CFA Institute®
CFA Program

ETHICAL AND PROFESSIONAL STANDARDS

CFA® Program Curriculum
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CONTENTS

How to Use the CFA Program Curriculum

The CFA® Program exams measure your mastery of the core knowledge, skills, and abilities required to succeed as an investment professional. These core competencies are the basis for the Candidate Body of Knowledge (CBOK™). The CBOK consists of four components:

A broad outline that lists the major CFA Program topic areas (www.cfainstitute.org/programs/cfa/curriculum/cbok/cbok)

Topic area weights that indicate the relative exam weightings of the top-level topic areas (www.cfainstitute.org/en/programs/cfa/curriculum)

Learning outcome statements (LOS) that advise candidates about the specific knowledge, skills, and abilities they should acquire from curriculum content covering a topic area: LOS are provided at the beginning of each block of related content and the specific lesson that covers them. We encourage you to review the information about the LOS on our website (www.cfainstitute.org/programs/cfa/curriculum/study-sessions), including the descriptions of LOS "command words" on the candidate resources page at www.cfainstitute.org/-/media/documents/support/programs/cfa-and-cipm-los-command-words.ashx.

The CFA Program curriculum that candidates receive access to upon exam registration

Therefore, the key to your success on the CFA exams is studying and understanding the CBOK. You can learn more about the CBOK on our website: www.cfainstitute.org/programs/cfa/curriculum/cbok.

The curriculum, including the practice questions, is the basis for all exam questions. The curriculum is selected or developed specifically to provide candidates with the knowledge, skills, and abilities reflected in the CBOK.

CFA INSTITUTE LEARNING ECOSYSTEM (LES)

Your exam registration fee includes access to the CFA Institute Learning Ecosystem (LES). This digital learning platform provides access, even offline, to all the curriculum content and practice questions. The LES is organized as a series of learning modules consisting of short online lessons and associated practice questions. This tool is your source for all study materials, including practice questions and mock exams. The LES is the primary method by which CFA Institute delivers your curriculum experience. Here, candidates will find additional practice questions to test their knowledge. Some questions in the LES provide a unique interactive experience.

DESIGNING YOUR PERSONAL STUDY PROGRAM

An orderly, systematic approach to exam preparation is critical. You should dedicate a consistent block of time every week to reading and studying. Review the LOS both before and after you study curriculum content to ensure you can demonstrate the knowledge, skills, and abilities described by the LOS and the assigned reading. Use the LOS as a self-check to track your progress and highlight areas of weakness for later review.

Successful candidates report an average of more than 300 hours preparing for each exam. Your preparation time will vary based on your prior education and experience, and you will likely spend more time on some topics than on others.

ERRATA

The curriculum development process is rigorous and involves multiple rounds of reviews by content experts. Despite our efforts to produce a curriculum that is free of errors, in some instances, we must make corrections. Curriculum errata are periodically updated and posted by exam level and test date on the Curriculum Errata webpage (www.cfainstitute.org/en/programs/submit-errata). If you believe you have found an error in the curriculum, you can submit your concerns through our curriculum errata reporting process found at the bottom of the Curriculum Errata webpage.

OTHER FEEDBACK

Please send any comments or suggestions to info@cfainstitute.org, and we will review your feedback thoughtfully.

Ethical and Professional Standards

LEARNING MODULE

1

Ethics and Trust in the Investment Profession

by Bidhan L. Parmar, PhD, Dorothy C. Kelly, CFA, Colin McLean, MBA, FIA, FSIP, Nitin Mehta, CFA, FSIP, and David B. Stevens, CIMC, CFA.

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LEARNING OUTCOMES

Mastery	*The candidate should be able to:*
□	explain ethics
□	describe the role of a code of ethics in defining a profession
□	describe professions and how they establish trust
□	describe the need for high ethical standards in investment management
□	explain professionalism in investment management
□	identify challenges to ethical behavior
□	compare and contrast ethical standards with legal standards
□	describe a framework for ethical decision making

INTRODUCTION

1

As a candidate in the CFA Program, you are both expected and required to meet high ethical standards. This reading introduces ideas and concepts that will help you understand the importance of ethical behavior in the investment industry. You will be introduced to various types of ethical issues within the investment profession and learn about the CFA Institute Code of Ethics.

The readings covering ethics and professional standards demonstrate that ethical behavior is central to creating trust. Professional behavior is equally important. Professions help maintain trust in an industry by establishing codes and setting standards that put a framework around ethical behavior and technical competence. Professions also set the wider goal of gaining and maintaining the trust of society as a whole. In this regard, professions have a sense of purpose that society values.

Imagine that you are employed in the research department of a large financial services firm. You and your colleagues spend your days researching, analyzing, and valuing the shares of publicly traded companies and sharing your investment recommendations with clients. You love your work and take great satisfaction in knowing that your recommendations can help the firm's investing clients make informed investment decisions that will help them meet their financial goals and improve their lives.

Several months after starting at the firm, you learn that an analyst at the firm has been terminated for writing and publishing research reports that misrepresented the fundamental risks of some companies to investors. You learn that the analyst wrote the reports with the goal of pleasing the management of the companies that were the subjects of the research reports. He hoped that these companies would hire your firm's investment banking division for its services and he would be rewarded with large bonuses for helping the firm increase its investment banking fees. Some clients bought shares based on the analyst's reports and suffered losses. They posted stories on the internet about their losses and the misleading nature of the reports. When the media investigated and published the story, the firm's reputation for investment research suffered. Investors began to question the firm's motives and the objectivity of its research recommendations. The firm's investment clients started to look elsewhere for investment advice, and company clients begin to transfer their business to firms with untarnished reputations. With business declining, management is forced to trim staff. Along with many other hard-working colleagues, you lose your job—through no fault of your own.

Imagine how you would feel in this situation. Most people would feel upset and resentful that their hard and honest work was derailed by someone else's unethical behavior. Yet, this type of scenario is not uncommon. Around the world, unsuspecting employees at such companies as SAC Capital, Stanford Financial Group, Everbright Securities, Enron, Satyam Computer Services, Arthur Andersen, and other large companies have experienced such career setbacks when someone else's actions destroyed trust in their companies and industries.

Businesses and financial markets thrive on trust—defined as a strong belief in the reliability of a person or institution. In a 2016 study on trust, investors indicated that to earn their trust, the top two attributes of an investment manager should be that it (1) has transparent and open business practices, and (2) has ethical business practices.[1] Although these attributes are valued by customers and clients in any industry, this reading will explore why they are of particular importance to the investment industry.

People may think that ethical behavior is simply about following laws, regulations, and other rules, but throughout our lives and careers we will encounter situations in which there is no definitive rule that specifies how to act, or the rules that exist may be unclear or even in conflict with each other. Responsible people, including investment professionals, must be willing and able to identify potential ethical issues and create solutions to them even in the absence of clearly stated rules.

1 CFA Institute From Trust to Loyalty: A Global Survey of What Investors Want (2013): http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n14.1.(2016): https://www.cfainstitute.org/research/survey-reports/from-trust-to-loyalty

ETHICS 2

☐ explain ethics

Through our individual actions, each of us can affect the lives of others. Our decisions and behavior can harm or benefit a variety of **stakeholders**—individuals or groups of individuals who could be affected either directly or indirectly by a decision and thus have an interest, or stake, in the decision. Examples of stakeholders in decisions made by investment industry professionals include our colleagues, our clients, our employers, the communities in which we live and work, the investment profession, trade associations, regulators, and other financial market participants. In some cases, our actions may benefit all of these stakeholder groups; in other cases, our actions may benefit only some stakeholder groups; and in still other cases, our actions may benefit some stakeholder groups and harm others. For example, recall the research analyst in the introduction who wrote misleading research reports with the aim of increasing the financial benefit to himself and his employer. In the very short term, his conduct seemed to directly benefit some stakeholders (certain clients, himself, and his employer) and to harm other stakeholders (clients who invested based on his reports). Over a longer time period, his conduct resulted in harm to himself and many other stakeholders—his employer, his employer's clients, his colleagues, investors, and through loss of trust when the story was published, the larger financial market.

Ethics encompasses a set of moral principles and rules of conduct that provide guidance for our behavior. The word "ethics" comes from the Greek word "ethos," meaning character, used to describe the guiding beliefs or ideals characterizing a society or societal group. Beliefs are assumptions or thoughts we hold to be true. A principle is defined as a belief or fundamental truth that serves as the foundation for a system of belief or behavior or a chain of reasoning. Our beliefs form our values—those things we deem to have worth or merit.

Moral principles or **ethical principles** are beliefs regarding what is good, acceptable, or obligatory behavior and what is bad, unacceptable, or forbidden behavior. Ethical principles may refer to beliefs regarding behavior that an individual expects of himself or herself, as well as shared beliefs regarding standards of behavior expected or required by a community or societal group.

The study of ethics examines the role of consequences and personal character in defining what is considered good, or ethical, conduct.

Ethical conduct is behavior that follows moral principles and balances self-interest with both the direct and the indirect consequences of the behavior on others. Ethical actions are those actions that are perceived as beneficial and conforming to the ethical expectations of society. An action may be considered beneficial if it improves the outcomes or consequences for stakeholders affected by the action. Telling the truth about the risks or costs associated with a recommended investment, for example, is an ethical action—that is, one that conforms to the ethical expectations of society in general and clients in particular. Telling the truth is also beneficial; telling the truth builds trust with customers and clients and enables them to make more informed decisions, which should lead to better outcomes for them and higher levels of client/customer satisfaction for you and your employer.

Widely acknowledged ethical principles include honesty, transparency, fairness or justice, diligence, and respect for the rights of others. Most societal groups share these fundamental ethical principles and build on them, establishing a shared set of rules regarding how members should behave in certain situations. The principles or rules may take different forms depending on the community establishing them.

Governments and related entities, for example, may establish laws and/or regulations to reflect widely shared beliefs about obligatory and forbidden conduct. Laws and regulations are rules of conduct specified by a governing body, such as a legislature or a regulator, identifying how individuals and entities under its jurisdiction should behave in certain situations. Most countries have laws and regulations governing the investment industry and the conduct of its participants. Differences in laws may reflect differences in beliefs and values.

In some countries, for example, the law requires that an investment adviser act in the best interests of his or her clients. Other countries require that investment professionals recommend investments that are suitable for their clients. These differing requirements can also hold true within one country where some advisers are held to a suitability standard and others to the fiduciary standard of the client's best interests. Investment advisers and portfolio managers who are required by law to act in their clients' best interests must always put their clients' interests ahead of their own or their employers' interests. An investment adviser who is required by law to act in a client's best interest must understand the client's financial objectives and risk tolerance, research and investigate multiple investment opportunities, and recommend the investment or investment portfolio that is *most* suitable for the client in terms of meeting his or her long-term financial objectives. In addition, the investment adviser would be expected to monitor the client's financial situation and investments to ensure that the investments recommended remain the *best* overall option for meeting the client's long-term financial objectives. In countries with only a suitability requirement, it is legal for investment professionals to recommend a suitable investment to a client even if other, similar suitable investments with lower fees are available. These differences in laws reflect differences in beliefs and values.

Specific communities or societal groups in which we live and work sometimes codify their beliefs about obligatory and forbidden conduct in a written set of principles, often called a **code of ethics**. Universities, employers, and professional associations often adopt a code of ethics to communicate the organization's values and overall expectations regarding member behavior. The code of ethics serves as a general guide for how community members should act. Some communities will also expand on their codes of ethics and adopt explicit rules or standards that identify specific behaviors required of community members. These **standards of conduct** serve as benchmarks for the minimally acceptable behavior of community members and can help clarify the code of ethics. Members can choose behaviors that demonstrate even higher standards. By joining the community, members are agreeing to adhere to the community's code of ethics and standards of conduct. To promote their code of ethics and reduce the incidence of violations, communities frequently display their codes in prominent locations and in written materials. In addition, most communities require that members commit to their codes in writing on an annual or more frequent basis.

Violations of a community's established code of ethics and/or standards of conduct can harm the community in a variety of ways. Violations have the potential to damage the community's reputation among external stakeholders and the general public. Violations can also damage the community's reputation internally and lead to reduced trust among community members and can cause the organization to fracture or splinter from within. To protect the reputation of its membership and limit potential harm to innocent members, the community may take corrective actions to investigate possible violations, repair any damages, and attempt to discipline the violator or, in severe cases, revoke the violator's membership in the community.

EXAMPLE 1

Ethics

1. Which of the following statements is *most* accurate? Ethics can be described as:

   A. a commitment to upholding the law.

   B. an individual's personal opinion about right and wrong.

   C. a set of moral principles that provide guidance for our behavior.

Solution:

C is correct. Ethics can be described as a set of moral principles that provide guidance for our behavior; these may be moral principles shared by a community or societal group.

2. Which of the following statements is *most* accurate? Standards of conduct:

   A. are a necessary component of any code of ethics.

   B. serve as a general guide regarding proper conduct by members of a group.

   C. serve as benchmarks for the minimally acceptable behavior required of members of a group.

Solution:

C is correct. Standards of conduct serve as benchmarks for the minimally acceptable behavior required of members of a group. Some organizations will adopt only a code of ethics, which communicates the organization's values and overall expectations regarding member behavior. Others may adopt both a code of ethics and standards of conduct. Standards of conduct identify specific behavior required of community members and serve as benchmarks for the minimally acceptable behavior of community members.

ETHICS AND PROFESSIONALISM 3

- ☐ describe the role of a code of ethics in defining a profession
- ☐ describe professions and how they establish trust
- ☐ describe the need for high ethical standards in investment management
- ☐ explain professionalism in investment management

A **profession** is an occupational community that has specific education, expert knowledge, and a framework of practice and behavior that underpins community trust, respect, and recognition. Most professions emphasize an ethical approach, the importance of good service, and empathy with the client.

Professions have grown in size and number over the last century: the rise of new specialist areas of expertise has created new professions. Driving forces of a new profession include governments and regulators, which encourage the formation of a ethical relationship between professionals and society at large. There is also demand for professions from individuals who see an advantage in working as a professional and from clients who desire to work with professionals.

Professions have not developed in every country. But in most countries, those who work in specialized areas—such as doctors, lawyers, actuaries, accountants, architects, and engineers—are subject to some combination of licensed status and technical standards. These standards distinguish professions from the craft guilds and trade bodies that were established in many countries. In particular, the requirement for members of professions to uphold high ethical standards is one clear difference. Another difference is that trade bodies do not normally have a mission to serve society or to set and enforce professional conduct rules for practitioners.

How Professions Establish Trust

For a profession to be credible, a primary goal is to establish trust among clients and among society in general. In doing so, professions have a number of common characteristics that, when combined, greatly increase confidence and credibility in professionals and their organizations.

Professions normalize practitioner behavior.

Professionalism is underpinned by codes and standards developed by professional bodies. Regulators typically support professional ethics and recognize the framework for ethics that professions can provide. Many regulators around the world have engaged closely with professional bodies to understand their codes and standards, as well as how they are enforced. Codes and standards developed by practitioners can be complementary to regulations, codifying many more individual practices than the high-level principles set by regulation.

Many governments have recognized that a profession can develop a more sophisticated system of standards than a regulator can, via continuous practitioner input and a strong mutual interest within the profession to maintain good standards and adopt best practices. Government support of professions is attributable to the role of professions in helping the public and ensuring expert and principled performance of complex services.

Professions provide a service to society.

There is an obligation for professionals to go beyond codes and standards. Professionals should advocate for higher educational and ethical standards in the industry, individually and through their companies. Professions can widen access to services and support economic activity by encouraging trust in the industries they serve. Professions have realized that earning community trust not only creates professional pride and acceptance but also delivers commercial benefits. A profession that earns trust may ultimately have greater flexibility and independence from government regulators to manage its own affairs, which allows members of the profession to develop service models that are both useful to clients and beneficial to members.

