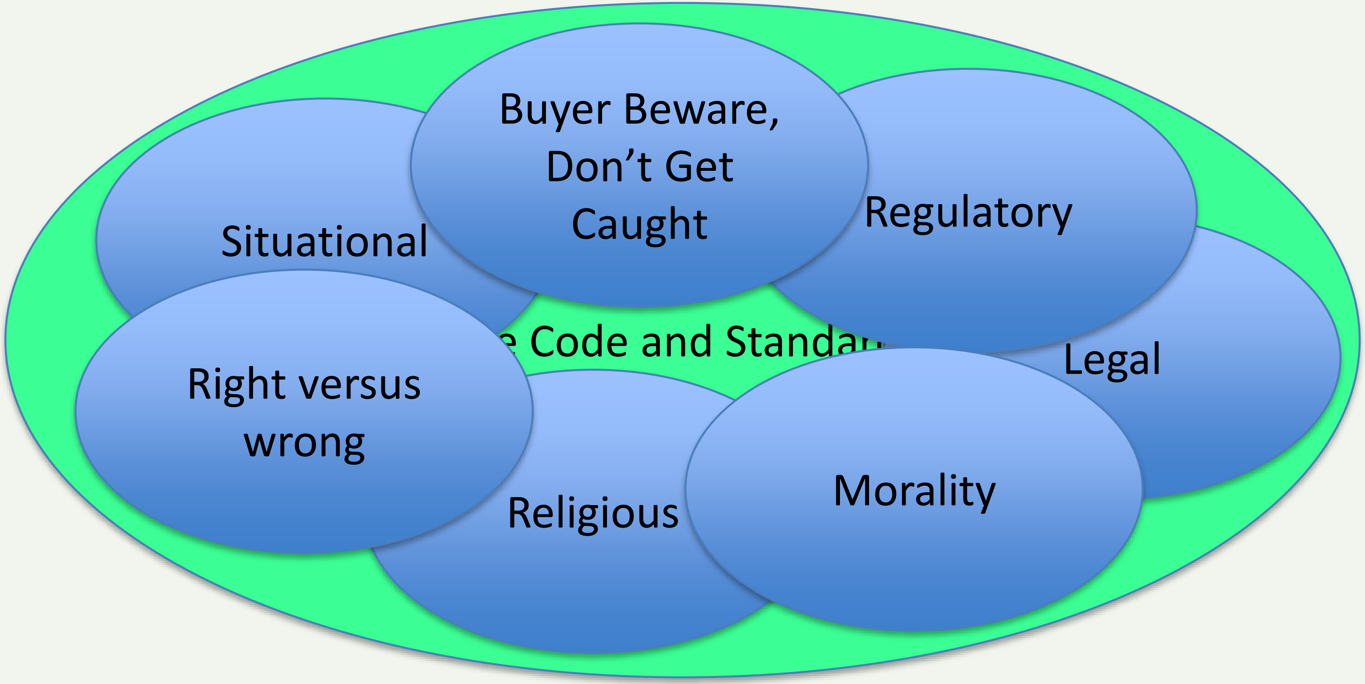
CFA® Exam Review

Ethical and Professional Standards (1) and (2)

What Is Ethics



For the Exam

The Code and Standards

Key Issues

- Know the primary requirements of the Standards of Professional Conduct
- Know the primary requirements of the AMC and GIPS
- Apply the above to the case facts to determine if there are violations
  - Expect a few questions where the best you can do is guess

The Standards of Professional Conduct

Professionalism

Integrity of Capital Markets

Duties to Clients

Duties to Employers

Self Interests

- Investment analysis, recommendations, and actions
- Conflicts of interests
- Responsibilities as a CFA Institute Member or CFA Candidate

