra-firm Pressure, NEW)** Jill Stein is head of performance for her firm. During the last quarter, many members of the organizations research department were removed because of the poor quality of their recommendations. The subpar research caused to one larger account holder to experience significant underperformance, which resulted in the client withdrawing half his money. The head of sales requests that Stein remove this account from the firm's performance composite, because the performance decline can be attributed to the departed research team and not the client's advisor.
- Comment: Pressure from other internal departments can create situations that cause a member or candidate to violate the Code and Standards. Stein must maintain her independence and objectivity and refuse to exclude specific accounts from the firm's performance composites to which they belong. As long as the client invested under a strategy similar to that of the defined composite, it cannot be excluded because of the poor stock selections that lead to the underperformance and asset withdrawal.

Guidance for Standards I-VII



Standard I(C): Content

➤ Content:

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

Standard I(C): Guidance- Definition of Misrepresentation

➤ 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).
 - ✓ “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- *classification of misrepresentation 1*

➤ *Omissions(new)*

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- *classification of misrepresentation 2*

➤ Guidance - *Impact on Investment Practice*

5. Guarantee the investment performance

- ✓ **Prohibit**: Guaranteeing specific return which is inherently volatile, because it is misleading to investors.
- ✓ **Not prohibit**: Providing clients with information on investments that have guarantees built into the structure of the product **or** for which an institution has agreed to cover any losses.

6. Members and candidates must not misrepresent any aspect of their practice, including (but not limited to) their qualifications or credentials, the qualifications or services provided by their firm, their performance record and the record of their firm, and the characteristics of an investment.

- ✓ A company is prohibited from saying “we can provide all services you need”. Proper way is to provide a list of services available.

Standard I(C): Guidance- *classification of misrepresentation 2*

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- *classification of misrepresentation 2*

➤ **Guidance-Performance Reporting(new)**

9. Members and candidates may misrepresent the success of their performance record through presenting benchmarks that are not comparable to their strategy.
 - ✓ clients can be misled if the benchmark's results are not reported on a basis comparable to that of the fund's or client's results.
 - ✓ **Best practice:** selecting the most appropriate available benchmark from a universe of available options.
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) does not require that a benchmark always be provided in order to comply. Some investment strategies may not lend themselves to displaying an appropriate benchmark because of the complexity or diversity of the investments included.

Standard I(C): Guidance- *classification of misrepresentation 2*

12. some investment strategies may use reference indices that do not reflect the opportunity set of the invested assets.
 - ✓ a hedge fund comparing its performance with a “**cash plus**” basis.
 - ✓ When such a benchmark is used, members and candidates should take reasonable efforts to ensure that they disclose the reasons behind the use of this reference index to avoid misrepresentations of their performance.
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- *classification of misrepresentation 2*

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- *classification of misrepresentation 2*

➤ *Social Media(new)*

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 – classification 2 (plagiarism)

➤ 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)

18. Forms of plagiarism:

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

Standard I(C): Guidance - Plagiarism

➤ Guidance - Plagiarism

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

Standard I(C): Guidance - *Work Completed for Employer*

➤ 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 for Compliance

➤ Recommended procedures for Compliance

- 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.
- 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 for Compliance

➤ Recommended procedures for Compliance

- Plagiarism policy:
 - ✓ Maintain copies: Keep copies of all material containing research ideas, new statistical methodologies, and other materials that were relied on in preparing the research report.
 - ✓ Attribute quotations: Attribute to their sources any direct quotations, including projections, tables, statistics, model/product ideas, and new methodologies prepared by persons other than recognized financial and statistical reporting services or similar sources. (知名机构的数据不必引用)
 - ✓ Attribute summaries: Attribute to their sources any paraphrases or summaries of material prepared by others. → If attribute other analyst's summaries to support his own analysis, he must acknowledge in his report the reliance on the other analyst's report.

Standard I(C): Case 1-3

- **Case 1*. (Disclosure of Issuer-Paid Research)** McGuire is an issuer-paid analyst hired by listed companies to promote their stocks online, but he concealed this contractual relationship and promoted as seemingly independent analyst.
 - **Comment:** McGuire violated Standard I(C) as he failed to disclose his arrangement with the listed companies and misled the investors online.
- **Case 2. (Correction of Unintentional Errors)** Yao is responsible for the marketing material and catches a typographical error that inflates the composite assets.(排版上的错误)
 - **Comment:** Yao did not knowingly make the misrepresentation, he didn't violate Standard I(C). Yao should make necessary correction as soon as he catch the error.
- **Case 3. (Noncorrection of Known Errors)** The firm exaggerates Muhammad's academic degree in its promotional material, for years, Muhammad and the others distributed this material.
 - **Comment:** Muhammad may not have been directly responsible for the misrepresentation, but that he knew and used the material is clear violation.

Standard I(C): Case 4-6

- **Case 4. (Plagiarism)** Grant read a mining company research report prepared by others, then she made minor further consult and used the main report and circulated as her own report.
 - **Comment:** Grant plagiarized other people's report without acknowledgment, it's a clear violation.
- **Case 5. (**Misrepresentation of Information**)** Marks describes the interest-only strips as "guaranteed by the US government" to his pension clients who are required by law to purchase securities only guaranteed by the US government. In fact, the **IOs** are subject to interest rate changes and the clients incurred losses.
 - **Comment:** Marks misrepresented the terms and characteristics of the investment and it's a violation.

Standard I(C): Case 7-8

- **Case 6. (Potential Information Misrepresentation)** Abdrabbo advises his to-be retired clients to move their investment from equity to bank sponsored CD and money-market accounts so the principal will be guaranteed up to a certain amount.
- **Comment:** While there is risk that the institution offering the certificates of deposits and money-market accounts could go bankrupt, in the United States, these accounts are insured by the U.S. government through the Federal Deposit Insurance Corporation. Therefore, using the term “guaranteed” in this context is not inappropriate as long as the amount is within the government-insured limit. Abdrabbo should explain these facts to the clients.
- **Case 7. (Plagiarism)** Swanson is preparing a research report for acquisition, and was given an accomplished report prepared by others for reference. Swanson finds that report is not complete for the purpose and reports this to the partner of the firm who tells him to “use Davis report ,change a few words, sign your name, and get it out.”
- **Comment:** If Swanson does as requested, he will violate Standard I(C). He could refer to those portions of the Davis report that he agrees with if he identifies Davis as the source; he could then add his own analysis and conclusions to the report before signing and distributing it.

Standard I(C): Case 9-10

- **Case 8. (Plagiarism)** Browning is intrigued by Jorrely's new concept during a seminar; he proceeds to test the model, making some minor mechanical changes while retaining the concept. He then claims he discovered a new model.
 - **Comment:** Although Browning tested Jorrely's model on his own and even slightly modified it, he must still acknowledge the original source of the idea. Browning can certainly take credit for the final, practical results; he can also support his conclusions with his own test. The credit for the innovative thinking, however, must be awarded to Jorrely.
- **Case 9*. (Plagiarism)** Zubia includes in his marketing materials plain-language descriptions of various concepts like P/E ratio, standard deviation etc, which come from other sources. He concerns whether he should refer to the original author.
 - **Comment:** Copying verbatim any material without acknowledgment is a violation, even though these concepts are general. **The best practice would be for Zubia to describe in his own words or cite the source.**

Standard I(C): Case 11-12

- **Case 10*. (Plagiarism)** Through a mainstream media, Schneider learns from a media about a study that she would like to cite in her research.
 - **Comment:**
 - ✓ Best practice would be either to obtain the complete study from its original author and cite only that author,
 - ✓ or to use the information provided by the media and cite both sources.
- **Case 11. (Misrepresentation of Information)** Ostrowski's firm subscribes research report from a third party and distributes these reports to clients as its own work.
 - **Comment:** Ostrowski can rely on third-party research that has a reasonable and adequate basis, but he cannot imply that he is the author of the report. Otherwise, Ostrowski would misrepresent the extent of his work in a way that would mislead the firm's clients or prospective clients.

Standard I(C): Case 13-14

- **Case 12. (Misrepresentation of Information)** Stafford communicates his concerns about the overstated quality of the investment issued by Open Air to his team leader and supervisor, who responds that Open Air owns the product and is responsible for all marketing and distribution. Stafford's supervisor goes on to say that the product is outside of the U.S. regulatory regime and that all risks of the product are disclosed at P184 of the prospectus.
- **Comment:** Stafford is qualified to recognize the degree of accuracy of the materials that characterize the portfolio. he should continue to pursue the issue of Open Air's inaccurate promotion of the portfolio according to the firm's policies and procedures.
- **Case 13. (Avoiding a Misrepresentation)** Smith concluded that the team cannot effectively distinguish between potentially good and bad investment options. The team decides that the highly structured mortgage segment should not become part of the core of the fund's portfolio; they will allow some of the less complex securities to be part of the core.
- **Comment:** Smith is in compliance with Standard I(C) by not investing in securities that she and her team cannot effectively understand.

Standard I(C): Case 14

- **Case 14 *** (Misrepresenting Composite construction, NEW)** Robert Palmer is head of performance for a fund manager. When asked to provide performance numbers to fund rating agencies, he avoids mentioning that the fund manager is quite liberal in composite construction. The ease with which accounts are included/excluded is not fully explained. The values reported to the rating agencies for the composites, although accurate for the accounts shown each period, may not present a true representation of the fund manager's ability.
- Comment: "Cherry picking" accounts to include in either published reports or information provided to the rating agencies conflicts with Standard I(C). Moving accounts into or out of a composite to influence the overall performance results materially misrepresents the reported values over time. Palmer should work with his firm to strengthen its reporting practices concerning composite construction to avoid misrepresenting the firm's track record or the quality of the information being provided.

Standard I(C): Case 15

- **Case 15*** (Presenting Out-of-Date Information, NEW)** David is a sales director at a commercial bank, where he directs the bank's client advisers in the sale of third-party mutual funds. Each quarter he provides fact sheets on funds the bank is allowed to offer to clients. These fact sheets are created by the fund firms and contain information about the funds including investment strategy and target distribution rates. Finch knows that some of the fact sheets are out of date, for example, one long-only fund approved the use of significant leverage last quarter as a method to enhance returns. He continues to provide them to the sales team without updates because the bank has no control over the marketing material released by the mutual fund firms.
- Comment: Finch is violating Standard I(C) by providing information that misrepresents aspects of the funds. By not providing the sales team and ultimately the clients with the updated information, he is misrepresenting the potential risks associated with the funds with outdated fact sheets. Finch can instruct the sales team to clarify the deficiencies in the factsheets with clients and ensure they have the most recent fund prospectus document before accepting orders for investing in any fund.

Standard I(C): Case 16

- **Case 16*** (Overemphasis of Firm Results, NEW):** Bob Anderson is chief compliance officer for Optima Asset Management Company. Seven of the eight funds had 10-year returns below the median for their respective sectors. Anderson approves a recent advertisement: “Optima Asset Management is achieving excellent returns for its investors. For example, the Optima Emerging Markets Equity fund has 10-year returns that exceed the sector median by more than 10%.”
- Comment: From the information provided it is difficult to determine whether a violation has occurred as long as the sector outperformance is correct. Anderson may be attempting to mislead potential clients by citing the performance of the sole fund that achieved such results. Past performance is often used to demonstrate a firm’s skill and abilities in comparison to funds in the same sectors.
 - However, if all the funds outperformed their respective benchmarks, then Anderson’s assertion that the company “is achieving excellent returns” may be factual. Funds may not have to exceed the median in a sector comparison to exhibit positive returns for investors. Members and candidates need to ensure their marketing efforts do not include statements that misrepresent their skills and abilities to remain compliant with Standard I(C). Unless the returns of a single fund reflect the performance of a firm as a whole, the use of a singular fund for performance comparisons should be avoided.

Guidance for Standards I-VII



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

Standard I(D): Recommended procedures for Compliance

➤ Recommended procedures for Compliance

- 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 1-3

- **Case 1. (Professionalism and Competence)** Sasserman is clearly intoxicated after lunch with friends and thus compromise his judgment while working in the afternoon.
 - **Comment:** Sasserman's excessive drinking is a violation of Standard I (D), because his judgment is compromised.
- **Case 2. (Fraud and Deceit)** Hoffman deceitfully increases the health insurance amount due.
 - **Comment:** This is a clearly violation as Hoffman's intentional conduct involving fraud and deceit.
- **Case 3. (Fraud and Deceit)** Brink, an auto analyst and volunteer of local charities, while handling purchasing agreement of vans, deliberately directs the purchase to his friend dealer at abnormal higher price and splits the surcharge.
 - **Comment:** Brink's conduct involves dishonesty, fraud, and misrepresentation and is a violation.

Standard I(D): Case 4-5

- **Case 4. (Personal Actions and Integrity)** Garcia, a mutual fund manager, is also an environmental activist. During nonviolent protests, he has been arrested for trespassing the property of a petrochemical plant.
- **Comment:** Generally, Code and Standards focus on professional conduct and don't cover acts of civil disobedience in support of personal beliefs. It's not a violation.
- **Case 5. (Professional Misconduct)** When many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen approaches the head of trading about her concern and is told that she should not ask any questions, and the fund is big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, who also tells her to stay away from the issue of the hedge fund's reporting.
- **Comment:** Rasmussen has come upon an error in compliance practices. According to the firm's procedures for reporting potentially unethical activity, should pursue the issue by gathering some proof of her reason for doubt.
 - If all internal communications do not satisfy her concerns, should consider reporting the activity to the appropriate regulator.
 - ✓ See also Standard IV(A) for guidance on whistleblowing
 - ✓ Standard IV(C) for the duties of a supervisor.

Guidance for Standards I-VII



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

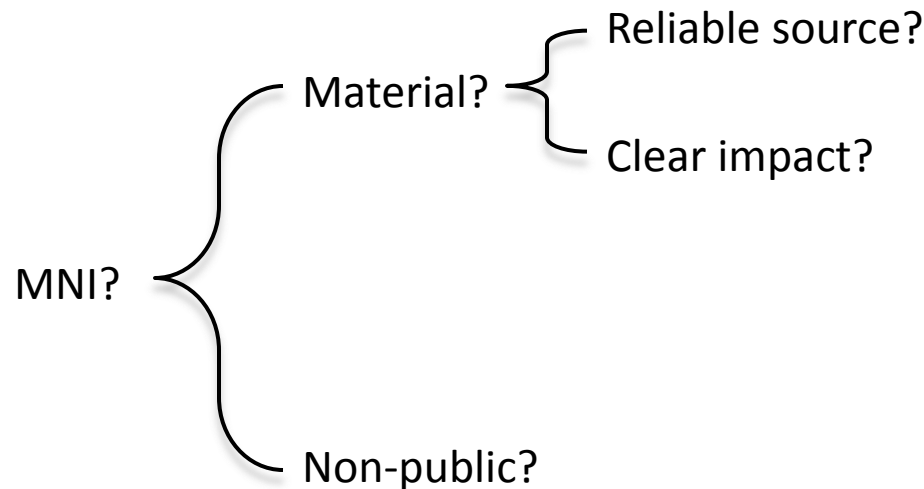
2. Trading or inducing others to trade on material nonpublic information will cause investors to avoid capital markets because the markets are perceived to be “rigged” in favor of the knowledgeable insider.
3. Must not use such information to:
 - ✓ directly buy and sell of individual securities or bonds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

Standard II(A): Guidance - *What Is “Material” Information ?*

➤ 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.



Standard II(A): Guidance - *What Is “Material” Information ?*

➤ **Guidance - *What Is “Material” Information ?***

5. Substance and specificity determines the materiality

● Company-related information

- ✓ Earnings
- ✓ Mergers, acquisitions, tender offers, or joint ventures
- ✓ Changes in assets or asset quality
- ✓ Innovations products, processes, or discoveries
- ✓ New licenses, patents, registered trademarks, or regulatory approval/rejection of a product
- ✓ 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 - *What Is “Material” Information ?*

➤ 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(new)**
 - ✓ Information about trials of a new drug
 - ✓ 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 - *What constitutes “nonpublic” Information ?*

➤ 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，要analyst自行判断。如果只是一小撮analyst获得了信息，就视为selective，不能使用）

Standard II(A): Guidance - *What constitutes “nonpublic” Information*

➤ Guidance – *When can use “nonpublic” Information ? (new)*

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

Standard II(A): Guidance - *Mosaic theory*

➤ Guidance – *Mosaic Theory*

9. Mosaic theory:

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

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

Standard II(A): Guidance – *Social media*

➤ Guidance – *Social Media(new)*

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(new)*

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 - *Investment Research Reports*

➤ Guidance - *Investment Research Reports*

12. When a well-known or respected analyst issues a report or makes changes to his or her recommendation, that information alone may have an effect on the market and thus may be considered material. Theoretically, such a report would have to be made public before it was distributed to clients.
13. Analyst is not a company insider, and has no access to inside information. Presumably, the analyst created the report from public information and by using his expertise to interpret the information. His hard work, paid for by clients, generated the conclusions.
14. ***Simply because the public in general find the conclusions material does not require that the analyst make his/her work public***. Investors who are not clients of the analyst can either do the work themselves or become clients of the analyst for access to the analyst's expertise.

Standard II(A): Recommended Procedures for Compliance

➤ Recommended procedures for Compliance

- Achieve public dissemination.
- Adopt compliance procedures¹².
- Adopt disclosure procedures.
- Issue press releases¹³.
- Firewall elements¹⁴.
- Appropriate interdepartmental communications.
- Physical separation of departments.
- Prevention of personnel overlap.
- A reporting system¹⁵.
- Personal trading limitations¹⁶.
- Record maintenance¹⁷.
- Proprietary trading procedures (自营业务)¹⁸.
- Communication to all employees¹⁹.

Standard II(A): Recommended Procedures for Compliance

➤ Recommended procedures for Compliance

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 for Compliance

➤ Recommended procedures for Compliance

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 for Compliance

➤ Recommended procedures for Compliance

17. Firewall

- ✓ The minimum elements include, but are not limited to, the following:
 - ◆ substantial control of interdepartmental communications, preferably through a clearance area in either the compliance or legal department;
 - ◆ documentation of the procedures designed to limit the flow of information between departments and of the actions taken to enforce those procedures;
 - ◆ review of employee trading through the maintenance of “watch,” “restricted,” and “rumor” lists;
 - ◆ heightened review or restriction of proprietary trading while a firm is in possession of MNI.

Standard II(A): Recommended Procedures for Compliance

➤ Recommended procedures for Compliance

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 for Compliance

➤ Recommended procedures for Compliance

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 for Compliance

➤ Recommended procedures for Compliance

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, demonstrate stringent review and documentation of firm trades.

Standard II(A): Recommended Procedures for Compliance

➤ Recommended procedures for Compliance

22. Communication to all employees.

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

Standard II(A): Case 1-2

- **Case 1*. (Acting on Nonpublic Information)** Staple gets the information of the tender offer for SmartTown from his wife who is the niece of the president and controlling shareholder of SmartTown, and immediately buys the stock.
 - Comment: The info is both material and nonpublic so it is a violation of Standard II (A).
- **Case2. (Controlling Nonpublic Information)** During the telephone conference call with Bright Company, Peter is advised that the earnings projections have significantly dropped. The colleagues of Peter walk in and out during the call and get the information and traded on the information at once.
 - Comment: Peter violated Standard II (A) as he failed to prevent the transfer and misuse of material nonpublic information and his colleagues who traded also committed violation.

Standard II(A): Case 3-4

- **Case 3*. (Selective Disclosure of Material Information)** In a meeting with the finance director of the manufacturer and the other 10 largest shareholders of that company, Levenson knew a forthcoming strike which will cripple the production. She concerns whether she could change the rating based on this information.
- **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).
 - Violate III(E)-Preservation of Confidentiality
- **Case 4*. (Determining Materiality)** Fechtman collects information from his doctor who thinks a takeover is imminent and it is good to long stocks. After talking to investment professionals and checking opinions on the company and industry trends, Fechtman decides to accumulate more stock.
- **Comment:** Although information on an expected takeover bid may be of the type that is generally material and nonpublic, in this case, the source of information is unreliable and could not be considered material. Therefore, Fechtman can trade the stock on the basis of this information.

Standard II(A): Case 5-6

- **Case 5. (Applying the Mosaic Theory)** Teja is covering furniture industry and through his research and analysis he believes SFC is overpriced because its high cost and slow demand and issues a sell recommendation. Investment managers act on this recommendation.
- **Comment:** Information on quarterly earnings figures is material and nonpublic. However, Teja arrived at his conclusion about the earnings drop based on public information and on pieces of nonmaterial nonpublic information. Therefore, trading based on Teja's correct conclusion is not prohibited by Standard II(A).
- **Case 6. (Applying the Mosaic Theory)** Clement, a famous auto analyst, after his due diligence with the manufacturer, salesman, banker, labor union and etc, changed his recommendation from buy to sell mainly based on: unsuitable new model, labor union stress, depreciation of Korean won and bank loan pressure.
- **Comment:** To reach a conclusion about the value of the company, Clement has pieced together a number of nonmaterial or public bits of information that affect Turgot Chariots. Therefore, under the "mosaic theory," Clement has not violated Standard II(A) in drafting the report.

Standard II(A): Case 7

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

Standard II(A): Case 8

- **Case 8*. (Acting on Nonpublic Information)** Kellogg manages his own portfolio and owns shares in NS Bank. A close friend, John, is a senior executive at NS. 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:** Even though Kellogg believes that John would not break the law by disclosing insider information and money was lost on the purchase, he should not have purchased 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. Kellogg has violated Standard II(A).