Professions are client focused.

An integral part of a profession's mission is to develop and administer codes, best practice guidelines, and standards that guide an industry. These codes, standards, and guidelines help ensure that all professionals place the integrity of their profession and the interests of clients above their own personal interests. At a minimum, professionals must act in the best interest of the client, exercising a reasonable level of care, skill, and diligence. The obligation to deliver a high standard of care when acting for the benefit of another party is called *fiduciary duty*. Other entities, including employers, regulators, trade associations, and not-for-profit organizations, may also support an industry but are not the same as professional bodies. Unlike professions, these other entities generally do not exist to set and maintain professional standards. Most employers encourage employees to be members of relevant professions, and many give financial support for this membership to ideally improve the quality of client service and reinforce ethical awareness.

Professions have high entry standards.

Membership in a profession is a signal to the market that the professional will deliver high-quality service of a promised standard, going beyond simply academic credentials. Professions develop curricula that equip future professionals with competence, including technical skills, knowledge, and ethics.

Professions possess a body of expert knowledge.

A repository of knowledge, developed by experienced and skilled practitioners, is made available to all members of a profession. This knowledge helps members work effectively and ethically and is based on best practice.

Professions encourage and facilitate continuing education.

Entry into a profession does not, on its own, guarantee that an individual will maintain competency and continue to uphold professional standards. After qualification and throughout the working life of a professional, there will be changes in knowledge and technical skills to perform certain jobs, in technology and standards of ethical behavior, in services that can be offered, and in the legal and business environment in which professional services are delivered. These all require the development of competence and ethical awareness. Most professional bodies make it a condition of membership that a specific amount of new learning is undertaken each year. Typically, such conditions specify a time commitment, which may be separated into different competencies and types of learning activity. This is often referred to as *continuing professional development* and is seen as an important part of maintaining professional standards. The training and education that professionals undertake increase the value of human capital, which can contribute to economic growth and social mobility.

Professions monitor professional conduct.

Members of a profession must be held accountable for their conduct to maintain the integrity and reputation of an industry. Doing so often involves self-regulation by professional bodies through monitoring and imposition of sanctions on members.

Professions are collegial.

Professionals should be respectful to each other, even when they are competing. At the very least, they must respect the rights, dignity, and autonomy of others.

Professions are recognized oversight bodies.

Many professional bodies are not-for-profit organizations with a mission emphasizing excellence, integrity, and public service. Although it is the responsibility of individual professionals to remain competent, an oversight body typically monitors this responsibility. Such bodies provide individuals with ongoing educational resources and access to information about changes in standards and imposes a framework of discipline. Continuing membership indicates sustained competence in (and updating of) practical skills while maintaining ongoing compliance with an ethical code of conduct.

Professions encourage the engagement of members.

Participation by members as volunteers is part of the essence of a profession. Professionals are more likely to refer to, use, and adhere to values that they have helped develop, and they typically have the power as members to revise these values. A good professional will want to mentor and inspire others who recently entered or wish to enter the profession. Professionals should be willing to volunteer to advance the profession and engage with peers to develop expertise and ethics. Professionals should volunteer to help educate new generations in ethical knowledge and ethical decision making and to foster a productive debate about new areas of ethics. Most professionals find that the experience of volunteering within the profession enhances their skills and widens their contacts within the industry. Membership in a professional body allows the necessary engagement with other professionals.

Professions Are Evolving

No profession stands still. Such trends as greater transparency and public accountability force professions to adapt to change. Meanwhile, technology opens up possibilities for new services and different ways of working. In addition, key processes of a profession's responsibilities may need to be reviewed by a government agency or independent public body. In general, professions often engage with non-member individuals. This can help a profession evaluate the viewpoints of the public, clients, or other stakeholders when determining policy and practice and can encourage public trust for a profession's conduct and disciplinary process.

Effective professions continue to develop their role to account for changing best practices. Some medical professional bodies, for instance, have been established for more than 500 years but may now have the same need to adapt as the much younger investment management profession. This means that at any point in time, society may recognize an area of work as a profession even if it has not fully or universally implemented all the expectations. As the requirements for a profession evolve, gaps open up that may take time to remedy. Effective professions also actively learn from other professions, particularly in the area of ethics. New standards of conduct in the accounting profession might be an influence on standards considered in investment management, for example.

Professionalism in Investment Management

> Successful investing professionals are disciplined and consistent and they think a great deal about what they do and how they do it.
>
> —Benjamin Graham, *The Intelligent Investor* (1949)

Investment management is a relatively young profession, which means that public understanding of its practice and codes is still developing. Recognition by regulators and employers also lags established professions. Not everyone engaged in investment management is a professional; some practitioners have not undertaken specific investment training or are not members of a professional body. That creates a challenge for the investment management profession to gain trust, because not all practitioners need to be committed to high ethical standards. However, key elements of the profession have been steadily established over several decades. For example, the publication of Graham and Dodd's *Security Analysis* in 1934 was an important step in establishing a body of knowledge for investment.

The investment management profession meets most, but currently not all, of the expectations of a profession. In most countries, some form of certification or licensing is needed to practice, but there may not be a requirement to join a professional body.

Globally, the trend is to require examined entry to practice investment management and to maintain competence. But few professions have perfect implementation of all the expected attributes. The investment management profession, similar to other professions, is on a journey to improve implementation and keep up with changing demands.

The investment management profession has become increasingly global as capital markets have opened up around the world. Investment management professionals may seek cross-border opportunities or may need to relocate between offices within multinational asset management firms. Regulatory coordination across borders and the emergence of technology are contributing factors to this globalization of investment management. Various investment management professional bodies have developed in individual countries, and several of these bodies have expanded internationally. In addition, several other professional bodies, including those focused on actuarial and accountancy services, have investment management professionals as members.

Trust in Investment Management

The investment management professional today has similarities with professionals in longer-established professions, such as medicine and law. Like doctors and lawyers, investment management professionals are trusted to draw on a body of formal knowledge and apply that knowledge with care and judgement. In comparison to clients, investment professionals are also expected to have superior financial expertise, technical knowledge, and knowledge of the applicable laws and regulations. There is a risk that clients may not be fully aware of the conflicts, risks, and fees involved, so investment management professionals must always handle and fully disclose these issues in a way that serves the best interests of clients. Compliance with codes of ethics and professional standards is essential, and practice must be guided by care, transparency, and integrity.

The investment management profession and investment firms must be interdependent to maintain trust. Employers and regulators have their own standards and practices that may differ from regulations and standards set by professional bodies. The investment management professional bodies typically direct professionals in how to resolve these differences.

In many developed economies, the investment management profession affects many key aspects of the economy, including savings, retirement planning, and the pricing and allocation of capital. In most countries, skilled evaluation of securities leads to more efficient capital allocation and, combined with ethical corporate governance, can assist in attracting investment from international investors. The investment management profession can deliver more value to society when higher levels of trust and better capital allocation reduce transaction costs and help meet client objectives. These reasons explain why practitioners, clients, regulators, and governments have supported the development of an investment management profession.

CFA Institute as an Investment Management Professional Body

CFA Institute is the largest body for investment management professionals.[2] Reflecting the globalization of investment management, CFA Institute moved beyond North America in the 1980s. CFA Institute initiated a number of other changes in line with the growth of investment management. One significant change occurred in 2015, when CFA Institute decided to implement the highest standards of governance in the

2 Eligibility and requirements for becoming a member of CFA Institute vary by jurisdiction. Please consult www.cfainstitute.org for further details.

US not-for-profit sector. The Board of Governors resolved "to implement US Public Company Standards and US not-for-profit leading practices, unless the Board determines that it is not in the best interest of the membership or organization to do so."

The mission of CFA Institute is "to lead the investment profession globally, by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society." The CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards) promote the integrity of charterholders and establish a model for ethical behavior. CFA Institute candidates and charterholders must meet the highest standards among those established by CFA Institute, regulators, or the employer. If candidates and charterholders do not meet these standards, there are negative consequences. Where client interests and market interests conflict, the Code and Standards set an investment management professional's duty to market integrity as the overriding obligation. The advocacy efforts of CFA Institute aim to build market integrity by calling for regulations that align the interests of firms and clients.

As a professional body, CFA Institute gathers knowledge from practicing investment professionals, conducts rigorous examinations, and ensures practitioner involvement in developing its codes and values. The CFA Institute Global Body of Investment Knowledge (GBIK) and Candidate Body of Knowledge (CBOK) are updated on an ongoing basis through a process known as *practice analysis*. Through interactions with practicing investment management professionals, practice analysis helps ensure that the body of knowledge for the investment management profession remains current and globally relevant. The CFA Program ensures that candidates have sufficiently mastered the core knowledge, skills, and abilities (competencies) necessary that are generally accepted and applied by investment professionals. CFA Institute also contributes to the dissemination of new research and ideas in finance with the publication of the *Financial Analysts Journal*; CFA Institute Research Foundation books, research briefs, and reviews; and *CFA Institute Magazine*.

CFA Institute encourages charterholders to engage in their professional communities and involves charterholders in its initiatives. CFA Institute local societies keep charterholders connected and engaged in their communities. CFA Institute assists local societies with providing continuing education programs and events that facilitate charterholders engagement. For CFA charterholders, a local CFA society is an important route to maintaining professionalism, particularly for continuing professional development.

CFA charterholders and CFA Program candidates are required to adhere to the Code and Standards and to sign annually a statement attesting to that continued adherence. Charterholders and candidates must maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

EXAMPLE 2

Ethics and Professionalism

1. Which of the following statements is *most* accurate? Investment professionals have a special responsibility to act ethically because:

   A. the industry is heavily regulated.

   B. they are entrusted to protect clients' assets.

   C. the profession requires compliance with its code of ethics.

Solution:

B is correct. Investment professionals have a special responsibility because clients entrust them to protect the clients' assets.

2. Which of the following statements *best* completes the following sentence? Professionals use their specialized knowledge and skills:

   A. in service to others.

   B. to advance their career.

   C. for the exclusive benefit of their employers.

Solution:

A is correct. Professionals use specialized knowledge and skills in service to others. Their career and employer may benefit, but those results are not the primary focus of a professional's use of his or her specialized knowledge and skills.

3. Which of the following statements is *most* accurate? A profession's code of ethics:

   A. includes standards of conduct or specific benchmarks for behavior.

   B. ensures that all members of a profession will act ethically at all times.

   C. publicly communicates the shared principles and expected behaviors of a profession's members.

Solution:

C is correct. A profession's code of ethics publicly communicates the shared principles and expected behaviors of a profession's members. The existence of a code of ethics does not ensure that all members will behave in a manner consistent with the code and act ethically at all times. A profession will often establish a disciplinary process to address alleged violations of the code of ethics. A profession may adopt standards of conduct to enhance and clarify the code of ethics.

CHALLENGES TO ETHICAL CONDUCT

4

☐ identify challenges to ethical behavior

Professionals generally aim to be responsible and to adhere to high moral standards, so what is the benefit of studying ethics? Throughout our careers, we may find ourselves in difficult or at least unfamiliar situations in which an appropriate course of action is not immediately clear and/or there may be more than one seemingly acceptable choice; studying ethics helps us prepare for such situations. This section addresses challenges to engaging in ethical conduct. Failure to acknowledge, understand, or consider these challenges can lead to poor decision making, resulting in unintentional consequences, such as unethical conduct and potential violations of the Code and Standards.

Several challenges can make adherence to ethical conduct difficult. First, people tend to believe that they are ethical people and that their ethical standards are higher than average. Of course, everyone cannot be above average. However, surveys show this belief in above averageness remains.

These survey results illustrate overconfidence, a common behavioral bias that can lead to faulty decision making. Studies have shown that our beliefs and emotions frequently interfere with our cognitive reasoning and result in behavioral bias, a tendency to behave in a way that is not strictly rational. As a result of the overconfidence bias, we are more likely to overestimate the morality of our own behavior, particularly in situations that we have not faced before. The overconfidence bias can result in a failure to consider, explicitly or implicitly, important inputs and variables needed to form the best decision from an ethical perspective. In general, the overconfidence bias leads us to place too much importance on internal traits and intrinsic motivations, such as "I'm honest and would not lie," even though studies have shown that internal traits are generally not the main determinant of whether or not someone will behave ethically in a given situation.

A second challenge is that decision makers often fail to recognize and/or significantly underestimate the effect of situational influences, such as what other people around them are doing. **Situational influences** are external factors, such as environmental or cultural elements, that shape our thinking, decision making, and behavior. Social psychologists have studied how much situational influences affect our behavior and have found that even good people with honorable motives can and often will be influenced to do unethical things when put into difficult situations. Experiments have shown that even people who consider themselves strong, independent, free thinkers will conform to social pressures in many situations. The bystander effect, for example, demonstrates that people are less likely to intervene in an emergency when others are present. Fortunately, experiments have also shown that situational influences can induce people to act more ethically. For example, people tend to behave more ethically when they think someone else is watching or when there is a mirror placed close to them. The important concept to understand is that situational influences have a very powerful and often unrecognized effect on our thinking and behavior. Thus, learning to recognize situational influences is critical to making good decisions.

Common situational influences in the investment industry that can shape thinking and behavior include money and prestige. One experiment found that simply mentioning money can reduce ethical behavior. In the experiment, participants were less likely to cooperate when playing a game if the game was called the Wall Street Game, rather than the Community Game. In the investment industry, large financial rewards—including individual salaries, bonuses, and/or investment gains—can induce honest and well-intentioned individuals to act in ways that others might not consider ethical. Large financial rewards and/or prestige can motivate individuals to act in their own short-term self-interests, ignoring possible short-term risks or consequences to themselves and others as well as long-term risks or consequences for both themselves and others. Another extremely powerful situational influence is loyalty. Loyalty to supervisors or organizations, fellow employees, and other colleagues can tempt individuals to make compromises and take actions that they would reject under different situational influences or judge harshly when taken by others.

Situational influences often blind people to other important considerations. Bonuses, promotions, prestige, and loyalty to employer and colleagues are examples of situational influences that frequently have a disproportionate weight in our decision making. Our brains more easily and quickly identify, recognize, and consider these short-term situational influences than longer-term considerations, such as a commitment to maintaining our integrity and contributing to the integrity of the financial markets. Although absolutely important, these long-term considerations often have less immediate consequences than situational influences, making them less obvious as factors to consider in a decision and, therefore, less likely to influence our overall decision making. Situational influences shift our brain's focus from the long term to the short or immediate term. When our decision making is too narrowly focused on short-term factors and/or self-interest, we tend to ignore and/or minimize the longer-term risks and/or costs and consequences to ourselves and others, and the likelihood of suffering ethical lapses and making poor decisions increases.

Loyalty to employer and/or colleagues is an extremely powerful situational influence. Our colleagues can influence our thinking and behavior in both positive and negative ways. For example, colleagues may have encouraged you to signal your commitment to your career and high ethical standards by enrolling in the CFA Program. If you work for or with people who are not bound by the Code and Standards, they might encourage you to take actions that are consistent with local law, unaware that the recommended conduct falls short of the Code and Standards.

Well-intentioned firms may adopt or develop strong compliance programs to encourage adherence to rules, regulations, and policies. A strong compliance policy is a good start to developing an ethical culture, but a focus on adherence to rules may not be sufficient. A compliance approach may not encourage decision makers to consider the larger picture and can oversimplify decision making. Taken to the extreme, a strong compliance culture can become another situational influence that blinds employees to other important considerations. In a firm focused primarily on compliance, employees may adopt a "check the box" mentality rather than an ethical decision-making approach. Employees may ask the question "What *can* I do?" rather than "What *should* I do?"