Professionalism

- Laws and regulation:
  - Know and follow the stricter laws and regulations
  - Do not knowingly participate in illegal or unethical activity
  - Charterholders are not generally presumed to be experts in all ethical issues; seek qualified advice as needed
- Be independent and objective in professional actions
  - Do not accept compensation or gifts which compromise this
- Act professionally
  - Do not embarrass the profession
- Do not misrepresent

Integrity of Capital Markets

- Do not act on material non-public information
  - Principals and their agents of public and private companies are a different situation
- Do not act with the intent to manipulate market price and trading volume

Duties to Clients

- Put the interests of clients first
  - Use the client's soft dollars for the benefit of the client
  - Vote proxies as appropriate for the client
- Know and consider the client's situation
  - Clients can choose to limit your role
- Deal fairly and objectively with clients
  - Provide the level of service agreed to
- Keep client information confidential
  - Share information to achieve client objectives when appropriate
  - Follow the law and regulations
- Present fair, accurate, and complete information (as relevant)

Duties to Employers

- Be loyal and act in the employer's best interests
  - A contractor is not an employee (in this context) and is obligated only to meet the terms of their contract
- Do not accept other compensation (in competition with the employer) or lavish gifts without written consent from the employer
  - Clients are not employers (in this context)
- Supervisors have an affirmative duty to make reasonable efforts to prevent, detect, and correct violations
  - Or they cannot accept supervisory responsibility

Investment Analysis, Recommendations, and Actions

- Be diligent, thorough, and independent
  - Have a reasonable and adequate basis
  - Support with appropriate research
  - Retain appropriate records to support the work
- Communicate material issues:
  - The basic principles and process used for analysis
  - Limitations and risks
  - Distinguish facts from opinions (conclusions are opinions)
  - Promptly update for and communicate material changes

Conflicts of Interest

- Fully disclose potential and actual conflicts of interest to those affected
  - Use the “hindsight rule”
- Place the interests of client’s and employers ahead of self interest
  - Recall that there are limited capital market issues that precede duties clients and employers
- Disclose referral fees

Basic issue:

- Minimize conflicts of interest but accept that some are unavoidable
- Meeting the requirements may not be enough to maintain you best interests

Responsibilities as a CFA Institute Member or CFA Candidate

- Do not compromise the reputation and integrity of the CFA Institute, its programs, or the designation
- Do not misrepresent or exaggerate the meaning of the CFA program or designation
  - Factual accurate descriptions of the program are encouraged
  - Do not use the CFA designation as a noun
  - You are not a charterholder until you receive the designation

Professionalism

Is in the long term best interest of:

- The profession and its professionals
- The clients
- Society

A profession rests on:

- A body of knowledge
- A frame work of ethical behavior, clients come first
- The trust of clients and society

Establishing Trust

- Follow a code of ethics and standards of professional conduct
- Provide service to society
- Be client focused and exercise fiduciary duty
- Have high standards of entry
- Follow a body of knowledge
- Encourage professional development
- Monitor professional conduct
- Be collegial with other professionals
- Recognize and cooperate with regulatory bodies
- Engage with the profession
- Evolve over time

Professionalism in Investment Management

- A young profession, still gaining trust
- A body of knowledge exist and increasing expertise is required
- Fees and conflicts of interest must be fully disclosed
- The profession impacts the economy, financial markets, and society
- The CFA Institute provides global leadership
- Charterholders and candidates:
  - Must follow the Code and Standards
  - Must sign an annual statement of compliance
  - Are encouraged to continue their professional development

Expectations of Investment Professionals

- Honesty; integrity; altruism; continuous improvement; excellence; loyalty and respect for colleagues, clients, and employers
- High (but not perfect) standards of behavior
- Ethical behavior that balances self-interest with the direct and indirect impact of actions on others
  - Go beyond minimum legal requirements

A Framework for Ethical Decision Making

- Follow ethical principles
- Evaluate decisions from multiple viewpoints to identify the critical issues, make wise decisions, and minimize adverse consequences:
  - Identify the relevant facts, issues, and involved parties
  - Consider the situational and behavioral issues, seek additional guidance, and consider alternative actions
  - Decide and act
  - Review the subsequent results