Standard II(A): Case 9

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

Standard II(A): Case 10

- **Case 10 *** (Materiality Determination, NEW)** Larry Nadler is a trader for a mutual fund, He gets a text message from another firm's trader, who he has known for years, that indicates a software company is going to report strong earnings when the firm publicly announces in two days. Nadler has a buy order from a portfolio manager within his firm to purchase several hundred thousand shares of the stock. Nadler is aggressive in placing the portfolio manager's order and completes the purchases by the following morning, a day ahead of the firm's planned earnings announcement.
- Comment: There are often rumors and whisper numbers before a release of any kind. The text message from the other trader would most likely to be considered market noise.
 - Unless Nadler knew that the trader had an ongoing business relationship with the public firm, he had no reason to suspect he was receiving material nonpublic information that would prevent him from completing the trading request of the portfolio manager.

Standard II(A): Case 11

- **Case 11 *** (Using an Expert Network, NEW)** Mary McCoy is the senior drug analyst at a mutual fund. Her firm hires a service that connects her to experts in the treatment of cancer. Through various phone conversations, McCoy enhances her understanding of the latest therapies for successful treatment. This information is critical to Mary making informed recommendations of the companies producing these drugs.
- Comment: McCoy is appropriately using the expert networks to enhance her evaluation process.
 - She has neither asked for nor received information that may be considered material and nonpublic, such as preliminary trial results.
 - McCoy is allowed to seek advice from professionals within the industry that she follows.

Standard II(A): Case 12

- **Case 12***(Using an Expert Network, NEW)** Tom Watson is a research analyst working for a hedge fund. To stay informed, Watson relies on outside experts for information on such industries as technology and pharmaceuticals, where new advancements occur frequently. Watson arranges a call to discuss future prospects for one of the fund's existing technology company holdings that was testing a new semiconductor product. The scientist leading the tests indicates his disappointment with the performance of the new semiconductor. Following the call, Watson relays the insights he received to others at the fund. The fund sells its current position in the company and writes many put options because the market is currently priced on the basis of the perceived success of the new semiconductor.
- Comment: Watson has violated Standard II(A) by passing along material nonpublic information concerning the ongoing product tests, which the fund used to trade in the securities and options of the related company.
 - Watson cannot simply rely on the agreements signed by individuals who participate in expert networks that state that he has not received information that would prohibit his trading activity. He must make his own determination whether information he received through these arrangements reaches a materiality threshold that would affect his trading abilities.

Guidance for Standards I-VII



Standard II(B): Content

- **Content:** must not engage in practices that
- distort prices or artificially inflate trading volume
 - with the intent to mislead market participants.
1. Market manipulation includes:
- ✓ Info-based: Dissemination of false or misleading information
 - ◆ Pump up prices by issuing misleading positive info, then dump.
 - ✓ Transaction-based: Members or candidates knew or should have known that transactions deceive or would be likely to mislead market participants by distorting the price-setting mechanism. It includes:
 - ◆ artificially affect prices or volume to give misleading impression of price movement, which represent a diversion from the expectations of a fair and efficient market.
 - ◆ securing a dominant position to exploit and manipulate the price of related derivative and the underlying asset.

Standard II(B): Guidance

➤ Guidance

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

Standard II(B): Case 2

- **Case 2. (Personal Trading Practices and Price, NEW)** John Gray is a private investor who bought a large position several years ago in Fame Pharmaceuticals, a fairly limited float German small cap security. He has now decided to significantly reduce his holdings because of worse than expected performance. Gray devises a plan to divide his holdings into multiple accounts in different brokerage firms and private banks in the names of family members, friends, and even a private religious institution. He then creates a rumor campaign on various blogs and social media outlets promoting the company. Gray begins to buy and sell the stock using the accounts to raise the trading volume, public awareness, and the price. He conducts the trades through multiple brokers, selling slightly larger positions than he bought on a tactical schedule and over time, he is able to reduce his holding as desired without reducing the price received.
- **Comment:** John violated Standard II(B) by fraudulently creating the appearance that there was a greater investor interest in the stocks through the online rumors. Additionally, through his trading strategy he created the appearance that there was greater liquidity in the stock than actually existed. He was able to manipulate the price through both misinformation and trading practices.

Standard II(B): Case 3-4

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

Standard II(B): Case 5-6

- **Case 5*. (“Pump-Priming” Strategy)** In order to demonstrate best liquidity of a new contract, Gonchar, chairman of the ACME Futures Exchange, enters into agreements with members so that they commit to a substantial minimum trading volume on the new contract for a specific period in exchange for reductions of commission.
- **Comment:** If ACME fully discloses its agreement with members to boost transactions over some initial launch period, it does not violate Standard II(B). ACME’s intent is not to harm investors but on the contrary to give them a better service. For that purpose, it may engage in a liquidity-pumping strategy, but it must be disclosed.
- **Case 6. (Creating Artificial Price Volatility)** Gordon believes the earnings projection of Hygene is substantially underestimated. Failing to get confirmation from the CFO, she tries to force a comment from the company by disseminating unrealistically high earnings projection to one of her clients who follow a momentum style.
- **Comment:** By exaggerating her earnings projections in order to try to fuel a quick gain in Hygene’s stock price, Gordon is in violation of Standard II (B). Also violate III(B)-fair dealing for only discussing with selective clients.
 - The report should: be in a range of possible outcomes; outline assumption; distribute to all clients in an equitable manner.

Standard II(B): Case 7-8

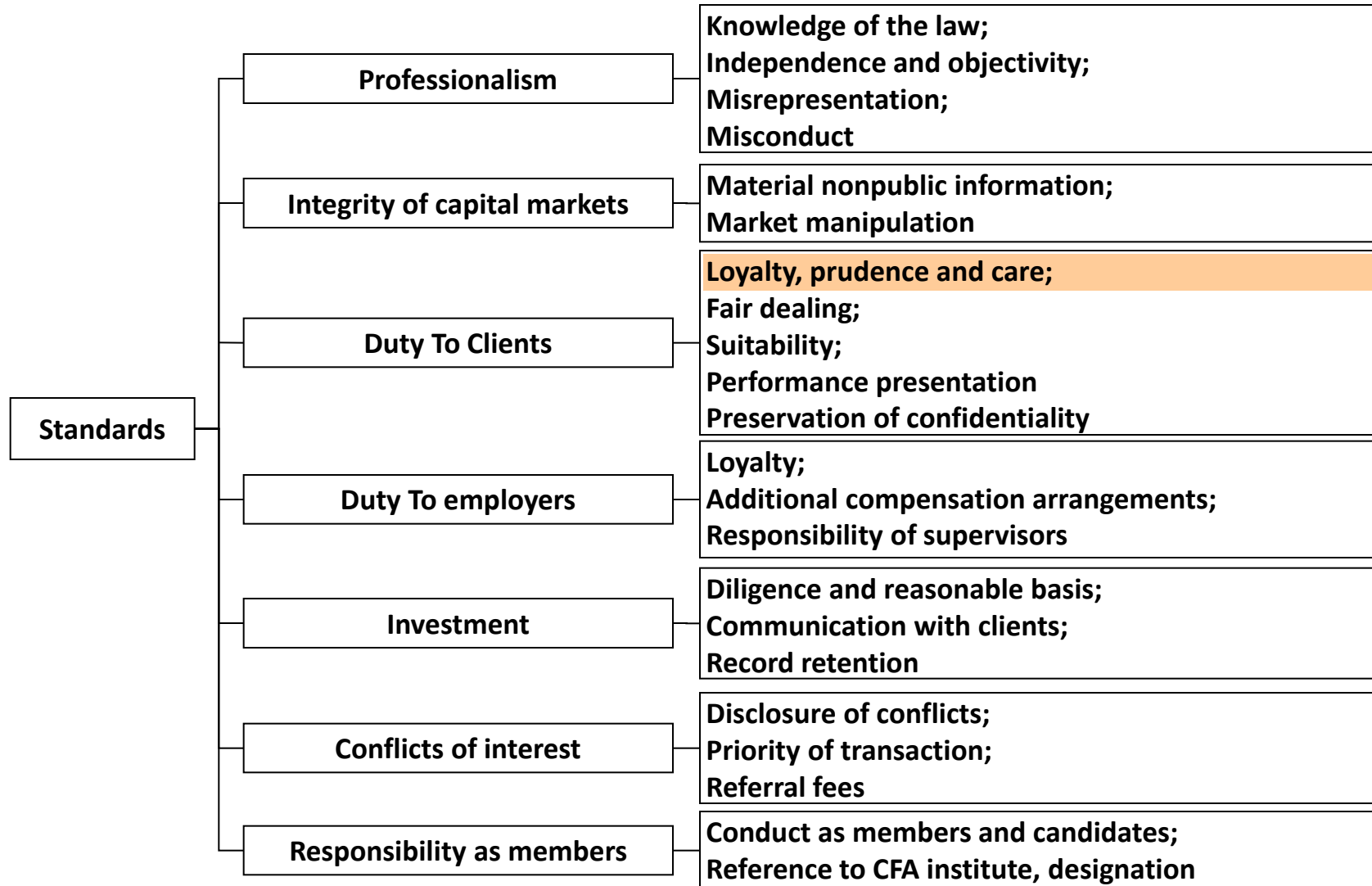
- **Case 7. (Pump and Dump Strategy)** In an effort to pump up the price of his holdings in M&BR Company, Weinberg logs on to several investor chat rooms on the internet to start rumors that the company is about to expand its rail network in anticipation of receiving a large contract for shipping lumber.
- **Comment:** Weinberg has violated Standard II(B) by disseminating false information about M&BR with the intent to mislead market participants.
 - **Also violate V(A).**
- **Case 8.*** (Manipulating Model Inputs, NEW)** To achieve best rating possible, Mandeville uses **most positive scenarios** as model inputs scenarios. The resulting output support the idea that the new structured products have minimal potential downside risk. His compensation is partially based on the level of rating and successful sale of products but does not have a link to the long-term performance of the products. Mandeville leads SPI as the top for the next two years. In the third year, the economy experiences difficulties and the values of the underlying assets significantly decline. The subsequent defaults lead to major turmoil in the capital markets, the demise of SPI Bank, and his unemployment.
- **Comment:** Mandeville manipulates the inputs of a model to minimize associated risk to achieve higher ratings. This information manipulation for short-term gain, which is in violation of Standard II(B), Such loss of confidence affects the ability of the capital markets to operate efficiently.

● **I(B), VI(A)**

Standard II(B): Case 9

- **Case 9*** (Information Manipulation, NEW)** Allen King is a performance analyst for Torrey Investment Funds. King believes that the portfolio manager for the firm's small- and micro-cap equity fund dislikes him because the manager never offers him tickets to the local baseball team's games but does offer tickets to other employees. To incite a potential regulatory review of the manager, King creates user profiles on several online forums under the portfolio manager's name and starts rumors about potential mergers for several of the smaller companies in the portfolio. As the prices of these companies' stocks increase, the portfolio manager sells the position, which leads to an investigation by the regulator as King desired.
- Comment: King has violated Standard II(B) even though he did not personally profit from the market's reaction to the rumor.
 - In posting the false information, King misleads others into believing the companies were likely to be acquired. Although his intent was to create trouble for the portfolio manager, his actions clearly manipulated the factual information that was available to the market.

Guidance for Standards I-VII



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**.
 - ✓ 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(new)

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(new)

- ✓ 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 - *Identifying the Actual Investment Client*

➤ 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 - *Identifying the Actual Investment Client*

➤ Guidance - *Identifying the Actual Investment Client* (con't)

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

Standard III(A): Guidance - *Developing the Client's Portfolio*

➤ 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 - *Developing the Client's Portfolio*

➤ Guidance - *Developing the Client's Portfolio* (con't)

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

Standard III(A): Guidance - *Soft Commission Policies*

➤ 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 that benefit the investment manager → “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).
 - ✓ **Mutually benefit:** 若client 1多付钱, soft \$只能给client 1使用; 若没有多付, 只要与其它clients互惠互利, soft \$就能给其它客户使用, 但要披露自己如何解决其中的利益冲突。

Standard III(A): Guidance - *Soft Commission Policies*

➤ 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 price” and “best execution”, 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 be getting best execution from the directed brokerage if he insist on trading through that broker.

Standard III(A): Guidance – *Proxy Voting Policies*

➤ 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 nonroutine 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 for compliance

➤ Recommended procedures for compliance

- Regular account information¹⁸
- Client approval¹⁹
- 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
 - ✓ Diversify²¹
 - ✓ Carry out regular reviews
 - ✓ Deal fairly with all clients with respect to investment actions
 - ✓ Disclose conflicts of interest
 - ✓ Disclose compensation arrangements
 - ✓ Vote proxies in the best interest of beneficiaries and clients (disclose to clients their proxy-voting policies)²²
 - ✓ Maintain confidentiality
 - ✓ Seek best execution
 - ✓ Place client interest first

Standard III(A): Recommended procedures for compliance

➤ Recommended procedures for compliance

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 for compliance

➤ Recommended procedures for compliance

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 1-2

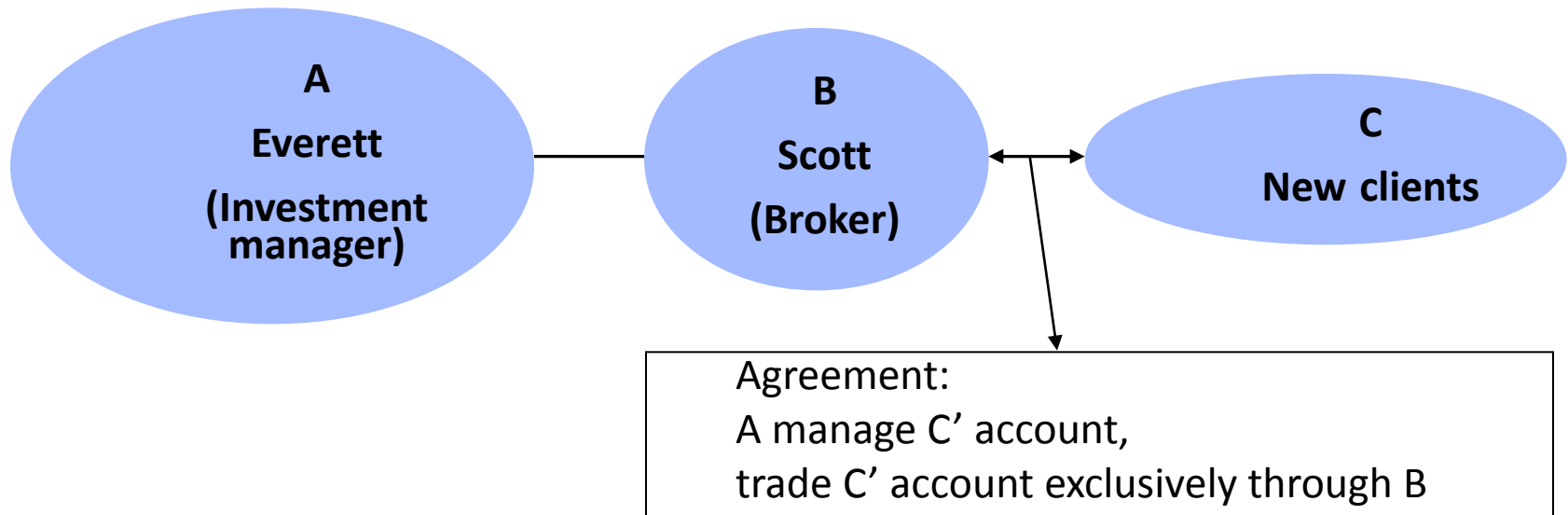
- **Case 1 * (Identifying the Client-Plan Participants).** Wiley serves as trustee for Miller's pension plan and is requested by the Miller's managers to support their anti-takeover action by buying Miller's common stock for the plan. Wiley generally believes the stock overvalued, follows the request considering maintaining the company's good favor and realizing additional new business. 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 violation.
- **Case 2* (Client Commission Practices).** JNI, a successful investment manager for local pension plans, directed large portion of brokerage to Thompson because of close relationships between the executives of the two firms. JNI considers Thompson's research services and execution capabilities average. But commission structure is high relative to charges from other firms. In exchange for JNI directing brokerage to Thompson, Thompson absorbs a portion of overhead expenses of JNI.
- **Comment:** JNI did not obtain best execution for clients and indirectly used clients' brokerage to cover overhead, it is clear violation.

Standard III(A): Case 3

- **Case 3.* (Soft dollar)** Everett, an independent investment advisor, serves as investment manager for the pension plans of several companies. One of her brokers, Scott, is close to consummating management agreements with prospective new clients whereby Everett would manage the new client accounts and trade the accounts exclusively through Scott. One of Everett's existing clients, Crayton, has directed Everett to place securities transactions for Crayton's account exclusively through Scott. But to induce Scott to exert efforts to send more new accounts for her, Everett also directs transactions to Scott from other clients without their knowledge.
- **Comment:** Everett has an obligation at all times to seek best price and execution on all trades. Everett may direct new client trades exclusively through Scott Company as long as Everett receives best price and execution on the trades or receives a written statement from new clients that she is **not** to seek best price and execution and that they are aware of the consequence for their accounts. Everett may trade other accounts through Scott as a reward for directing clients to Everett only if the accounts receive best price and execution and the practice is disclosed to the accounts. Because Everett did not disclose the directed trading, Everett has violated Standard III(A).

Standard III(A): Case 3

➤ Case 3. (Case outline)



Standard III(A): Case 3

➤ Case 3. (Soft dollar: Case analysis)

- Everett may direct new client trades exclusively through Scott as long as:
 - ✓ Everett receives best price and execution or
 - ✓ Receives written statement from new clients that she is not to seek best price and execution and that they are aware of the consequence for their accounts.
- Everett may trade other accounts through Scott as long as:
 - ✓ Everett receive best price and execution and
 - ✓ the practice is disclosed to the accounts.

Standard III(A): Case 4-5

- **Case 4 (Brokerage Arrangements).** Emilie is a trust officer for Paget. Her supervisor is responsible for reviewing her trust account transactions and monthly reports of personal stock transactions. Emilie has been using Gray, a broker, exclusively for trust account brokerage transactions. When Gray makes a market in stocks, he has been giving Emilie a lower price for personal purchases and higher price for sales than trust accounts and other investors.
- **Comment:** Emilie is violating her duty of loyalty to the bank's trust accounts by using Gray for brokerage transactions simply because Gray trades her personal account on favorable terms. She is placing her own interests before those of her clients. Also violates VI(B)-Priority of transactions
- **Case 5 (Client Commission Practices).** Parker covers South American equities and directs brokerage to SouthAM who pays Parker's briefing trip to South America through a soft dollar arrangement, without knowing whether the broker's execution is competitive. The broker also pays Parker's hotel expenses using commission dollars.
- **Comment:** Parker violated Standard III(A) by not exercising her duty of loyalty to her clients to determine whether the commissions charged by SouthAM were reasonable in relation to the benefit of the research provided by the trip and by not determining that best execution and prices can be received from SouthAM. The hotel expenses should not be paid for with commission dollars, which is client asset.

Standard III(A): Case 6-7

- **Case 6* (Excessive Trading).** A major part of Knauss's management fee is based on trading commissions. Knauss engages in extensive trading for each of her clients and the amount of trading exceeds what is necessary to achieve the client's investment objectives.
- **Comment:** Knauss has violated Standard III (A) **because she is using the assets of clients to benefit her firm and herself.**
- **Case7 ** (Managing Family Accounts).** Dill's father and brother opened new fee-paying accounts. Dill manages the original accounts of his family members. An IPO is a suitable investment for many of his clients, including his brother. Dill does not receive the amount of stock he requested, so to avoid any conflict of interest, he does not allocate any shares to his brother's account.
- **Comment:** Dill is not acting for the benefit of his brother's account as well as his other accounts. The brother's account is a regular fee-paying account. By not allocating the shares proportionately for which he thought the IPO was suitable, Dill is disadvantaging specific clients. Dill would have been correct in not allocating shares to his brother's account if that account was being managed outside the normal fee structure of the firm.
 - **Also violate III(B).**

Standard III(A): Case 8-9

- **Case 8 **(Identifying the Client)**. Donna Hensley has been hired by a law firm to testify as an expert witness. Although the testimony is intended to represent impartial advice, she is concerned that her work may have negative consequences for the law firm. If the law firm is Hensley's client, how does she ensure that her testimony will not violate the required duty of loyalty, prudence, and care to one's client?
- **Comment:** In this situation, the law firm represents Hensley's employer and the aspect of "who is the client" is not well defined. When acting as an expert witness, Hensley is bound by the standard of independence and objectivity in the same manner as an independent research analyst would be bound. Hensley must not let the law firm influence the testimony she is to provide in the legal proceedings.
- **Case 9 **(Identifying the Client)**: Jon Miller is a mutual fund portfolio manager. Wanda Spears is a private wealth manager in the same city as Miller. Spears mentions to Miller that her new client is an investor in Miller's fund. She states that the two of them now share a responsibility to this client.
- **Comment:** Spears' statement is not totally correct. Because she provides the advisory services to her new client, she alone is bound by the duty of loyalty to this client. Miller's responsibility is to manage the fund according to the investment policy statement of the fund. His actions should not be influenced by the needs of any particular fund investor.