EXAMPLE 3

Challenges to Ethical Conduct

1. Which of the following will *most likely* determine whether an individual will behave unethically?

   A. The person's character

   B. The person's internal traits and intrinsic motivation

   C. External factors, such as environmental or cultural elements

Solution:

C is correct. Social psychologists have shown that even good people may behave unethically in difficult situations. Situational influences, which are external factors (e.g., environmental or cultural elements), can shape our thinking, decision making, and behavior and are more likely to lead to unethical behavior than internal traits or character.

2. Which of the following statements is *most* accurate?

   A. Large financial rewards, such as bonuses, are the most powerful situational influences.

   B. When decision making focuses on short-term factors, the likelihood of ethical conduct increases.

   C. Situational influences can motivate individuals to act in their short-term self-interests without recognizing the long-term risks or consequences for themselves and others.

Solution:

C is correct. Situational influences can motivate individuals to act in their short-term self-interests without recognizing the long-term risks or consequences for themselves and others. Large financial rewards are powerful situational influences, but in some situations, other situational influences, such as loyalty to colleagues, may be even more powerful.

5 ETHICAL VS. LEGAL STANDARDS

☐ compare and contrast ethical standards with legal standards

Many times, stakeholders have common ethical expectations. Other times, different stakeholders will have different perceptions and perspectives and use different criteria to decide whether something is beneficial and/or ethical.

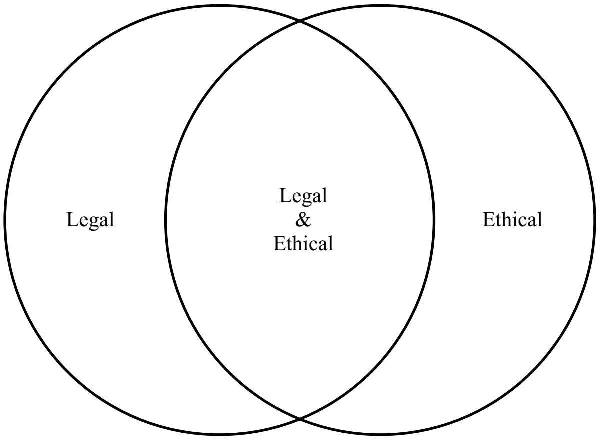
Laws and regulations often codify ethical actions that lead to better outcomes for society or specific groups of stakeholders. For example, some laws and regulations require businesses and their representatives to tell the truth. They require specific written disclosures in marketing and other materials. Complying with such rules is considered an ethical action; it creates a more satisfactory outcome that conforms to stakeholders' ethical expectations. As an example, consider disclosure requirements mandated by securities regulators regarding the risks of investing. Complying with such rules creates better outcomes for you, your clients, and your employer. First, compliance with the rule reduces the risk that clients will invest in securities without understanding the risks involved, which, in turn, reduces the risk that clients will file complaints and/or take legal action if their investments decline in value. Complying with the rules also reduces the risk that regulators will initiate an investigation, file charges, or/and discipline or sanction you and/or your employer. Any of these actions could jeopardize the reputation and future prospects of you and your employer. Conduct that reduces these risks (e.g., following disclosure rules) would be considered ethical; it leads to better outcomes for you, your clients, and your employer and conforms to the ethical expectations of various stakeholders.

Although laws frequently codify ethical actions, legal and ethical conduct are not always the same. Think about the diagram in Exhibit 1. Many types of conduct are both legal and ethical, but some conduct may be one and not the other. Some legal behaviors or activities may be considered unethical, and some behaviors or activities considered ethical may be deemed illegal in certain jurisdictions. Acts of civil disobedience, such as peaceful protests, may be in response to laws that individuals consider unethical. The act of civil disobedience may itself be considered ethical, and yet it violates existing local laws.

The investment industry has examples of conduct that may be legal but considered by some to be unethical. Some countries, for example, do not have laws prohibiting trading while in possession of material nonpublic information, but many investment professionals and CFA Institute consider such trading unethical.

Another area in which ethics and laws may conflict is the area of "whistleblowing." Whistleblowing refers to the disclosure by an individual of dishonest, corrupt, or illegal activity by an organization or government. Depending on the circumstances, a whistleblower may violate organizational policies and even local laws with the disclosure; thus, a whistleblower's actions may be deemed illegal and yet considered by some to be ethical.

Exhibit 1: Types of Conduct



Some people advocate that increased regulation and monitoring of the behavior of participants in the investment industry will increase trust in the financial markets. Although this approach may work in some circumstances, the law is not always the best mechanism to reduce unethical behavior for several reasons. First, laws typically follow market practices; regulators may proactively design laws and regulations to address existing or anticipated practices that may adversely affect the fairness and efficiency of markets or reactively design laws and regulations in response to a crisis or an event that resulted in significant monetary losses and loss of confidence/trust in the financial system. Regulators' responses typically take significant time, during which the problematic practice may continue or even grow. Once enacted, a new law may be vague, conflicting, and/or too narrow in scope. A new law may reduce or even eliminate the existing activity while simultaneously creating an opportunity for a different, but similarly problematic, activity. Additionally, laws vary across countries or jurisdictions, allowing questionable practices to move to places that lack laws relevant to the questionable practice. Laws are also subject to interpretation and compliance by market participants, who may choose to interpret the law in the most advantageous way possible or delay compliance until a later date. For these reasons, laws and regulations are insufficient to ensure the ethical behavior of investment professionals and market participants.

Ethical conduct goes beyond what is legally required and encompasses what different societal groups or communities, including professional associations, consider to be ethically correct behavior. To act ethically, individuals need to be able to think through the facts of the situation and make good choices even in the absence of clear laws or rules. In many cases, there is no simple algorithm or formula that will always lead to an ethical course of action. Ethics requires judgment—the ability to make considered decisions and reach sensible conclusions. Good ethical judgment requires actively considering the interests of stakeholders and trying to benefit multiple stakeholders—clients, family, colleagues, employers, market participants, and so forth—and minimize risks, including reputational risk.

EXAMPLE 4

Ethical vs. Legal Standards

1. Which of the following statements is *most* accurate?

   A. All legal behavior is ethical behavior.

   B. Some ethical behavior may be illegal.

   C. Legal standards represent the highest standard.

Solution:

B is correct. Some ethical behavior may be illegal. Civil disobedience is an example of what may be illegal behavior that some consider to be ethical. Legal and ethical behavior often coincide but not always. Standards of conduct based on ethical principles may represent a higher standard of behavior than the behavior required by law.

2. Which of the following statements is *most* accurate?

   A. Increased regulations are the most useful means to reduce unethical behavior by market participants.

   B. Regulators quickly design and implement laws and regulations to address practices that adversely affect the fairness and efficiency of markets.

   C. New laws designed to reduce or eliminate conduct that adversely affects the markets can create opportunities for different, but similarly problematic, conduct.

Solution:

C is correct. New laws designed to reduce or eliminate conduct that adversely affects the markets can create opportunities for different, but similarly problematic, conduct.

6 ETHICAL DECISION-MAKING FRAMEWORKS

☐ describe a framework for ethical decision making

Laws, regulations, professional standards, and codes of ethics can guide ethical behavior, but individual judgment is a critical ingredient in making principled choices and engaging in appropriate conduct. One strategy to increase trust in the investment industry is to increase the ability and motivation of market participants to act ethically and help them minimize the likelihood of unethical actions. By integrating ethics into the decision-making activities of employees, firms can enhance the ability and the motivation of employees to act ethically, thereby reducing the likelihood of unethical actions. The ability to relate an ethical decision-making framework to a firm's or profession's code of ethics allows investment professionals to bring the principles of the code of ethics to life. An investment professional's natural desire to "do the right thing" can be reinforced by building a culture of integrity and accountability in the workplace. Development, maintenance, and demonstration of a strong culture of integrity within the firm by senior management may be the single most important factor in promoting ethical behavior among the firm's employees.

Adopting a code that clearly lays out the ethical principles that guide the thought processes and conduct the firm expects from its employees is a critical first step. But a code of ethics, although necessary, is insufficient. Simply nurturing an inclination to do right is no match for the multitude of daily decisions that investment professionals make. We need to exercise ethical decision-making skills to develop the muscle memory necessary for fundamentally ethical people to make good decisions despite the reality of conflicts and our natural instinct for self-preservation. Just as coaching and practice transform our natural ability to run across a field into the technique and endurance required to run a race, teaching, reinforcing, and practicing ethical decision-making skills prepare us to confront the hard issues effectively. It is good for business, individuals, firms, the industry, and the markets, as well as society as a whole, to engage in the investment management profession in a highly ethical manner. A strong ethical culture, built on a defined set of principles, that helps honest, ethical people engage in ethical behavior will foster the trust of investors, lead to robust global financial markets, and ultimately benefit society. That is why ethics matter.

The Framework for Ethical Decision-Making

When faced with decisions that can affect multiple stakeholders, investment professionals must have a well-developed set of principles; otherwise, their thought processes can lead to, at best, indecision and, at worst, fraudulent conduct and destruction of the public trust. Establishing an ethical framework to guide your internal thought process regarding how to act is a crucial step to engaging in ethical conduct. Investment professionals are generally comfortable analyzing and making decisions from an economic (profit/loss) perspective. Given the importance of ethical behavior in carrying out professional responsibilities, it is also important to analyze decisions and their potential consequences from an ethical perspective. Using a framework for ethical decision making will help investment professionals to effectively examine their choices in the context of conflicting interests common to their professional obligations (e.g., researching and gathering information, developing investment recommendations, and managing money for others). Such a framework will allow investment professionals to analyze and choose options in a way that allows them to meet high standards of ethical behavior. An ethical decision-making framework provides investment professionals with a tool to help them adhere to a code of ethics. By applying the framework and analyzing the particular circumstances of each available alternative, investment professionals are able to determine the best course of action to fulfill their responsibilities in an ethical manner.

An ethical decision-making framework will help a decision maker see the situation from multiple perspectives and pay attention to aspects of the situation that may be less evident with a short-term, self-focused perspective. The goal of getting a broader picture of a situation is to be able to create a plan of action that is less likely to harm stakeholders and more likely to benefit them. If a decision maker does not know or understand the effects of his or her actions on stakeholders, the likelihood of making a decision and taking action that harms stakeholders is more likely to occur, even if unintentionally. Finally, an ethical decision-making framework helps decision makers explain and justify their actions to a broader audience of stakeholders.

Ethical decision-making frameworks are designed to facilitate the decision-making process for all decisions. They help people look at and evaluate a decision from multiple perspectives, enabling them to identify important issues they might not otherwise consider. Using an ethical decision-making framework consistently will help you develop sound judgment and decision-making skills and avoid making decisions that have unanticipated ethical consequences. Ethical decision-making frameworks come in many forms with varying degrees of detail. A general ethical decision-making framework is shown in Exhibit 2.

Exhibit 2: Ethical Decision-Making Framework

- Identify: Relevant facts, stakeholders and duties owed, ethical principles, conflicts of interest
- Consider: Situational influences, additional guidance, alternative actions
- Decide and act
- Reflect: Was the outcome as anticipated? Why or why not?

The ethical decision-making process includes multiple phases, each of which has multiple components. The process is often iterative, and you, the decision maker, may move between phases in an order different from what is presented. For simplicity, we will discuss the phases sequentially. In the initial phase, you will want to identify the important facts that you have available to you, as well as information that you may not have but would like to have to give yourself a more complete understanding of the situation. It is helpful to distinguish between facts and personal opinion, judgements, and biases. You will also want to identify the stakeholders—clients, family, colleagues, your employer, market participants, and so forth—and the duties you have to each of them. You will then want to identify relevant ethical principles and/or legal requirements that might apply to the situation. You should also identify any potential conflicts of interest inherent in the situation or conflicts in the duties you hold to others. For example, your duty to your client may conflict with your duty to your employer.

In the second phase of ethical decision making, you will take time to consider the situational influences as well as personal behavioral biases that could affect your thinking and thus decision making. These situational influences and biases could include a desire to please your boss, to be seen as successful by your peers and family, to gain acceptance, to earn a large bonus, and so on. During this phase, you may seek additional guidance from trusted sources—perhaps a family member, colleague, or mentor who can help you think through the situation and help you identify and evaluate alternative actions. You may turn to your compliance department for assistance or you may even consult outside legal counsel. Seeking additional guidance is a critical step in viewing the situation from different perspectives. You should seek guidance from someone, possibly external to the firm, who is not affected by the same situational influences and behavioral biases as you are and can, therefore, provide a fresh perspective. You should also seek guidance from your firm's policies and procedures and the CFA Institute Code and Standards. A helpful technique might be to imagine how an ethical peer or role model might act in the situation.

The next phase of the framework is to make a decision and act. After you have acted on your decision, you should take the time to reflect on and assess your decision and its outcome. Was the outcome what you anticipated? Why or why not? Had you properly identified all the important facts, stakeholders, duties to stakeholders, conflicts of interest, and relevant ethical principles? Had you considered the situational influences? Did you identify personal behavioral biases that might affect your thinking? Had you sought sufficient guidance? Had you considered and properly evaluated a variety of alternative actions? You may want to reflect on the decision multiple times as the immediate and longer-term consequences of your decision and actions become apparent.

The process is often iterative. After identifying the relevant facts and considering situational influences, you may, for example, decide that you cannot make a decision without more information. You may seek additional guidance on how to obtain the information you need. You may also begin considering alternative actions regarding how to proceed based on expectations of what the additional information will reveal, or you may wait until you have more information, reflect on what you have done and learned so far, and start the process over again. Sometimes cases can be complicated and multiple iterations may reveal that no totally acceptable solution can be created. Applying an ethical decision-making framework can help you evaluate the situation so you can make the best possible decision. The next section shows applications of the framework shown in Exhibit 2.

Applying the Framework

To illustrate how the framework could be applied in your career, consider the scenario in Example 5.

EXAMPLE 5

Applying an Ethical Decision-Making Framework I

1. You have been hired as a junior analyst with a major investment bank. When you join the bank, you receive a copy of the firm's policies as well as training on the policies. Your supervisor is the senior technology analyst for the investment bank. As part of your duties, you gather information, draft documents, conduct analysis, and perform other support functions for the senior analyst.

   Your employer is one of several investment banks working on the initial public offering (IPO) of a well-known technology company. The IPO is expected to generate significant revenues for the investment banks participating in the offering. The IPO has been highly anticipated and is in the news every day.

   You are thrilled when your supervisor asks you to work on several research projects related to analyzing and valuing the upcoming IPO for investors. You eagerly compile information and draft a one-page outline. You stop to consider what other information you could add to improve the report before proceeding. You realize that you have two excellent contacts in the technology industry who could review your work and provide some additional and potentially valuable perspectives. You draft an email to your contacts reading:

   > I am working on an analysis and valuation of Big Tech Company for investors. My employer is one of the banks participating in the IPO, and I want to make sure I have considered everything. I was hoping you could give me feedback on the prospects and risks facing Big Tech. Please treat all the attached material as confidential.

   Before hitting the send button, you stop and think about the ethical decision-making framework you have studied. You decide to apply the framework and jot down some notes as you work through the process: On the first page, you work through the identification phase and make a list of the relevant facts, stakeholders to whom you owe a duty, potential conflicts of interest, and ethical principles. This list is shown is Exhibit 3.