Regulation and Technology

- Accept regulation is beneficial to increasing professionalism
- The profession is changing to incorporate rapidly expanding:
  - Computer power
  - Data quantity and types
  - Internet connectivity
  - Expectations for expertise and service delivery

The AMC and GIPS

- The Code of Ethics and Standards of Professional Conduct (C&S) are mandatory for covered persons
- The Asset Manager Code of Professional Conduct and Global Investment Performance Standards:
  - Apply to investment firms
  - Are voluntary and encouraged
  - Fully consistent with the C&S, but require additional resources to implement
  - Are principle based, the Firm is responsible for determining how to implement

Asset Manager Code (AMC)

- Voluntary but encouraged
- Applies to investment firms
- Ethically based
- Consistent with the Code and Standards but requires additions resources, expenses, and actions by the firm
  - The firm must develop relevant policies and procedures
  - Covers requirements that must be met to comply with the AMC and recommendations that are encouraged

Asset Manager Code (AMC)

- Covers:
  - Loyalty to clients
  - Investment process and actions
  - Trading
  - Risk management, compliance, and support
  - Performance and valuation
  - Disclosures

- These largely reiterate what is already required by the Code and Standards for covered persons
- These slides focus on the AMC's clarifications and additional requirements

AMC: Additional Clarifications and Requirements

Investment process and actions

- Firm’s may offer differing levels of service (and cost) as long as these are disclosed and available to all clients
- Managers of style, strategy, or mandate specific portfolios are not responsible for determining individual client suitability
- Client’s determine how much information to disclose and the limits of the role of the manager

AMC: Additional Clarifications and Requirements

Trading

- Develop compliance procedures to limit access within the firm to material non-public information the firm may legitimately have access to

Performance and valuation

- Use fair value in valuing assets

AMC: Additional Clarifications and Requirements

Risk management, compliance, and support

- Develop appropriate policies and procedure (P&P) to meet the AMC, local law, and regulation
- Appoint a qualified compliance officer with responsibility for and authority to implement the P&P
  - Provide appropriate staff and resources
  - Maintain relevant records
- Provide accurate, *independently verified* performance information to clients
- Establish both a business continuity plan and a firm wide risk management process

AMC: Additional Clarifications and Requirements

Disclosure:

- Regulatory and disciplinary actions against the firm and its employees
- The basic investment process of the firm including the use of lock-up periods, derivatives, and leverage
- Any use of soft-dollars and bundled commissions
- Valuation methods used to make decisions and value client portfolios
- Shareholder voting, trade allocation, and the risk management processes used by the firm
- Results of audits or reviews of the firm or accounts by third parties

GIPS

- Global standards for calculating and presenting performance results
- A voluntary process
- Facilitate dialogue between investment firms and their clients
- Allow clients to compare results of different firms

- Benefits the firms and their customers

GIPS: Scope and Content

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 accounts

GIPS: Fundamentals of Compliance

- Must be Firm wide
  - Disclose the definition of the firm (an entity represented as and operating as a distinct business entity)
- Follow GIPS, local law, and regulation; disclose any conflicts
- Maintain appropriate P&P, including verification of client assets
- Provide clients with a GIPS report at least annually, if practical
- Do not alter the historical GIPS record, except to correct mistakes
  - Acquisition of another firm is covered later
- Joint marketing with other noncompliant firms must clearly distinguish compliant from noncompliant material

GIPS: Input Data

- Capture and maintain all necessary data used for calculations
- Value portfolios at least monthly and on the date of large ECFs
    - Large is any amount sufficient to materially affect calculations and may be composite specific
    - GIPS reporting is by annual calendar year end (Dec. 31), unless some other date is more relevant to the accounts)