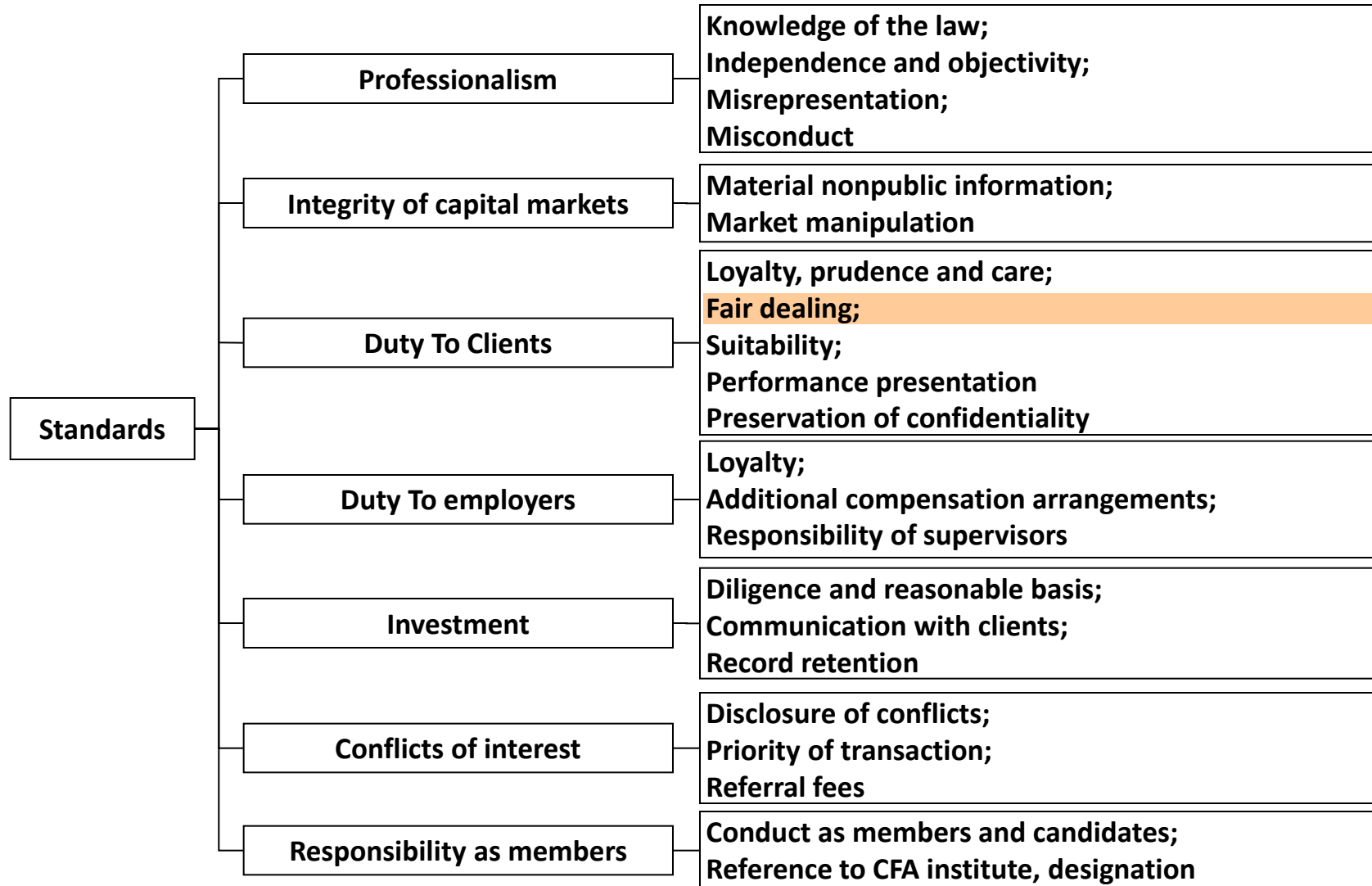
Standard III(A): Case 10

- **Case 10*** (Client Loyalty, NEW)** After providing client account investment performance to the external-facing departments, but prior to it being finalized for release to clients, An Nguyen, an investment performance analyst, notices the reporting system missed a trade. This omission created a large loss within the reporting period for a client that had previously placed the firm on “watch” for potential termination owing to underperformance in prior periods. Nguyen knows this news is unpleasant, but informs the appropriate individuals that the report needs to be updated before releasing it to the client.
- Comment: Nguyen’s actions align with the requirements of Standard III(A). Even though the correction may lead to the firm’s termination by the client, withholding information on errors would not be in the best interest of the client.

Standard III(A): Case 11

- **Case 11*** (Execution Only Responsibilities, New)** Baftija Sulejman recently became a candidate in the CFA Program. He is a broker who executes client directed trades for several high net worth individuals. Sulejman does not provide any investment advice and only actualizes the trading decisions made by clients. He is concerned that the Code and Standards impose a fiduciary duty on him in his dealing with clients and sends an e-mail to the CFA Ethics Helpdesk (ethics@cfainstitute.org) to seek guidance on this issue.
- Comment: In this instance, Sulejman serves in an execution only capacity and his duty of loyalty, prudence and care is centered on the skill and diligence used when executing trades, namely by seeking best execution and making trades within the parameters set by the clients (instructions on quantity, price, timing, etc).
 - Acting in the best interests of the client dictates that trades are executed on the most favorable terms that can be achieved for the client. Given this job function, the requirement of the Code and Standards for loyalty, prudence and care clearly do not impose a fiduciary duty.

Guidance for Standards I-VII



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. Fairly ≠ equally

- Fairly: Not to discriminate against any clients when disseminating recommendations or taking investment action.
- Equally: Not required to treat all clients exactly the same, e.g. reach all clients exactly the same time, by e-mail or telephone.

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

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

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

Standard III(B): Guidance - *Investment Recommendations*

➤ 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 - *Investment Recommendations*

➤ Guidance - *Investment Recommendations*

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

Standard III(B): Guidance - *Investment Action*

➤ 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 - *Investment Action*

➤ 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 for compliance

➤ Recommended procedures for compliance

- 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 dissemination¹⁸
 - ✓ Publish guideline for pre-dissemination behavior
 - ✓ Simultaneous dissemination¹⁹
 - ✓ Maintain a list of clients and their holdings
 - ✓ Develop and document trading allocation procedures²⁰
- Disclose trade allocation procedures²¹
- 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 for compliance

➤ Recommended procedures for compliance

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 for compliance

➤ Recommended procedures for compliance

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 for compliance

➤ Recommended procedures for compliance

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 1-2

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

Standard III(B): Case 3-4

- **Case 3 (Fair Dealing and IPO Distribution)**. Morris convinces Arena to do the financing which he believes sure hot issue and arrange some options for himself. When the issue is oversubscribed, Morris fills all the orders (including his own) and cuts back the institutional blocks.
- **Comment:** Morris has violated Standard III (B) by not treating all clients fairly. He shouldn't have taken any himself and have prorated the shares among all clients. Also violated VI(A), because he should have disclosed to his firm and clients that he received options.
- **Case 4 (Selective Disclosure)**. SIWM publicly indicates a conservative earnings forecast which Roberts believes much lower than it actually is. He repeats the conservative figure in his report to all clients but informally tells his larger clients that the earnings to be higher, making SIWM a good buy.
- **Comment:** By not sharing his opinion regarding the potential for a significant upside earnings surprise with all clients, Roberts isn't treating all clients fairly and has violated Standard III (B).

Standard III(B): Case 5-6

- **Case 5 (Fair Dealing and Transaction Allocation).** Preston is troubled for trying to retain his biggest client, Colby who is disgruntled and threatens to leave if no performance improvement. When allocating trades executed days before, Preston intentionally allocate the profitable trades to Colby and spread the losing trades among other accounts.
- **Comment:** Preston violated Standard III(B) 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
- **Case 6* (Additional Services for Select Clients).** Weng uses email to issue a new recommendation to all his clients and then calls his 3 biggest clients to discuss the recommendation in detail.
- **Comment:** Weng has not violated Standard III (B) because he fairly disseminated the recommendation to all clients prior to discussing it with a select few. Weng's larger clients received additional personal service that they presumably pay for through bigger fees or because they have a large amount of assets under Weng's management. Weng would have violated Standard III(B) if he had discussed the report with a select group of clients prior to distributing it to all his clients.

Standard III(B): Case 7

- **Case 7* (Minimum Lot Allocations):** Hampton is a private wealth manager. She determines that a new 10-year bond being offered by HP is appropriate for five of her clients. Three clients request to purchase US\$10,000 each, and the other two request US\$50,000 each. The minimum lot size is established at US\$5,000, and the issue is oversubscribed at the time of placement. Her firm's policy is that odd-lot allocations, especially those below the minimum, should be avoided because they may affect the liquidity of the security at the time of sale. Hampton is informed she will receive only US\$55,000 of the offering for all accounts. Hampton distributes the bond investments as follows: The three accounts that requested US\$10,000 are allocated US\$5,000 each, and the two accounts that requested US\$50,000 are allocated US\$20,000 each.
- Comment: Hampton has not violated Standard III(B), even though the distribution is not on a complete pro rata basis because of the required minimum lot size. With the total allocation being significantly below the amount requested, Hampton ensured that each client received at least the minimum lot size of the issue. This approach allowed the clients to efficiently sell the bond later if necessary. $(11 \times 30 / 130 = 2.54)$

Standard III(B): Case 8

- **Case 8*** (Excessive Trading, NEW)** Ling Chan manages the accounts for many pension plans, including the plan of his father's employer. Chan developed similar, but not identical, investment policies for each client so the investment portfolios are rarely the same. To minimize the brokerage cost of his father's pension plan, he intentionally trades more frequently in the other clients' accounts to ensure the required brokerage is incurred to continue receiving the firm's research.
- Comment: Chan is violating Standard III(B) because his trading actions are disadvantaging his clients to enhance a relationship with a preferred client.
 - All clients are benefiting from the research being provided and should incur their fair portion of the costs.
 - This does not mean that additional trading should occur if a client has not paid an equal portion of the commission; trading should occur only as required by the strategy.

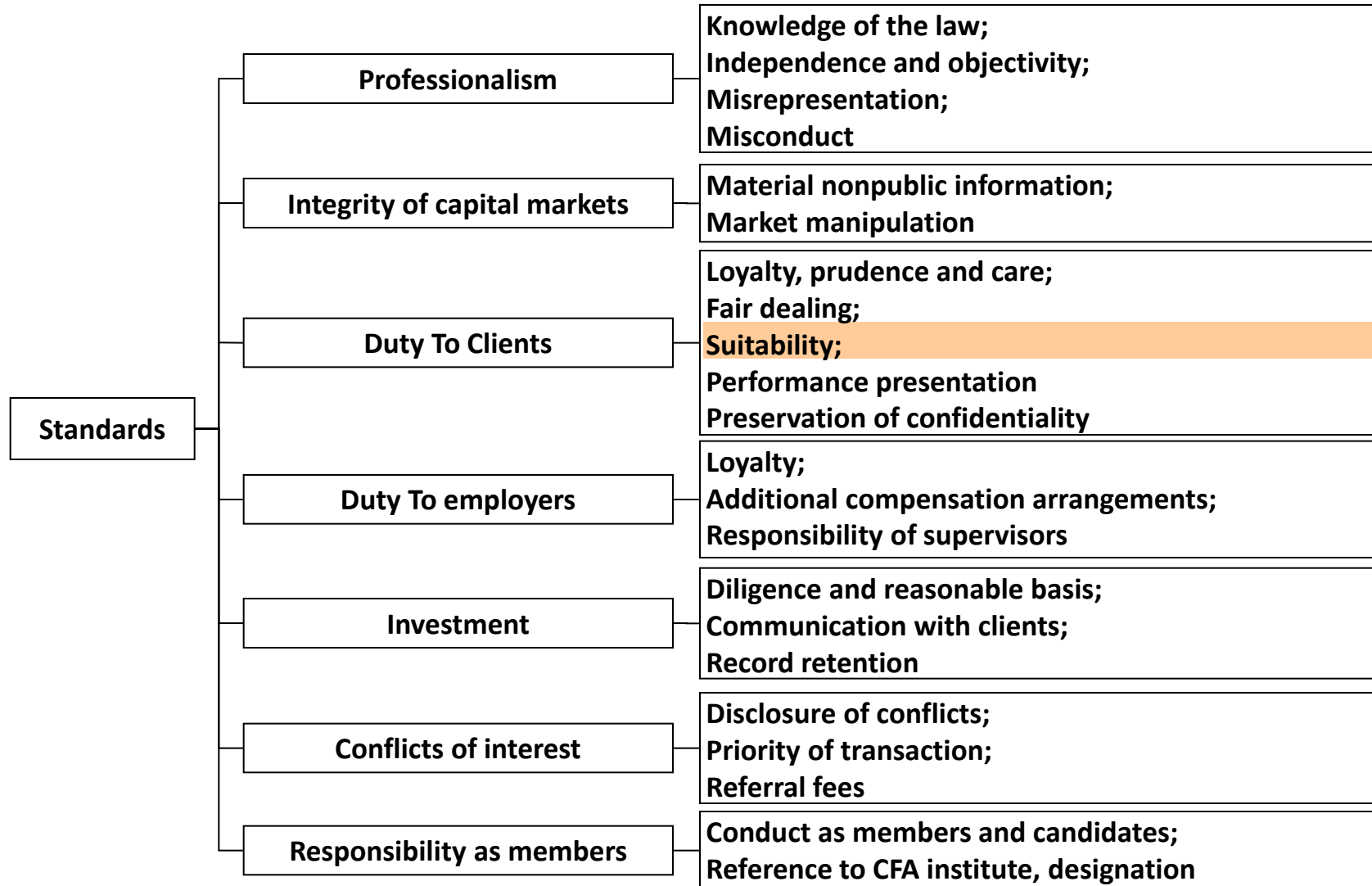
Standard III(B): Case 9

- **Case 9 *** (Limited Social Media Disclosures, NEW)** Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page. As part of her auto industry research for FIM, Burdette is completing a report on the financial impact of Sun Drive Auto, Ltd.'s new solar technology for compact automobiles. This research report will be her first for FIM, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, Burdette sends a quick tweet to FIM Twitter followers summarizing her "buy" recommendation for Sun Drive Auto stock.
- Comment: Burdette has violated Standard III(B) by sending an investment recommendation to a select group of contacts prior to distributing it to all clients. Burdette must make sure she has received the appropriate training about FIM's policies and procedures, including the appropriate business use of personal social media networks before engaging in such activities.

Standard III(B): Case 10

- **Case 10 *** (Fair Dealing between Clients, NEW)** Paul Rove, performance analyst for Alpha-Beta Investment Management is describing to the firm's chief investment officer (CIO) two new reports he would like to develop to assist the firm in meeting their obligations to treat clients fairly. Because many of the firm's clients have similar investment objectives and portfolios, Rove first suggests a report detailing securities owned across several clients and the percentage of their portfolios the security represents. The second report would be run following the performance calculations each month that compared the portfolios of similar strategies. The outliers within each report would be submitted to the CIO for review and clarification by the portfolios' advisers.
- **Comment:** As a performance analyst, Rove likely has little direct contact with clients and thus has limited opportunity to treat clients differently. The recommended reports comply with Standard III(B) while helping the firm conduct after-the-fact reviews of how effectively the firm's advisers are dealing with their client's portfolios. Reports that monitor the fair treatment of clients are an important oversight tool to ensure that clients are treated fairly.

Guidance for Standards I-VII



Standard III(C): Content

➤ Content

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

Standard III(C): Guidance

➤ Guidance - *Developing an Investment Policy*

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

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

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

➤ Guidance - *Updating an Investment Policy*

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

Standard III(C): Guidance

➤ Guidance - *The Need for Diversification*

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

➤ Guidance - *Managing to an Index or Mandate*

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

Standard III(C): Guidance

➤ **Addressing Unsolicited Trade Requests(new)**

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 for Compliance

➤ Recommended Procedures for Compliance

11. Investment policy statement.

- ✓ Include needs, circumstances, performance benchmarks and objectives, and review at least annually;
- ✓ An appropriate suitability determination will not prevent some investments or investment actions from losing value.
- ✓ Update investors' objectives and constraints periodically

Standard III(C): Recommended Procedures for Compliance

➤ Recommended Procedures for Compliance

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 for Compliance

➤ Recommended Procedures for Compliance

13. Suitability test policies.

- ✓ Should require the investment professional to look beyond the potential return of the investment and include the following:
 - ◆ an analysis on the impact on the portfolio's diversification,
 - ◆ a comparison of the investment risks with the client's assessed risk tolerance, and
 - ◆ the fit of the investment with the required investment strategy.

Standard III(C): Case 1-2

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

Standard III(C): Case 3-5

- **Case 3* (IPS Updating).** A manager learns in a meeting with client that the client has just inherited a larger sum of money which will increase his net worth fourfold.
 - **Comment:** The client's financial circumstances have definitely changed, so the manager must **update the IPS** and discuss with client to determine how to adjust the investment objectives, high equity ratio, tilted to low-yield, growth-oriented issues.
- **Case 4 (Following an Investment Mandate).** Perkowski buys zero-dividend stock he believes undervalued for his high-income mutual fund.
 - **Comment:** Perkowski has violated Standard III (C) because zero-dividend stock is absolutely not suitable for high-income mutual fund.
- **Case 5 (IPS Requirements and Limitations).** Gubler, a manager of insurance company, has an IPS mandate for highly liquid investments. Recently he is attracted by a VC seed fund which have a fairly long lock-up period and after extensive analysis he invests 4% in the seed fund, leaving the portfolio's total equity exposure still well below its upper limit.
 - **Comment:** violation because of conflict between IPS and practice.

Standard III(C): Case 6

- **Case 6 (Submanager and IPS Reviews).** Ostrowski uses the CFA Institute model “request for proposal” to design a questionnaire for his search. By deadline, he receives seven questionnaires from domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm’s bottom line.
- **Comment:** When selecting an external or subadviser, Ostrowski needs to ensure that the new manager’s services are appropriate for his clients. This due diligence includes comparing the risk profile of the clients with the investment strategy of the manager. In basing the decision on the fee structure alone, Ostrowski may be violating Standard III(C). When clients ask to diversify into international products, it is an appropriate time to review and update the clients’ IPS. Ostrowski’s review may determine that the risk of international investments modifies the risk profiles of the clients or does not represent an appropriate investment.
 - See also Standard V(A)-Diligence and Reasonable Basis for further discussion of the review process needed in selecting appropriate submanagers.

Standard III(C): Case 7

- **Case 7* (Investment Suitability-Risk Profile):** All Snead's clients have long-term investment objectives. Snead's employer introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indices. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' investment policy statements. One of Snead's pension fund clients, asks why portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.
- **Comment:** Snead violated Standard III(C) by investing the clients' assets in high-beta stocks. These high-risk investments are contrary to the long-term risk profile established in the clients' IPS. Snead has changed the investment strategy of the clients in an attempt to reap short-term rewards offered by her firm's new compensation arrangement, not in response to changes in clients' investment policy statements.
 - See also Standard V(B); VI(A) → I(B).

Standard III(C): Case 8

- **Case 8:***(Investment Suitability)** Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, he was an account manager with EI, a hedge fund managed by his friend Reed. To attract clients to Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the EI funds. No one is turned away because Conduit is seeking to expand its assets under management.
- **Comment:** Shrub has violated Standard III(C) because the risk profile of the fund may not be suitable for every client. Shrub needs to establish an IPS for each client and recommend investments accordingly. Shrub is required to act as more than a simple sales agent for EI fund. Although Shrub cannot disobey the direct request of a client to purchase a specific security, he should fully discuss the risks of a planned purchase and provide reasons why it might not be suitable for a client. This requirement may cause to decline new customers if those customers' requested investment decisions are significantly out of line with their stated requirements.
 - See also Standard V(A)–Diligence and Reasonable Basis.

Guidance for Standards I-VII



Standard III(D): Content

➤ Content:

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

➤ Guidance:

2. The presentation should be **fair, accurate, complete**
3. Not misrepresent past performance or reasonably expected performance.
 - ✓ Not state or imply to obtain what was achieved in the past
4. Include terminated portfolio as part of performance history.
5. The performance of weighted rate of return rather than a single performance.

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 for Compliance

➤ Recommended Procedures for Compliance

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

Standard III(D): Recommended Procedures for Compliance

➤ Recommended Procedures for Compliance

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

Standard III(D): Case 1-3

- **Case 1* (Performance Calculation and Length of Time).** Taylor communicates his clients that “You can expect steady 25% annual compound growth of the value of your investments over the year.” In fact, Taylor’s performance only achieves the rate of 25% per annum once for the past years.
 - **Comment:** Taylor dishonestly **overstates** his performance, it is a violation. Also violates I(C) Misrepresentation.
- **Case 2 (Performance Calculation and Asset Weighting).** Judd, a senior partner of ACM, circulates a performance sheet and claims compliance with the GIPS. But his composites are not asset weighted which is a violation of GIPS.
 - **Comment:** It’s a false claim of GIPS compliance and violates Standard III (D).
- **Case 3 *(Performance Presentation and Prior Fund/Employer).** McCoy is recently recruited by a new company. The new company prepared a marketing campaign in which includes McCoy’s equity performance achieved at his old company and the advertisement did not identify the old source.
 - **Comment:** McCoy violate Standard III (D) by distributing material performance misrepresentations regarding the historical performance of the new company. Generally, the standard does not prohibit showing past record so long as it is fully disclosed where the performance comes from and the person’s role in it.

Standard III(D): Case 4-5

- **Case 4* (Performance Presentation and Simulated Results).** Davis produced performance results from 1990-95 based on historical data and simulated performance results for the period from 1996-2003. Then he includes all these in advertisement to clients and does not indicate that the simulated results.
 - **Comment:** Davis violated Standard III (D) by failing to clearly identify simulated performance results.
- **Case 5* (Performance Calculation and Selected Accounts Only).** In a presentation, Kilmer constructed the composite with balanced objective, and arbitrarily excluded accounts under certain asset level 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) by misrepresenting the facts in the promotional material sent to prospective clients, distorting his firm's performance record, and failing to include disclosure that would have clarified the presentation.