Exhibit 3: Identification Phase

- Relevant facts:
  - *Working on the deal/IPO of the decade*
  - *Employer is one of several investment banks working on IPO*
  - *The IPO is highly anticipated*
  - *A successful IPO could lead to additional investment banking deals and revenues for the firm*
  - *Supervisor is relying on me*
  - *Employer has documented policies and procedures*
  - *Industry is regulated, with many rules and regulations in place*
- Stakeholders and duties owed. I have a duty to the following:
  - *Supervisor*
  - *Employer*
  - *Employer's corporate client, the technology company*
  - *Employer's asset management and other investing clients*
  - *Employer's partners in the IPO*
  - *Investors and market participants interested in the IPO*
  - *All capital market participants*
  - *Profession*
  - *Society as a whole*
- Conflicts or potential conflicts of interest include the following:
  - *Gathering additional research from external sources versus maintaining confidentiality*
  - *Duty to supervisor versus desire to impress*
  - *Duty to corporate client versus duty to other clients of the firm*
  - *The firm's corporate client benefits from a high IPO price whereas the firm's asset management clients would benefit from a low IPO price*
  - *Making the IPO look attractive to the market (sell-side marketing) versus objective analysis of the investment potential of this deal (buy-side analysis)*

- *My bonus, compensation, and career prospects are tied to my supervisor's and the IPO's success; duty to employer, employer's investing clients, profession*

- Ethical principles that are relevant to this situation include the following:
  - *Duty of loyalty to employer*
  - *Client interests come first*
  - *Maintain confidences and confidentiality of information*
  - *Objectivity of analysis*
  - *Fairness to market participants*

On the next page, you write notes relating to the second phase of the framework, considering the various situational factors and the guidance available to you before considering alternative actions. These notes are shown in Exhibit 4.

Exhibit 4: Consideration Phase

- Situational influences:
  - *The firm's written policies*
  - *The bank will earn big fees from the IPO*
  - *I want to impress my boss—and potential future bosses*
  - *My bonus, compensation, and career prospects will be influenced by my contribution to the success of this deal and other deals*
  - *I am one of very few people working on this deal; it is a real honor, and others would be impressed that I am working on this deal*
  - *My employer is filled with successful and wealthy people who are go-getters; I want to be successful and wealthy like them*

- Additional guidance. I could seek guidance from the following:
  - *The firm's code of ethics*
  - *The firm's written policies*
  - *A peer in my firm*
  - *My supervisor, the senior analyst*
  - *The compliance department*
  - *A mentor either at the firm or perhaps from university or industry*
  - *The CFA Institute Code and Standards*

- *Outside legal counsel*

- Alternative actions. I could consider the following:
  - *Asking contacts what they have heard*
  - *Submitting the report as a draft and suggesting that contacts in the industry might be able to provide more perspective*
  - *Sending a survey to various technology industry veterans soliciting their viewpoints on developments*

After completing these steps, you decide to check the firm's policies. Under a section entitled "Research Analyst Role in Securities Offerings," the manual states, "You may not distribute any written (which include email, fax, electronic, and other means) material related to companies and/or their offerings . . . during the course of any offering and the related quiet period."

You read further and note a section entitled "Wall Crossing Policy and Procedures" that states that "employees with confidential information may not communicate the information to anyone who does not have a valid need to know" without first obtaining clearance from the legal and compliance department.

You decide that your contacts do not have a "valid need to know" and that it is unlikely the firm's legal and compliance professionals would approve sharing the information. You then decide to mention your contacts to the senior research analyst. He suggests that they may have some useful perspective and that you might talk to them to hear their perspective and cautions you not to disclose any information about any of the firm's clients, pending deals, or research. You return to your desk, delete the email, and following the senior research analyst's advice, call your contacts on the telephone to discuss the technology sector, its prospects, and its challenges. During the calls, you take care not to reveal any details about Big Tech Company or its offering.

Whatever action you take, you should take time afterward to reflect on the decision and the outcome. Was the outcome as anticipated? Why or why not?

The initial facts presented in the example are based on the real-life experience of a young junior analyst working on a highly anticipated IPO. The junior analyst may or may not have used an ethical decision-making framework to evaluate his situation. Without seeking additional guidance, the junior analyst sent an email similar to the one in the example with an attachment that included confidential, proprietary information, including the senior analyst's analysis and forecasts. Months later, long after the IPO offering, the junior analyst's email was discovered by his employer. When questioned, he admitted that he had received training regarding the firm's policies and that he did not discuss or seek approval from anyone before sending the email. Two days later, the firm terminated the junior analyst's employment and reported to regulatory authorities that he had been terminated for distributing written materials, by email, during a securities offering in violation of firm policies that prohibit the dissemination of any written materials during the course of a securities offering and related periods. The junior analyst's supervisor also lost his job for failing to properly supervise the analyst. Multiple regulators investigated the matter, and the firm was fined millions of dollars for failing to supervise its employees properly. The information regarding the junior analyst's termination was posted and remains available on the regulator's website for all to see. Future employers conducting routine background checks will know that the analyst was terminated for violating firm policies relating to a securities offering.

The example presented is similar to situations faced by many analysts. Using an ethical decision-making framework will help you evaluate situations from multiple perspectives, avoid poor decision making, and avoid the consequences that can result from taking an ill-conceived course of action. Using an ethical decision-making framework is no guarantee of a positive outcome but may help you avoid making unethical decisions.

EXAMPLE 6

Applying an Ethical Decision-Making Framework II

A financial adviser has been saving a portion of his salary to purchase a new vehicle. He is on track to have enough saved within the next three months. His employer has offered a special bonus for this quarter, which will go to the team that attracts the most new investors into the firm's investment funds. In addition to the potential bonus, the firm pays a 5% commission to employees who sell shares in the firm's investment funds. Several of the funds are highly rated, including one designed to provide steady income to investors.

The financial adviser has added only a few new investors to the firm's funds, but his teammates have been very successful in their efforts. The end of the quarter is one week away, and his team is competing closely with another team for the bonus. One of his teammates informs the financial adviser that he really needs the bonus so his elderly mother can receive medical treatment.

Later that day, the financial adviser meets with an elderly client on a limited income who is seeking more income from his investment portfolio. The client is 89 years old and in poor health. According to the client's will, the client's investment portfolio will go to his favorite charity upon his death.

1. Which of the following situational influences is likely to have the *most* effect on the financial adviser's efforts to get new clients to invest in the funds? His relationship with his:

   A. client.

   B. employer.

   C. teammates.

Solution:

C is correct. The financial adviser's relationship with his teammates is likely to have the most effect on the financial adviser's efforts. The teammates share in earning the bonus from the employer. In addition, the team works with each other on a regular basis where there is a likelihood that social influences of working together play a role in decision making and effort.

2. Which of the following statements is *most* accurate? An ethical decision-making framework:

   A. is only beneficial when a firm lacks a code of ethics.

   B. is used to improve compliance with laws and regulations.

C. is a tool for analyzing the potential alternative actions and consequences of a decision.

Solution:

C is correct. An ethical decision-making framework is a tool for analyzing the potential alternative actions and consequences of a decision.

3. Which of the following is *most* accurate? Ethical decision-making frameworks:

   A. raise awareness of different perspectives.

   B. focus attention on short-term consequences.

   C. allocate more weight to those who will directly benefit from the decision.

Solution:

A is correct. Ethical decision-making frameworks raise awareness of different perspectives. The framework should consider short-term consequences, but they are not the focus of the framework. Similarly, the framework may allocate more weight to those who directly benefit from decisions, but this is not the primary goal of an ethical decision-making framework.

4. Which of the following is *most* accurate? Ethical decision-making frameworks:

   A. are not needed if behavior is legal.

   B. identify who gains the most from a decision.

   C. can help reduce unanticipated ethical lapses and unexpected consequences.

Solution:

C is correct. Ethical decision-making frameworks can help avoid unanticipated ethical consequences. As it relates to A, ethics standards are often higher than legal standards so an ethical decision-making framework would be needed. Although B is accurate, identifying who gains most from the decision is a small component of the framework.

5. Using an ethical decision-making framework, which of the following duties would *most likely* take precedence in the scenario described? The financial adviser's duty to his:

   A. client.

   B. employer.

   C. colleagues.

Solution:

A is correct. Using an ethical decision-making framework, the financial adviser's relationship with his client would most likely take precedence in this scenario. The adviser should put his client's interests first. The exception to client interests taking precedence occurs when market integrity effects take precedence.

6. Using an ethical decision-making framework, the financial adviser would *most likely*:

   A. recommend that the elderly client invest at least some of his assets in the highly rated fund.

   B. research other investments that can provide steady income before making a recommendation to his elderly client.

   C. disclose the commission he would earn before recommending that the elderly client invest at least some of his assets in the highly rated fund.

Solution:

B is correct. Using an ethical decision-making framework, the financial adviser would identify the relevant facts, stakeholders, duties owed, and potential conflicts. In this scenario, the financial adviser owes a duty to his client as well as his employer. His client's interests take precedence over all other interests. The bonus and his colleague's desire to help his mother are situational influences. To navigate this situation, the financial adviser should seek additional information; he should research the risk and return parameters and fee structures of other investments that can provide steady income before making a recommendation to his client.

CONCLUSION

7

This reading introduced ideas and concepts that will help you understand the importance of ethical behavior in the investment industry as well as the challenges to adhering to high ethical standards. A code of ethics will communicate an organization's values and the expected behavior of its members as well as provide guidance for decision making. A code of ethics may be further enhanced and clarified by the adoption of standards of conduct. Professions and professional organizations, such as the CFA Institute, can help to establish codes and standards that provide a framework and technical competence for practitioners. An ethical decision-making framework combined with a code of ethics may help investment professionals analyze their decisions in a way that identifies potential conflicts and negative consequences.

Knowing the rules to apply in a particular situation, although important, may not be sufficient to ensure ethical conduct if used alone. Responsible professionals in the investment industry must be able both to recognize areas that are prone to ethical pitfalls and to identify and process those circumstances and influences that can impair judgment and lead to ethical lapses.

SUMMARY

- Ethics refers to the study of making good choices. Ethics encompasses a set of moral principles and rules of conduct that provide guidance for our behavior.
- Situational influences are external factors that may shape our behavior.

- Challenges to ethical behavior include being overconfident in our own morality, underestimating the effect of situational influences, and focusing on the immediate rather than long-term outcomes or consequences of a decision.
- In any given profession, the code of ethics publicly communicates the established principles and expected behavior of its members.
- Members of a profession use specialized knowledge and skills to serve others; they share and agree to adhere to a common code of ethics to serve others and advance the profession.
- A code of ethics helps foster public confidence that members of the profession will use their specialized skills and knowledge to serve their clients and others.
- A profession is an occupational group that has specific education, expert knowledge, and a framework of practice and behavior that underpins community trust, respect, and recognition.
- The requirement to uphold high ethical standards is one clear difference between professions and craft guilds or trade bodies.
- A primary goal of professions is to establish trust among clients and among society in general.
- Common characteristics of professions include normalization of practitioner behavior, service to society, client focus, high entry standards, a body of expert knowledge, encouragement and facilitation of continuing education, monitoring of professional conduct, collegiality, recognized overseeing bodies, and encouragement of member engagement.
- The investment management profession has become increasingly global, driven by the opening of capital markets, coordination of regulation across borders, and the emergence of technology.
- Investment management professionals are trusted to draw on a body of formal knowledge and apply that knowledge with care and judgement. In comparison to clients, investment professionals are also expected to have superior financial expertise, technical knowledge, and knowledge of the applicable laws and regulations.
- As a professional body, CFA Institute gathers knowledge from practicing investment professionals, conducts rigorous examinations, and ensures practitioner involvement in developing its codes and values.
- Investment management professionals are likely to encounter dilemmas, including those with ethical implications. Professionals should consider carefully how to determine the facts of the issue and assess the implications.
- High ethical standards always matter and are of particular importance in the investment management profession, which is based almost entirely on trust. Clients trust investment professionals to use their specialized skills and knowledge to serve clients and protect client assets. All stakeholders gain long-term benefits when investment professionals adhere to high ethical standards.
- Legal standards are often rule based. Ethical conduct goes beyond legal standards, balancing self-interest with the direct and indirect consequences of behavior on others.
- A framework for ethical decision making can help people look at and evaluate a decision from different perspectives, enabling them to identify important issues, make wise decisions, and limit unintended consequences.

PRACTICE PROBLEMS

1. Benchmarks for minimally acceptable behaviors of community members are:

   A. a code of ethics.

   B. laws and regulations.

   C. standards of conduct.

2. Specialized knowledge and skills, a commitment to serve others, and a shared code of ethics *best* characterize a(n):

   A. vocation.

   B. profession.

   C. occupation.

3. When unethical behavior erodes trust in an investment firm, that firm is *more likely* to experience:

   A. lower revenues only.

   B. higher expenses only.

   C. lower revenues and higher expenses.

4. High ethical standards are distinguishing features of which of the following bodies?

   A. Craft guilds

   B. Trade bodies

   C. Professional bodies

5. Fiduciary duty is a standard *most likely* to be upheld by members of a(n):

   A. employer.

   B. profession.

   C. not-for-profit body.

6. Which of the following *best* identifies an internal trait that may lead to poor ethical decision making?

   A. Overconfidence

   B. Loyalty to employer

   C. Promise of money or prestige

7. Situational influences in decision making will *most likely* be minimized if:

   A. strong compliance programs are in place.

   B. longer-term consequences are considered.

C. individuals believe they are truthful and honest.

8. Decision makers who use a compliance approach are *most likely* to:
   A. avoid situational influences.
   B. oversimplify decision making.
   C. consider more factors than when using an ethical decision-making approach.

9. To maintain trust, the investment management profession must be interdependent with:
   A. regulators.
   B. employers.
   C. investment firms.

10. Which is an example of an activity that may be legal but that CFA Institute considers unethical?
    A. Making legally required disclosures in marketing materials
    B. Trading while in possession of material nonpublic information
    C. Disclosure by an employee of his or her own company's dishonest activity

11. An ethical decision-making framework will *most likely*:
    A. include a pre-determined, uniform sequence.
    B. focus exclusively on confirmable facts and relationships.
    C. help avoid a decision that has unanticipated ethical consequences.

12. When an ethical dilemma occurs, an investment professional should *most likely* first raise the issue with a:
    A. mentor outside the firm.
    B. professional body's hotline.
    C. senior individual in the firm.

SOLUTIONS

1. C is correct. Standards of conduct are applied to specific communities or societal groups and identify specific behaviors required of community members. These standards of conduct serve as benchmarks for the minimally acceptable behavior of community members. Codes of ethics serve as a general guide for how community members should act; they communicate the organization's values and overall expectations regarding member behavior, but they do not identify specific behaviors required of community members. Laws and regulations are rules of conduct defined by governments and related entities about obligatory and forbidden conduct broadly applicable for individuals and entities under their jurisdiction.

2. B is correct. A profession has several characteristics that distinguish it from an occupation or vocation, such as specialized knowledge and skills, service to others, and a code of ethics shared by its members. A profession is the ultimate evolution of an occupation, resulting from excellence in practice, a mastery mindest, and expected adherence to a code of ethics and standards of practice.

3. C is correct. Unethical behavior ultimately harms investment firms. Clients are not attracted if they suspect unethical behavior, leading to less business and lower revenues. Investment firms may also experience higher relative costs because regulators are more likely to have cause to initiate costly investigations.

4. C is correct. High ethical standards distinguish professions from the craft guilds or trade bodies. Unlike trade bodies, professional bodies also typically have a mission to serve society and enforce professional conduct rules for practitioners.

5. B is correct. Fiduciary duty is an obligation to deliver a high standard of care when acting for the benefit of another party. Professionals must act in the best interest of the client, exercising a reasonable level of care, skill, and diligence. Other entities—including employers, regulators, trade associations, and not-for-profit bodies—may also support an industry but are not the same as professional bodies. Unlike professions, these other entities generally do not exist to set and maintain professional standards.

6. A is correct. An overconfidence bias can lead individuals to put too much importance on internal traits and intrinsic motivations, such as their own perceptions of personal honesty, that can lead to faulty decision making. Loyalty to an employer and promise of money or prestige are situational influences that can lead to faulty decision making.