GIPS: Input Data

- Used trade date accounting and include accrued interest
- Use fair value to price assets
  - Market value if available
  - Or in declining order of preference use prices inferred from:
    - Similar actively traded securities
    - Less actively traded securities
    - Observable inputs like PE
    - Less observable inputs like discounted cash flow

GIPS: Calculation Methodology

- Total return based on price and income
- Geometrically linked TWR by subperiod
  - Unless the manager controls the timing of ECFs, in that case use IRR (MWR)
- Gross return is after direct transaction expenses
- Net return is gross – investment management fees
- If bundled fees cannot be disaggregated, deduct the entire fee and fully disclose what is included in the fee
  - Bundled fees are some combination of transaction, investment management, and administrative (any other) fees

Basic Principles: TWR versus MWR

- With no ECFs they are equal
- With an unvarying rate of return during the full period they are equivalent
- With a large client contribution (+ECF):
  - Before a period of superior relative performance; MWR > TWR
  - Before a period of inferior relative performance; MWR < TWR
- With a large client withdrawal (-ECF):
  - Before a period of superior relative performance; MWR < TWR
  - Before a period of inferior relative performance; MWR > TWR

Choosing the Correct Calculation Approach

- TWR normally
- MWR when required (Firm controls the timing of ECFs)
- The Firm must define what is a large enough ECF to trigger a material difference in the calculations
  - Definition can be composite specific
  - Other approximation calculation methods are allowed if the Firm can document the results are materially the same

GIPS: Accounting for Cash

- Cash the manager chooses to hold must be included in account market values used to calculate returns

Illustration:

- A small cap value account has a total return for the month of 3.4%
- The manager held 11.4% of the account in cash equivalents during the month
- The stock only return was 3.7%

Account return included in the small cap value composite must be 3.4%

GIPS: Composite Construction

- Composites are groups of accounts with similar objectives and constraints
- All actual, fee-paying, discretionary accounts must be in at least one composite
  - Include accounts in all relevant composites
  - Hypothetical results can only be provided as supplemental information
  - Non-fee paying accounts may be included or excluded by consistent policy
  - Exclude nondiscretionary accounts
  - Disclose any minimum cutoff used for including accounts; the cutoff must be related to what is necessary to implement the composite strategy

GIPS: Composite Return

- The weight average return of the accounts in the composite
- Weighting can be by beginning value or beginning value plus time weighted ECFs
- Include returns for all accounts meeting the composite definition for the full month
- Add or remove accounts from the composite by full month (if the account objectives or composite definition change)

GIPS: Significant ECFs

- Significant ECFs are those large enough to temporarily make the account non-discretionary
- Preferred solution is to keep the account in its composite and temporarily direct the cash to a sub account (not included in the composite) until it is invested, then merge the subaccount back into the account and subsequent composite results
- Alternate solution is to remove the account from its composite's results until the funds are invested
- Remember accounts are added and removed by full month

GIPS: Carve Outs

- Carve outs by asset type or composite strategy are allowed but not required
  - Keep the full account in its composite
  - Include each carve-out in its relevant composite

Such carve out reporting is only allowed if each carve out is ***set up as a separate account managed by the managers of that composite***

Illustration:

$100M Balanced Account

Total account results in Balanced Composite

70% Equity
25% Bonds
5% Cash

Optional:

$70M equity subaccount in Equity Composite
$25M bond subaccount in Bond Composite

GIPS: Disclosures that **Must Appear**

- The relevant compliance statement
- Definition of the Firm
- Composite and relevant benchmark return by year
- Meaningful description of the composite and its benchmark
- Currency used
- Relevant fee schedule

GIPS: Disclosures that **Must Appear**

- Internal measure of composite dispersion (if there are 6 or more accounts in the composite for the full year) and disclose the dispersion measure used

E.g. The composite return for 2019 was 6.7% and the range of returns was 5.9 to 8.1%

- External dispersion of the composite and benchmark returns
  - Use annualized standard deviation of the trailing 36 monthly returns (unless some other dispersion measure is clearly more relevant)

E.g. The composite and benchmark return for 2019 were 6.7% and 6.5% respectively. Their annualized standard deviation of return for the preceding 36 months were 10.1 and 10.4%.