Standard III(D): Case 6

- **Case 6*** (Performance Attribution Changes, NEW)** Purell works for an investment management firm with a bottom-up, fundamentals-driven investment process that seeks to add value through stock selection. The attribution methodology currently compares each stock with its sector. The attribution report indicates that the value added this quarter came from asset allocation and that stock selection contributed negatively to the calculated return. Through running several different scenarios, Purell discovers that calculating attribution by comparing each stock with its industry and then rolling the effect to the sector level improves the appearance of the manager's stock selection activities. Because the firm defines the attribution terms and the results better reflect the stated strategy, the client reports should use the revised methodology.
- Comment:
 - ✓ Modifying the attribution methodology without proper notifications to clients would fail to meet the requirements of Standard III(D).
 - ✓ Purrell's recommendation is being done solely for the interest of the firm to improve its perceived ability to meet the stated investment strategy. Such changes are unfair to clients and obscure the facts regarding the firm's abilities.
 - ✓ Had Purell believed the new methodology offered improvements to the original model, then he would need to report the results of both calculations to the client. The report should also include the reasons why the new methodology is preferred, which allow the client to make a meaningful comparison to prior results and provide a basis for comparing future attributions.

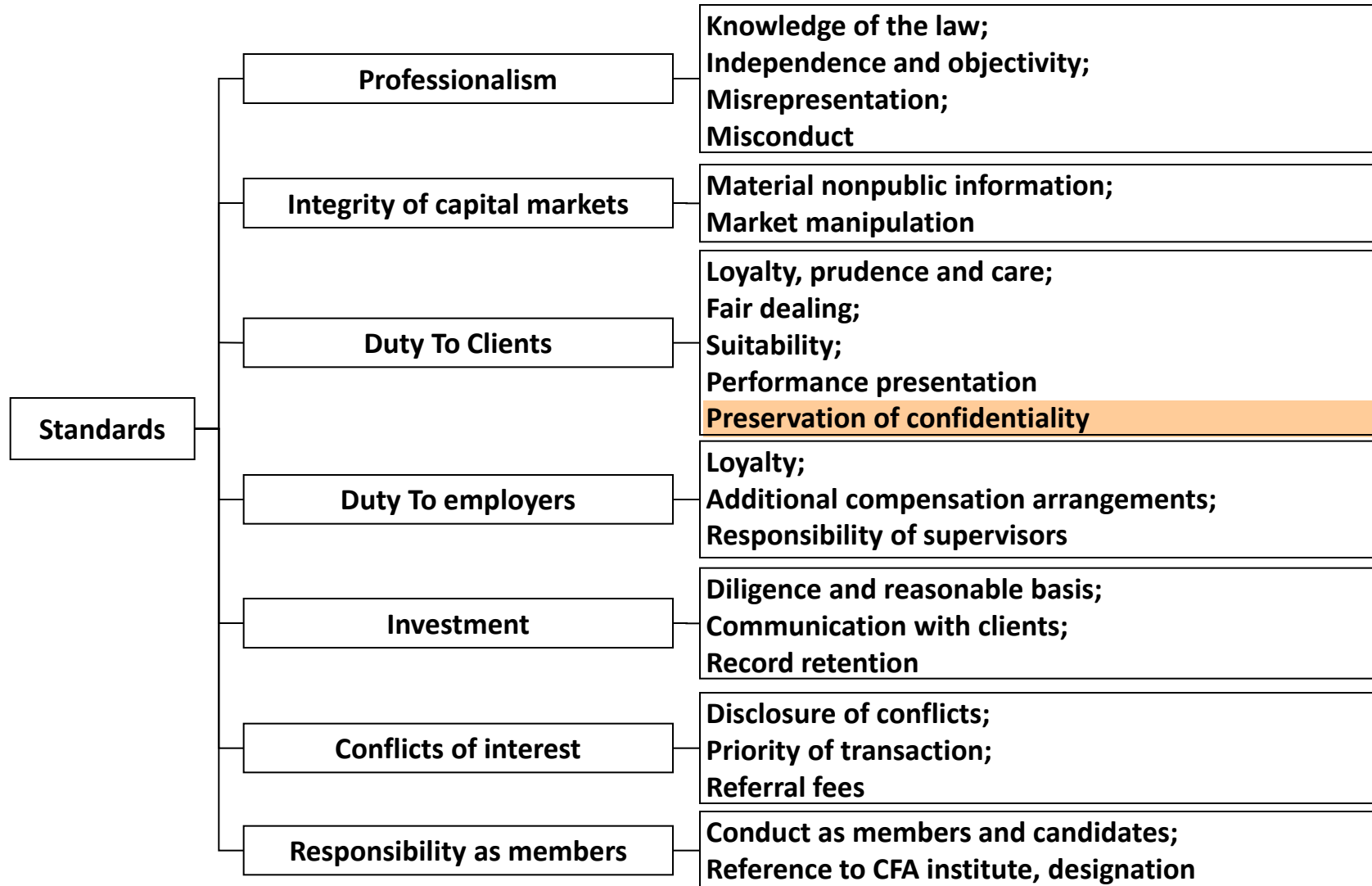
Standard III(D): Case 7

- **Case 7*** (Performance Calculation Methodology Disclosure, NEW)** While developing a new reporting package for existing clients, Alisha Singh, a performance analyst discovers that her company's new system automatically calculates both time-weighted and money-weighted returns. She asks the head of client services and retention which value would be preferred given that the firm has various investment strategies that include bonds, equities, securities without leverage, and alternatives. Singh is told not to label the return value so that the firm may show which ever value is greatest for the period.
- Comment: Following these instructions would lead to Singh violating Standard III(D).
 - In reporting inconsistent return values, Singh would not be providing complete information to the firm's clients. Full information is provided when clients have sufficient information to judge the performance generated by the firm.

Standard III(D): Case 8

- **Case 8*** (Performance Calculation Methodology Disclosure, NEW)** Richmond Equity Investors manages a long–short equity fund in which clients can trade once a week (on Fridays). For transparency reasons, a daily net asset value of the fund is calculated by Richmond. The monthly fact sheets of the fund report month-to-date and year-to-date performance. Depending on which results are better, Richmond publishes the performance either as of the last trading day of the month (typically, not the last business day) or as of the last business day of the month as determined by Richmond. The fact sheet mentions only that the data are as of the end of the month, without giving the exact date. Maggie Clark, the investment performance analyst in charge of the calculations, is concerned about the frequent changes and asks her supervisor whether they are appropriate.
- Comments Clark's actions in questioning the changing performance metric comply with Standard III(D). She has shown concern that these changes are not presenting an accurate and complete picture of the performance generated.

Guidance for Standards I-VII



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 clients⁴. 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- *Electronic Information and Security*

➤ Guidance - *Electronic Information and Security(new)*

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 - *Professional Conduct Investigations by CFA Institute*

➤ **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 for Compliance

➤ Recommended Procedures for Compliance

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

Standard III(E): Case 1-2

- **Case 1* (Possessing Confidential Information).** Connor, an advisor for Medical Centre, learns the Center's internal expansion plan during the routine investment advising meeting. Then he is approached by a potential donor for the Center who wants to find out the expansion plan of the Center first and does not want to speak to the Center.
 - **Comment:** The plan is confidential. Connor must not divulge the plan without the permission of the Center.
- **Case 2 (Disclosing Confidential Information).** Moody is an investment officer at the Lester Trust Company. She has an advisory customer who has talked to her about giving approximately US\$50,000 to charity to reduce her income taxes. Moody is also treasurer of the Home for Indigent Widows (HIW), which is planning its annual giving campaign. HIW hopes to expand its list of prospects, particularly those capable of substantial gifts. Moody recommends that HIW's vice president for corporate gifts call on her customer and ask for a donation in the US\$50,000 range.
 - **Comment:** Moody violated Standard III (E) by revealing confidential information about his client.

Standard III(E): Case 3-4

- **Case 3* (Disclosing Possible Illegal Activity)**. Samuel is the manager for Garcia Company's pension plan and is approached by government officer for potential illegal activities of Garcia management. Samuel consults her employer's general counsel and is advised that Garcia probably has violated tax regulations.
 - **Comment:** Samuel should inform her supervisor and seek legal advice for appropriate action. She may have a duty to disclose the evidence of the illegal violations of Garcia. See also I(A)
- **Case 4* (Disclosing Possible Illegal Activity)**. Bradford manages money for a family-owned firm as well as the family members and officers. During his work, Bradford finds some questionable practices of the CFO and believes the CFO is embezzling money from the firm.
 - **Comment:** Bradford should check with the compliance dept. or appropriate legal counsel to determine whether it is appropriate to report the CFO's financial records.

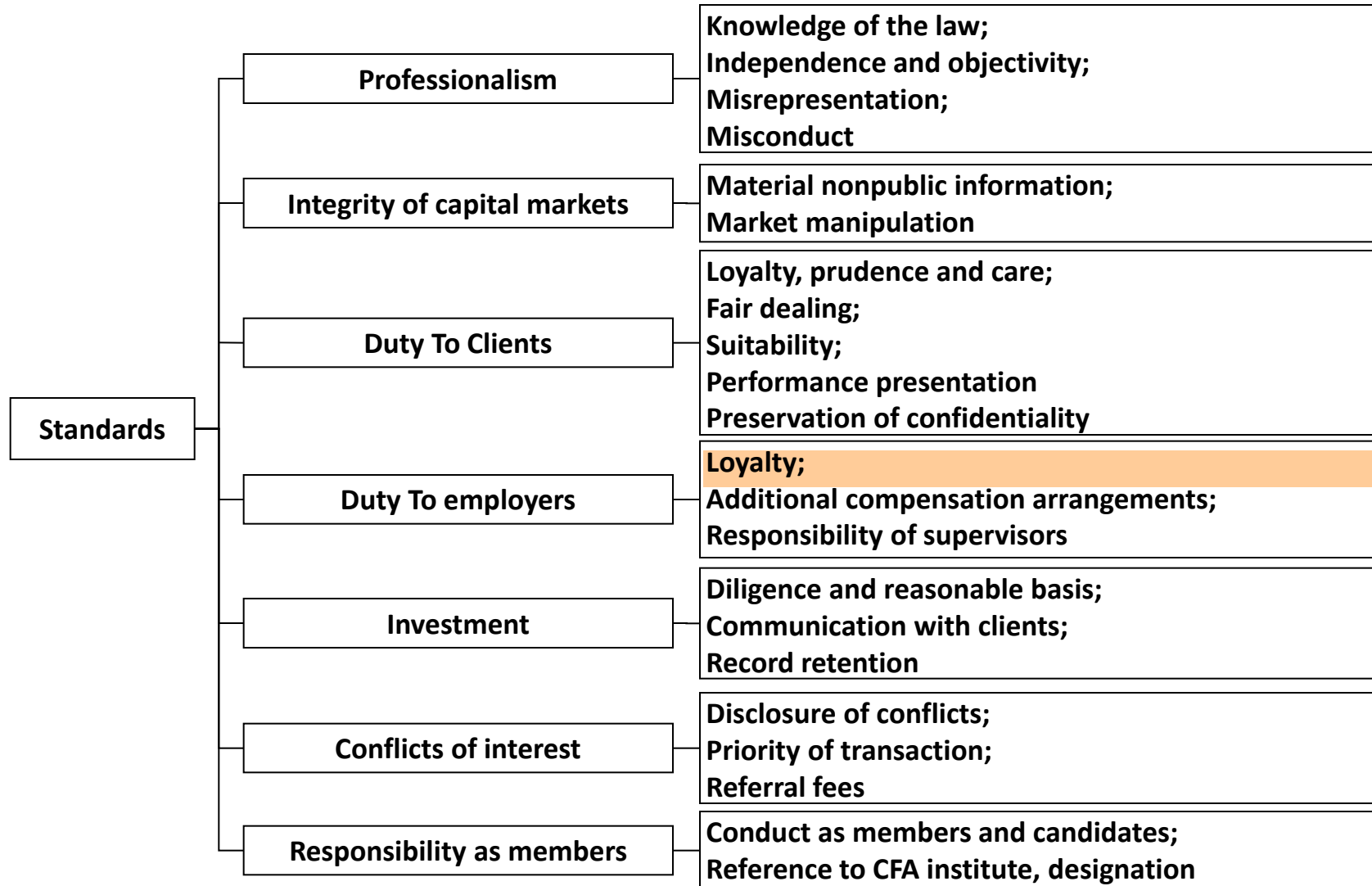
Standard III(E): Case 5

- **Case 5 (Accidental Disclosure of Confidential Information, NEW)** Lynn Moody is an investment officer at the Lester Trust Company (LTC). She has stewardship of a significant number of individually managed taxable accounts. Under the direction of her firm's technology and compliance departments, she established a new group page on an existing social media platform specifically for her clients. In the instructions provided to clients, Moody asked them to "join" the group so they may be granted access to the posted content. The instructions also advised clients that all comments posted would be available to the public and thus the platform was not an appropriate method for communicating personal or confidential information.
- Six months later, in early January, Moody posted LTC's year-end "Market Outlook." The report outlined a new asset allocation strategy that the firm is adding to its recommendations in the New Year. Moody introduced the publication with a note informing her clients that she would be discussing the changes with them individually in their upcoming meetings.
 - One of Moody's clients responded directly on the group page that his family recently experienced a major change in their financial profile. The client described highly personal and confidential details of the event. Unfortunately, all clients that were part of the group were also able to read the detailed posting until Moody was able to have the comment removed.

Standard III(E): Case 5

- Comment:
 - ✓ Moody has taken reasonable steps for protecting the confidentiality of client information while using the social media platform.
 - ◆ She provided instructions clarifying that all information posted to the site would be publically viewable to all group members and warned against using this method for communicating confidential information.
 - ◆ The accidental disclosure of confidential information by a client is not under Moody's control. Her actions to remove the information promptly once she became aware further align with Standard III(E).
 - ✓ In understanding the potential sensitivity clients express surrounding the confidentiality of personal information,
 - ◆ this event highlights a need for further training.
 - ◆ Moody might advocate for additional warnings or controls for clients when they consider using social media platforms for two way communications.

Guidance for Standards I-VII



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:** Whether injure the firm, deprive the firm of its profit, or compromise the advantage of employee's skill and capability

➤ 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 - *Independent Practice*

➤ 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 - *Leaving an Employer*

➤ 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 - *Leaving an Employer*

➤ 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 - *Leaving an Employer*

➤ 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 - *Leaving an Employer*

➤ Guidance – *Use of Social Media(new)*

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 for Compliance

➤ Recommended Procedures for Compliance

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 for Compliance

➤ Recommended Procedures for Compliance (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 1-2

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

Standard IV(A): Case 3-4

- **Case 3* (Addressing Rumors).** Winston, an all-equity manager at TAM which was acquired by a large bond mutual fund 10 years ago. And now rumors are around that TAM will be sold; Winston and his associates who can not get a clarification for the rumor, contemplates leading an employee buyout of the TAM's equity management business.
- **Comment:** An employee-led buyout would be consistent with Standard IV (A) because it would rest on the permission of the employer and the clients. If not sure, should consult for advice.
- **Case 4 (Ownership of Completed Prior Work).** Clay enters an oral part time working agreement (a study of wireless industry using BA's resources) with BA while seeking a full time job. As Clay nears completion of the study, she gets a job at W&C and is pondering submitting the draft of the wireless study for publication by W&C.
- **Comment:** Clay must not give her draft to W&C unless gets permission from BA because she has an employer-employee relationship with BA therefore has the obligation to act for the benefit of the employer. Clay must not take from BA any research file material that she may have used.

Standard IV(A): Case 5-6

- **Case 5* (Ownership of Completed Prior Work).** Madeline spends her summer as an unpaid intern at M&L helping GIPS compliance work. Two months later, she gets a job at MMC, also a GIPS compliant. Before leaving M&L, **she copies the firm's software that she helped develop.**
- **Comment:** Internship is an employment and Madeline violated Standard IV (A) because she misappropriated M&L's property without permission.
- **Case 6* (Starting a New Firm).** Allen, an equity analyst, without notice to her employer, registers to start an investment that will compete with her employer. However, she has not actively sought clients.
- **Comment:** It is not a violation as long as Allen only prepares her new business on her own time outside the office and if Allen will not be soliciting clients for the business or otherwise operating the new company until she has left her current employer.

Standard IV(A): Case 7-8

- **Case 7** (Soliciting Former Clients).** Chisolm left his former firm for a competing firm and wants to contact his former clients. Is this a violation of Standard IV (A) for Chisolm?
- **Comment:** It mainly depends on the nature and extent of the contact with former clients and the information Chisolm uses. If Chisolm uses confidential or privileged information obtained from former employer, it is violation. If Chisolm maintains his duty of loyalty before joining new firm and adheres to non-compete agreement and just use public information about former firm after departing to contact former clients, it is not violation.
- **Case 8 (Competing with Current Employer).** Some employees are departing in a few weeks and have been careful not to conflict with their duty to current employer. An RFP (request for proposal) for hiring new investment consultant from current clients has been sent to the employer and other competitors. The employees believe the new entity would be qualified to respond to the RFP and eligible for the business. The RFP submission period is likely to end before resignations are effective. Is it permissible for the departing employees to respond to the RFP?
- **Comment:** A group of employees responding to RFP that their employer is also responding to would lead to direct competition between the employees and the employer. Such conduct would violate Standard IV(A) unless the group of employees received permission from their employer as well as the entity sending out the RFP.

Standard IV(A): Case 9-10

- **Case 9** (Externally Compensated Assignments).** Mota is an analyst at Tyson Investments. He works part time as a mayor for his hometown.
- **Comment:** If Mota's mayoral duties are so extensive and time consuming that they might detract from his ability to fulfill his responsibilities at Tyson, he should discuss his outside activities with his employer and come to a mutual agreement regarding how to manage his personal commitments with his responsibilities to his employer.
- **Case 10* (Soliciting Former Clients).** McQuillen leaves her employer without a non-compete agreement and she does not take any of her client lists or other employer property. Now she obtains the phone number of former clients through public records and contacts them.
- **Comment:** McQuillen is not in violation of Standard IV(A) because she has not used information or records from her former employer and is not prevented by an agreement with her former employer from soliciting her former clients.

Standard IV(A): Case 11

➤ **Case 11 (Whistleblowing):** When many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen approaches the head of trading about her concern and is told that she should not ask any questions, and the fund is big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, who also tells her to stay away from the issue of the hedge fund's reporting

- **Comment:**

- ✓ Rasmussen has come upon an error in compliance practices in the firm's operations. Having been unsuccessful in finding a resolution with her supervisor and compliance officer, she should consult whistleblowing policy to determine the appropriate steps to informing management. The potentially unethical actions are appropriate grounds for further disclosure, so whistleblowing would not represent a violation of IV(A).
- ✓ Standard I(D)–Misconduct
- ✓ Standard IV(C)–Responsibilities of Supervisors.

Standard IV(A): Case 12

- **Case 12 (Soliciting Former Clients)** Angel Crome has been a private banker for YBSafe Bank for the past eight years. She has been very successful and built a considerable client portfolio during that time but is extremely frustrated by the recent loss of reputation by her current employer and subsequent client insecurity. A locally renowned headhunter contacted Crome a few days ago and offered her an interesting job with a competing private bank. This bank offers a substantial signing bonus for advisers with their own client portfolios. Crome figures that she can solicit at least 70 percent of her clients to follow her and gladly enters into the new employment contract.
- Comment: Crome may contact former clients upon termination of her employment with YBSafe Bank, but she is prohibited from using client records built and kept with her in her capacity as an employee of YBSafe Bank. Client lists are proprietary information of her former employer and must not be used for her or her new employer's benefit. The use of written, electronic, or any other form of records, other than publicly available information, to contact her former clients at YBSafe Bank will be a violation of Standard IV(A).

Standard IV(A): Case 13

- **Case 13 (Notification of Code and Standards)** Smith is responsible for structuring CDO made up of securities in the firm's inventory. At a meeting, the head trader says that it is a good time to unload some junk and disguise it with ratings and an unreadable prospectus. Smith is worried and asks her colleagues what the trader meant, and is told that it's a joke. But it seems partly true because the CDO is regarded as an opportunity to improve the quality of the firm's inventory.

Smith talks to her supervisor and provides the trader with a copy of Code and Standards. He thinks they should place the interest of client above the firm and advise that the development of the new CDO will not adhere to this responsibility. The trader assures Smith that the appropriate analysis will be conducted and the ratings are assigned by an independent firm and the prospectus will include full and factual disclosures. Smith is reassured by the meeting, but he also reviews the company's procedures for reporting potential violations.

- **Comment:** Smith's review of the company policies for reporting violations allows him to be prepared to report through the appropriate whistleblower process. He complies with the Code and Standards principles of placing the clients' interests first and being loyal to her employer. In providing his supervisor with a copy of the Code and Standards, Smith is highlighting the high level of ethical conduct in her professional activities.