7. B is correct. Consciously considering long-term consequences will help offset situational influences. We more easily recognize and consider short-term situational influences than longer-term considerations because longer-term considerations have fewer immediate consequences than situational influences do. When decision making is too narrowly focused on short-term factors, we tend to ignore longer-term risks and consequences, and the likelihood of poor ethical decision making increases. A strong compliance policy is a good first step toward developing an ethical culture; a focus on rules adherence may not be sufficient. Emphasis on compliance may not encourage decision makers to consider the larger picture and can oversimplify decision making. Taken to the extreme, a strong compliance culture can become another situational influence that blinds employees to other important considerations. An overconfidence bias can place too much importance on internal traits and intrinsic motivations, such as “I'm honest and would

not lie," even though studies have shown that internal traits are generally not the main determinant of whether or not someone will behave ethically in a given situation.

8. B is correct. A compliance approach can oversimplify decision making and may not encourage decision makers to consider the larger picture. A strong compliance culture may be a good start in developing an ethical culture but can become another situational influence that may result in employees failing to consider other important factors.

9. C is correct. The investment management profession and investment firms must be interdependent to maintain trust. Employers and regulators have their own standards and practices, which may differ from regulations and standards set by professional bodies.

10. B is correct. The investment industry has examples of conduct that may be legal but that CFA Institute considers unethical. Trading while in possession of material nonpublic information is not prohibited by law worldwide and can, therefore, be legal, but CFA Institute considers such trading unethical.

11. C is correct. Using an ethical decision-making framework consistently will help you develop sound judgment and decision-making skills and avoid making decisions that have unanticipated ethical consequences. The decision-making process is often iterative, and the decision maker may move between phases of the framework. A decision maker should consider more than confirmable facts and relationships; for example, the decision maker should consider situational influences and personal biases.

12. C is correct. When a dilemma occurs, raising an issue internally with a senior employee is often a good starting place and creates an opportunity for an independent internal review. Protecting the client and the firm may take priority over the position of an individual professional raising a concern.

LEARNING MODULE

2

Code of Ethics and Standards of Professional Conduct

LEARNING OUTCOMES

Mastery	*The candidate should be able to:*
□	describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards
□	identify the six components of the Code of Ethics and the seven Standards of Professional Conduct
□	explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard

PREFACE

1

□	describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards

The *Standards of Practice Handbook* (*Handbook*) provides guidance to the people who grapple with real ethical dilemmas in the investment profession on a daily basis; the *Handbook* addresses the professional intersection where theory meets practice and where the concept of ethical behavior crosses from the abstract to the concrete. The *Handbook* is intended for a diverse and global audience: CFA Institute members navigating ambiguous ethical situations; supervisors and direct/indirect reports determining the nature of their responsibilities to each other, to existing and potential clients, and to the broader financial markets; and candidates preparing for the Chartered Financial Analyst (CFA) examinations.

Events in global financial markets test the ethical mettle of financial market participants, including CFA Institute members and candidates. The standards taught in the CFA Program and by which CFA Institute members and candidates must abide represent timeless ethical principles and professional conduct for all market conditions. Through adherence to these standards, which continue to serve as the model for ethical behavior in the investment profession globally, each market participant does his or her part to improve the integrity and efficient operations of the financial markets.

The *Handbook* provides guidance for understanding the interconnectedness of the aspirational and practical principles and provisions of the Code of Ethics and Standards of Professional Conduct (Code and Standards). The Code contains high-level aspirational ethical principles that drive members and candidates to create a positive and reputable investment profession. The Standards contain practical ethical principles of conduct that members and candidates must follow to achieve the broader industry expectations. However, applying the principles individually may not capture the complexity of ethical requirements related to the investment industry. The Code and Standards should be viewed and interpreted as an interwoven tapestry of ethical requirements. Through members' and candidates' adherence to these principles as a whole, the integrity of and trust in the capital markets are improved.

Evolution of the CFA Institute Code of Ethics and Standards of Professional Conduct

The Code and Standards are regularly reviewed and updated so that they remain effective and continue to represent the highest ethical standards in the global investment industry. CFA Institute strongly believes that revisions of the Code and Standards are undertaken not for cosmetic purposes but to add value by addressing legitimate concerns and improving comprehension. In 2023, the CFA Institute Board of Governors approved revisions to the Code and Standards that are fully described later in this learning module.

Changes to the Code and Standards have far-reaching implications for the CFA Institute membership, the CFA Program, and the investment industry as a whole. CFA Institute members and candidates are *required* to adhere to the Code and Standards. In addition, the Code and Standards are often adopted, in whole or in part, by firms and regulatory authorities. Their relevance goes well beyond CFA Institute members and candidates.

Standards of Practice Handbook

The periodic revisions of the *Standards of Practice Handbook* have come in conjunction with updates of the Code and Standards. The *Handbook* is the fundamental element of the ethics education effort of CFA Institute and the primary resource for guidance in interpreting and implementing the Code and Standards. The *Handbook* seeks to educate members and candidates on how to apply the Code and Standards to their professional lives and thereby benefit their clients, employers, and the investing public in general. The *Handbook* explains the purpose of the Code and Standards and how they apply in a variety of situations. The sections discuss and amplify each standard and suggest procedures for compliance.

Examples in the "Application of the Standard" sections are meant to illustrate how the standard applies to hypothetical but factual situations. The names contained in the examples are fictional and are not meant to refer to any actual person or entity. Unless otherwise stated (e.g., one or more people are specifically identified), individuals in each example are subject to the requirements of the Code and Standards. Because factual circumstances vary so widely and often involve gray areas, the explanatory material and examples are not intended to be all inclusive. Many examples set forth in the application sections involve standards that have legal counterparts; ***members are strongly urged to discuss with their supervisors and legal and compliance departments the content of the Code and Standards and the members' general obligations under the Code and Standards***.

CFA Institute recognizes that the presence of any set of ethical standards may create a false sense of security unless the documents are fully understood, enforced, and made a meaningful part of everyday professional activities. The *Handbook* is intended to provide a useful frame of reference that outlines ethical professional conduct for the organization's members and candidates. The *Handbook* cannot cover every contingency or circumstance, however, and it does not attempt to do so. The development and interpretation of the Code and Standards are evolving processes; the Code and Standards will be subject to continuing refinement.

Summary of the 2023 Revisions to the Code and Standards

In 2023, the CFA Institute Board of Governors revised the Standards of Professional Conduct in three areas, resulting in the inclusion of one new standard and revisions to two existing standards. The following is a summary of the changes:

1. Within Standard I: Professionalism, the Board approved a new standard requiring members to act with and maintain the competence necessary to fulfill their professional responsibilities, thus reinforcing the principle set forth in the Code of Ethics.
2. Within Standard V: Investment Analysis, Recommendations, and Actions, the Board revised Standard V(B) Communication with Clients and Prospective Clients to require disclosures about the nature of the services provided by members and candidates and the costs to the client associated with those services.
3. Within Standard VI: Conflicts of Interest, the Board changed the name of Standard VI(A) to "Standard VI(A) Avoid or Disclose Conflicts" and revised the standard to require members and candidates to either avoid conflicts of interest or disclose those conflicts. Previously, there was no mention of avoiding conflicts of interest in the standard.

New guidance and examples have been added to the *Handbook* to fully explain these new requirements.

New and Revised Standards of Professional Conduct

Competence Standard

I. PROFESSIONALISM

E. Competence

Members and Candidates must:

1. Act with and maintain the competence necessary to fulfill their professional responsibilities.

Given the diverse range of professional services engaged in by members and candidates, the knowledge, skills, and abilities necessary to successfully fulfill their role will vary according to the nature of their professional duties. Over time, a member's role may expand, requiring new or different knowledge, skills, and abilities. Members will develop and refine their skills and abilities throughout their professional careers. Requiring members and candidates to act with and maintain appropriate levels of competence will help ensure they provide a high standard of professional service for their clients and employers.

Currently, the Code of Ethics requires members and candidates to "act with integrity, competence, and diligence" and to "maintain and improve their professional competence and strive to improve the competence of other investment professionals." This new standard is consistent with and directly supports the requirements of the Code of Ethics. Standard I(E) makes these requirements of the Code of Ethics more explicit and emphasizes the need for members and candidates to continuously maintain or improve the competence required by their professional position.

The skills and abilities necessary for members and candidates to successfully fulfill their role vary according to the nature and complexity of their professional duties. As a result, there will be different criteria for competence for different members. An examination of the facts and circumstances of each member or candidate will dictate their expected conduct under this standard.

Finally, Standard I(E) does not require members and candidates to engage in any specific program of professional development or continuing education. There are a variety of ways members and candidates can demonstrate and maintain competence when engaging in their professional responsibilities.

Disclosure of Nature of Services and Costs to Client

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

B. Communication with Clients and Prospective Clients

Members and Candidates must:

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

A fundamental goal of the Code and Standards is to protect client interests and allow clients to make fully informed decisions about their investments and financial well-being. Providing clients with information about the nature of the services they can expect from investment professionals and the financial impact they can expect from those services is critical to achieving this goal. The disclosures required by this new standard will permit clients to make informed decisions as to whether to engage with the member or candidate and their firm.

Standard V(B) Communication with Clients and Prospective Clients also requires members to disclose the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and to promptly disclose any material changes to these processes. The associated financial impact is an important part of the investment process but, until now, was not explicitly addressed as part of this disclosure. The revision to Standard V(B) fills this gap.

Revised Standard Relating to Conflicts

VI. CONFLICTS OF INTEREST

Avoid or Disclose Conflicts

Members and Candidates must:

1. Avoid or make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity and interfere with respective duties to their clients, prospective clients, and employer.

2. Ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

Standard VI(A) has always required members and candidates to disclose conflicts, but previously, the language of the standard made no mention of avoiding conflicts. Nevertheless, the guidance for Standard VI: Conflicts of Interest has long stated that best practice is to avoid conflicts or the appearance of conflicts. Including the option to avoid versus simply disclosing conflicts in the language of the standard emphasizes that members and candidates should avoid conflicts of interest whenever reasonably possible. While avoiding conflicts altogether is preferred, often in the investment industry it may not be reasonable for members and candidates to avoid a conflict or the perception of a conflict. When it is not reasonable for members and candidates to avoid a conflict, Standard VI(A) continues to require clear and complete disclosure of the conflict.

CFA Institute Professional Conduct Program

All CFA Institute members and candidates enrolled in the CFA Program are required to comply with the Code and Standards. The CFA Institute Board of Governors maintains oversight and responsibility for the Professional Conduct Program (PCP), which, in conjunction with the Disciplinary Review Committee (DRC), is responsible for enforcement of the Code and Standards. The DRC is a volunteer committee of CFA charterholders who serve on panels to review conduct and partner with Professional Conduct staff to establish and review professional conduct policies. The CFA Institute Bylaws and Rules of Procedure for Professional Conduct (Rules of Procedure) form the basic structure for enforcing the Code and Standards. The Professional Conduct division is also responsible for enforcing testing policies of other CFA Institute education programs, as well as the professional conduct of Certificate in Investment Performance Measurement (CIPM) certificants.

Professional Conduct inquiries come from a number of sources. First, members and candidates must self-disclose on the annual Professional Conduct Statement all matters that question their professional conduct, such as involvement in civil litigation or a criminal investigation or being the subject of a written complaint. Second, written complaints received by Professional Conduct staff can bring about an investigation. Third, CFA Institute staff may become aware of questionable conduct by a member or candidate through the media, regulatory notices, or another public source. Fourth, candidate conduct is monitored by proctors who complete reports on candidates suspected to have violated testing rules on exam day. Lastly, CFA Institute may also conduct analyses of scores and exam materials after the exam, as well as monitor online and social media to detect disclosure of confidential exam information.

When an inquiry is initiated, the Professional Conduct staff conducts an investigation that may include requesting a written explanation from the member or candidate; interviewing the member or candidate, complaining parties, and third parties; and collecting documents and records relevant to the investigation. Upon reviewing the material obtained during the investigation, the Professional Conduct staff may conclude the inquiry with no disciplinary sanction, issue a cautionary letter, or continue proceedings to discipline the member or candidate. If the Professional Conduct staff believes a violation of the Code and Standards or testing policies has occurred, the member or candidate has the opportunity to reject or accept any charges and the proposed sanctions.

If the member or candidate does not accept the charges and proposed sanction, the matter is referred to a panel composed of DRC 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.

Adoption of the Code and Standards

The Code and Standards apply to individual members of CFA Institute and candidates in the CFA Program. CFA Institute does encourage firms to adopt the Code and Standards, however, as part of their code of ethics. Those who claim compliance should fully understand the requirements of each of the principles of the Code and Standards.

Once a party—nonmember or firm—ensures its code of ethics meets the principles of the Code and Standards, that party should make the following statement whenever claiming compliance:

> [Insert name of party] claims compliance with the CFA Institute Code of Ethics and Standards of Professional Conduct. This claim has not been verified by CFA Institute.

CFA Institute welcomes public acknowledgement, when appropriate, that firms are complying with the CFA Institute Code of Ethics and Standards of Professional Conduct. For firms that would like to distribute the Code and Standards to clients and potential clients, attractive one-page copies of the Code and Standards, including translations, are available on the CFA Institute website (www.cfainstitute.org).

CFA Institute has also published the Asset Manager Code, which is designed, in part, to help asset managers comply with regulations mandating codes of ethics for investment advisers. Whereas the Code and Standards are aimed at individual investment professionals who are members of CFA Institute or candidates in the CFA Program, the Asset Manager Code applies to firms. The Asset Manager Code provides specific, practical guidelines for asset managers in six areas: loyalty to clients, the investment process, trading, compliance, performance, and disclosure. The Asset Manager Code and the appropriate steps to acknowledge compliance can be found on the CFA Institute website (www.cfainstitute.org).

Acknowledgments

CFA Institute is a not-for-profit organization that is heavily dependent on the expertise and intellectual contributions of member volunteers. Members devote their time because they share a mutual interest in the organization's mission to promote and achieve ethical practice in the investment profession. CFA Institute owes much to the volunteers' abundant generosity and energy in extending ethical integrity.

The CFA Institute Standards of Practice Council (SPC), a group consisting of CFA charterholder volunteers from many different countries, is charged with maintaining and interpreting the Code and Standards and ensuring that they are effective. The SPC draws its membership from a broad spectrum of organizations in the securities field, including brokers, investment advisers, banks, and insurance companies.

The SPC continually evaluates the Code and Standards, as well as the guidance in the *Handbook*, to ensure that they are

- representative of high standards of professional conduct,
- relevant to the changing nature of the investment profession,
- globally applicable,
- sufficiently comprehensive, practical, and specific,
- enforceable, and
- testable for the CFA Program.

Over the years, many volunteer members of the SPC have spent countless hours reviewing and discussing revisions to the Code and Standards and updates to the guidance that make up the *Handbook*. CFA Institute would like to thank all the current and former members of the SPC who generously donated their time and energy to this effort.

ETHICS AND THE INVESTMENT INDUSTRY

2

Society ultimately benefits from efficient markets where capital can freely flow to the most productive or innovative destination. Well-functioning capital markets efficiently match those needing capital with those seeking to invest their assets in revenue-generating ventures. In order for capital markets to be efficient, investors must be able to trust that the markets are fair and transparent and offer them the opportunity to be rewarded for the risk they choose to take. Laws, regulations, and enforcement play a vital role but are insufficient alone to guarantee fair and transparent markets. The markets depend on an ethical foundation to guide participants' judgment and behavior. CFA Institute maintains and promotes the Code of Ethics and Standards of Professional Conduct in order to create a culture of ethics for the ultimate benefit of society.

Why Ethics Matters

Ethics can be defined as a set of moral principles or rules of conduct that provide guidance for our behavior when it affects others. Widely acknowledged fundamental ethical principles include honesty, fairness, diligence, and care and respect for others. Ethical conduct follows those principles and balances self-interest with both the direct and the indirect consequences of that behavior for other people.