GIPS: Disclosures that **Must Appear**

- State that a full list of the Firm's composites is available upon request
  - Any composite terminated within the last 5 years must be included
- State that the Firm's P&P used to calculate, value, and present performance is available upon request

GIPS: Disclosures that **Must Only Appear if Relevant**

- Disclose any material items that a reasonable user would want to know
- Disclosure :
  - The extent and nature of derivatives, leverage, and short positions used
  - Any noncompliant data that is included in the report (relating to immaterial noncompliant data that was allowed prior to 2000)
  - Description and date of any redefinition of the firm
  - Changes in the name of the composite

GIPS: Disclosures that **Must Only Appear if Relevant**

- Minimum account size for inclusion in the composite
- How withholding taxes are handled for the account and benchmark returns
- Differences between the composite and benchmark related to exchange rates and valuation sources
- The handling of any conflicts between local law and GIPS
- Any bundled fees and the nature of those fees
- The extent of and use of sub-advisors selected by the firm
- For periods prior to 2010 (when these were allowable):
  - Any use of internal carve out accounting (no subaccounts set up)
  - Valuation based on periods other than monthly

GIPS: Disclosures that **Must Only Appear if Relevant**

- For periods after 2010, any asset valuations based on subjective inputs
- Any deviations from the recommended composite hierarchy
- The definition of and handing of significant ECFs
- If no relevant composite benchmark exists, explain
- Explanation for any benchmark change
- Complete disclosure of the nature of any custom benchmark used
- The inclusion of any performance data from a past firm or affiliation

GIPS: Three Possible Compliance Statements

Verified: "[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.

"Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis, and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation."

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

GIPS: Three Possible Compliance Statements

Verified and Specific Composites Examined: "[Insert name of firm] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of firm] has been independently verified for the periods [insert dates].

"Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firmwide basis, and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The [insert name of composite] composite has been examined for the periods [insert dates]. The verification and examination reports are available upon request.

GIPS: Verification

- Recommended but not required
- Must be conducted by an independent, qualified, knowledgeable third party
- More complex firms require more work
- Verification is firm wide
- Verifier issues a report of whether the Firm's P&P are adequate and if the firm is in compliance
- The minimum period for verification is one year (or since inception), the recommended period is for the period covered by the GIPS report
- Verification is not a guarantee of accuracy

GIPS: Presentation and Reporting

Report a minimum of 5 calendar years of composite return and other required data when first adopting GIPS

- If the composite style has been in application for less than 5 years, report since inception
  - Report periodic returns for any period less than a year
- Each year, add a year to the report until a minimum of 10 years are reported
- You may choose to report for longer periods (more years)

GIPS: Presentation and Reporting

For each time period (year), report:

- Composite and benchmark annual returns
- Number of accounts in the composite (if 6 or more)
- Internal dispersion of returns in the composite for the full year (if 6 or more)
- Size of composite and firm assets (as amount or %)
- External ex post annualized standard deviation of rolling 36 months of returns (starting in 2011) for the composite and benchmark
- % of non-fee paying assets and/or bundled fee accounts in the composite

GIPS: Acquisitions

- If a non complaint GIPS firm is acquired, the GIPS compliant acquiring firm has 1 year to bring those assets into compliance
- If the acquiring firm substantially retains the same decision process, key personnel, and historical documentation (and otherwise meets GIPS requirements)
  - The acquired firm's record is retroactively incorporated into the acquiring firm's GIPS report
  - With full disclosure