Standard IV(A): Case 14

- **Case 14 *** (Leaving an Employer, NEW)** Laura Webb just left her position as portfolio analyst at Research Systems, Inc. (RSI). Her employment contract included a non-solicitation agreement that requires her to wait two years before soliciting RSI clients for any investment related services. Upon leaving, Webb was informed that RSI would contact clients immediately about her departure and introduce her replacement. While working at RSI, Webb connected with clients, other industry associates, and friends through her LinkedIn network. Her business and personal relationships were intermingled because she considered many of her clients to be personal friends. Realizing that her LinkedIn network would be a valuable resource for new employment opportunities, she updated her profile several days following her departure from RSI. LinkedIn automatically sent a notification to Webb's entire network that her employment status had been changed in her profile.
- Comment: Prior to her departure, Webb should have discussed any client information contained in her social media networks.
 - By updating her LinkedIn profile after RSI notified clients, she has appropriately placed her employer's interests ahead of her own personal interests. In addition, she has not violated the non-solicitation agreement with RSI, unless it prohibited any contact with clients during the two-year period.

Standard IV(A): Case 15

- **Case 15 *** (Confidential Firm Information, NEW)** Sanjay Gupta is a research analyst at Naram Investment Management (NIM). NIM uses a team-based research process that results in a company view on the investment opportunities covered by the team members. Gupta provides commentary for NIM's clients through the company blog which is posted weekly on the NIM password protected website. **According to NIM's policy, every contribution to the website must be approved by the company's compliance department before posting.** Any opinions expressed on the website are disclosed as representing the perspective of the company. Gupta also writes a personal blog to share his experiences with friends and family. As with most blogs, Gupta's personal blog is widely available to interested readers through various internet search engines. Occasionally, when he disagrees with the team-based research opinions of NIM, Gupta uses his personal blog to express his own opinions as a counterpoint to the commentary posted on the NIM website. Gupta believes this provides his readers with a more complete perspective on these investment opportunities.
- **Comment:** Gupta is in violation of Standard IV(A) 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) members and candidates must receive consent from their employer prior to using company resources.

Guidance for Standards I-VII



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.

disclose	consent	violate
✓	×	IV(B)
✓	✓	-
×	×	IV(B) → VI(A) → I(B)

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 for Compliance

➤ Recommended Procedures for Compliance

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

Standard IV(B): Case 1-2

- **Case 1* (Notification of Client Bonus Compensation).** Whitman, an employee at ATC, manages the account of Cochran, a client. Cochran proposes to Whitman that if the performance above 15% before tax, the 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) by failing to disclose the vacation arrangement to his employer. This arrangement could compromise objectivity. Violate IV(B)→VI(A)→ I(B)
- **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) by failing to disclose to his employer the non-monetary benefits for his directorship. Violate IV(B)→VI(A)→ I(B)

Standard IV(B): Case 3

- **Case 3* (Prior Approval for Outside Compensation).** Hollis, an analyst is currently recommending the purchase of ABC Oil shares. ABC offers to send a company plane to pick Hollis up and arrange for his accommodations while visiting. Hollis, after gaining the approvals, accepts the meeting with the CEO but declines the offered travel arrangements. Following the meeting, Hollis joins Andrews and the investment relations officer for dinner at an upscale restaurant near ABC headquarters. Upon returning to Specialty Investment Management, Hollis provides a full review of the meeting to the director of research, including a disclosure of the dinner attended.
- **Comment:** Hollis's actions did not violate Standard IV(B).
- 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. I(B), VI(A)

Guidance for Standards I-VII



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.

➤ 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(new)

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 system 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 cannot discharge supervisory responsibilities because of the inadequate or absence of a compliance system, should decline in writing to accept supervisory responsibility until adoption

Standard IV(C): Guidance

➤ Guidance – *System for supervision*

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

Standard IV(C): Recommended Procedures for Compliance

➤ Recommended Procedures for Compliance

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 for Compliance

➤ Recommended Procedures for Compliance

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 for Compliance

➤ Recommended Procedures for Compliance

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 for Compliance

➤ Implementation of compliance education and training(new)

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 1-2

- **Case 1* (Supervising Research Activities).** Mattock, head of research dept. of H&V, a brokerage firm, has decided to change recommendation for Timber from buy to sell. In line with H&V's procedures, she orally advises other executives of recommendation change before publication. After her conversation with Frampton, one of the executives of H&V, Frampton immediately sells (front running) Timber stock from his own account and some discretionary client accounts. Other personnel also inform certain institutional customers of the changed recommendation before publication and dissemination to all H&V customers.
- **Comment:** Mattock violated Standard IV (C) by failing to supervise reasonably and adequately the actions of those accountable to her. She also must ensure that her firm has adequate procedures for unethical practice.
 - Meanwhile, violate II(A), VI(B).
- **Case 2 (Supervising Research Activities).** Miller, the research director, is under pressure to find potential acquisition target. Miller gets a proposal from one of his staff who recommend such a candidate and without extensive analysis and due diligence, he asks the staff to make a memo and send it to the portfolio manager before his vacation. After Miller returns, he only finds the staff's advice is untrustworthy.
- **Comment:** Miller violated Standard IV (C) by not exercising reasonable supervision when he agrees to send out the memo without reasonable and adequate basis. Also violate V(A).

Standard IV(C): Case 3

- **Case 3* (Supervising Trading Activities).** Edwards, a trainee trader at WHC, assists a client in paying for the shares of H&L by using anticipated profits from the immediate sale of the same securities. Despite the fact that H&L is not on WHC's recommended list, a large volume of its stock is traded through WHC in this manner. Mason, the VP responsible for compliance at WHC *whose salary partially based on commission revenue from trading department*, notices the increased trading activity and does nothing to investigate or halt it.
- **Comment:** Mason violated Standard IV (C) by failing to adequately review and investigate purchase orders in H&L stocks executed by Edwards, and failure to supervise the trainee's wrongdoing. Supervisors should be sensitive to actual or potential conflicts between self-interests and supervisory responsibilities.
 - Also see VI(A) – Disclosure of conflicts.

Standard IV(C): Case 4

- **Case 4 (Supervising Trading Activities and Record Keeping).** Henry, the president of Crozet, extremely impressed with Tabbings, one of his best managers in Crozet, directed both the mutual funds and 20% of the firm's pension fund to him. Unbeknownst to Henry, Tabbings frequently places futures for both funds without providing the FCMs designation of the account for which the trade has been placed. Crozet has no written operating procedures or compliance manual concerning its futures trading, and its compliance dept. does not review such trading. After observing the market's movement, Tabbings assigns to the pension fund the positions with favorable execution prices and assigns positions with less-favorable execution prices to the mutual funds.
- **Comment:** Henry violated Standard IV (C) by failing to adequately supervise Tabbings with respect to her futures trading and establish necessary control system to detect or prevent Tabbings's violations.

Standard IV(C): Case 5

➤ **Case 5*** (Accepting Responsibility):** When many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen approaches the head of trading about her concern and is told that she should not ask any questions, and the fund is big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, who also tells her to stay away from the issue of the hedge fund's reporting

- **Comment:**

- ✓ Rasmussen has come upon an error in compliance practices within the firm's operations. According to Standard IV(C), the supervisor and the compliance officer have the responsibility to review the concerns. Supervisors have the responsibility of establishing an ethical culture in the firm. The dismissal of Rasmussen's question violates Standard IV(C) and undermines the firm's ethical operations.
- ✓ Standard I(D)—Misconduct
- ✓ Standard IV(A)—Loyalty, for guidance on whistleblowing.

Standard IV(C): Case 6

- **Case 6* (Inadequate Procedures)**. Over time, Witt's ability to manage his educational requirements and his work requirements begin to conflict with one another. Knowing a recommendation is due the next day for On-line, Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the "hot" security of the day.

- **Comment:**

- ✓ Allowing the report submitted by Witt to be posted highlights a lack of compliance procedures by the research firm. Witt's supervisor needs to work with the management of On-line to develop an appropriate review process to ensure that all contracted analysts comply with the requirements.
- ✓ Standard V(A)–Diligence and Reasonable Basis, as it relates to Witt's responsibility for substantiating a recommendation.

Standard IV(C): Case 7

- **Case 7***(Inadequate Supervision):** Papis is the chief investment officer of the retirement fund. The fund uses outside advisers for the real estate allocation, and this info is clearly presented in all fund communications. In previous years, the performance of the real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend Nagel and seek better returns by moving real estate allocation to Accessible, which was founded by Nagel. The only notice of the change in adviser appears in the next annual report.
- **Comment:** Papis's actions highlight the need for supervision and review at all levels in an organization. His responsibilities may include the selection of external advisers, but the decision to change advisers appears arbitrary. Members and candidates should ensure that their firm has appropriate policies and procedures in place to detect inappropriate actions such as the action taken by Papis.
 - See also Standard V(A)–Diligence and Reasonable Basis,
 - Standard V(B)–Communication with Clients and Prospective Clients,
 - and Standard VI(A)–Disclosure of Conflicts.

Standard IV(C): Case 8

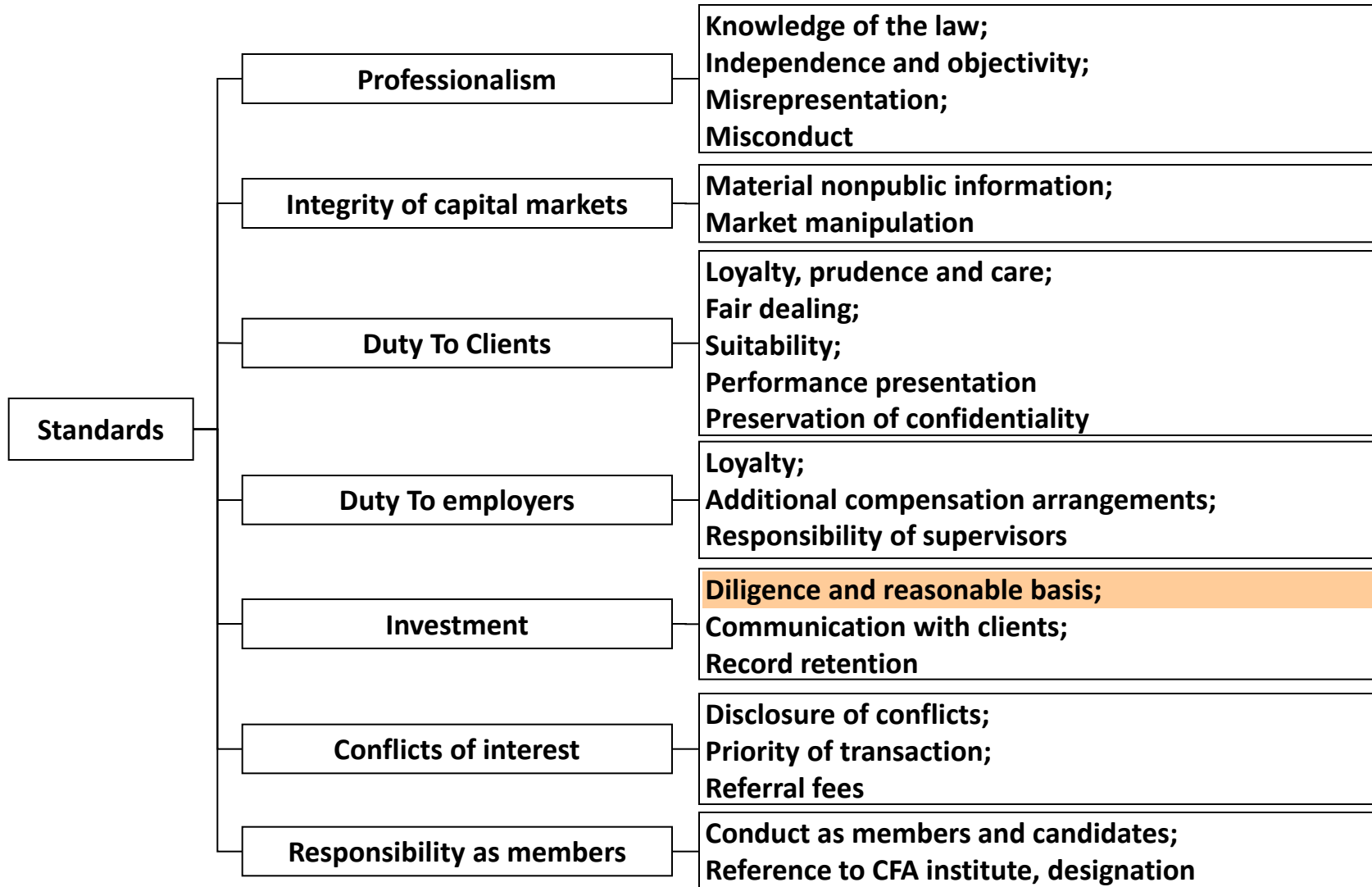
- **Case 8*** (Supervising Research Activities, NEW)** Mary Burdette was a junior auto industry analyst. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.
- Comment:
 - ✓ Graf has violated Standard IV(C) by failing to reasonably supervise Burdette with respect to the contents of her tweet.
 - ✓ He did not establish reasonable procedures to prevent the unauthorized dissemination of company research through social media networks.
 - ✓ Graf must make sure all employees receive regular training about FIM's policies and procedures, including the appropriate business use of personal social media networks.

Standard IV(C): Case 9

➤ **Case 9 *** (Supervising Research Activities, NEW)** 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 she is uncomfortable providing a "buy" or "sell" opinion of ZYX on the basis of the completed analysis. As a result, she researches various websites and blogs on the banking sector for whatever she can find on ZYX. One independent blogger provides a new interpretation of the recently reported data and concludes with a strong "sell" recommendation for ZYX. She is impressed by the originality and resourcefulness of this blogger's report. Huang submits her report and "sell" recommendation to Chen without any reference to the independent blogger's report. 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.

- Comment: Chen has violated Standard IV(C) 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.

Guidance for Standards I-VII



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 - *Defining Diligence and Reasonable Basis*

➤ 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 - *Using Secondary or Third-Party Research*

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

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

Standard V(A): Guidance - *Quantitatively Oriented Research*

➤ **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 - *Quantitatively Oriented Research*

➤ **Guidance – Developing Quantitatively Oriented Research(new)**

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 - *Selecting External Advisers and Subadvisers*

➤ **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 - *Group Research and Decision Making*

➤ 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 agree conclusion, dissociated 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 for Compliance

➤ Recommended Procedures for Compliance

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 for Compliance

- **Recommended Procedures for Compliance (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 1-2

- **Case 1* (sufficient due diligence):** Hawke, a corporate finance officer, believes the tax benefit for oil and gas companies will soon be removed and convinces some companies that to capitalize on this, an equity financing must be arranged very quickly. Lacking sufficient resources to conduct adequate research on all the prospective issuers, Hawke decides to estimate the issuing prices based on the relative size of each company and to justify the pricing later.
 - **Comment:** Hawke has violated Standard V (A) by pricing the issues simply based on size without reasonable and adequate analysis. He should have taken on only the work he could adequately handle.
- **Case 2 (sufficient scenario testing):** Dhaliwal, a corporate finance manager, is persuading FRL, whose multiples are higher than equivalent stocks, to do a secondary equity financing. During the sales marketing, Dhaliwal use the optimal projections made by the FRL management as the base-case number to justify the high price for the secondary issue.
 - **Comment:** Dhaliwal has violated Standard V (A) by misrepresenting the optimal level as the base level and misleading the investors.

Standard V(A): Case 3-4

➤ **Case 3* (developing a reasonable basis):** Witt creates a website to attract new clients, and due to time deadline, Witt created a report based on a few news articles and what markets deemed hot securities online.

- **Comment:**

- ✓ Witt has violated Standard V (A) because his **continuing recommendation for IT** stocks has not been based on reasonable and adequate basis.
- ✓ IV(C) Responsibility of supervisors

➤ **Case 4 (timely client updates):** Dunlop is searching a specialist US equity manager for her pension client. She conducts thorough due diligence and extensive analysis and selects 5 qualified managers and puts them in briefing report that is delivered to the client 10 days later. In the time of Dunlop's search and delivery of the report to the client, she gets an update for one of the manager in her briefing report (top executive leaves), and **she does not provide the client with this updated information.**

- **Comment:** Dunlop violated Standard V (A) by **not checking the database in a timely manner and updating her report to the client.**

Standard V(A): Case 5-6

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

Standard V(A): Case 7

- **Case 7* (due diligence in submanager selection):** Ostrowski uses the CFA Institute model “request for proposal” to design a questionnaire for his search. By deadline, he receives seven questionnaires from domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm’s bottom line.
- **Comment:** The selection of an external adviser or subadviser should be based on a full and complete review of the advisers’ services, performance history, and cost structure. In basing the decision on the fee structure alone, Ostrowski may be violating Standard V(A).
 - See also Standard III(C)—Suitability as it relates to the ability of the selected adviser to meet the needs of the clients.

Standard V(A): Case 8

➤ **Case 8*** (Sufficient Due Diligence)** Papis is the chief investment officer of the retirement fund. The fund uses outside advisers for the real estate allocation, and this info is clearly presented in all fund communications. In previous years, the performance of the real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend Nagel and seek better returns by moving real estate allocation to Accessible, which was founded by Nagel. The only notice of the change in adviser appears in the next annual report.

- **Comment:** Papis violated Standard V(A) in this example. His responsibilities may include the selection of the external advisers, but the decision to change advisers appears to have been arbitrary. If Papis was dissatisfied with the current real estate adviser, he should have conducted a proper solicitation to select the most appropriate adviser.
- See also Standard IV(C)–Responsibilities of Supervisors,
- Standard V(B)–Communication with Clients and Prospective Clients,
- Standard VI(A)–Disclosure of Conflicts.

Standard V(A): Case 9

- **Case 9*** (Sufficient Due Diligence)** Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, he was an account manager with EI, a hedge fund managed by his friend Reed. To attract clients to Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the EI funds. No one is turned away because Conduit is seeking to expand its assets under management.
- **Comment:** Shrub violated Standard V(A) by not conducting a thorough analysis of EI hedge fund before developing Conduit fund. Due diligence must be applied more deeply than review of a single security. It includes a review of outside managers and investment funds. Shrub's reliance on his personal relationship with Reed and his prior knowledge of EI are insufficient justification. The funds may be appropriately considered, but a full review of their operating procedures and transparency are elements of the necessary due diligence.
 - See also Standard III(C),
 - May also violate IV(C) and VI(A).

Standard V(A): Case 10

- **Case10 (Sufficient Due Diligence)** Bob is responsible for sensitivity analysis on securitized subprime mortgages. He insists that the analysis should include a scenario run with – 10% for Year 1, – 5% for the Year 2, and then (to project a worst case scenario) 0% for Years 3 through Year 5. The manager think these assumptions too dire because there has never been a time in their available database when House Price Appreciation (HPA) < 0.

Bob evaluates the securities in the worst-case scenario, an unlikely but possible environment. Based on the results, he does not recommend the purchase of the securitization. Against the market trends, the manager follows his recommendation and does not invest. The following year, the housing market collapses and the manager's portfolio outperforms its peer group that year.

- **Comment:** Bob's actions in running the scenario test adheres to Standard V(A). His concerns over recent trends provide a sound basis for further analysis. He understands the limitations of his model, when combined with the limited available historical information, to accurately predict the performance of the funds if market conditions change negatively.
- See also Standard I(B)–Independence and Objectivity.

Standard V(A): Case 11

- **Case 11* (use of quantitatively oriented models):** Liakos' client, Carapalis, is convinced that commodity prices will become more volatile. Carapalis asks Liakos to quickly engineer a strategy to benefit from this expectation. Because of tight deadline, the modeling group outsources parts of the work to trusted 3rd parties. Liakos implements the disparate components of the strategy as the firms complete them.

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

- **Comment:** violated Standard V(A). Must understand the statistical significance of the model results and be able to explain them to clients.

Liakos did not take adequate care to ensure a thorough review of the whole model; its components were evaluated only individually. Because Carapalis intended to implement the strategy as a whole rather than as separate parts, Liakos should have tested how the components interacted as well as how they performed individually.

Standard V(A): Case 12

➤ **Case 12** (successful due diligence/failed investment):** Newbury is an investment adviser to high-net-worth clients. A client with an aggressive risk profile in his IPS asks about investing in the TS hedge fund, which has reported 20 percent returns for the first three years. TS states that its strategy involves long and short positions in the energy sector and extensive leverage. Based on his analysis of the fund's track record, the principals managing the fund, the fees charged, and risk profile, Newbury recommends the fund to the client and secures a position in it. The next week, TS announces that it has suffered a loss of 60 percent of its value and is suspending operations and redemptions. His client calls him in a panic and asks for an explanation.

- **Comment :** Newbury's actions were consistent with Standard V(A). Analysis of an investment that results in a reasonable basis for recommendation does not guarantee that the investment will have no down-side risk.
- Newbury should discuss the analysis process with the client while reminding him or her
 - ✓ that past performance does not lead to guaranteed future gains
 - ✓ and that losses in an aggressive investment portfolio should be expected.

Standard V(A): Case 13

➤ **Case 13 *** (Quantitative Model Diligence, NEW)** Barry Cannon is the lead quantitative analyst at Hedge Fund. He is responsible for the development, maintenance and enhancement of the proprietary models the fund uses to manage its investors' assets. Cannon reads several high-level mathematical publications and blogs to stay informed of current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Cannon is under pressure from firm executives to improve the models predictive abilities and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

- Comment: Cannon has violated Standard V(A) by failing to have a reasonable basis for the new recommendations made to the portfolio managers. He needed to diligently research the effect of incorporating the new factors before offering the output recommendations. Cannon may use the blog for ideas, but it is his responsibility to determine the effect on the firm's proprietary models.
- See Standard VII(B) regarding the violation by "Expert CFA" in the use of the CFA designation.