Not only does unethical behavior by individuals have serious personal consequences—ranging from job loss and reputational damage to fines and even jail—but unethical conduct from market participants, investment professionals, and those who service investors can damage investor trust and thereby impair the sustainability of the global capital markets as a whole. Unfortunately, there seems to be an unending parade of stories bringing to light accounting frauds and manipulations, Ponzi schemes, insider-trading scandals, and other misdeeds. Not surprisingly, this has led to erosion in public confidence in investment professionals. Empirical evidence from numerous surveys documents the low standing in the eyes of the investing public of banks and financial services firms—the very institutions that are entrusted with the economic well-being and retirement security of society.

Governments and regulators have historically tried to combat misconduct in the industry through regulatory reform, with various levels of success. Global capital markets are highly regulated to protect investors and other market participants.

However, compliance with regulation alone is insufficient to fully earn investor trust. Individuals and firms must develop a "culture of integrity" that permeates all levels of operations and promotes the ethical principles of stewardship of investor assets and working in the best interests of clients, above and beyond strict compliance with the law. A strong ethical culture that helps honest, ethical people engage in ethical behavior will foster the trust of investors, lead to robust global capital markets, and ultimately benefit society. That is why ethics matters.

Ethics, Society, and the Capital Markets

CFA Institute includes the concept "for the ultimate benefit of society" as part of its mission. The premise is that we want to live in a socially, politically, and financially stable society that fosters individual well-being and welfare of the public. A key ingredient for this goal is global capital markets that facilitate the efficient allocation of resources so that the available capital finds its way to places where it most benefits that society. These investments are then used to produce goods and services, to fund innovation and jobs, and to promote improvements in standards of living. Indeed, such a function serves the interests of the society. Efficient capital markets, in turn, provide a host of benefits to those providing the investment capital. Investors are provided the opportunity to transfer and transform risk because the capital markets serve as an information exchange, create investment products, provide liquidity, and limit transaction costs.

However, a well-functioning and efficient capital market system is dependent on trust of the participants. If investors believe that capital market participants—investment professionals and firms—cannot be trusted with their financial assets or that the capital markets are unfair such that only insiders can be successful, they will be unlikely to invest or, at the very least, will require a higher risk premium. Decreased investment capital can reduce innovation and job creation and hurt the economy and society as a whole. Reduced trust in capital markets can also result in a less vibrant, if not smaller, investment industry.

Ethics for a global investment industry should be universal and ultimately support trust and integrity above acceptable local or regional customs and culture. Universal ethics for a global industry strongly supports the efficiency, values, and mission of the industry as a whole. Different countries may be at different stages of development in establishing standards of practice, but the end goal must be to achieve rules, regulations, and standards that support and promote fundamental ethical principles on a global basis.

Capital Market Sustainability and the Actions of One

Individuals and firms also have to look at the indirect impacts of their actions on the broader investment community. The increasingly interconnected nature of global finance brings to the fore an added consideration of market sustainability that was, perhaps, less appreciated in years past. In addition to committing to the highest levels of ethical behavior, today's investment professionals and their employers should consider the long-term health of the market as a whole.

Apparently isolated and unrelated decisions, however innocuous when considered on an individual basis, in aggregate can precipitate a market crisis. In an interconnected global economy and marketplace, each participant should strive to be aware of how his or her actions or the products he or she distributes may have an impact on capital market participants in other regions or countries.

Investment professionals should consider how their investment decision-making processes affect the global financial markets in the broader context of how they apply their ethical and professional obligations. Those in positions of authority have a special responsibility to consider the broader context of market sustainability in their development and approval of corporate policies, particularly those involving risk management and product development. In addition, corporate compensation strategies should not encourage otherwise ethically sound individuals to engage in unethical or questionable conduct for financial gain. Ethics, sustainability, and properly functioning capital markets are components of the same concept of protecting the best interests of all. To always place the interests of clients ahead of both investment professionals' own interests and those of their employer remains a key ethos.

The Relationship between Ethics and Regulations

Some equate ethical behavior with legal behavior: If you are following the law, you must be acting appropriately. Ethical principles, like laws and regulations, prescribe appropriate constraints on our natural tendency to pursue self-interest that could harm the interests of others. Laws and regulations often attempt to guide people toward ethical behavior, but they do not cover all unethical behavior. Ethical behavior is often distinguished from legal conduct by describing legal behavior as what is required and ethical behavior as conduct that is morally correct. Ethical principles go beyond that which is legally sufficient and encompass what is the right thing to do.

Given many regulators' lack of sufficient resources to enforce well-conceived rules and regulations, relying on a regulatory framework to lead the charge in establishing ethical behavior has its challenges. Therefore, reliance on compliance with laws and regulation alone is insufficient to ensure ethical behavior of investment professionals or to create a truly ethical culture in the industry.

Inevitably, some individuals will succeed at circumventing the regulatory rules for their personal gain. Only the application of strong ethical principles, at both the individual level and the firm level, will limit abuses. Knowing the rules or regulations to apply in a particular situation, although important, may not be sufficient to ensure ethical conduct. Individuals must be able both to recognize areas that are prone to ethical pitfalls and to identify and process those circumstances and influences that can impair ethical judgment.

Applying an Ethical Framework

Laws, regulations, professional standards, and codes of ethics can guide ethical behavior, but individual judgment is a critical ingredient in making principled choices and engaging in appropriate conduct. When faced with an ethical dilemma, individuals must have a well-developed set of principles; otherwise, their thought processes can lead to, at best, equivocation and indecision and, at worst, fraudulent conduct and destruction of the public trust. Establishing an ethical framework for an internal thought process prior to deciding to act is a crucial step in engaging in ethical conduct.

Most investment professionals are used to making decisions from a business (profit/loss) outlook. But given the importance of ethical behavior in carrying out professional responsibilities, it is critical to also analyze decisions and potential conduct from an ethical perspective. Utilizing a framework for ethical decision making will help investment professionals effectively examine their conduct in the context of conflicting interests common to their professional obligations (e.g., researching and gathering information, developing investment recommendations, and managing money for others). Such a framework will allow investment professionals to analyze their conduct in a way that meets high standards of ethical behavior.

An ethical decision-making framework can come in many forms but should provide investment professionals with a tool for following the principles of the firm's code of ethics. Through analyzing the particular circumstances of each decision, investment professionals are able to determine the best course of action to fulfill their responsibilities in an ethical manner.

Commitment to Ethics by Firms

A firm's code of ethics risks becoming a largely ignored, dusty compilation if it is not truly integrated into the fabric of the business. The ability to relate an ethical decision-making framework to a firm's code of ethics allows investment professionals to bring the aspirations and principles of the code of ethics to life—transforming it from a compliance exercise to something that is at the heart of a firm's culture.

An investment professional's natural desire to "do the right thing" must be reinforced by building a culture of integrity in the workplace. Development, maintenance, and demonstration of a strong culture of integrity within the firm by senior management may be the single most important factor in promoting ethical behavior among the firm's employees. Adopting a code of ethics that clearly lays out the ethical principles that guide the thought processes and conduct the firm expects from its employees is a critical first step. But a code of ethics, while necessary, is insufficient.

Simply nurturing an inclination to do right is no match for the multitude of daily decisions that investment managers make. We need to exercise ethical decision-making skills to develop the muscle memory necessary for fundamentally ethical people to make good decisions despite the reality of conflicts of interest. Just as coaching and practice transform our natural ability to run across a field into the technique and endurance required to run a race, teaching, reinforcing, and practicing ethical decision-making skills prepare us to confront the hard issues effectively. It is good for business, individuals, firms, the industry, and the markets, as well as society as a whole, to engage in the investment management profession in a highly ethical manner.

Ethical Commitment of CFA Institute

An important goal of CFA Institute is to ensure that the organization and its members and candidates develop, promote, and follow the highest ethical standards in the investment industry. The CFA Institute Code of Ethics (Code) and Standards of Professional Conduct (Standards) are the foundation supporting the organization's quest to uphold the industry's highest standards of individual and corporate practice and to help serve the greater good. The Code is a set of principles that define the overarching conduct CFA Institute expects from its members and CFA Program candidates. The Code works in tandem with the Standards, which outline professional conduct that constitutes fair and ethical business practices.

For more than 60 years, CFA Institute members and candidates have been required to abide by the organization's Code and Standards. Periodically, CFA Institute has revised and updated its Code and Standards to ensure that they remain relevant to the changing nature of the investment profession and representative of the highest standard of professional conduct. Within the *Standards of PracticeHandbook*, CFA Institute addresses ethical principles for the profession, including individual professionalism; responsibilities to capital markets, clients, and employers; ethics involved in investment analysis, recommendations, and actions; and possible conflicts of interest. Although the investment world has become a far more complex place since the first publication of the *Standards of Practice Handbook*, distinguishing right from wrong remains the paramount principle of the Code and Standards.

New challenges will continually arise for members and candidates in applying the Code and Standards because many decisions are not unambiguously right or wrong. The dilemma exists because the choice between right and wrong is not always clear. Even well-intentioned investment professionals can find themselves in circumstances that may tempt them to cut corners. Situational influences can overpower the best of intentions.

CFA Institute has made a significant commitment to providing members and candidates with the resources to extend and deepen their understanding of how to appropriately apply the principles of the Code and Standards. The product offerings from CFA Institute offer a wealth of material, through publications, conferences, webcasts, and podcasts, the ethical challenges of investment professionals are brought to light. Archived issues of these items are available on the CFA Institute website (www.cfainstitute.org).

By reviewing these resources and discussing with their peers, market participants can further enhance their abilities to apply an effective ethical decision-making framework. In time, this should promote the trust of clients, investors, and market participants.

Markets function to an important extent on trust. Investment professionals should remain mindful of the long-term health of financial markets and incorporate this concern for the market's sustainability in their investment decision making. CFA Institute and the Standards of Practice Council hope the *Handbook* will assist and guide investment professionals in meeting the ethical demands of the highly interconnected global capital markets for the ultimate benefit of society.

CFA INSTITUTE CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

3

- ☐ identify the six components of the Code of Ethics and the seven Standards of Professional Conduct
- ☐ explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard

Preamble

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to continue to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst [CFA] designation) and CFA candidates have the personal responsibility to embrace and uphold the provisions of the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

The Code of Ethics

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates") must:

- Act with integrity, competence, diligence, and 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.

Standards of Professional Conduct

i. PROFESSIONALISM

A. Knowledge of the Law

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. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity

Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates 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.

C. Misrepresentation

Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct

Members and Candidates 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.

E. Competence

Members and Candidates must act with and maintain the competence necessary to fulfill their professional responsibilities.

ii. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information

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.

B. Market Manipulation

Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

iii. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care

Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing

Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability

1. When Members and Candidates are in an advisory relationship with a client, they must:

a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.

b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

c. Judge the suitability of investments in the context of the client's total portfolio.

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation

When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality

Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,

2. Disclosure is required by law, or

3. The client or prospective client permits disclosure of the information.

iv. DUTIES TO EMPLOYERS

A. Loyalty

In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements

Members and Candidates 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.

C. Responsibilities of Supervisors

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.

v. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis

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.

B. Communication with Clients and Prospective Clients

Members and Candidates must:

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

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

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

4. 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.

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

C. Record Retention

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

vi. CONFLICTS OF INTEREST

A. Avoid or Disclose Conflicts

Members and Candidates must avoid or make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity and interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions

Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees

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.

vii. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Participants in CFA Institute Programs

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 CFA Institute programs.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program

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.

PRACTICE PROBLEMS

1. Which of the following statements *best* describes an aspect of the Professional Conduct Program process?
   - **A.** Inquiries are not initiated in response to information provided by the media.
   - **B.** Investigations result in Disciplinary Review Committee panels for each case.
   - **C.** Investigations may include requesting a written explanation from the member or candidate.

2. A current Code of Ethics principle reads in full, "Promote the integrity:
   - **A.** and viability of the global capital markets."
   - **B.** of and uphold the rules governing capital markets."
   - **C.** and viability of the global capital markets for the ultimate benefit of society."

3. Which of the following is correct with regard to the Standards of Professional Conduct?
   - **A.** They require supervisors to focus only on the detection and prevention of violations.
   - **B.** They set ethical conduct requirements for members and candidates that have remained unchanged since their creation.
   - **C.** They address the risks and limitations of recommendations being made to clients.

4. Which of the following statements *best* describes an aspect of the Standards of Professional Conduct? Members and candidates are required to:
   - **A.** ensure a portfolio mandate is suitable for all investors.
   - **B.** promptly disclose changes that might materially affect investment processes.
   - **C.** have a reasonable and adequate basis for decisions about client confidentiality.

5. A CFA Institute member or candidate violates Standard II(A) Material Nonpublic Information by:
   - **A.** conducting price distortion practices.
   - **B.** inappropriately causing others to act.
   - **C.** inadequately maintaining investment records.

6. Standard III(C) Suitability requires members and candidates in an advisory relationship with a client to:
   - **A.** place their client's interests before their own interests.
   - **B.** consider investments in the context of the client's total portfolio.
   - **C.** not knowingly make misrepresentations relating to recommendations.

7. Standard III: Duties to Clients states that members and candidates must:

   A. document client financial constraints after an initial investment action.

   B. maintain an equal balance of interests owed to their clients and employers.

   C. deal fairly and objectively with all clients when engaging in professional activities.

8. Standard IV: Duties to Employers states that members and candidates must not:

   A. accept any gifts that might compromise their independence and objectivity.

   B. deprive their employer of their skills and abilities as related to their employment.

   C. accept compensation competing with their employer's interest without the written consent of their employer only.

9. Standard V: Investment Analysis, Recommendations, and Actions states that members and candidates must:

   A. find an investment suitable for their client before making a recommendation.

   B. make reasonable efforts to ensure that performance presentation is fair, accurate, and complete.

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

10. Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate explicitly states a requirement regarding:

    A. loyalty.

    B. responsibility of supervisors.

    C. reference to the CFA Program.

SOLUTIONS

1. C is correct. When an inquiry is initiated, the Professional Conduct staff conducts an investigation that may include requesting a written explanation from the member or candidate.

   A is incorrect because Professional Conduct inquiries can be initiated in response to information provided by the media. CFA Institute staff may become aware of questionable conduct by a member or candidate through the media, regulatory notices, or other public sources.

   B is incorrect because although the Disciplinary Review Committee (DRC) is responsible for enforcement of the Code and Standards in conjunction with the Professional Conduct Program (PCP), only in the event that a member or candidate does not accept the charges and proposed sanction is the matter referred to a panel composed of DRC members.

2. C is correct. One of the principles in the Code of Ethics reflects the role that the capital markets have in society as a whole.

   A is incorrect because it is incomplete, missing the additional language to reflect the role that the capital markets have in society as a whole.

   B is incorrect because the principle as written in the Code of Ethics reflects the role of the capital markets in society as a whole.

3. C is correct. Given the constant development of new and exotic financial instruments and strategies, the standard regarding communicating with clients includes an implicit requirement to disclose to clients the risks and limitations of recommendations being made to clients.

   A is incorrect because the standard for members and candidates with supervision or authority over others within their firms stresses broader compliance expectations beyond the detection and prevention aspects of violations.

   B is incorrect because the standards have evolved over time to remain representative of the highest standards of professional conduct and relevant to the changing nature of the investment profession.

4. B is correct. The Standards of Professional Conduct require members and candidates to promptly disclose any changes that might materially affect investment processes.

   A is incorrect because under Standard III(C) Suitability, when members and candidates are responsible for managing a portfolio according to a specific mandate, they must take only investment actions that are consistent with the stated objectives of the portfolio and not be concerned with whether the mandate is suitable for all investors.

   C is incorrect because under Standard III(E) Preservation of Confidentiality, members and candidates must keep information about current clients confidential unless the information concerns illegal activities on the part of the client, disclosure is required by law, or the client permits disclosure. No decisions on confidentiality are required, with the “reasonable and adequate basis” criterion related to Standard V(A) Diligence and Reasonable Basis.