GIPS: Real Estate and Private Equity

- The normal provisions of GIPS apply to:
  - Portfolios of publicly traded assets such as REITS and MBS
  - Open end funds that allow client admissions and withdrawals and have no capital commitments (open-ended or evergreen funds)
- Additional special GIPS provisions apply for RE and PE that are:
  - Illiquid
  - Require appraisal valuation
  - Give the manager control of client admissions and withdrawals (ECFs)

GIPS: RE and PE Special Provisions

- RE: SI-IRR using quarterly cash flows must be reported until liquidation of all accounts in the composite
- PE: SI-IRR using daily cash flows must be reported until liquidation of all accounts in the composite
- PE: Disclose how benchmark returns are calculated
- RE and PE: Composites and benchmarks must be by vintage year

GIPS: RE and PE Special Provisions

RE: Quarterly (not monthly) valuation is acceptable

- Valuation can be done internally with an external valuation every 12 months (or every 36 months if approved by the client)
- Annually disclose the % of composite assets externally valued
- Report returns gross or net with return components reported the same way and with the same frequency

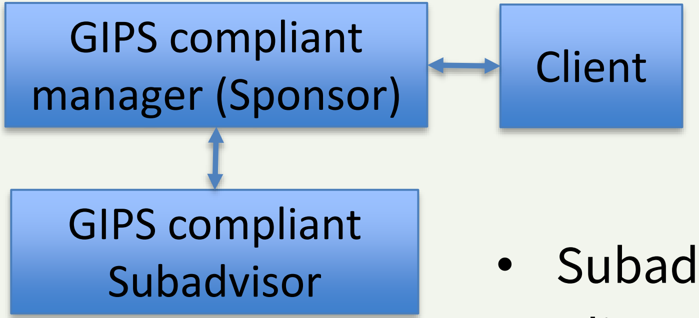
PE: Annual valuation is acceptable

GIPS: RE & PE Component Returns

In addition to total return, report:

- Committed capital (CC), the money investors are obligated to contribute
- Paid in capital (PIC), the cumulative money contributed to date
- Distributions (D), distributions of money or assets made to the investors
- Investment multiple, total value of the investment (TV) / PIC
- Realized multiple, cumulative D/ PIC
- Unrealized multiple, (TV - cumulative D) / PIC

GIPS: Wrap Fee Separately Managed Accounts



- Sponsor interacts with client and handles all account duties; delegating asset investment decisions
- Subadvisor makes asset investment decisions
- Client pays Sponsor one bundled fee and Sponsor pays Subadvisor

- The normal provisions of GIPS apply to both Sponsor and Subadvisor
- WFSMA provisions deal with Subadvisor performance reporting

GIPS: WFSMA Reporting

Subadvisor:

- May calculate account performance or use the calculations of the sponsor in the Subadvisor's composites
- Returns must be net of entire bundled fee
- Follow a consistent policy of including WFSMA and non-WFSMA in the same or in separate composites
- Composites must be style specific
- Style and sponsor specific composites can only be used for reporting to that sponsor

GIPS: Advertising Guidelines

Allow GIPS compliant firms to advertise GIPS results. The material must include:

- The statement: "[Name of firm] claims compliance with the Global Investment Performance Standards (GIPS®)"
- How to receive the full GIPS report
- A description of the Firm

GIPS: Advertising Guidelines with Performance Data

- If performance data is included, show either:
  - The most recent 1, 3, and 5 year results in the GIPS report
  - Or the last 5 annual returns
  - Year to date results can also be included
- Show the relevant benchmark returns
- Disclose and material use of derivatives, leverage, and short selling
- Any other information cannot be more prominent than the above info

GIPS: After-Tax Reporting

Intent: Allow firms that wish to do so to provide after-tax return information

Process:

(Pretax) composite and benchmark returns from the GIPS report

Disclose the assumptions used to calculated the composite and benchmark after-tax returns

Report the results as supplemental information

Prospects determine relevance

Approaches:

- Pre-liquidation method: Only deduct taxes owed each period
- Mark-to-liquidation method: Assume and deduct for 100% of return taxation each period