Standard V(A): Case 14

- **Case 14*** (Selecting a Service Provider, NEW)** Ellen Smith is a performance analyst at Artic Global Advisors, a firm that manages global equity mandates for institutional clients. She was asked by her supervisor to review five new performance attribution systems and recommend one that would more appropriately explain the firm's investment strategy to clients. On the list was a system she recalled learning about when visiting an exhibitor booth at a recent conference. The system is highly quantitative and something of a “black box” in how it calculates the attribution values. Clark recommended this option without researching the others, because the sheer complexity of the process was sure to impress the clients.
- Comment: Smith's actions do not demonstrate a sufficient level of diligence in reviewing this product to make a recommendation for selecting the service.
 - Besides not reviewing or considering the other four potential systems, she did not determine whether the “black box” attribution process aligns with the investment practices of the firm, including its investments in different countries and currencies.
 - Smith must review and understand the process of any software or system before recommending its use as the firm's attribution system.

Standard V(A): Case 15

- **Case 15*** (Subadviser Selection,NEW)** Craig Jackson is working for Adams Partners, Inc. and has been assigned to select a hedge fund subadviser to diversify the portfolios of the firm's large fund-of-funds accounts. The allocation must be in place before the start of the next quarter. Jackson uses a consultant database to find a list of firms that claim compliance with the GIPS standards. He calls more than 20 firms on the list to confirm they are seeking new allocations and to determine their most recent quarterly and annual total return values. Because of the short turnaround, Jackson recommends the firm with the greatest total return values for selection.
- Comment: By only considering performance and GIPS Compliance, Jackson has not conducted sufficient review of potential firms to satisfy the requirements of Standard V(A).
 - A thorough investigation of the firms and their operations should be conducted to ensure their addition would add to the diversity of clients' portfolios.

Standard V(A): Case 16

- **Case 16 *** (Manager Selection, NEW)** Timothy Green works for Peach Asset Management, where he creates proprietary models that analyze data from the firm request for proposal questionnaires to identify managers for possible inclusion in the firm's fund-of-funds investment platform. Various criteria must be met to be accepted to the platform. Because of the number of respondents to the questionnaires, Green only uses the data submitted to make a recommendation for adding a new manager.
- Comment: By failing to conduct a thorough review of the managers' information, Green has not satisfied the requirements of Standard V(A).
 - Before recommending a firm for inclusion he must go beyond considering only the information provided by the manager on the request for proposal questionnaire.

Standard V(A): Case 17

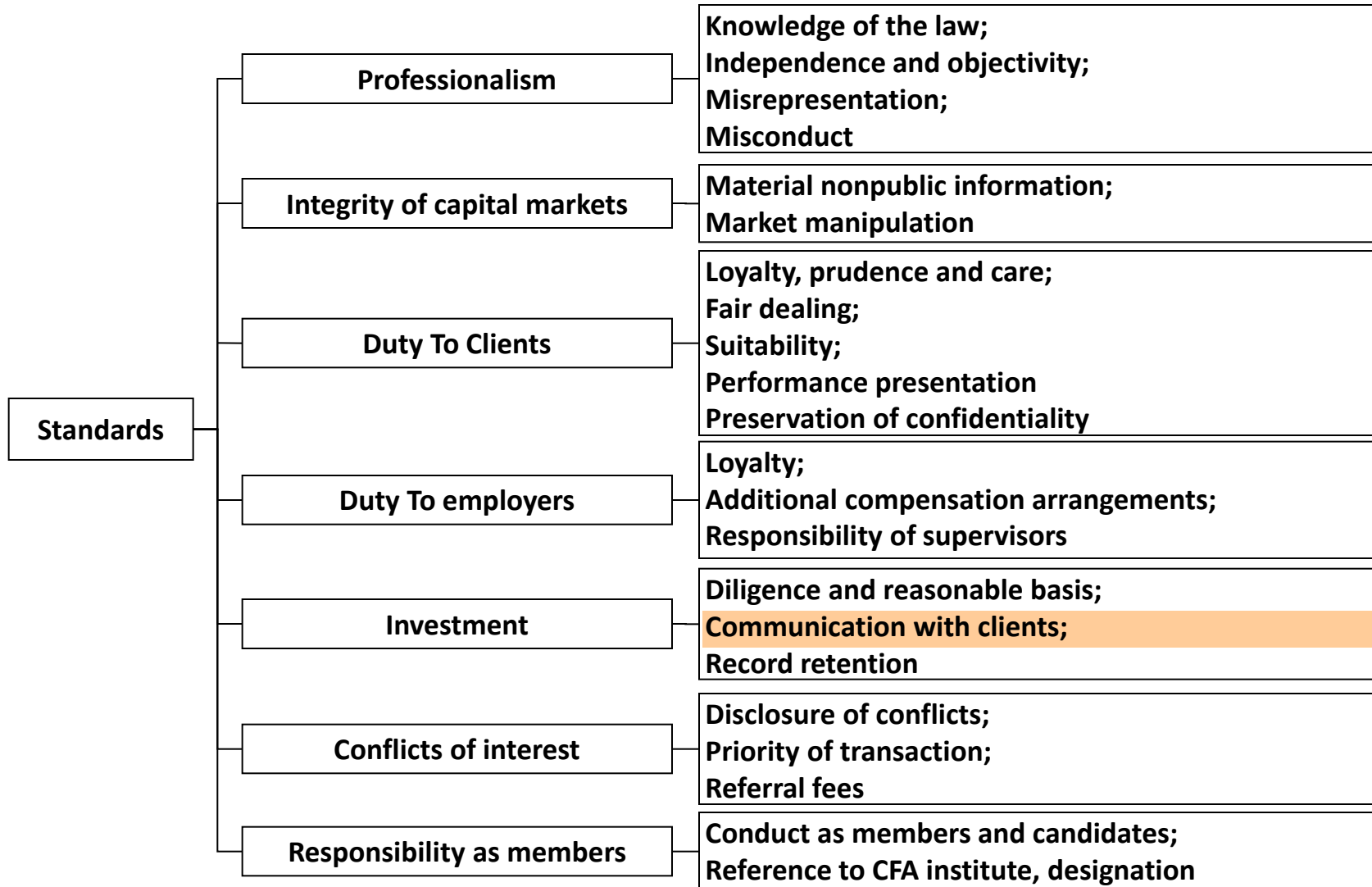
- **Case 17 *** (Technical Model Requirements, NEW)** Jérôme Dupont is in charge of developing and updating credit risk models. His models need to be regularly updated with the latest market data. Dupont does not interact with or manage money for any of the firm's clients. John Smith has only very superficial knowledge of the model and asks very basic questions regarding the output recommendations. However, Smith does not consult Dupont with respect to finalizing his clients' investment strategies. Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. Dupont thus neglecting 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 following the quick "fix", another set of diagnostic statistics reveals nonsensical results and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Smith. Smith realizes that some of the prior trades he performed were due to erroneous model results. Smith reverses the trades in question without reporting the issue to anyone else.

Standard V(A): Case 17

➤ Comment:

- Smith violated standard V(A), 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) 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-programmed analytical tools they use. Such validation should occur before incorporating the tolls into their decision-making process.
- See also Standard V(B)-Communication with Clients and Prospective Clients.

Guidance for Standards I-VII



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(new)*

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 limiting factors that influence a client's or potential client's investment decision.
 - Examples of such factors and attributes include but are not limited to investment liquidity and capacity.
 - ✓ **Liquidity** is the ability to liquidate an investment on a timely basis at a reasonable cost.
 - ✓ **Capacity** is the investment amount beyond which returns will be negatively affected by new investments.
12. Members and candidates have to disclose significant risks known to them at the time of the disclosure.
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(new)

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 for Compliance

➤ Recommended Procedures for Compliance

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 1-2

- **Case 1* (sufficient disclosure of investment system)** Williamson is marketing a sophisticated new model to high-net-worth investors. To simplify the newsletter, she includes only each week's top-five recommendations and to leave out details of the valuation models and the portfolio-structuring scheme.
 - **Comment:** Williamson violated Standard V (B) by not including all the relevant factors behind the investment advice.
- **Case 2* (providing opinions as facts)** Dox, a mining analyst, included in his report his own assessment of the geological extent of mineral reserves likely to be found on the subject company. He wrote, "Based on **the fact** that the company has 500,000 ounces of gold to mined, I recommend a strong buy."
 - **Comment:** Dox's assessment of the gold reserve is a opinion not a fact, he just did not distinguish fact from opinion. It's a violation.

Standard V(B): Case 3-4

- **Case 3 (proper description of a security)** Thomas, an analyst specializing in bond trading, describes an investment strategy to exploit interest rate movement to clients. Citing the proprietary nature of the strategy, he does not include details concerning probable return in the scenarios nor in the contrary situation.
- **Comment:** Thomas violated Standard V (B) by failing to describe the **basic characteristics** of the actual and implied risk of the investment strategy.
- **Case 4* (notification of fund mandate change)** MAA is a successful small cap manager with increasing new clients. For liquidity purpose, the CIO decides to lift the maximum **market-cap ceiling** from 250 million to 500 million and informs prospective clients and third-party consultants.
- **Comment:** The CIO must also inform the existing clients about this material change otherwise he violated Standard V (B).

Standard V(B): Case 5-6

- **Case 5 (notification of fund mandate change):** . Continued with Case 4, MAA extends its small-cap universe to include non-US stock rather than lifting the ceiling for its universe.
 - **Comment:** Standard V(B) requires that May's CIO advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in domestic small-cap stocks.
- **Case 6 (notification of changes to the investment process)** RJZ is a value equity manager using multifactor models. After some successful back-testing analysis, the company decides to replace **its multifactor models** with a new DDM.
 - **Comment:** Because the introduction of a new model and different valuation model represents a material change in the investment process, RJZ must communicate to the firm's clients. RJZ is moving toward DDM that is at least partly dependent on the firm's forecasting skills. Clients would likely view that as a significant change rather than a mere refinement.

Standard V(B): Case 7-8

- **Case 7 (notification of changes to the investment process)** RJZ loses its chief architect of its multifactor valuation system and without informing its clients, the president decides to redirect the firm to indexing style.
 - **Comment:** The president violated Standard V (B) by failing to disclose to clients a substantial change to its investment process.
- **Case 8 (notification of changes to the investment process)** FAM has just changed its internal investment policy whereby the responsibility for selecting stock from outside the firm's approved list is shifted from individual analyst to a committee. Morales, a manager in FAM, fails to notify her clients of the change.
 - **Comment:** It's a violation for Morales that did not disclose the process change to all her clients.

Standard V(B): Case 9

- **Case 9 * (Sufficient Disclosure of Investment System)** Chinn is the investment director for DAM, which manages the endowment of a charitable organization. Because of recent staff departures, DAM has decided to limit its direct investment to large-cap securities and supplement the needs for small-cap and midcap management by outside managers. In describing the plan to the charity, Chinn's letter states, "As investment director, I will directly oversee the investment team managing the endowment's large-capitalization allocation. I will coordinate the selection and ongoing review of external managers responsible for allocations to other classes." The letter also describes the reasons for the change and the characteristics external managers must have.
- **Comment:** Standard V(B) requires the disclosure of the investment process used to construct the portfolio of the fund. Changing the investment process from managing all classes of investments within the firm to the use of external managers is one example of information that needs to be communicated to clients.
 - Chinn and her firm have embraced Standard V(B) by providing their client with relevant information. The charity can make a reasonable decision about whether DAM remains the appropriate manager.

Standard V(B): Case 10

➤ **Case 10*** (Notification of Changes to the Investment Process)** Papis is the chief investment officer of the retirement fund. The fund uses outside advisers for the real estate allocation, and this info is clearly presented in all fund communications. In previous years, the performance of the real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend Nagel and seek better returns by moving real estate allocation to Accessible, which was founded by Nagel. The only notice of the change in adviser appears in the next annual report.

- **Comment:** Papis has violated Standard V(B). He attempted to hide the nature of his decision to change external managers by making only a limited disclosure. The plan recipients and the fund's trustees need to be aware when changes are made to ensure that operational procedures are being followed.
- See also Standard IV(C)–Responsibilities of Supervisors,
- Standard V(A)–Diligence and Reasonable Basis,
- Standard VI(A)–Disclosure of Conflicts.

Standard V(B): Case 11

- **Case 11 *** (Notification of Error, NEW)** Jérôme Dupont is in charge of developing and updating credit risk models. His models need to be regularly updated with the latest market data. 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 Smith very basic questions regarding the output recommendations. However, Smith does not consult Dupont with respect to finalizing his clients' investment strategies. Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. Dupont thus neglecting 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 following the quick "fix", another set of diagnostic statistics reveals nonsensical results and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Smith. Smith realizes that some of the prior trades he performed were due to erroneous model results. Smith reverses the trades in question without reporting the issue to anyone else.
- Comment: Smith violated V(B) by not disclosing a material error in the investment process. Clients should have been informed about the error and the corrective actions the firm was undertaking on their behalf.
 - See also Standard V(A)—Diligence and Reasonable Basis

Standard V(B): Case 12

- **Case 12 *** (Notification of Risks and Limitations, NEW)** Quantitative analyst Yuri Yakovlev, has developed a quantitative strategy that selects small-cap stocks on the basis of quantitative signals. After a thorough examination of the strategy's risks, stress testing, historical backtesting, and scenario analysis, QSC decides to seed the strategy with US\$10 million of internal capital. After two years, QSC decides to actively market the fund to large institutional investors. While creating the offering materials, Yakovlev informs the marketing team that the capacity of the strategy is limited. Yakovlev indicates that given the current market conditions, investments in the fund beyond US\$100 million of capital could become more difficult and negatively affect expected fund returns. Alan Wellard, the manager of the marketing team, thinks that the offering material should focus solely on the great track record of the fund. Yakovlev does not object because the fund with US\$12 million of capital is very far from the US\$100 million threshold.
- Comment: Yakovlev and Wellard have not appropriately disclosed a significant limitation associated with the investment product. Yakovlev believes this limitation, once reached, will materially affect the returns of the fund.
 - While the fund is currently far from the US\$100 million mark, current and prospective investors must be made aware of this capacity issue.
 - If significant limitations are complicated to grasp and clients do not have the technical background required to understand them, Yakovlev and Wellard should either educate the clients or ascertain whether the fund is suitable for each client.

Standard V(B): Case 13

- **Case 13*** (Notification of Risks and Limitations, NEW)** Brickell Advisers offers investment advisory services mainly to South American clients. Julietta Ramon, a risk analyst at Brickell, describes to clients how the firm uses value at risk (VaR) analysis to track the risk of its strategies. Ramon assures clients that calculating a VaR at a 99% confidence level, using a 20-day holding period, and applying a methodology based on an ex-ante Monte Carlo simulation is extremely effective. The firm has never had losses greater than those predicted by this VaR analysis.
- Comment: Ramon has not sufficiently communicated the risks associated with the investment process to satisfy the requirements of Standard V(B).
 - The losses predicted by a VaR analysis depend greatly on the inputs used in the model. The size and probability of losses can differ significantly from what an individual model predicts.
 - Ramon must disclose how the inputs were selected and the potential limitations and risks associated with the investment strategy.

Standard V(B): Case 14

- **Case 14*** (Notification of Risks and Limitations, NEW)** Lily Smith attended an industry conference and noticed that John Baker, an investment manager with Baker Associates attracted a great deal of attention from the conference participants. On the basis of her knowledge of Baker's reputation and the interest he received at the conference, Smith recommends adding Baker Associates to the approved manager platform. Her recommendation to the approval committee included the statement "John Baker is well respected in the industry and his insights are consistently sought after by investors. Our clients are sure to benefit from investing with Baker Associates."
- Comment: Smith is not appropriately separating facts from opinions in her recommendation to include the manager within the platform. Her actions conflict with the requirements of Standard V(B). Smith is relying on her opinions about Baker's reputation and the fact that many attendees were talking with him at the conference.
 - Smith should also review the requirements to Standard V(A) regarding reasonable basis to determine the level of review necessary to recommend Baker Associates.

Guidance for Standards I-VII



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(new)*

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 place greater responsibility on the individual for ensuring that all relevant information is retained.

➤ Guidance - *Local Requirements*

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

Standard V(C): Recommended Procedures for Compliance

➤ Recommended Procedures for Compliance

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 1-3

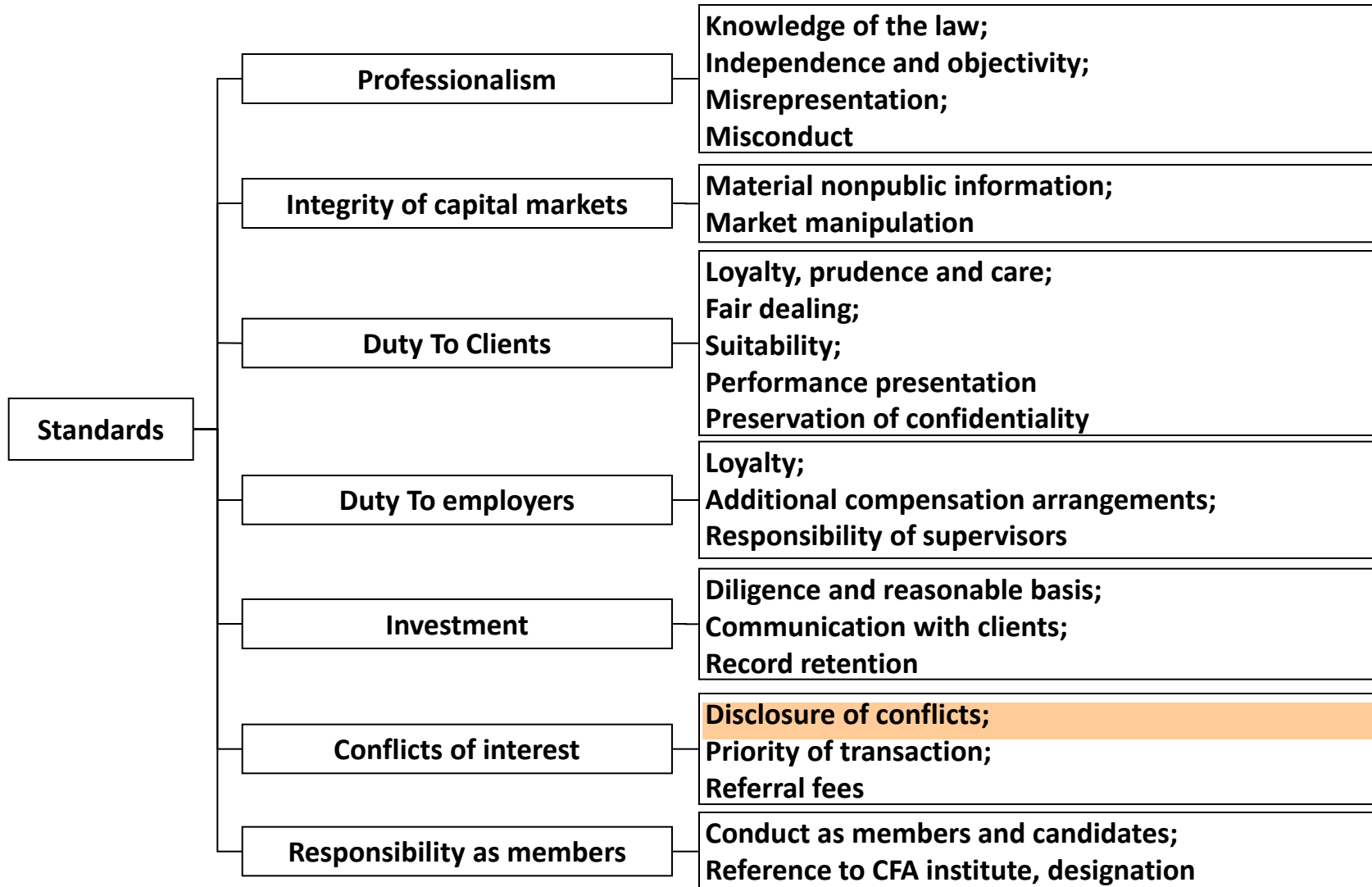
- **Case 1 (record retention and IPS objectives and recommendations):** One of Lindstrom's clients is complaining that his benchmark-oriented portfolio incurred severe losses in technology sector. The IPS of the clients mandates to follow benchmark and the portfolio technology weight is consistent with the benchmark and acknowledged by the client.
 - **Comment:** Lindstrom has not violated Standard V (C) as long as he has records indicating the investment management is consistent with the IPS and the records have been acknowledged by the clients.
- **Case 2 (record retention and research process, NEW):** Young, a luxury retail analyst, bases his report on various sources, including onsite company visits, interviews with management, customer surveys etc.
 - **Comment:** Young must carefully document and keep records of all the information that goes into his report, including secondary or third-party research.
- **Case 3 (records as firm, not employee, property):** Blank has successfully developed an analytical model while working at GPIM, now he is hired by one of the GPIM's competitors. Blank takes copies of the records supporting the model to his new firm.
 - **Comment:** The records created by Blank supporting the research model he developed at GPIM are the records of GPIM. He can't take the record without the permission of GPIM. Blank must re-create the records supporting his model at the new firm. Violate IV(A). NOT V(C)

Example: Standard V(C) Record Retention

- George, CFA, is a fund manager working for the general partner of a new private equity fund. George includes in the fund marketing material his performance history from his previous employer. He is permitted by his former employer to take his historical return figures and the supporting research reports he used to make the related investment decisions. Did George most likely violate the CFA Institute Code of Ethics and Standards of Professional Conduct?
- A. Yes, regarding Record Retention.
 - B. No.
 - C. Yes, regarding Loyalty.

Solution: A

Guidance for Standards I-VII



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 for Compliance

➤ Recommended Procedures for Compliance

11. Disclosure of performance arrangement

- Firms are encouraged to include information on compensation package in firms' promotional literature.
- If fee based on capital gains or capital appreciation (performance fee), should disclose;
- If outstanding options exist for incentives, should disclose the amount and expiration date of these options as a footnote to any research report published.