5. B is correct. Under Standard II(A) Material Nonpublic Information, members who possess material nonpublic information that could affect the value of an investment must not cause others to act on the information.

   A is incorrect because price distortion is mentioned in Standard II(B) Market Manipulation, not Standard II(A) Material Nonpublic Information.

C is incorrect because the maintenance of appropriate records to support investment analyses is noted in Standard V(C) Record Retention, not Standard II(A) Material Nonpublic Information.

6. B is correct. Standard III(C) Suitability states that when members and candidates are in an advisory relationship with a client, they must judge the suitability of investments in the context of the client's total portfolio.

   A is incorrect because this requirement is addressed under Standard III(A) Loyalty, Prudence, and Care, not Standard III(C) Suitability.

   C is incorrect because this requirement is addressed under Standard I(C) Misrepresentation, not Standard III(C) Suitability.

7. C is correct. Under Standard III(B) Fair Dealing, members and candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

   A is incorrect because under Standard III(C) Suitability, members and candidates in an advisory relationship must make a reasonable inquiry into a client's financial constraints prior to (not after) taking investment action and must reassess and update this regularly.

   B is incorrect because under Standard III(A) Loyalty, Prudence, and Care, members and candidates must act for the benefit of their clients and place their clients' interests before (not maintain an equal balance with) their employer's or their own interests.

8. B is correct. Standard IV(A) Loyalty states that members and candidates cannot deprive their employer of the advantage of their skills and abilities in matters related to their employment.

   A is incorrect because accepting gifts that might compromise a member's or candidate's independence and objectivity is addressed by Standard I: Professionalism, not Standard IV: Duties to Employers.

   C is incorrect because Standard IV(B) Additional Compensation Arrangements permits members and candidates to accept compensation that competes with their employer's interest if they obtain written consent from all parties involved.

9. C is correct. Standard V(B) Communication with Clients and Prospective Clients states that members and candidates must distinguish between fact and opinion in the presentation of investment analysis and recommendations.

   A is incorrect because this standard is discussed in Standard III: Duties to Clients.

   B is incorrect because performance presentation is discussed in Standard III: Duties to Clients.

10. C is correct. Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program explicitly states the appropriate manner to make reference to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program.

    A is incorrect because Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate does not refer to loyalty. Loyalty is addressed in two other standards, Standard III(A) Loyalty, Prudence, and Care and as part of Standard IV: Duties to Employers.

    B is incorrect because Standard VII does not refer to the responsibility of supervisors. The responsibility of supervisors is addressed in Standard IV(C) Responsibility of Supervisors.

LEARNING MODULE

3

Guidance for Standards I–VII

LEARNING OUTCOMES	
Mastery	*The candidate should be able to:*
☐	demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity
☐	recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct
☐	identify conduct that conforms to the Code and Standards and conduct that violates the Code and Standards

STANDARD I: PROFESSIONALISM

1

Standard I(A) Knowledge of the Law

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. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

Guidance

Highlights:

- *Relationship between the Code and Standards and Applicable Law*
- *Participation in or Association with Violations by Others*
- *Investment Products and Applicable Laws*

Members and candidates must understand the applicable laws and regulations of the countries and jurisdictions where they engage in professional activities. These activities may include, but are not limited to, trading of securities or other financial instruments, providing investment advice, conducting research, or performing other investment services. On the basis of their reasonable and good faith understanding, members and candidates must comply with the laws and regulations that directly govern their professional activities and resulting outcomes and that protect the interests of the clients.

When questions arise, members and candidates should know their firm's policies and procedures for accessing compliance guidance. This standard does not require members and candidates to become experts, however, in compliance. Additionally, members and candidates are not required to have detailed knowledge of or be experts on all the laws that could potentially govern their activities.

During times of changing regulations, members and candidates must remain vigilant in maintaining their knowledge of the requirements for their professional activities. New financial products and processes, along with uncovered ethical missteps, create an environment for recurring and potentially wide-ranging regulatory changes. Members and candidates are also continually provided improved and enhanced methods of communicating with both clients and potential clients, such as mobile applications and web-based social networking platforms. As new local, regional, and global requirements are updated to address these and other changes, members, candidates, and their firms must adjust their procedures and practices to remain in compliance.

Relationship between the Code and Standards and Applicable Law

Some members or candidates may live, work, or provide investment services to clients living in a country that has no law or regulation governing a particular action or that has laws or regulations that differ from the requirements of the Code and Standards. When applicable law and the Code and Standards require different conduct, members and candidates must follow the more strict of the applicable law or the Code and Standards.

"Applicable law" is the law that governs the member's or candidate's conduct. Which law applies will depend on the particular facts and circumstances of each case. The "more strict" law or regulation is the law or regulation that imposes greater restrictions on the action of the member or candidate or calls for the member or candidate to exert a greater degree of action that protects the interests of investors. For example, applicable law or regulation may not require members and candidates to disclose referral fees received from or paid to others for the recommendation of investment products or services. Because the Code and Standards impose this obligation, however, members and candidates must disclose the existence of such fees.

Members and candidates must adhere to the following principles:

- Members and candidates must comply with applicable laws or regulations related to their professional activities.
- Members and candidates must not engage in conduct that constitutes a violation of the Code and Standards, even though it may otherwise be legal.
- In the absence of any applicable law or regulation or when the Code and Standards impose a higher degree of responsibility than applicable laws and regulations, members and candidates must adhere to the Code and Standards. Applications of these principles are outlined in Exhibit 1.

The applicable laws governing the responsibilities of a member or candidate should be viewed as the minimal threshold of acceptable actions. When members and candidates take actions that exceed the minimal requirements, they further support the conduct required of Standard I(A).

CFA Institute members are obligated to abide by the CFA Institute Articles of Incorporation, Bylaws, Code of Ethics, Standards of Professional Conduct, Rules of Procedure, Membership Agreement, and other applicable rules promulgated by CFA Institute, all as amended periodically. CFA candidates who are not members must also abide by these documents (except for the Membership Agreement) as well as rules and regulations related to the administration of the CFA® exam, the Candidate Responsibility Statement, and the Candidate Pledge.

Participation in or Association with Violations by Others

Members and candidates are responsible for violations in which they *knowingly* participate or assist. Although members and candidates are presumed to have knowledge of all applicable laws, rules, and regulations, CFA Institute acknowledges that members may not recognize violations if they are not aware of all the facts giving rise to the violations. Standard I(A) applies when members and candidates know or should know that their conduct may contribute to a violation of applicable laws, rules, or regulations or the Code and Standards.

If a member or candidate has reasonable grounds to believe that imminent or ongoing client or employer activities are illegal or unethical, the member or candidate must dissociate, or separate, from the activity. In extreme cases, dissociation may require a member or candidate to leave his or her employment. Members and candidates may take the following intermediate steps to dissociate from ethical violations of others when direct discussions with the person or persons committing the violation are unsuccessful. The first step should be to attempt to stop the behavior by bringing it to the attention of the employer through a supervisor or the firm's compliance department. If this attempt is unsuccessful, then members and candidates have a responsibility to step away and dissociate from the activity. Dissociation practices will differ on the basis of the member's or candidate's role in the investment industry. It may include removing one's name from written reports or recommendations, asking for a different assignment, or refusing to accept a new client or continue to advise a current client. 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.

CFA Institute strongly encourages members and candidates to report potential violations of the Code and Standards committed by fellow members and candidates. Although a failure to report is less likely to be construed as a violation than a failure to dissociate from unethical conduct, the impact of inactivity on the integrity of capital markets can be significant. Although the Code and Standards do not compel members and candidates to report violations to their governmental or regulatory organizations unless such disclosure is mandatory under applicable law (voluntary reporting is often referred to as whistleblowing), such disclosure may be prudent under certain circumstances. Members and candidates should consult their legal and compliance advisers for guidance.

Additionally, CFA Institute encourages members, nonmembers, clients, and the investing public to report violations of the Code and Standards by CFA Institute members or CFA candidates by submitting a complaint in writing to the CFA Institute Professional Conduct Program via e-mail (pcprogram@cfainstitute.org) or the CFA Institute website (www.cfainstitute.org).

Investment Products and Applicable Laws

Members and candidates involved in creating or maintaining investment services or investment products or packages of securities and/or derivatives should be mindful of where these products or packages will be sold as well as their places of origination. 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. Members or candidates should make reasonable efforts to review whether associated firms that are distributing products or services developed by their employing firm also abide by the laws and regulations of the countries and regions of distribution. Members and candidates should undertake the necessary due diligence when transacting cross-border business to understand the multiple applicable laws and regulations in order to protect the reputation of their firm and themselves.

Given the complexity that can arise with business transactions in today's market, there may be some uncertainty surrounding which laws or regulations are considered applicable when activities are being conducted in multiple jurisdictions. Members and candidates should seek the appropriate guidance, potentially including the firm's compliance or legal departments and legal counsel outside the organization, to gain a reasonable understanding of their responsibilities and how to implement them appropriately.

Exhibit 1: Global Application of the Code and Standards

Members and candidates who practice in multiple jurisdictions may be subject to varied securities laws and regulations. If applicable law is stricter than the requirements of the Code and Standards, members and candidates must adhere to applicable law; otherwise, they must adhere to the Code and Standards. The following chart provides illustrations involving a member who may be subject to the securities laws and regulations of three different types of countries:

NS: country with no securities laws or regulations

LS: country with *less* strict securities laws and regulations than the Code and Standards

MS: country with *more* strict securities laws and regulations than the Code and Standards

Applicable Law	Duties	Explanation
Member resides in NS country, does business in LS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, the member must adhere to the Code and Standards.
Member resides in NS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in LS country, does business in NS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.

Applicable Law	Duties	Explanation
Member resides in LS country, does business in NS country; LS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the locality where the business is conducted governs and there is no local law, the member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; LS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the law of MS country.	Because applicable law of the locality where the business is conducted governs and local law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in MS country, does business in LS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in MS country, does business in LS country; MS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the locality where the business is conducted governs and local law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in MS country, does business in LS country with a client who is a citizen of LS country; MS law applies, but it states that the law of the client's home country governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the client's home country governs (which is less strict than the Code and Standards), member must adhere to the Code and Standards.
Member resides in MS country, does business in LS country with a client who is a citizen of MS country; MS law applies, but it states that the law of the client's home country governs.	Member must adhere to the law of MS country.	Because applicable law states that the law of the client's home country governs and the law of the client's home country is stricter than the Code and Standards, the member must adhere to the more strict applicable law.

2 STANDARD I(A): RECOMMENDED PROCEDURES

Members and Candidates

Suggested methods by which members and candidates can acquire and maintain understanding of applicable laws, rules, and regulations include the following:

- *Stay informed*: Members and candidates should establish or encourage their employers to establish a procedure by which employees are regularly informed about changes in applicable laws, rules, regulations, and case law. 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. Also, participation in an internal or external continuing education program is a practical method of staying current.
- *Review procedures*: Members and candidates 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 and/or the Code and Standards. Recommended compliance procedures for specific items of the Code and Standards are discussed in this *Handbook* in the "Guidance" sections associated with each standard.
- *Maintain current files*: Members and candidates should maintain or encourage their employers to maintain readily accessible current reference copies of applicable statutes, rules, regulations, and important cases.

Distribution Area Laws

Members and candidates 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 are most likely to be distributed to clients.

Legal Counsel

When in doubt about the appropriate action to undertake, it is recommended that a member or candidate seek the advice of compliance personnel or legal counsel concerning legal requirements. If a potential violation is being committed by a fellow employee, it may also be prudent for the member or candidate to seek the advice of the firm's compliance department or legal counsel.

Dissociation

When dissociating from an activity that violates the Code and Standards, members and candidates should document the violation and urge their firms to attempt to persuade the perpetrator(s) to cease such conduct. To dissociate from the conduct, a member or candidate may have to resign his or her employment.

Harrel includes all this information in a research report and provides a positive analysis of the company. However, Corix does not have agreements with indigenous tribes, nor does it have regulatory approval—the certificate of compliance is a forgery—and Corix never cultivated or harvested significant quantities of commercial hemp.

Chong, a CFA charterholder and research analyst at Nature's Harvest Investment Management (NHIM), incorporates the information and conclusions from Harrel's research report into his own research on Corix and includes a "buy" recommendation on the company. Chong's report is distributed to portfolio managers at NHIM. Corix is ultimately shown to be a fake operation, leading to substantial losses for NHIM's clients.

Which individual(s) most likely violated the CFA Institute Code and Standards?

A. Harrel only

B. Chong only

C. Both Harrel and Chong

Analysis

C is correct. Standard V(A) Diligence and Reasonable Basis states that CFA Institute members and candidates must exercise diligence and thoroughness in analyzing investments and must have a reasonable and adequate basis that is supported by appropriate research and investigation for any investment recommendation. Harrel and Chong do not meet the requirements of this standard. By relying on the statements given by Corix and not conducting an independent investigation into the accuracy of the information, Harrel did not exercise diligence and thoroughness in analyzing the company. Chong seemingly relied on Harrel's research to formulate his "buy" recommendation without conducting his own independent research. Investment professionals who rely on third-party research must make reasonable and diligent efforts to determine whether that research is correct. The facts do not indicate that Chong independently verified the information, critically assessed Harrel's research, or had reason to rely on Harrel's report based on past experience and familiarity with the quality of Harrel's work. In addition, Harrel works as an independent researcher and thus has no management structure that could enforce due diligence standards, which should raise concerns about the quality of Harrel's due diligence. Chong also did not recognize that Harrel's work was issuer-paid research and thus subject to increased scrutiny. NHIM should have had clear due diligence policies and procedures in place that Chong would need to follow before completing and disseminating research on behalf of the firm.

A is incorrect. Both Harrel and Chong violated the Code and Standards.

B is incorrect. Both Harrel and Chong violated the Code and Standards.

Communication with Clients and Prospective Clients

Members and Candidates must:

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

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

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

4. 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.

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

Dukis

Dukis, CFA, is a managing director at a global credit ratings service. She is responsible for the group that assigns new issue and surveillance credit ratings to commercial mortgage-backed securities (CMBSs). To determine the ratings, Dukis and her group calculate the debt service coverage ratio (DSCR) of each security, a key quantitative metric used to rate CMBSs. Shortly after the global financial crisis, the ratings agency changes its methodology for calculating the DSCR for certain securities so that it more accurately reflects risk. Dukis's group publishes subsequent credit ratings without disclosing the change. When the new methodology is used, the securities receive higher credit ratings than they would have received if the original methodology had been used.

Dukis's actions are

- **A.** appropriate because the new methodology more accurately reflects risk.
- **B.** a violation of the CFA Institute Code and Standards because she did not disclose the change in methodology to the investing public.
- **C.** appropriate because no disclosure is necessary, given that calculating DSCR is only one element in determining the overall rating of the security.

Analysis

B is correct. Standard V(B) Communication with Clients and Prospective Clients requires CFA Institute members and candidates to disclose to investors the basic format and general principles of the investment process they use to analyze investments, as well as any changes that might materially affect those processes. Ratings agencies' consistency and transparency are important to investors. If rating methodologies are not applied consistently, ratings might not be easily comparable. Similarly, without transparency, investors cannot assess the methodologies used by the credit ratings agency or the application of those methodologies, which means they cannot determine how much weight to give the rating. Dukis should have disclosed to investors the change in methodology for calculating the DSCR.

A is incorrect. Even if the new methodology does more accurately reflect risk, the change must still be communicated to investors.

C is incorrect. The DSCR is clearly a key quantitative metric used to rate the securities because the change in methodology materially affected the credit ratings by rating them higher than the original method. A change in such a key factor must be disclosed.