12. Incentive fees should not be in conflict with the interests of clients'.

- If Yes, should disclose to clients;
- If employer not permit disclosure, should dissociate, or quit the job.

Standard VI(A): Case 1-3

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

Standard VI(A): Case 4-5

- **Case 4 (conflicts of interest and personal stock ownership):** Robert is speculating in penny stocks and buys 100,000 shares of D. Mining. Then she is asked to write a report on the penny stock in the mining industry. Robert would recommend D. Mining even without owning it.
 - **Comment:** Robert must disclose the ownership in the report and to her employer before writing the report.
- **Case 5*** (conflicts of interest and compensation arrangement):** Dyson is managing pension funds with long term objectives. After his employer introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance, Dyson changes his strategy and buys high beta stocks to boost short term performance without changing the IPS.
 - **Comment:**
 - ✓ Dyson violated Standard VI (A) by failing to inform her clients of the changes in her compensation arrangement that created a conflict of interest.
 - ✓ Also violate III (C) and I(B)

Standard VI(A): Case 6-7

- **Case 6 (conflicts of interest and options and compensation arrangement):** Wayland Securities often takes agent options for undertaking small issues to compensate relatively small fees. Hunter, the head of Wayland, worries about the agent option for FRL, a small IPO client, will expire with no profit. She indicates Fitzpatrick, an analyst at research dept., that he is eligible for 30% of the option and should give some additional coverage to FRL. Fitzpatrick agrees and immediately issues a favorable report.
- **Comment:** Fitzpatrick must disclose in the report the volume and the expiration date of the option otherwise he would violate Standard VI (A), I(B), V(A) and II(B).
- **Case 7 (conflicts of interest and compensation arrangement):** Carter is approached by a 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.
- **Comment:** Carter violated Standard VI (A) by failing to disclose the additional compensation to his clients and employer, this conflict of interest would interfere his independence and objectivity.
 - Violate IV(B) → VI(A) → I(B)

Standard VI(A): Case 8-9

- **Case 8 (conflicts of interest and directorship):** Corky, a manager of a small investment firm, recently involved as a trustee with a very large nonprofit foundation. Corky thinks it's not necessary to inform his firm his involvement with the foundation because the asset level of the foundation is too large for his firm.
- **Comment:** Corky violated Standard VI (A) by not informing her employer his involvement as trustee. **Outside job must be disclosed.**
 - Violate IV(B)→VI(A)→I(B); Also violate IV(A)
- **Case 9 (conflicts of interest and personal trading):** Smith buys a Russian equity-linked note linking to telecom industry for his personal account as he thinks his firm would not be interested in such a security. Later, Smith decides that the firm should invest in Russian equity-linked notes and write a report that concludes to purchase several notes including the same one in Smith's personal account.
- **Comment:** Smith violated Standard VI (A) **by failing to disclose his ownership of the equity-linked notes in the report.** Also, before buying the notes, Smith should make sure whether it is appropriate personal trading according to the firm's policy. Also violate I(B)

Standard VI(A): Case 10

- **Case 10** (Conflict of Interest and Requested Favors)** Papis is the chief investment officer of the retirement fund. The fund uses outside advisers for the real estate allocation, and this info is clearly presented in all fund communications. In previous years, the performance of the real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend Nagel and seek better returns by moving real estate allocation to Accessible, which was founded by Nagel. The only notice of the change in adviser appears in the next annual report.
- **Comment:** Papis has violated Standard VI(A) by not disclosing to his employer his personal relationship with Nagle. Disclosure of his past history with Nagle would allow his firm to determine whether the conflict may have impaired Papis's independence in deciding to change managers.
 - See also Standard IV(C)–Responsibilities of Supervisors,
 - Standard V(A)–Diligence and Reasonable Basis,
 - Standard V(B)–Communication with Clients and Prospective Clients.

Standard VI(A): Case 11

- **Case 11* (Conflict of Interest and Business Relationships)** Wade, trust manager for a bank, was approached by Western Funds about promoting its funds. To entice the bank to promote, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee, Wade asked one of the investment managers to review the Western Funds family of funds to determine whether they were suitable for clients of the bank. The manager completed due diligence and determined that the funds were fairly valued. Wade decided to accept Western's offer and instructed portfolio managers to exclusively promote these funds and the service-fee class to clients. Not to influence the investment managers, Wade did not disclose the fee and allowed that income to flow directly to the bank.
- **Comment:** Wade is violating VI(A) by not disclosing the portion of the service fee. Although the investment managers may not be influenced by the fee, neither they nor the client have the proper information about Wade's decision to exclusively market this fund family and class of investments. The bank may rely on the new fee as a component of the firm's profitability and may be unwilling to offer other products in the future that could affect the fees received.
 - See also Standard I(B)–Independence and Objectivity.

Standard VI(A): Case 12

- **Case 12*** (Disclosure of Conflicts to Employers, NEW)** Yehudit Dagan is a portfolio manager for Risk Management Bank (RMB), whose clients include retirement plans and corporations. RMB provides a defined contribution retirement plan for its employees that offers 20 large diversified mutual fund investment options, including a mutual fund managed by Dagan's RMB colleagues. Currently, Dagan invests her retirement plan assets in five of the investment options, all of which are mutual funds managed by other companies. She is now planning to invest in two additional fund options; one of which is the fund managed by her RMB colleagues. Dagan is concerned about the paperwork that would be required for her to disclose her retirement account holdings to RMB and to receive preclearance for her transactions.
- Comment: Standard VI(A) would not require Dagan to disclosure her personal or retirement investments in large diversified mutual funds, unless specifically required by their employer. For practical reasons the standard does not require Dagan to gain preclearance for ongoing payroll deduction contributions to retirement plan account investment options.
 - Dagan should ensure that her firm does not have a specific policy regarding investment—whether personal or in the retirement account—for funds managed by the company's employees. These mutual funds may be subject to the company's disclosure, preclearance, and trading restriction procedures to identify possible conflicts prior to the execution of trades.

Guidance for Standards I-VII



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 the beneficial owner, 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.

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 for Compliance

➤ Recommended Procedures for Compliance:

11. Basic procedures:

- ✓ Limited participation in equity IPOs;
- ✓ Restrictions on private placement;
- ✓ Establish blackout/restricted periods;
- ✓ Should have reporting procedures for investment personnel, including:
 - ◆ disclosure of personal holdings/beneficial ownerships at least annually
 - ◆ duplication of confirmations 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 through reporting requirements.
- ✓ Disclosures of policies

Standard VI(B): Case 1-2

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

Standard VI(B): Case 3-4

- **Case 3*** (personal trading and disclosure):** Michaels is leading a luxury life with a low paying job as a investment staff serving both the research depart. and the investment management depart. The director of the company investigates and discovers that Michaels has made front running trading based on firms recommendations. **Michaels declined to complete his quarterly personal transaction form.**

- **Comment:**

- ✓ Michaels violated Standard VI (B) by placing personal trading ahead of client transactions.
- ✓ And his supervisor violated Standard IV (C) for having not prevented this.
- ✓ Michaels violated Standard II(A) for serving both the research department and investment management department.

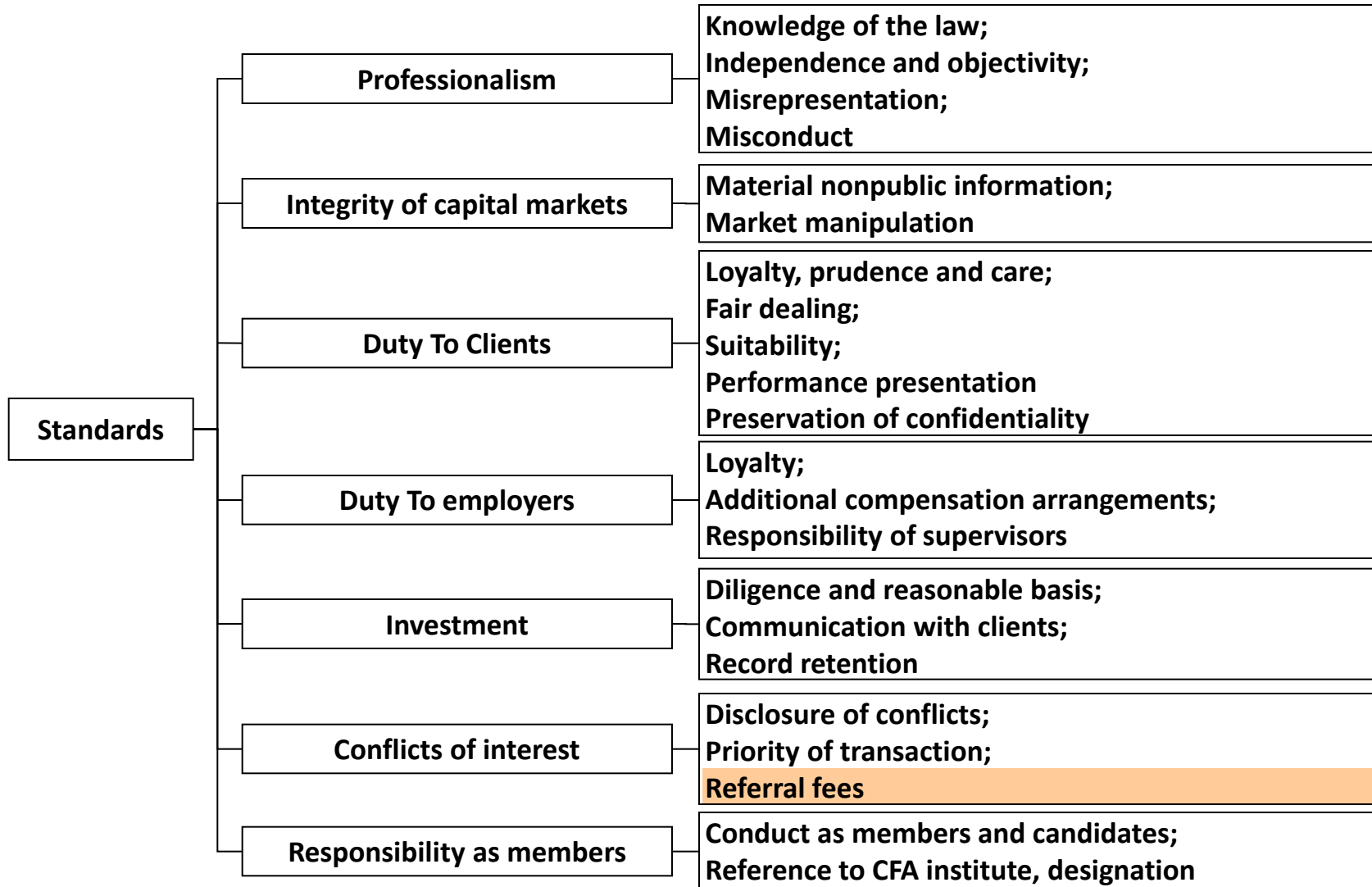
- **Case 4* (trading prior to report dissemination):** Seven minutes after informed the sell recommendation for a stock in an in-house meeting, Riley closes out a long call option in that stock and establishes a sizable put position. She claims she took this to facilitate clients' sales.

- **Comment:** Riley exploited the sell recommendation and did not give customers the opportunity to act before the firm itself did. It's a violation.

Standard VI(B): Case 5

- **Case 5*** (Family accounts as equal):** Toffler, a portfolio manager at Esposito, manages retirement account established with the firm by her parents. Whenever IPOs is available, she first allocates shares to all her other clients for whom the investment is appropriate; only then does she place remaining portion in her parents' account if appropriate.
- Comment: As fee-paying clients, Toffler's parents are entitled to the same treatment as other clients. So Toffler also **violated III(B)**, but **not VI(B)**.

Guidance for Standards I-VII



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
 - ✓ any partiality shown in any recommendation of services
 - ✓ the full cost of the service.
3. Disclose nature of consideration.

Standard VI(C): Recommended procedures for compliance

➤ Recommended procedures for compliance

- 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 1-2

- **Case 1 (disclosure of referral arrangements and outside parties):** BSI, a broker, enters a referral arrangement with LBL, a consulting firm. BSI directs certain prospective accounts to LBL in exchange for research service and commission business. Maxwell Inc., contacts White, a partner at LBL, and says they want him to serve as an investment manager for them. White accepted but did not disclose the referral arrangement.
- **Comment:** White violated Standard VI (C) by failing to inform the client the **referral fee** payable in services and commissions to BSI. Such disclosure could have caused Maxwell to reassess this plan and make a critical evaluation of LBL services.
- **Case 2 (disclosure of interdepartmental referral arrangements):** Handley works for the trust dept. at CTB and receives compensation for each referral he makes to brokerage dept and the personal management dept. at CTB. He refers several clients to personal management dept. and does not disclose the referral arrangement.
- **Comment:** Handley has violated Standard VI (C) by failing to disclose the referral arrangement even within the firm.

Standard VI(C): Case 3-4

- **Case 3 (disclosure of referral arrangements and informing firm):** Roberts, a portfolio manager at KI managing assets for high-net-worth individuals, directs a large portion of its commissions to her alumni's firm, NI, which provides not-so-useful research reports. In return, NI recommends the investment services of Roberts to its wealthiest clients. This arrangement is not disclosed to either KI or the clients referred by NI.
- **Comment:** Roberts violated Standard VI (C) by failing to inform her employer of the referral arrangement.
- **Case 4 (disclosure of referral arrangements and employer compensation):** Wen, a portfolio manager for a bank, receives additional monetary compensation from his employer when he is successful in assisting in sales process and generation of assets under management.
- **Comment:** The best practice is to disclose the additional arrangement to clients which allows clients to determine whether there is any partiality on the part of the manager.

Standard VI(C): Case 5

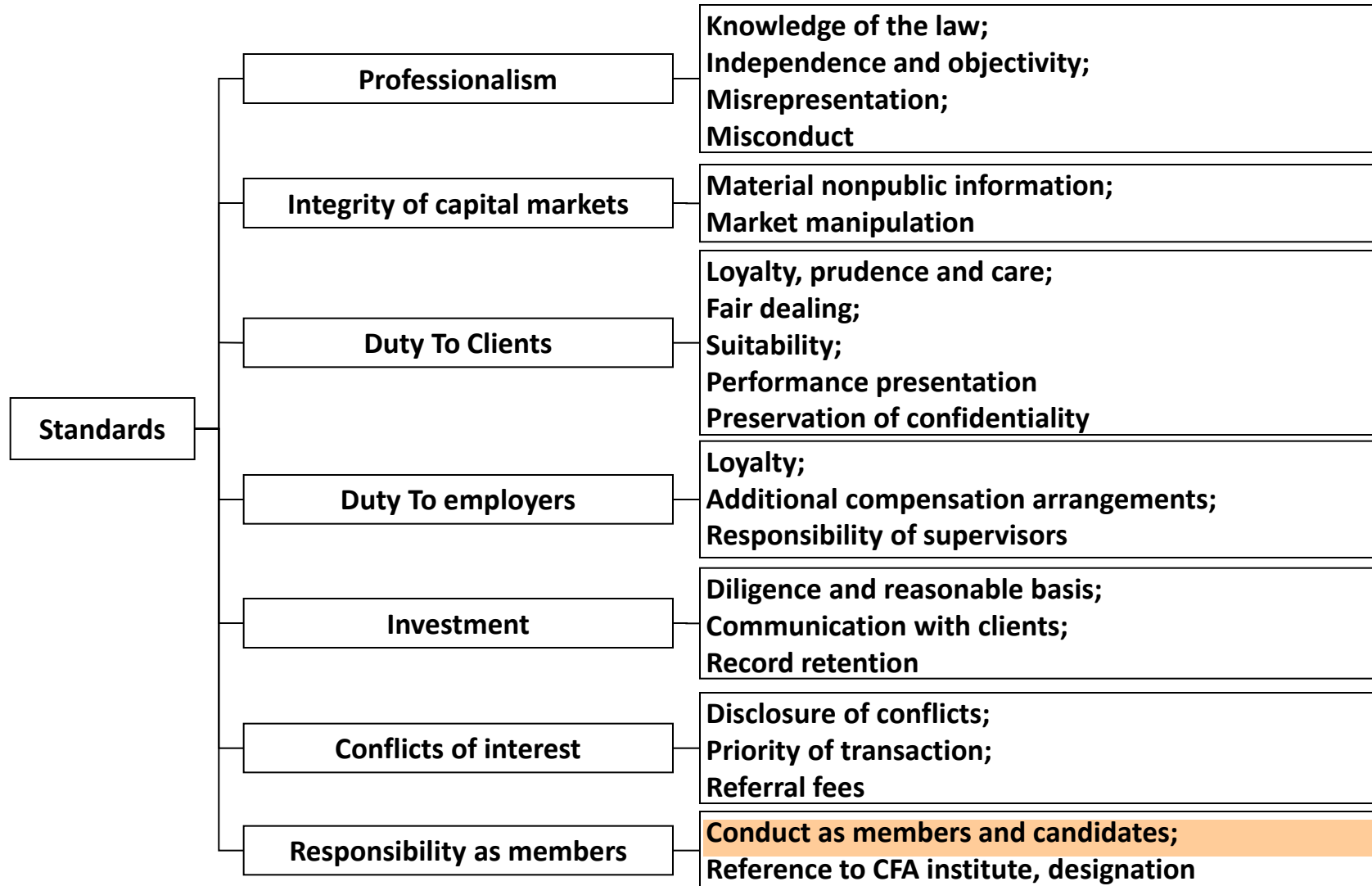
- **Case 5 (Disclosure of Referral Arrangements and Outside Organizations)** Burl is a portfolio manager at HI, an investment advisory firm. Burl is on the advisory board of his child's school, which is seeking to raise money to purchase new playground. Burl discusses a plan with his supervisor in which he will donate to the school a portion of his service fee from new clients referred by the parents. After approved by HI, Burl presents the idea to the school's board. The school agreed the program and asks Burl to provide written materials for distribution. A week after distribution, Burl receives the first referral. In establishing the client's IPS, Burl clearly discusses the school's referral and outlines the plans for distributing the donation back to the school.
- **Comment:** Burl has not violated Standard VI(C) because he secured the permission of his employer, HI, and the school prior to beginning the program and because he discussed the arrangement with the client at the time the IPS was designed.

Standard VI(C): Case 6

➤ **Case 6** (Disclosure of Referral Arrangements and Outside Parties)** The sponsor of a pension is seeking to hire a firm to manage the pension plan's emerging market allocation. Arrow is contracted by the sponsor to represent its best interest in selecting the most appropriate new manager. The process runs smoothly, and Overseas Investments is selected as the manager. The following year, Arrow is under investigation for accepting kickbacks from investment managers. Overseas is involved. Although the sponsor is happy with the performance of Overseas, the sponsor still decides to have an independent review of the proposals and the selection process to ensure that Overseas was the appropriate firm. The review confirms that, the recommendation of Overseas is objective and appropriate, even though Arrow was being paid by both parties.

- **Comment:** Arrow has violated Standard VI(C) for not disclosing the fee being paid by Overseas. Thus raises the question of a potential lack of objectivity in the recommendations.
- Regulators and governmental agencies may adopt requirements of allowable consultant activities. Regulator policies may prohibit acceptance of payments from investment managers receiving allocations and require regular reporting of contributions made to political organizations and candidates. Arrow would have to adhere to these requirements as well as the Code and Standards.

Guidance for Standards I-VII



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 prohibits candidates from disclosing confidential material gained during the exam process.

➤ 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 1-2

- **Case 1. (Sharing Exam Questions)** Nero reviews a copy of the Level II exam on the evening prior to the exam's administration and provides information concerning the exam questions to two candidates who use it to prepare for the exam.
 - **Comment:** Nero and the two candidates have violated Standard VII(A).
- **Case 2. (Bring Written Material into Exam Room)** Prior to entering the exam room, Sullivan writes the formula on the palm of his hand. During the afternoon section of the exam, a proctor notices Sullivan looking at the palm of his hand. She asks to see his hand and finds the formula to be readable.
 - **Comment:** Sullivan's conduct compromised the validity of his exam performance and violated Standard VII(A). Sullivan's conduct was also in direct contradiction of the rules and regulations of the CFA Program, the Candidate Pledge, and the CFA Institute Code and Standards.

Standard VII(A): Case 3-4

- **Case 3. (Writing after Exam Period End)** The proctors announce that all candidates are to stop writing immediately. John Davis continues to randomly fill in ovals on his answer sheet. A proctor reminds him that he should stop writing immediately. Davis, however, continues to complete the answer sheet. After the proctor asks him to stop writing two times, Davis finally puts down his pencil.
- **Comment:** By continuing to complete his exam after time was called, Davis has violated Standard VII(A).
- **Case 4. (Sharing Exam Content)** 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) 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) and the Candidate Pledge.

Standard VII(A): Case 5-6

- **Case 5. (Sharing Exam Content)** The week after completing the Level I examination, Gagne and several others begin a discussion thread on the forum about the most challenging questions and attempt to determine the correct answers.
- **Comment:** Gagne has violated Standard VII(A) by providing and soliciting confidential exam information. The group's discussion included question-specific details considered to be confidential to the CFA Program.
- **Case 6. (Sharing Exam Content)** The day after the CFA examination, CFA4Sure sends an e-mail to all its customers asking them to share with the company the hardest questions from the exam. Marisol Pena e-mails a summary of the questions she found most difficult on the exam.
- **Comment:** Pena has violated Standard VII(A) by disclosing a portion of the exam questions. If the CFA4Sure employees who participated in the solicitation of confidential CFA Program information are CFA Institute members or candidates, they also have violated Standard VII(A).