Record Retention

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

Duermott

Duermott, CFA, is president of Enhanced Investment Strategies (EIS), a small investment firm. Most clients of EIS are longtime associates of Duermott who have had their investment portfolios with the firm for decades. Because of his close personal relationship with his clients, Duermott is very familiar with their investment profile, income and retirement requirements, and risk tolerance. He keeps up with all his clients' life-changing events—such as health issues, real estate purchases, children's university expenses, and retirement—and adjusts the clients' portfolios accordingly. Duermott regularly meets with his clients at EIS's offices, and he also sees them on numerous occasions outside the office, which gives him additional opportunities to update them on their investments. EIS clients complete a client agreement and risk profile when opening their account, and those profiles are updated whenever Duermott finds the time to do so.

Duermott's business practices are

A. a violation of the CFA Institute Code and Standards.

B. acceptable because he regularly communicates with clients about their investments.

C. acceptable because he adjusts clients' investments to ensure that they are suitable for the clients' needs given their changing income and risk profile.

Analysis

A is correct. Standard V(C) Record Retention states that CFA Institute members and candidates must "develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients." In this case, Duermott is personally close to his clients, but he updates client records only when he "finds the time to do so," which does not appear to be promptly or regularly. Duermott has a responsibility as his clients' adviser and as the president of his company to maintain appropriate records when client circumstances change. Without necessary, relevant, and up-to-date know-your-client information, Duermott would have difficulty establishing and proving that EIS has identified the needs and circumstances of its clients and has taken them into account in recommending investments. When client circumstances, investment goals, risk tolerances, or income needs change, records should be promptly updated, and they should be reviewed regularly to document these changes.

B is incorrect. Although Duermott is fulfilling his ethical obligations as an investment manager by communicating regularly with his clients, he is not keeping regular, up-to-date client records.

C is incorrect. Although Duermott is reviewing and adjusting client portfolios on a timely basis to meet clients' changing financial circumstances, he is not keeping regular, up-to-date client records.

CONFLICTS OF INTEREST 7

- ☐ evaluate practices, policies, and conduct relative to the CFA Institute Code of Ethics and Standards of Professional Conduct
- ☐ explain how the practices, policies, and conduct do or do not violate the CFA Institute Code of Ethics and Standards of Professional Conduct

Avoid or Disclose Conflicts

> Members and Candidates must avoid or 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 employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

Reebh

Reebh, CFA, is the CEO and founding partner of Lux Asset Management (Lux). Reebh provides asset management and allocation services for high-net-worth individuals and several small institutional clients. His services include investing client funds with third-party subadvisers who have a specialty in a particular asset class. Reebh's clients are aware and approve of Lux's allocation of their assets to subadvisers. The third-party subadvisers make payments to Lux based on the total value of a client's assets placed or invested in the subadvisers' funds.

Reebh's actions are

A. appropriate because Reebh has disclosed the use of subadvisers.

B. inappropriate because the payments are an improper referral fee.

C. inappropriate unless Reebh discloses the financial arrangement he has with the subadvisers to his clients.

Analysis

C is correct. Standard VI(A) Avoid or Disclose Conflicts requires CFA Institute members and candidates to "avoid or 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." The payments subadvisers make to Lux based on the value of the client assets Lux places with the subadvisers creates a potential conflict of interest because Reebh is thereby incentivized to hire subadvisers who pay the fee but who might not necessarily be the best subadvisers for his clients. Reebh can avoid this conflict by not agreeing to this compensation structure. If Reebh continues to accept payment in this manner, Reebh must disclose the financial arrangement to clients.

A is incorrect. Reebh has disclosed Lux's use of subadvisers, but he has not disclosed the financial arrangement for Lux to use those subadvisers.

B is incorrect. Although referral arrangements might be acceptable with full disclosure to clients, Reebh is not referring clients to the subadvisers but is hiring them directly on his clients' behalf.

Priority of Transactions

> Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

Yang

Yang, CFA, is a research analyst at Dacco, a registered broker/dealer and investment adviser. While employed with Dacco, Yang establishes Prestige Trade Investments Limited (Prestige) and acts as investment adviser for the firm's clients. Yang is responsible for formulating Prestige's investment strategy and directs all trades on behalf of

Prestige. Over several days, Yang purchases 50,000 shares of Zhongpin stock and 1,978 Zhongpin call options for his personal account at Dacco. Shortly after, Yang uses $29.8 million of Prestige's funds to purchase more than 3 million shares of Zhongpin stock.

Yang's actions are

A. a violation of the CFA Institute Code and Standards.

B. acceptable because Yang's personal investments are not in conflict with the investment advice being given to his clients at Prestige.

C. acceptable as long as Prestige clients are not negatively affected by Yang's prior purchase of Zhongpin securities through his account at Dacco.

Analysis

A is correct. Standard VI(B) Priority of Transactions states that "investment transactions for clients . . . must have priority over investment transactions in which a [CFA Institute] Member or Candidate is the beneficial owner." Yang is "front-running" his Prestige clients' trades. Front-running involves trading for one's personal account before trading for client accounts. Yang purchases Zhongpin stock and call options in his personal account at Dacco before directing the Zhongpin trades for clients at Prestige. The $29.8 million of Prestige funds invested in Zhongpin stock could have a material upward effect on the price of the stock and options Yang holds. Even the perception that Yang could profit by using Prestige's funds will diminish investors' trust in Yang and the capital markets.

B is incorrect. Yang's personal investments are tracking with his client investments, so no conflict exists between his personal trading and the investment actions/advice for clients. However, the timing of the trades is the issue in this case because Yang is "front-running" his clients' trades.

C is incorrect. The fact that Prestige clients are not harmed by Yang's earlier trades for his personal accounts does not make his actions acceptable.

Kapadia

Kapadia, CFA, is a trader for an asset management company that manages several large global mutual funds. Kapadia executes the equity buy-and-sell orders for the portfolio managers of one of the company's mutual funds. He has the discretion to execute the orders at any time during the day, depending on market conditions. Before executing the orders, Kapadia contacts several close friends and relatives to give them information on which securities the mutual fund will be trading. In turn, these friends and relatives make trades that mirror the imminent trades to be executed by Kapadia on behalf of the mutual fund.

Kapadia's actions are

A. a violation of the CFA Institute Code and Standards.

B. inappropriate only if the client is harmed financially by the conduct.

C. appropriate because he does not share confidential information about individual clients.

Analysis

A is correct. Standard VI(B) Priority of Transactions states that "investment transactions for clients must have priority over investment transactions" for a member or candidate's personal benefit. Kapadia is facilitating front-running by his friends and relatives on the trades of his employer's mutual fund. Front-running is the unethical and often illegal practice of trading on advance information for one's personal account before trading for client accounts to gain an economic advantage. Although Kapadia might not directly benefit financially, he benefits personally by providing the information to those with whom he has close relationships.

B is incorrect. Kapadia's engagement in the practice of front-running, which involves trading in personal accounts before trading for client accounts, is unethical and inappropriate even if the trades of Kapadia's friends and relatives do not disadvantage the mutual fund by moving the price of the security or causing the fund to lose the price advantage or any profit from its own trades.

C is incorrect. Although Kapadia does not share the confidential information of individual clients or individual investors in the fund, he does share confidential information about the fund itself.

Perrkins

Perrkins, CFA, is the chief investment officer of GT Financial (GTF). Perrkins's wife is GTF's compliance officer. GTF has several dozen retail clients and total assets under management of $70 million. All client assets are managed on a discretionary basis. Perrkins frequently makes trades for his clients using an omnibus trading account through a broker/dealer, which allows Perrkins to buy and sell securities in a block trade on behalf of multiple clients simultaneously. Perrkins regularly allocates the securities purchases to individual client accounts after the market closes. Over one six-month period, Perrkins allocates 75% of the profitable trades to nine accounts that Perrkins and his wife own or control. At the same time, he allocates 82% of the unprofitable trades to the account of the three largest GTF clients.

Perrkins's actions are

A. a violation of the CFA Institute Code and Standards.

B. acceptable as long as he discloses the trade allocation practices to his clients.

C. acceptable as long as he reverses his trade allocation practices to favor the larger clients so that they are not harmed over the long term.

Analysis

A is correct. Standard VI(B) Priority of Transactions states that investment transactions for clients have priority over personal transactions. By trading in the firm's omnibus account and then delaying the allocation of trades to a specific account until he has an opportunity to observe the security's intraday performance, Perrkins can pick the winning trades for accounts in which he has a beneficial interest. This practice is a violation of Standard VI(B). He then allocates the losing trades to clients' accounts that are large enough to absorb incremental trading losses without arousing suspicion that the losses are due to fraud. Perrkins's actions are also likely a violation of Standard III(B) Fair Dealing, which states that members and candidates "must deal fairly and objectively with all clients when . . . taking investment action or engaging in other professional activities."

B is incorrect. Disclosure to his clients as to how he is allocating the trades does not make Perrkins's unethical, fraudulent behavior acceptable.

C is incorrect. Perrkins cannot temporarily favor his personal interests over his clients' interests with the intent of rectifying the situation for his clients in the future. Ethical conduct is not subject to a ledger-keeping exercise. CFA Institute members and candidates must comply with the ethical principles and requirements of the Code and Standards at all times.

Referral Fees

> 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.

Kiang

Kiang, CFA, is a successful investment adviser with several high-net-worth clients who are very happy with his services. Many of Kiang's clients recommend his advisory services to their friends and family, and Kiang encourages these recommendations to build his business. Each year, Kiang hosts an elaborate party for clients who have referred new clients to his advisory firm. At the party, Kiang distributes nominal gift cards to attendees. In some cases, Kiang offers discounts on advisory fees to clients who sent him referrals that proved particularly lucrative. Many of the clients attending these celebrations were referred to Kiang by other clients, and they, in turn, continue the cycle of recommending Kiang to a wider circle of friends and family.

Kiang's actions most likely are

A. acceptable as a reward for client loyalty.

B. acceptable because he treats all clients fairly.

C. a violation of the CFA Institute Code and Standards.

Analysis

C is correct. Standard VI(C) Referral Fees states that members and candidates "must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit . . . paid to others for the recommendation of . . . services." In this case, Kiang hosts an elaborate party, distributes gift cards, and, in some cases, offers discounted advisory fees to clients who have referred particularly lucrative clients. Under the standard, these benefits would be considered referral fees that must be disclosed. The facts do not indicate that Kiang makes any disclosure to potential clients. The fact that some prospects, upon becoming clients, become aware that he pays for referrals when they receive discounted fees is insufficient disclosure. It would be acceptable if Kiang were to host a party or give gift cards to all his clients to reward their loyalty, regardless of whether they provided referrals.

A is incorrect. The party, gift cards, and discounted advisory fees are more than a reward for client loyalty and would be considered referral fees that are provided only to existing clients for recommending Kiang's services.

B is incorrect. Arguably, Kiang treats his clients fairly because he offers all of his clients the opportunity to receive these benefits and fee discounts as long as they refer others to his business, and whether the clients access these benefits by making referrals is up to them. However regardless of whether Kiang is treating all clients fairly, he is violating Standard VI(C) by not disclosing the benefits and compensation he awards for referrals.

RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE 8

- [ ] evaluate practices, policies, and conduct relative to the CFA Institute Code of Ethics and Standards of Professional Conduct
- [ ] explain how the practices, policies, and conduct do or do not violate the CFA Institute Code of Ethics and Standards of Professional Conduct

Conduct as Participants in CFA Institute Programs

> 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.

Taveras

Taveras, CFA, leads an exam preparation course sponsored by his local society. The society hosts a celebration for the students after the exam is over. During the celebration, several of Taveras's students describe their experience of taking the exam. Most give their opinion on the relative difficulty of the exam compared to their expectations, and some describe their surprise about areas of the curriculum that were not tested. Taveras asks his students for their opinions on the most difficult exam questions.

Under the CFA Institute Code and Standards, Taveras is most likely

- **A.** prohibited from discussing the exam with students after it is over.
- **B.** free to pass along information about the exam to candidates in future prep courses to help prepare them for the exam.
- **C.** allowed to share the opinions of his students about the difficulty of the exam with candidates in future prep courses to emphasize the need to thoroughly prepare.

Analysis

B is correct. Standard VII(A) Conduct as Participants in CFA Institute Programs states that candidates "must not engage in any conduct that compromises . . . the integrity, validity, or security of CFA Institute programs." For Taveras to share with future prep course participants the opinions of his previous students who found the CFA exam more difficult than expected is acceptable as a way to encourage future students to study the curriculum thoroughly and prepare as much as possible. However, Tavares should not solicit or pass on information regarding the specifics of the exam.

A is incorrect. A group of candidates who collectively completed the rigorous process of studying for and taking the CFA exam will naturally want to celebrate the accomplishment and discuss the exam after it is over. Candidates are allowed to discuss their exam experience with Taveras in general terms, but they cannot provide specific information about the exam regarding the questions or the general areas tested.

C is incorrect. Taveras cannot pass along specific information to future candidates and should not be soliciting information about specific questions; doing so would be a violation of Standard VII(A), which is designed to protect the integrity and security of future exams.

Reference to CFA Institute, the CFA Designation, and the CFA Program

> 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.

Ahmed

Ahmed recently earned his CFA designation and joined a medium-sized hedge fund as a senior analyst. His supervisor, Bennett, the firm's founder, earned her CFA designation 10 years ago and proudly uses the CFA designation on her business card and on all marketing materials for the fund. Bennett shares with Ahmed that she has not paid her CFA Institute membership dues for the past four years and no longer participates in the organization's continuing education program. When Ahmed asks Bennett about her use of the designation, she states that by passing the CFA exam, she earned the CFA charter and that the credential is like a university degree that cannot be taken away. Later, during a marketing meeting the two have with a potential investor, the investor notes that he narrowed his manager search to only firms that employ CFA charterholders in senior positions. When he asks Bennett if everyone in the firm on the investment side is a CFA charterholder, she responds, "Yes, that is correct." Ahmed does not respond.

Did either Ahmed or Bennett violate the CFA Institute Code and Standards?

A. Ahmed violated the Code and Standards, but Bennett did not.

B. Bennett violated the Code and Standards, but Ahmed did not.

C. Both Ahmed and Bennett violated the Code and Standards.

Analysis

C is correct. Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program states that when referring to the CFA designation, members and candidates "must not misrepresent . . . holding the CFA designation." The CFA designation is not like a degree from a university, because once individuals have been granted the right to use the designation, they must also satisfy CFA Institute membership requirements, which include paying dues, to maintain the right to refer to themselves as CFA charterholders. Participation in the CFA Institute Professional Learning program is not mandatory for members to maintain their designation, but it is encouraged as a way to meet the CFA Institute Code of Ethics provision that members maintain and improve their professional competence. Bennett's membership is considered lapsed because she has not been paying dues to CFA Institute. Until she reactivates her membership, Bennett is violating Standard VII(B) by continuing to use the CFA designation and representing herself as a charterholder to a potential client. Ahmed knows that Bennett's CFA Institute membership has lapsed. Standard I(A) Knowledge of the Law prohibits members and candidates from knowingly participating or assisting in the violations of others and requires members and candidates to dissociate from any unethical or illegal conduct. By staying silent in a sales meeting in which he knows false information is being given to a potential investor that could cause harm to that investor, Ahmed would be seen as assisting Bennett in providing that false information, even though Ahmed is not actively engaging in the misconduct himself. Best practice would be for Ahmed to address Bennett directly about her conduct and ask her to reinstate her membership or correct the statement she made to the potential investor. If Bennett refuses to take corrective action, Ahmed should report her conduct to the fund's compliance department for it to address and should dissociate himself from the activity by not participating in any additional sales meetings with Bennett.

A is not correct, because both Ahmed and Bennett violated the Code and Standards.

B is not correct, because both Ahmed and Bennett violated the Code and Standards.