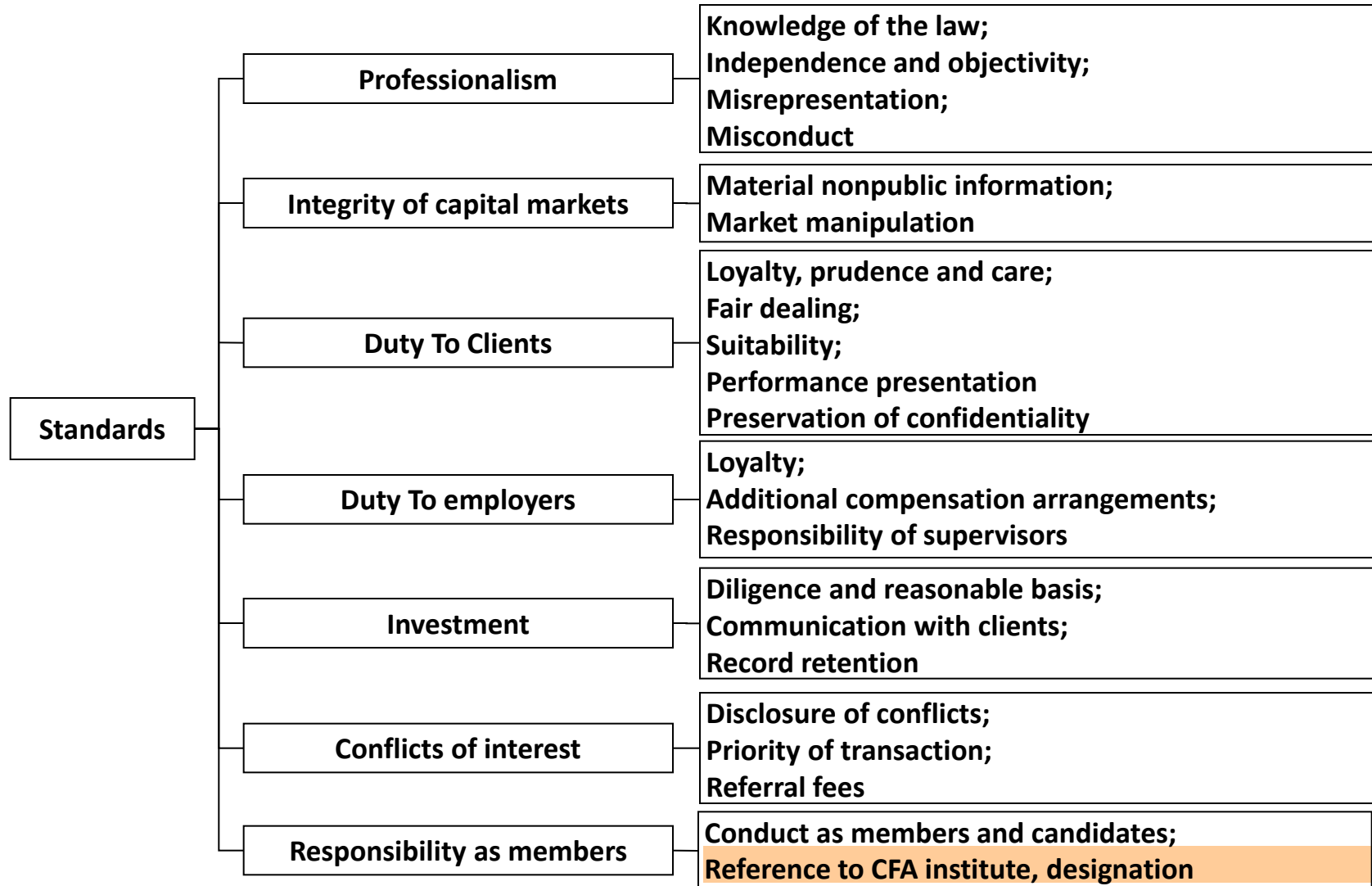
Standard VII(A): Case 7

- **Case 7. (Discussion of Exam Grading Guidelines and Results)** Prior to participating in grading CFA examinations, Wesley Whitcomb is required to sign a CFA Institute Grader Agreement. As part of the Grader Agreement, Whitcomb agrees not to reveal or discuss the exam materials with anyone except CFA Institute staff or other graders. Several weeks after the conclusion of the CFA exam grading, Whitcomb tells several colleagues who are candidates in the CFA Program which question he graded. He also discusses the guideline answer and adds that few candidates scored well on the question.
- **Comment:** Whitcomb violated Standard VII(A) by breaking the Grader Agreement and disclosing information related to a specific question on the exam, which compromised the integrity of the exam process.

Standard VII(A): Case 8-9

- **Case 8. (Compromising CFA Institute Integrity as a Volunteer)** Jose Ramirez is a IR consultant. 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).
- **Case 9. (Compromising CFA Institute Integrity as a Volunteer)** As a member of the Executive Committee, Marguerite Warrenski has advance knowledge of confidential information regarding the GIPS standards. She tells her clients that her Executive Committee membership will allow her to better assist her clients in keeping up with changes to the Standards and facilitating their compliance with the changes.
- **Comment:** Warrenski is using her association with the GIPS Executive Committee to promote her firm's services to clients and potential clients. In defining her volunteer position at CFA Institute as a strategic business advantage over competing firms and implying to clients that she would use confidential information to further their interests, Warrenski is compromising the reputation and integrity of CFA Institute and thus violating Standard VII(A).

Guidance for Standards I-VII



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 a statement of fact,
 - ✓ but must not over-promise the competency and future investment results

Standard VII(B): Recommended procedures

➤ Recommended procedures for compliance

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

Standard VII(B): Case 1-2

- **Case 1. (Passing Exams in Consecutive Years)** An advertisement for AZ Investment Advisors states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.
- **Comment:** AZ may state that all principals passed the three examinations on the first try as long as this statement is true, but it must not be linked to performance or imply superior ability. Implying that (1) CFA charterholders achieve better investment results and (2) those who pass the exams on the first try are more successful would violate Standard VII(B).
- **Case 2. (Right to Use CFA Designation)** Louis Vasseur resigns his position as an investment analyst and traveling abroad. He does not file a completed Professional Conduct Statement and does not pay his CFA Institute membership dues. At the conclusion of his travels, without reinstating his CFA Institute membership by filing his Professional Conduct Statement and paying his dues, he prints business cards that display "CFA" after his name.
- **Comment:** Vasseur has violated Standard VII(B) because his right to use the CFA designation was suspended when he failed to file his Professional Conduct Statement and stopped paying dues.

Standard VII(B): Case 3-4

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

Asia Futures Ltd.



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

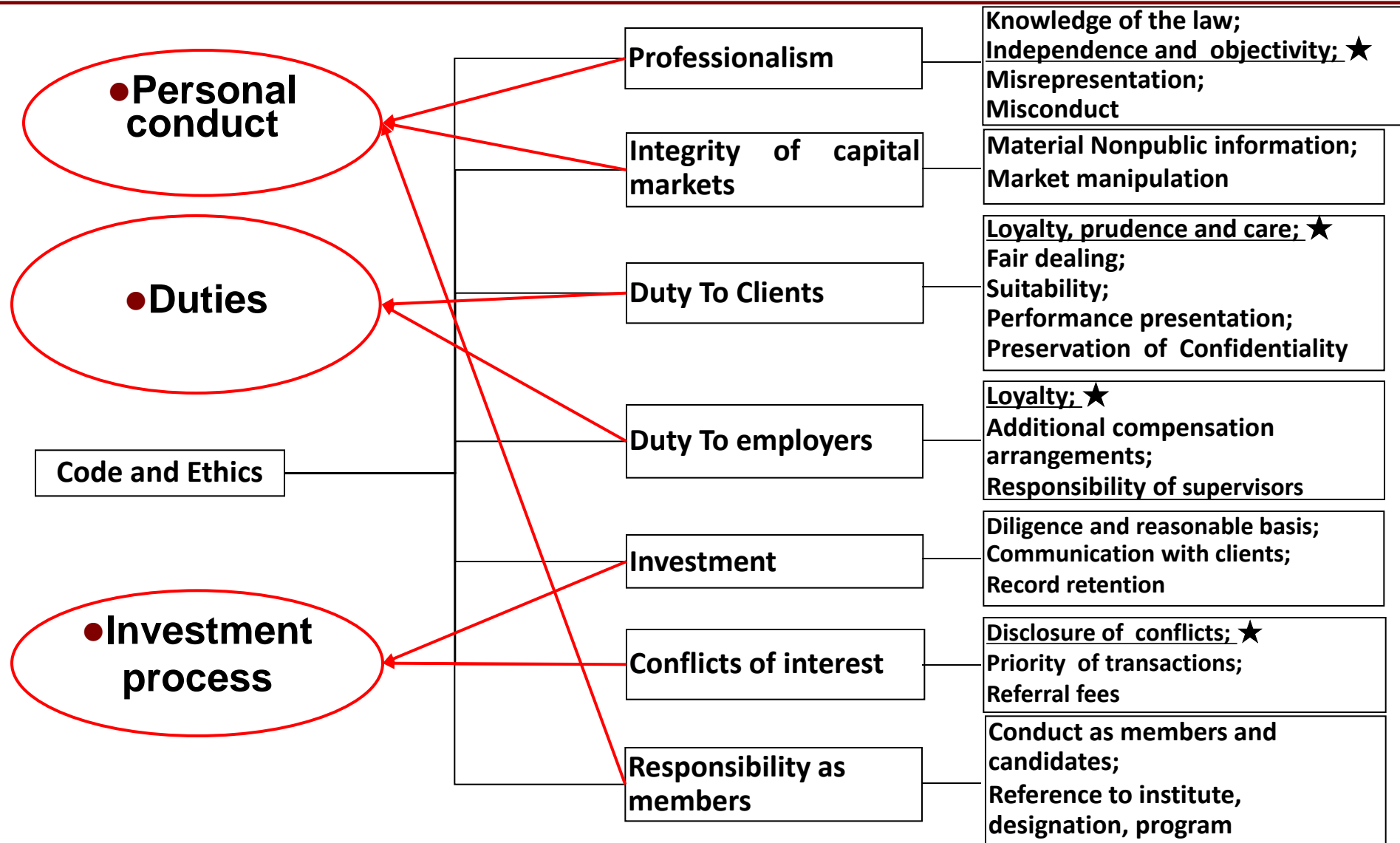
Standard VII(B): Case 5-6

- **Case 5. (Stating Facts about CFA Designation and Program)** Rhonda Reese has been a CFA charterholder since 2000. In a conversation with a friend who is considering enrolling in the CFA Program, she states 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). Her statements refer to facts: The CFA Program enhanced her knowledge, and many firms require the CFA designation for their investment professionals.
- **Case 6. (Order of Professional and Academic Designations)** Tatiana Prittima has earned both her CFA designation and a PhD in finance. She would like to cite both her accomplishments on her business card but is unsure of the proper method for doing so.
- **Comment:** The order of designations cited on such items as resumes and business cards is a matter of personal preference. Prittima is free to cite the CFA designation either before or after citing her PhD.

Standard VII(B): Case 7

- **Case 7 (Use of Fictitious Name, NEW)** Barry Glass is the lead quantitative analyst at CityCenter Hedge Fund. Glass is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Glass reads several high-level mathematical publications and blogs to stay informed on current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Glass is under pressure from firm executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research to updated output recommends several new investments to the fund's portfolio managers.
- Comment: "Expert CFA" has violated Standard VII(B) by using the CFA designation inappropriately.
 - As with any research report, authorship of online comments must include the charterholder's full name along with any reference to the CFA designation.

Summary of Seven Standards



Contrast between some similar standards

1: I(C) Misrepresentation, III(D) performance Presentation, V(B) Communication with clients

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

➤ TIPS

- IV(B) → VI(A) → I(B)
- III(D) → I(C)

Contrast between some similar standards

➤ Contrast between some similar standards

I(C) Misrepresentation	<u>所有的</u> 不正当陈述
III(D) Performance presentation	<u>业绩的</u> 不正当陈述
V(B) Communication with Clients and Prospective Clients	向客户 <u>披露自身的变化</u> ，并且区分事实与意见

Contrast between some similar standards

2: III(B) Fair dealing, VI(B) Priority of Transactions

- III(B) focuses on constraining the fairness of the order of transaction between clients
- VI(B) focuses on the order of transaction among clients, individuals and employers

3: IV(B) Additional compensation arrangement, VI(A) Disclosure of Conflicts

- IV(B) focuses on disclosing the additional compensation from clients and the third-party to the employer
- VI(A) focuses on disclosing the possible interest conflict to clients and public, so that clients can have right judgments

Contrast between some similar standards

➤ Contrast between some similar standards

III(B) Fair Dealing	<u>客户之间</u> 的交易优先顺序
VI(B) Priority of Transactions	客户>雇主>个人

IV(B) Additional Compensation Arrangements	为 <u>雇主的利益</u> ，向其披露额外收入
VI(A) Disclosure of conflicts	为 <u>客户及公众的利益</u> ，向其披露额外收入

Frame work of this course

- Code of Ethics
- Guidance for Standards I-VII
- Global Investment Performance Standards (GIPS)

Introduction to GIPS - Who can claim compliance

II. Who can claim compliance

- Complying with the GIPS standards is voluntary
- Only an investment management firm that actually manage assets can claim compliance with the Standards.
 - Plan sponsors & consultants → can't claim compliance unless actually manage assets.
 - Software (and vendor of software) cannot be compliant → can assist firms in compliance with GIPS
- Firm-wide and full compliance
 - Can't be achieved on a single product or composite.
 - Two options: (1) Fully comply with all requirements; (2) Not comply with all requirements and not claim compliance

Introduction to GIPS - Composites

IV. Composites

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

Introduction to GIPS - Verification

V. Verification

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

GIPS – Key characteristics

➤ Definition of Firm

- The definition should reflect the “distinct business entity” that is held out to clients and prospects as the investment firm .
- GIPS are ethical standards for performance presentation which ensure fair representation of results and full disclosure .

➤ Key characteristics

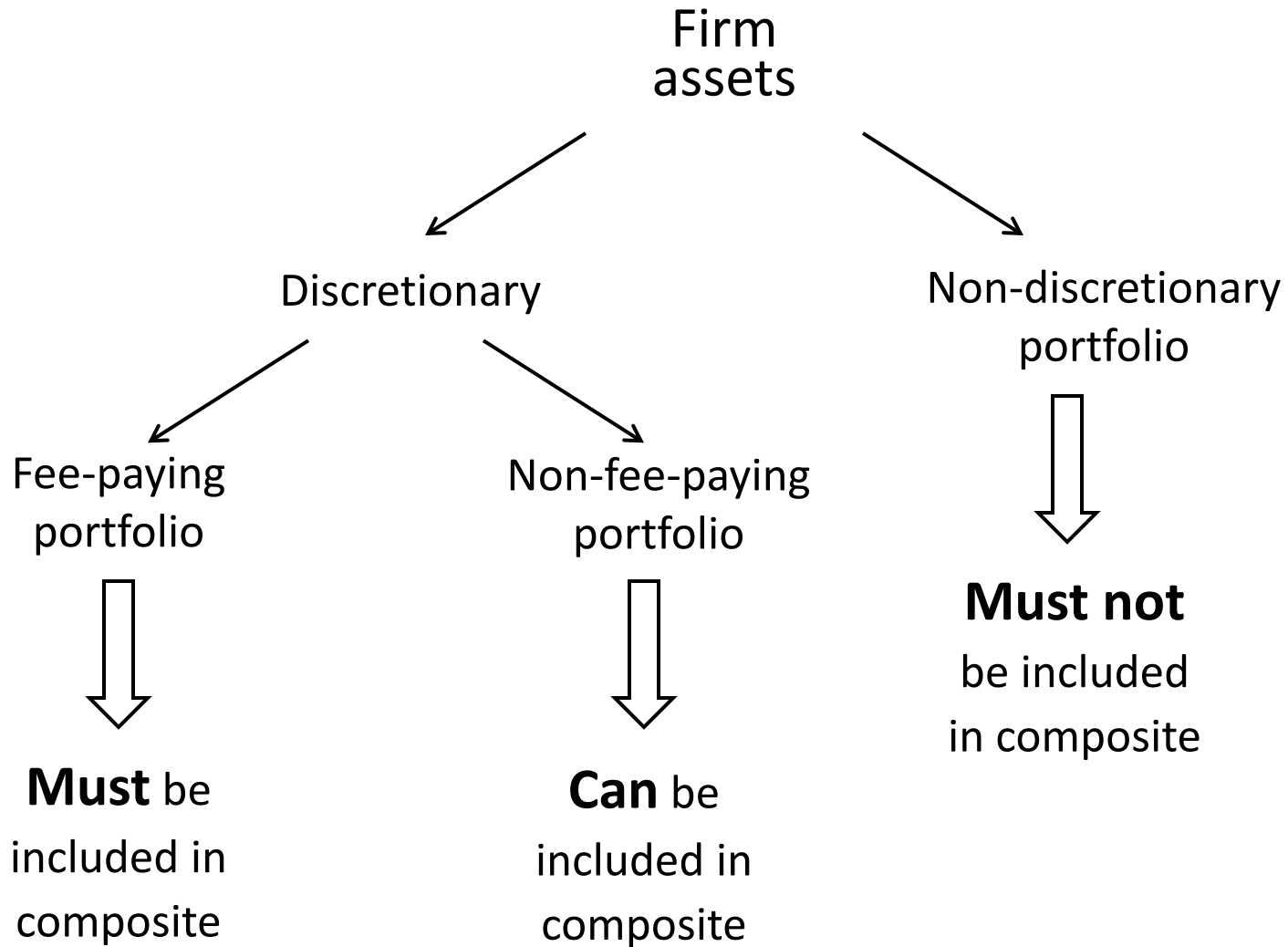
- Include all actual fee-paying, discretionary portfolios in composites for a minimum of 5 years or since firm or composite inception. After presenting five years of compliant data, the firm must add annual performance each year going forward up to a minimum of 10 years.
 - ✓ 公司只成立3年怎么办？
 - ✓ 公司有15年的业绩数据，怎么处理？
- No partial compliance and only full compliance can be claimed.

GIPS – Objectives & Key characteristics

➤ Key characteristics (con't)

- Firms are required to use certain calculation and presentation standards and make specific disclosures.
 - ✓ E.g. composite → asset weighted
- GIPS contain both required and recommended provisions.
- Follow the local laws for cases in which a local or country-specific law or regulation conflicts with GIPS , but disclose the conflict.

Introduction to GIPS - Composites



GIPS - Nine major sections of GIPS

Nine major sections of GIPS

0. Fundamentals of compliance

1. Input data

2. Calculation methodology

3. Composite construction

4. Disclosure

5. Presentation and reporting

6. Real estate

7. Private equity

8. Wrap fee/Separately Managed Account Portfolios

GIPS - Fundamentals of compliance

0. Fundamentals of compliance

- Firm-wide basis
 - Compliance cannot be achieved on a single product or composite.
- Full compliance
 - If the Firm does not meet all the requirements of the GIPS standards, must not represent or state that it is “in compliance with the Global Investment Performance Standards except for...”
- Statements referring to the calculation methodology as being “in accordance,” “in compliance,” or “consistent” with the Global Investment Performance Standards, or similar statements, are ***prohibited***.
- Firms must document their policies and procedures used in establishing and maintaining compliance with the GIPS standards
- Statements referring to the calculation methodology as being “in accordance”, “in compliance,” or “consistent” with the Global Investment Performance Standards, or similar statements, are prohibited.

GIPS - Fundamentals of compliance

0. Fundamentals of compliance (con't)

- Statements referring to the performance of a single, existing client portfolio as being “calculated in accordance with the Global Investment Performance Standards” are prohibited, except when a GIPS-compliant firm reports the performance of an individual client’s portfolio to that client.
- 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 client has received a compliant presentation within the previous 12 months, the firm has met this requirement.
- Firms must provide a complete list of composite descriptions to any prospective client on request. Must include **terminated composites on the firm’s list of composite descriptions for at least five years** after the composite termination date.
- Firms must provide a compliant presentation for any composite listed on the firm’s list of composite descriptions to any prospective client on request.
- Firms must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity.

GIPS - Fundamentals of compliance

0. Fundamentals of compliance (con't)

- **Fair Value**: the amount at which an investment could be exchanged in a current arm's length transaction between willing parties in which the parties each act knowledgeably and prudently.
 - Fair value must include accrued income.
 - Valuation must be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date. In the absence of such market price, valuation must represent the firm's best estimate of the market value.
- **Valuation hierarchy**: 1) market price 2) market price for similar investment 3) market-based inputs for pricing the investment 4) subjective unobservable inputs for pricing the investment

GIPS

1. Input data

- For periods beginning on or after 1 January 2011, portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles.

2. Calculation methodology

- Firms must calculate time-weighted rates of return that adjust for external cash flows. Both periodic and sub-period returns must be geometrically linked.

3. Composite construction

- 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.
- Firms must not link performance of simulated or model portfolios with actual performance.

5. Presentation and reporting

- The following items must be presented in each compliant presentation:
 - 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.
- 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.

7. Private Equity

- Firms must calculate the annualized since-inception internal rates of return (SI-IRR).

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

- **Wrap fee**: A type of bundled fee and are specific to a particular investment product.
- **A wrap fee portfolio** is sometimes referred to as a “Separately managed account” (SMA) or “managed account.”

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。